ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2022

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STABILITY REPORT 2022

Resilience Amid a Resurging Pandemic

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a comprehensive due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, but is not limited to, the issuance of exposure drafts, the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit **www.ifsb.org**.

ASSUMPTIONS AND CONVENTIONS

In this *IFSI Stability Report 2022*, the following conventions are used:

- *IFSI Stability Report "2022"* implies that the report covers activities for the year 2021 and is published in the year 2022.
- "1H'21" means the first half of the year 2021.
- "4Q'21" means quarter 4 of the year 2021.
- "Billion" means a thousand million.
- "Trillion" means a thousand billion.
- "IFSB Secretariat workings" means figures indicated in the corresponding table or chart are based on IFSB staff estimates or calculations.
- "PSIFIs" implies that the data used in a corresponding table or chart are obtained from the IFSB's Prudential and Structural Islamic Financial Indicators database.
- "SR2021" refers to *IFSI Stability Report 2021*.
- The data and analysis in the *IFSI Stability Report* are compiled by IFSB staff from various sources and are assumed to be correct at the time of publication. The data analysed correspond to the latest data available to the IFSB.
- Data for *ṣukūk* outstanding and Islamic funds are for full-year 2021. Data for Islamic banking are mainly as at the end of December 2021 (4Q'21). Data for *takāful* are mainly for full-year 2020 and as per the available indicated data period in 2021.
- In all cases, where data for the periods indicated above are not available to the IFSB Secretariat, the latest data available to the IFSB Secretariat have been used.
- Data used are mainly from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.), as well as from the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) database and IFSB surveys.
- Where primary data are unavailable, third-party data providers have been used.

As much as possible, the data used and charts and figures provided in the *IFSI Stability Report 2022* have been checked for accuracy, completeness and timeliness. Discrepancies in the sums of component figures and totals shown are likely due to the rounding-off effect. Where errors are observed, corrections and revisions will be incorporated in the online version of the report. The IFSB appreciates feedback on the report, which is available for free download at **www.ifsb.org**.

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PREFACE

The Islamic Financial Services Board's (IFSB) *Islamic Financial Services Industry (IFSI) Stability Report* provides recent updates on the trends and developments, as well as insights on the soundness and resilience of various sectors, in the global IFSI. The report also shares a selection of results of the IFSB's internal research and surveys so as to achieve a broader and common understanding of critical issues in Islamic finance. Finally, the report provides an in-depth study on emerging issues in Islamic finance that have implications for regulation and supervision of this fast-growing industry.

The analysis and information in the *IFSI Stability Report 2022* have been provided by a project team from the Technical and Research Department of the IFSB Secretariat comprising Dr. Rifki Ismal (Assistant Secretary General), Dr. Abideen Adeyemi Adewale (Project Manager), Ms. Aminath Amany Ahmed and Dr. Dauda Adeyinka Asafa. Other members include Dr. Hechem Ajmi, Mr. Mohammad Arif Hasan, Mr. Reza Mustafa, Mr. Ahmed Nasser Al Aamri, Mr. Mohamed Omer Elamin Abbasher, Mr. Erfanul Alam Siddiquee, Ms. Cindhi Cintokowati, Ms. Ainaz Faizrakhman, Mr. Ahmed Barakat and Mr. Osama Alchaar. Mr. Peter Casey provided extensive review of the report.

Mrs. Ida Shafinaz Ab. Malek, Ms. Fadhila Izzati Mokhtar and Ms. Nur Khairunissa Md. Zawawi of the IFSB Secretariat provided support in circulating the preliminary draft of the report to IFSB member institutions. Ms. Natejah Ahmad and Ms. Sri Mumtaz Abdul Rahim, also from the IFSB, provided assistance in the editing, formatting and publication of the final document, while Mrs Intan Zalina Zamani assisted with the procurement matters. Dr. Ahmad Mohamed Mokhtar assisted with checking the Arabic terms, while Mr. Muhammad Nur Faaiz F. Achsani and Mr. Md. Alamgir Hossain assisted with data compilation.

Finally, the report has benefited immensely from comments and suggestions by the IFSB Regulatory and Supervisory Authority members. In particular, the IFSB Technical Committee and the Stability Report Quality Improvement Committee provided guidance and feedback during the drafting of the report.

FOREWORD

The tenth edition of the Islamic Financial Services Board's (IFSB's) *Islamic Financial Services Industry (IFSI) Stability Report* takes place at a time when the global financial system is gradually recovering from the impact of the COVID-19 pandemic. In addition to the emergence of new mutations of the virus, which has further fueled uncertainty around the speed and pattern of economic recovery given the uneven access to and distribution of COVID-19 vaccines, new financial stability risks have also arisen from events such as the Russia–Ukraine conflict.

The Russia–Ukraine conflict intensified pre-existing inflation concerns due to soaring oil and commodity prices, and disruptions in global supply chains. The consequential tightening of financial conditions is expected to compound the delicate balance faced by central banks in curbing rising inflation without slowing down economic recovery. This effect of the war poses a great challenge to many emerging and developing economies, especially those facing debt-sustainability issues. The conflict is also expected to impact the environmental, social and governance (ESG) initiatives in many jurisdictions given the huge investment required for renewable alternatives amid slower global economic growth.

Various fiscal and monetary measures that were introduced and adopted by governments and regulatory authorities to stimulate the economy and reduce the burden on citizens and businesses have proven to be effective. The extent of the vulnerability of the financial system and the magnitude of financial risks masked by the forbearance measures will now become discernible as the various support measures are partially or totally suspended. There are also concerns around the heightening of financial stability risks that could result from the increasing interconnectedness of crypto-assets with the mainstream financial system, especially due to lack of operational data and inadequate regulatory oversight in most jurisdictions.

Notwithstanding the potential downside risks and the lower global economic growth projection amid a possible resurgence in COVID-19 and a prolonged conflict in Ukraine, the global Islamic financial services industry (IFSI) is expected to remain resilient. The optimism is hinged on the limited direct exposure of many Islamic finance jurisdictions to the impact of the Russia–Ukraine conflict, gradual recovery and reopening of economies, an accelerated digital transformation process, and the improved financial soundness and resilience performance recorded in 2021.

The worth of the global IFSI increased to an estimated USD 3.06 trillion in 2021 (from USD 2.75 trillion in 2020). The IFSI sustained its growth momentum with a growth rate of 11.3% year-on-year (y-o-y) based on significant improvement, especially in the Islamic banking and Islamic capital markets segments in some key markets. Furthermore, the financial stability indicators remained satisfactory, especially when compared with previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies.

Based on cautious optimism in view of the downside risks, a positive but slower growth in IFSI assets, and in financial soundness and resilience indicators, is envisaged in many jurisdictions' Islamic finance industry in 2022. This will depend on the speed and magnitude of the reopening and recovery of their economies, fiscal and monetary capacity, digital transformation process, extent of exposure to the effect of the conflict in Ukraine, their level of Islamic finance development, the adequacy and effectiveness of their extant post-pandemic recovery plan, and multilateral cooperation to mitigate the potential challenges posed by developments in crypto-assets, climate risks, etc.

The IFSB closely monitors developments in the global financial system generally, and specifically in its member jurisdictions. In line with its core mandate, the IFSB, in addition to issuing guiding statements on measures to mitigate the impact of COVID-19 in the IFSI, published a compendium of policy responses across its member jurisdictions as well as issued working papers on the effectiveness of the various COVID-19 policy measures in relation to the key segments of the IFSI.

The IFSB has issued several standards, guidance/technical notes and research papers that generally complement the work of other international standard setters but, most importantly, cater for the specificities of the IFSI. In this regard, since the publication of the IFSI SR 2021, the IFSB has issued three new standards, along with five working papers, and has conducted numerous workshops on the implementation of its standards. Presently, the IFSB is working on nine standards and guidance/technical notes across its three main segments, as well as on four research working papers that specifically focus on various aspects relating to the prominent role of the IFSI in the global financial system.

As always, it is my fervent hope that the *IFSI Stability Report 2022* will provide a better understanding of current trends, structural developments, prudential issues, and other related matters in the IFSI across jurisdictions and sectors, as well as of the workings of the IFSB and of both the extant and emerging issues that affect the stability and resilience of the IFSI.

Dr. Bello Lawal Danbatta
Secretary-General
Islamic Financial Services Board
July 2022

KEY IFSI HIGHLIGHTS

GLOBAL IFSI SUSTAINED POSITIVE GROWTH IN 2021:

Global IFSI assets grew by 11.3% (y-o-y) with a total worth estimated at USD 3.06 trillion (2021). The projected sense of optimism for further growth in 2022 is expected to be impacted by a number of headwinds and tailwinds.

HEADWINDS	TAILWINDS
Uneven access to COVID-19 vaccines amid new mutations Russia–Ukraine conflict Spillover of effect of financial tightening in advanced economies Rising oil and commodity prices amid inflation concerns Exchange rate volatility Financial stability risk Political impasse, social unrest and civil conflict Climate change risk	Reopening and recovery of many economies Increased digitalisation Increased sustainability-linked investments Increased mergers and acquisitions Limited direct exposure to the Russia–Ukraine conflict

SECTORAL ANALYSIS

Islamic Banking ^
Growth (y-o-y): **6.5%**
Share of IFSI: **68.7%**

Islamic Capital Market *
Growth (y-o-y): **11.6%**
Share of IFSI: **30.5%**

Takāful* *
Growth (y-o-y): **5.2%**
Share of IFSI: **0.8%**

^ *Islamic banking data as at end-4Q'21 as IFSB PSIFIs database.*
* *Islamic capital market share comprises sukūk and Islamic funds assets as at end-2021.*
** *Takāful as at end-2020 due to limited or non-availability of data as at the time of drafting the report.*

STYLISED FACTS

Islamic Finance Assets

GCC region (52.4%), South-East Asia region (23.5%), Middle East and South Asia region (17.4%), Africa region (2.1%), and "Others" (4.5%).

Systemically Important Jurisdictions

Islamic banking segment is systemically important in 15 IFSB jurisdictions

Islamic Banking Assets

94.0% of Islamic banking assets are concentrated in the top three key regions

***Sukūk* Outstanding**

82.5% of *ṣukūk* outstanding in 2021 were in jurisdictions where Islamic banking is systemically important

EXECUTIVE SUMMARY

The Islamic Financial Services Board's (IFSB's) *Islamic Financial Services Industry (IFSI) Stability Report 2022* presents an assessment of the key vulnerabilities, resilience and future outlook of the global IFSI in general, and in the IFSB member jurisdictions in particular, across three key segments: Islamic banking, Islamic capital market (ICM) and *takāful*. The report provides an indicative outlook for the IFSI, which makes it a prime reference for key information on the stability and resilience of Islamic finance globally and across jurisdictions.

Similar to its previous editions, the *IFSI Stability Report 2022* is divided into four chapters. It is worth noting that, in addition to a rearrangement of the chapters, the period of coverage for Islamic banking data is extended for the first time to the fourth quarter of the reporting year, in this case, 2021. The analysis conducted on the Islamic banking segment in this report is based on the IFSB's PSIFIs database. The IFSB has extended the coverage of the database to both the Islamic capital market and *takāful* segments from 2020 onwards to complement data obtained from other external sources.

CHAPTER 1: STRUCTURAL DEVELOPMENTS IN THE IFSI

This chapter of the report, as in previous editions, provides updates on the key trends in growth and development in the global financial system, and analytical and structural outlooks, across the Islamic banking, ICM and *takāful* sectors since the *IFSI Stability Report 2021*.

The various COVID-19 policy measures implemented since 2020 have generally proven to be effective at helping to reduce the risk of worst-case-scenario economic and financial crises in 2021. Financial stability risks were contained, and the financial system's resilience was sustained, globally during the year. Furthermore, there was increased capital flow to emerging markets for sustainability investment purposes due to a generally favourable economic condition. Economies also became adapted to the new normal, especially via increased digitalisation. Moreover, both the advanced and emerging economies – especially those that export oil and gas, and high-tech commodities – benefited from soaring global demand for their exports due to the reopening of economic activities.

However, the momentum in the recovery and reopening of many economies, especially in the first half of 2021, slowed down and has remained uneven since the third quarter of the year due to a new wave of the COVID-19 pandemic.[1] This necessitated reintroduction of movement restrictions and other lockdown measures, which caused further disruptions in the global value chain and increased costs of containerised transport.

Amid rising global debt, inflation rates also increased globally due to an increase in oil and commodity prices, and supply–demand mismatches, as economies reopened. Moreover, tighter financial conditions (reflected in an upward review of policy rates) were introduced in most emerging and developing economies in 2021 in response to rising inflation, causing a slowdown in international bank financing to poorer economies already faced with a limited fiscal space and debt sustainability issues.

[1] Initially through the Delta variant, and later the Omicron variant.

Given the presence of several potential downside risks, the Russia–Ukraine conflict is also expected to test the soundness and resilience of a global financial system just recovering from the effect of the COVID-19 pandemic. If the conflict in Ukraine is prolonged, it will cause a further rise in commodity and oil prices, thus fuelling global inflation and heightening the potential for security risks and cyber-attacks.

Islamic Banking

The global Islamic financial services industry (IFSI), which grew 11.3% y-o-y and is estimated at USD 3.06 trillion in 2021, has so far demonstrated resilience amid the COVID-19 pandemic (its first major test). The effects of a prolonged Russia–Ukraine conflict on the dynamics of economic recovery and financial stability present another, different test of resilience.

On a sectoral analysis basis, the Islamic banking segment, which grew by 6.5% and is estimated at USD 2.10 trillion, retained the highest share (68.7%) of IFSI assets, and remained systemically significant in 15 jurisdictions in 2021. This number is envisaged to grow in the near term given that the proportion of Islamic banking assets relative to the entire banking system's assets increased across the many jurisdictions on the back of momentum in the reopening and recovery of economies, increased digitalisation of financial services, and merger and acquisition activities. Nonetheless, Islamic banking remained largely concentrated, with the five highest jurisdictions in terms of assets accounting for 80.2% of global Islamic banking assets.

Islamic Capital Markets

The ICM segment further entrenched its prominence in the IFSI for the fourth year running. Many jurisdictions returned to the market to take advantage of the reopening and recovery of their economies, favourable market conditions, and so on. The segment accounted for 30.5% of global IFSI assets and is estimated at USD 930.3 billion in 2021. Supported by a resilient global risk appetite and favourable external conditions, the *ṣukūk* sub-segment remains dominant in the ICM sector with an estimated value of USD 775.7 billion and a y-o-y growth of 12.5%. Notably, corporate issuances improved significantly on the back of improvements in the issuance process and facilitative environments.

The sectoral distribution for *ṣukūk* issuers has not changed significantly, with financial sector issuers still making up the largest proportion of *ṣukūk* issuers after issuances by governments. In terms of origination, there were a number of new entrants to the market in 2021 and the return of issuers from jurisdictions that are not core Islamic finance markets. Sustainability-related *ṣukūk* issuances, led by the Islamic Development Bank (IsDB), Indonesia and Malaysia, have continued to grow in both existing and new markets. During 2021, sovereign entities in Saudi Arabia and Oman introduced sustainability-related debt frameworks. Following the numerous climate-focused commitments agreed to by many countries and international financial institutions during the United Nations Climate Change Convention (COP 26) held in Glasgow, Scotland, in November 2021, it is expected that sustainability-linked bonds will continue to gain prominence and help to attract funding into the emerging markets.

The total assets under management (AuM) of Islamic funds grew by 6% from the previous year. Core domiciles for Islamic funds remain unchanged, although the overall share of core markets has contracted slightly, signalling the growing size of other markets. In the Islamic equity markets, a key trend in 2021 was a sector rotation from growth stocks, such as the technology sector (which did well at the outbreak of the pandemic), to defensive and cyclical stocks. Overall, Islamic indices experienced similar movements to the conventional market, but again outperformed their conventional counterparts in 2021.

Takāful

Despite structural developments in the *takāful* segment, especially via digitalisation, its share of the IFSI's asset worth remains marginal. The overall *takāful* sector's direct contributions increased by 4.8% y-o-y to USD 24.2 billion in 2020, after a significant decline (–14.8%) in 2019. The sustained growth recorded in the segment is the positive outcome of supervisory relief measures and forbearances taken in the wake of the pandemic outbreak and subsequently. The regulatory framework for the *takāful* sector has improved in the majority of countries in recent years. Different measures are being introduced. In particular, the introduction of risk-based capital regimes in some jurisdictions has prompted a greater emphasis on technical profitability, as volatile equity and property investments could require higher solvency capital charges.

CHAPTER 2: ASSESSMENT OF RESILIENCE

This chapter provides a detailed assessment of the resilience of the three sectors of the IFSI based on technical analyses and interpretation of the likely implications of selected stability indicators. These indicators are compared with the previous year's report, with conventional financial institutions in the respective jurisdictions, and with international benchmarks. Cognition is given to the effectiveness of policy measures adopted in various jurisdictions to ensure the stability and resilience of the IFSI amid a resurgence of the COVID-19 pandemic, rising inflation, and other headwind factors (especially the military conflict in Ukraine).

Islamic Banking

In many cases, across many financial soundness indicators and jurisdictions, there were notable improvements; in some cases, levels that hadn't been seen since before the pandemic were recorded – a testament to the effectiveness of the various COVID-19 policy support measures introduced since 2020. While some of these measures have been either partially or completely withdrawn, the Islamic banking sector sustained its recovery momentum in 2021 due to economic reopening in many jurisdictions and generally improving global economic conditions.

In terms of profitability, the global Islamic banking industry improved in 2021, surpassing its pre-pandemic level. This was due to diverse reasons across jurisdictions, including normalisation of operating income, relatively low y-o-y provisions for credit losses, increasing demand for Islamic banking products, etc. The liquidity position of the Islamic banking sector fluctuated but remained strong across various jurisdictions during the review period, in many cases satisfying regulatory thresholds; in some instances, they were back to their pre-pandemic levels. This was due to the positive outcome of the various liquidity support measures adopted across jurisdictions to mitigate the effect of liquidity pressure due to the pandemic, reopening and recovery of the economy, increased public-sector deposits, and cash inflows from both households and businesses due to the gradual suspension of payment moratoria.

The proportion of both foreign currency funding and foreign currency financing vis-à-vis the total funding and total financing of the global Islamic banks, respectively, remained relatively unchanged during the period under review. Except for a slight switch in proportion, the financing exposure remained concentrated in the real estate, sectors, followed by the construction sector. Due to the various forbearance measures put in place across jurisdictions, the asset quality of Islamic banks and windows measured by the average non-performing financing (NPF) ratio remained within tolerable levels. However, this should be viewed with caution as implying a true reflection of the cost of risk as it may also portend hidden vulnerability to asset quality issues. Such issues could morph into structural legacy problems that could both infringe the resilience of the global Islamic financial system and slow down economic recovery when forbearance measures are completely suspended.

In 2021, the regulatory capital of the Islamic banking industry across many jurisdictions remained stable and was also well above the IFSB's and respective jurisdictions' regulatory thresholds. In a few countries, the regulatory capital ratios show worryingly low levels on average, implying almost certainly that some Islamic banks in those jurisdictions have significantly lower figures. The leverage ratio remained well above the regulatory threshold given that Islamic banks are less prone to engaging in highly leveraged products because of *Sharī`ah* requirements.

Islamic Capital Markets

Supported by a continuation of accommodative policies, the *ṣukūk* market remained resilient in 2021, with major issuers remaining active and total *ṣukūk* outstanding surpassing previous years' values. The reduced pressure from the need for liquidity at the outbreak of the pandemic in 2020, and the increased revenue from soaring oil prices for the oil-exporting jurisdictions, resulted in a decrease in short-tenor *ṣukūk* issuances in 2021.

A robust demand for *ṣukūk* was indicated by the number of *ṣukūk* issuances that were oversubscribed in 2021. In addition to robust investor appetites for *ṣukūk*, the share of investment-grade *ṣukūk* in total *ṣukūk* outstanding has increased in 2021. A number of *ṣukūk* restructurings and *ṣukūk* defaults were also announced in 2021. During the 2011–21 period, the trend has shifted to lower yields (3–5% yield bucket) for the majority of *ṣukūk* outstanding. Plausible reasons include increasing investor confidence, and the flow of funds into *ṣukūk* markets pushing down yields, as well as improvements in credit ratings for *ṣukūk* issuers in 2021.

The geographic distribution of *ṣukūk* issuances in 2021 continued to be well balanced across regions, with strong interest from both regional and international markets Although the USD remained the dominant currency of issuance, the fact that there were significant local-currency *ṣukūk* issuances is a favourable indication of the ability to maintain financial stability by reducing currency mismatches. That said, *ṣukūk* markets across all jurisdictions generally remain illiquid with a narrow domestic investor base, and large investors adopting buy-and-hold strategies.

The Islamic funds market remained resilient despite the prolonged pandemic and ongoing uncertainty in 2021. The asset size composition of Islamic funds did not demonstrate any significant change compared to 2020. The issue of scale of funds, however, remains a challenge for the Islamic funds segment. Consistent with the previous trend, Islamic funds are mainly concentrated across money market, equity asset, and commodity classes. From a financial stability perspective, effective liquidity management of money market funds (MMFs) (which constitute the largest share of Islamic funds) and other open-ended funds remains the most important concern, particularly in the case of exogenous shocks.

In general, the Islamic equity markets maintained a remarkable buoyancy in 2021. While Islamic equity indices continued to outperform their conventional equivalents, emerging market indices underperformed compared to developed market indices in 2021.

Takāful

Most countries achieved strong underwriting performance in 2020 despite a decline in contributions due to low sales. This was boosted by the movement restriction order in many countries which reduced the frequency of motor claims. Medical claims were also reduced due to the government's coverage of treatment costs of-

COVID-19 cases, and the fact that visits to hospitals declined and non-emergency surgeries were cancelled or postponed. As the economy reopens and activities return almost to pre-pandemic levels, the implications for the loss ratios of *takāful* operators, especially in terms of motor and medical claims, will become more discernible. Some jurisdictions are already registering an increasing claims ratio due to a surge in claims related to COVID-19, and to a rise in the surrender rate due to deterioration of customers' disposable incomes during the pandemic.

The expense ratio showed a decreasing trend, which might be explained by a broad range of cost-saving measures to reduce overhead expenses in marketing and consulting services during the period, especially via the adoption of technology. The combined ratio also surged in some jurisdictions. Reasons include the difficulty of obtaining *retakāful* services in some of these markets, especially for medical products, and the slow collection of receivables for both new policies and policies in force.

Notwithstanding the effect of COVID-19 on the *takāful* sector's efficiency and stability in 2020, it remained resilient. Perhaps the various COVID-19 policy support measures have proven to be generally effective.

CHAPTER 3: EMERGING ISSUES IN THE IFSI

This chapter covers emerging issues in the IFSI, with a particular focus on the financial stability implications of the transition from London Interbank Offered Rate (LIBOR) to risk free rates (RFRs) in the IFSI. The transition from the LIBOR RFRs could have an impact on Islamic banks in particular and Islamic finance in general, subject to their exposure to LIBOR. A smooth transition therefore depends on Islamic banks' readiness in terms of legacy contracts, RFRs development and regulations. Full cooperation between regulatory and supervisory authorities and various stakeholders, including international standard-setting bodies, is needed during the RFR development process to ensure that the alternative rates are in line with both international norms and *Sharīah* requirements. Hence, the development of the Islamic alternative benchmark should be backed by a comprehensive governance guideline to provide guiding principles on: (i) the roles of RFR administrators; (ii) the benchmark's design and methodology; and (iii) the responsibilities of submitters.

CHAPTER 4: IFSB WORKSTREAM AND IMPLEMENTATION INITIATIVES

This chapter tracks initiatives and developments in the other international financial standard-setting bodies, with an emphasis on aspects that relate directly to the complementary role played by the IFSB. In addition, the various initiatives of the IFSB since the issuance of SR2021 are highlighted, including a synopsis of the IFSB standards implementation survey, standards development, research and working papers, and various industry collaborations.

Finally, this report also contains box articles contributed by the Islamic Development Bank Institute on "Islamic Finance, SDGs and Climate Change – An Aligned Spectrum"; by the Central Bank of the Republic of Turkey on "Central Bank Digital Currency (CBDC) Initiatives in Turkey"; by the Securities Commission Malaysia on "Sustainability *Ṣukūk* in Malaysia"; and by Fitch Ratings on "Global Islamic Financial Services Industry Outlook in 2022".

1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 Developments in the Global Financial System

In 2021, the global economy bounced back strongly with a real gross domestic product (GDP) growth of 5.9% compared to a contraction of –3.1% recorded in 2020. Improvement in global financial conditions was driven mainly by resumption of economic activities due to an intensive COVID-19 vaccine roll-out in both advanced and emerging economies. Financial stability risks were also contained due to the effectiveness of the various policy support measures that were implemented in 2020–1 across the various segments of the global financial system.

The recovery momentum, however, weakened and has remained uneven since 3Q'21, reflecting both country and regional peculiarities. Reasons for this include a resurgence in the COVID-19 pandemic initially through the Delta variant and later the Omicron variant, which triggered the reintroduction of lockdown measures, travel restrictions and supply chain disruption in some countries. The affluent and emerging countries across the regions were able to procure vaccines from diverse sources and thus recorded relatively more successes in their vaccination campaigns needed to reopen their economies and hasten economic recovery.[2] By contrast, less affluent countries were faced with funding and logistical constraints.[3]

Inflation rates also increased globally amid rising global debt in 2021. This was due mainly to soaring oil and commodity prices, and disruptions in global supply chains. While some countries, especially those adopting a fixed-peg exchange rate regime, were able to mitigate against the component of imported inflation and to effectively preserve price stability, headline inflation soared in others. In some other jurisdictions, the rising debt level and limited fiscal space also constrained the extent of subsidies as a means to reduce the impact of inflation pass-through from rising commodity prices.[4] This is envisaged to continue due to the impact of the Russia–Ukraine conflict, which the Food and Agriculture Organization of the United Nations (FAO) estimates could trigger a jump of up to 20% in global food and feed prices,[5] especially the prices of wheat, vegetable oil and corn. Past experiences also prove that fragile and conflict-affected countries could be highly susceptible to civil unrest due to increasing food prices[6] aggravated by pre-existing inequalities and vulnerabilities.

In response to rising inflation, tighter financial conditions (reflected in an upward review of policy rates) were introduced in most emerging and developing economies in 2021. The Russia–Ukraine conflict is expected to compound the delicate balance faced by central banks in curbing rising inflation by further tightening financial conditions without slowing down economic recovery. A downside risk, especially for the emerging and developing economies facing debt-sustainability issues, is a likely further hike in policy rates and a slowdown in international bank financing as the advanced economies tighten their financial conditions in response to rising inflation.

Although the envisaged significant increase in credit risk did not occur in most countries, investor concerns still reflect the uncertain economic outlook that may result from solvency risks in both the retail and corporate sectors. Investors are also concerned about the strength of the global economic recovery and the magnitude of financial risks that may crystallise as some of the previously granted regulatory forbearance measures unwind. The potential hidden financial vulnerabilities in asset quality would gradually become discernible and could morph into structural legacy problems that could both infringe the resilience of the global financial system and slow the speed of economic recovery.

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2 For instance, both the Gulf Cooperation Council (GCC) region and the South-East Asia (SEA) region achieved an average vaccination rate of 75% as at end-2021.

3 The Middle East and South Asia (MESA) and Africa regions recorded low average vaccination rates, at less than 30% and about 4.9%, respectively

4 For instance, Egypt provides bread subsidies for about two-thirds of its population. A soaring price of wheat would further weigh heavily on the country's fiscal deficit. Lebanon, which is presently faced with runaway inflation, also depends heavily on wheat imported from Ukraine.

5 https://www.reuters.com/world/un-agency-warns-ukraine-war-could-trigger-20-food-price-rise-2022-03-11/

6 For instance, soaring food prices have triggered a protest in southern Iraq where the anti-corruption protest that gripped the country in 2019 began. https://www.aljazeera.com/news/2022/3/9/iraq-protest-food-prices-russia-ukraine-war

Despite accounting for a relatively small proportion of global financial assets, the increasing prominence and high volatility of crypto-assets has financial stability implications. The potential financial stability risks may become heightened as crypto-assets become more interconnected with the mainstream financial system if they are not subjected to exchange restrictions or capital flow management. In addition, crypto-assets' activities have the tendency to heighten protection risks due to their poor disclosure and transparency practices. The lack of data on the extent of use, lending and trading platform operation results in inadequate regulatory oversight in most jurisdictions. Regulatory and supervisory authorities (RSAs) across countries have been developing the requisite framework for crypto-assets providers in their jurisdictions.

Developments relating to the introduction of the central bank digital currencies (CBDC) in some jurisdictions also saw increasing attention in 2021. CBDCs offer numerous potential benefits, including (but not limited to) broadened financial inclusion via digitalisation, lower cash management costs, a resilient payment system, and the promotion of market soundness and discipline via the regulatory oversight lacking in privately issued digital currencies. While some countries have already commenced implementing CBDCs, some others are running pilot projects alongside developing a regulatory framework, revising legislation, and exploring the possibility of enhancing existing alternative digital payment systems. Nonetheless, there are financial stability implications arising from CBDCs. For example, in addition to issues of cyber security and operational resilience, there is a likely disintermediation of the banking sector in the event that people decide to hold CBDCs in a substantial volume. This would not only compress banks' margins, but also increase their funding costs.

Environmental, social and governance (ESG) factors also gained more interest among global investors. The emphasis on the volatility in weather patterns as a front-burning development issue is a result of the unprecedented changes in climate. This also has implications for financing provision by banks, investment decisions by asset managers, and underwriting services and investment portfolios of insurance firms given that their balance sheets are potentially exposed to liability risks, asset impairment and rising claims from climate change–related risk. Regulators and financial institutions are building their capacity towards ESG risk management and are developing policy documents[7] and products, respectively, that support the transition to sustainable finance and a low-carbon global economy. However, the lack of universal guidelines on sustainable finance could also make the burgeoning market susceptible to greenwashing from both sovereigns and corporates.[8] Moreover, it is expected that the Russia–Ukraine conflict would moderate the dynamics of the magnitude and speed of transmission to a low-carbon economy due to rising gas prices, supply disruptions, and the huge investment required for renewable alternatives amid slower global economic growth.

The transition from the London Interbank Offered Rate (LIBOR) to risk-free reference rates (RFR), which has so far gone well,[9] has been achieved at the cost of a somewhat unsatisfactory position from a Sharīah viewpoint. Banks need not only to build both spread and term structures that are commensurate with the LIBOR, but also to ensure that the transition exposure is properly managed across various risk areas. For Islamic banks, the peculiarity of the contractual terms in their various extant products and the need to ensure *Sharī`ah* compliance present additional transitional complexities relative to conventional banks. For instance, the *Sharī`ah*-compliance requirement that parties agree in advance to a pre-agreed rental rate in an ijārah transaction or to a pre-agreed cost and markup in a murābahah transaction is at variance with the backward-looking rates used in the RFR, where the amount payable is only determinable a few days before the payment due date. While there are ongoing efforts to come up with an acceptable RFR, in the interim, the effect on Islamic finance will be the relative complexity of offering a *Sharīah*-compliant floating rate structure, as well as limitations in engaging in dual financing together with a conventional financing institution.

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7 Moody's ESG Solutions (2022), *Regulatory Calendar: Latest Regulatory State of Play Across Key Jurisdictions for 2022 and Beyond*. https://assets.website-files.com/5df9172583d7eec04960799a/6255a1c173ca566c9da9d291_RegulatoryCalendar_April2022.pdf

8 In November 2021, the International Sustainability Standards Board (ISSB) was created to cater for this need. https://www.ifrs.org/groups/international-sustainability-standards-board/ (See more on this and the related workstream of the Islamic Financial Services Board (IFSB) to cater for the Islamic capital markets in Chapter 4 of this report.)

9 Financial Stability Board (FSB), *FSB Statement Welcoming Smooth Transition Away from LIBOR*.

Given the presence of several potential downside risks – in particular, the ongoing COVID-19 pandemic and the Russia–Ukraine conflict – global growth projections for 2022 remain highly uncertain. Although the conflict in Ukraine is yet to have a worldwide systemic effect, its impact on the global economy is felt through an aggravation of the supply chain disruption, as the cost of containerised transport climbed sharply compared to the pre-pandemic period. A prolonged military conflict in Ukraine will not only cause a further rise in commodity and oil prices, thus fuelling global inflation, but real income and economic activities will also likely contract, with the potential for geopolitical risks and cyber-attacks heightened by any further escalation of the crisis. It is estimated that a significant number of non-Russian investors – many of them institutional insurance investors – are facing sizeable losses on their Russian assets as the market for them dries up.[10]

Although the projections for global economic recovery have remained positive so far in 2022, growth is expected to be lower than the International Monetary Fund (IMF) predicted in January 2022, at 3.6% compared to the predicted 4.4%.[11] Specifically, recovery in both the advanced economies and the emerging and developing markets in other regions is expected to continue to be slower than in the Association of Southeast Asian Nations (ASEAN), GCC and Africa, where Islamic finance is practised. While the global Islamic financial services industry (IFSI) has so far demonstrated resilience amid the COVID-19 pandemic (its first major test), the effect of a prolonged Russia–Ukraine conflict on the dynamics of economic recovery and financial stability offers a test of resilience.

The remainder of Chapter 1 provides a further analysis of growth and developments across the three key sectors of the global IFSI, while Chapter 2 provides further analyses from a stability and resilience perspective.

[10] See "Report on Political Risk, An End to Globalization", *Asia Insurance Review*, April 2022.
[11] https://www.imf.org/-/media/Files/Publications/WEO/2022/April/English/text.ashx

1.1.1 Developments in the IFSI

In 2021, the global IFSI demonstrated resilience, complemented various COVID-19 policy support measures, supported economies, and sustained its growth momentum despite a resurgence in the COVID-19 pandemic. The global IFSI is estimated to be worth USD 3.06 trillion in 2021[12] (see Table 1.1.1.1), marking a growth of 11.3% year-on-year (y-o-y) in assets in USD terms (2020: USD 2.75 trillion). Similar to the previous years' trend, the Islamic banking and Islamic capital markets sectors were the main contributors to the increase in total value of the global IFSI, as many countries experienced a reopening of their economies and benefited from an improving global economic condition. *Takāful* contributions also registered a marginal improvement amid increased pressure from the effect of the COVID-19 pandemic in 2020.

Table 1.1.1.1 Breakdown of the Global IFSI by Sector and Region (USD billion) (2021)

Region	Islamic Banking Assets	*Sukūk* Outstanding	Islamic Funds Assets	*Takāful* Contributions	Total	Share (%)
Gulf Cooperation Council (GCC)	1,212.5	332.3	46.0	12.7	1,603.5	52.4
South-East Asia (SEA)	287.5	390.3	37.5	4.7	720.0	23.5
Middle East & South Asia (MESA)	477.1	26.9	22.0	5.6	531.6	17.4
Africa	58.2	1.8	4.0	0.6	64.6	2.1
Others	68.8	24.4	45.1	0.7	139.0	4.5
Total	2,104.1	775.7	154.6	24.3	3,058.7	100.0
Share (%)	68.7	25.4	5.1	0.8	100	

Source: IFSB Secretariat workings.

Notes:

a) Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.) and from the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) database.
b) Where primary data are unavailable, third-party data providers have been used, including: Eikon-Refinitiv, Bloomberg, IMF database, etc.
c) *Takāful* contributions are used as a basis to reflect the growth in the *takāful* industry.
d) The breakdown of Islamic funds' assets is by domicile of the funds, while that for *ṣukūk* outstanding is by domicile of the obligor.
e) The regional classification is the same as that used in the previous IFSI stability reports. Other than the GCC and SEA regions, other jurisdictions in Asia are classified as Middle East and South Asia (MESA). The Africa region includes both North Africa and Sub-Saharan Africa. Jurisdictions not belonging to any of the four regions are classified as "Others", specifically countries located in Europe, North America, South America and the Commonwealth of Independent States (CIS).

[12] The figure quoted here is, in fact, a composite made up by adding assets in the banking sector and Islamic funds to the value of *ṣukūk* outstanding and *takāful* contributions. The latter is a measure of income, rather than assets, and elsewhere there may be elements of double counting – for example, if a bank holds *ṣukūk*. The figure is nevertheless the best measure we can offer in the current state of data availability.

Specifically, the global Islamic banking industry in 2021 experienced a 6.5 % y-o-y growth in assets (2020: 4.3%). The share of Islamic banking in the global IFSI assets was 68.7% as at end-4Q'21. Buffered by gains from the implementation of the various prudential standards and guidelines post the Global Financial Crisis (GFC) of 2007–8, the segment remained highly capitalised, profitable and liquid.[13] Thus, it was able to support economic recovery by continuing to provide financing to both households and corporates, by absorbing credit risk, and by complementing various policy support measures implemented across jurisdictions due to the pandemic.

The overall Islamic capital market (ICM) segment, consisting of *ṣukūk*, Islamic funds and Islamic equities, remained the fastest-growing segment of the IFSI over the past five years. This was due to the easing of COVID-19 restrictions and the resultant improved economic conditions and growth prospects. The segment's value of USD 930.3 billion accounted for a share of 30.5% of global IFSI assets. The *ṣukūk* sub-segment also retained its dominance within the ICM segment. Despite the reduction in sovereign issuances in some oil-exporting countries due to increased revenue from the sale of oil, many new (albeit low-rated) sovereign issuances were recorded in response to the global economic recovery and increasing investor risk appetite. There were also sustainability-linked *ṣukūk* issuances to fund development projects in some jurisdictions as they heightened their ESG activities. *Ṣukūk* outstanding registered a growth of 12.5% y-o-y, compared to the 7.5% y-o-y growth recorded in Islamic funds' assets as at end-2021.

The *takāful* segment's market share of the global IFSI remains marginal at 0.8%. Nonetheless, the segment registered a growth of 5.2% y-o-y to reach USD 24.3 billion as at end-2020. The growth was achieved due to improved economic conditions as economies reopened following relaxation of the various lockdown measures, especially in the last quarter of 2020. Other contributing factors include increased digital transformation activities through which *takāful* operators leveraged on technology to capture the growth potential in health and family *takāful* business lines. Additional factors include (but are not limited to) increased public awareness and appreciation for *takāful* offerings, and the positive impact of the various COVID-19 policy support measures taken by the various governments.

Regionally, the Gulf Cooperation Council retained its position as the largest domicile for Islamic finance assets in 2021. The value of the GCC region's share of global Islamic finance increased by 3.5 percentage points (pp) in 2021 and represented 52.4% of the total. The region also achieved a relatively broader coverage of COVID-19 vaccine roll-out compared to other regions, which helped to accelerate reopening and recovery of their economies. The impact of inflation and exchange rate volatility was also mild in the GCC compared to other regions given that the GCC countries maintain a US dollar–pegged exchange regime which helped to mitigate against components of imported inflation and to preserve price stability during 2021.

The GCC countries, being mainly hydrocarbon exporters, also benefited from the increase in the price of oil in 2021, which has soared further since the first quarter of 2022. This is expected to remain so in the medium term due to the agreement by the Organization of the Petroleum Exporting Countries (OPEC) to maintain a gradual production increase amid the sanctions imposed on Russia, a key global oil producer. The high elasticity of fiscal revenue to oil price in the region helped the GCC countries broaden their fiscal spaces and extend their policy support measures amid increased foreign exchange reserves and reduced sovereign issuances in 2021.[14] The increased revenue from oil is also expected to help drive the various economic transformation initiatives presently being pursued in different GCC countries with the aim of ensuring economic diversification and advanced technological development.

[13] A. Adewale (2021), *Assessing the Effectiveness of COVID-19 Policy Responses in the Islamic Banking Industry*. IFSB Working Paper Series No. WP-23/12/2021. https://www.ifsb.org/download.php?id=6309&lang=English&pg=/sec03.php

[14] Gains are also expected in some lines of insurance in oil-exporting countries, especially since government spending is directly related to oil prices in many of these countries.

The South-East Asia region retained its second position in terms of regional IFSI market share, notwithstanding a marginal decrease to 23.5% in 2021 (2020: 24.9%). In addition to the effect of headline inflation due to increased food prices, the SEA region witnessed a stronger resurgence in the COVID-19 pandemic in the second half of 2021. The resurgence necessitated another round of movement restrictions and disruptions to economic activities, especially in high-contact sectors. Nonetheless, the region's economic recovery is expected to be fast-paced given a high rate of vaccination recorded and the reopening of borders for tourism and other economic activities.

The impact of the potential increase in prices of oil and gas due to the Russia–Ukraine conflict is not expected to be significant among the countries in the SEA region, especially those with sizeable Islamic finance markets. Specifically, both Brunei Darussalam and Malaysia are net exporters of oil. Although Indonesia is a net importer of refined crude oil, it also continues to benefit as a major exporter of palm oil and metals, which have seen rising prices as a result of the conflict in Ukraine. Despite a relatively mild inflation outlook in the region amid gradual policy normalisation, commodity price pressures will be felt if the conflict in Ukraine escalates and becomes prolonged. The consequential imported inflation would further lead to currency depreciation, tightened financial conditions and a slower economic recovery amid reducing but prevalent COVID-19 cases.

The Middle East and South Asia region constituted the third-largest share, accounting for a lower 17.4% of global IFSI assets in 2021 (2020: 20.3%). In addition to the fact that most countries in the region were faced with a low COVID-19 vaccination rate amid a resurgence, rising inflation due to high oil and commodity prices also had a knock-on effect for economic recovery in some others. Iran, although a major global player in the oil industry, was not directly affected by the hike in both oil and energy prices but experienced a high inflation rate of 43.4% in 2021. The inflation was due to the economic sanctions imposed by the United States along with limited access to international trade and currency, and a slow recovery from the impact of the pandemic. Both Pakistan and Bangladesh, the other key Islamic finance jurisdictions in the MESA region, also experienced increased inflation on the back of soaring oil prices and oil's direct link to transport, electricity and food prices (especially cereals and cooking oil). A prolonged Russia–Ukraine conflict is expected to have a further inflationary effect on the prices of these important commodities in the region.

The Africa region's share of the global IFSI value, though improved, remained small at 2.1% (2020: 1.7%). Like the MESA region, the Africa region's economic recovery has been impeded by (among other things) inflation, exchange rate volatility and a low vaccination rate. Amid the risk of a potential resurgence in the pandemic, the region is highly susceptible to imported inflation from commodity prices due to its being highly dependent on imports. While oil-exporting countries such as Nigeria and Algeria may benefit from the increase in oil prices, there are other related factors that may attenuate such benefits. For instance, while Nigeria does not currently refine most of its oil locally, the North African countries are highly dependent on wheat and cereals from Russia and Ukraine, which has resulted in a hike in the price of bread and cereals. Moreover, the security situation in Africa may deteriorate further given the fragile peace in many countries in the region (e.g. Libya, Mali and Central African Republic, all with a huge presence of Russian forces).

The "Others" region, comprising Turkey, the United Kingdom (UK), and countries from the CIS region, accounted for the remaining 4.5% of total global IFSI assets in 2021 (2020: 4.3%). While both the UK and Turkey are G20 countries with a high rate of vaccination and notable economic reopening and recovery from the pandemic, they are both exposed to increased commodity and energy prices due to the Russia–Ukraine conflict. Specifically, Turkey as a key Islamic finance jurisdiction in the region experienced a high rate of currency depreciation in USD terms, which subsumed the USD value of Islamic finance assets. For the CIS countries, the conflict in Ukraine provides opportunities for commodities exporters such as Kyrgyzstan, Uzbekistan, Tajikistan and Kazakhstan to increase supply. However, these countries are also highly susceptible to inflation and currency depreciation due to limited shipping activities in the region, especially through the Black Sea.

1.2 Global Islamic Banking Sector

The growth rate recorded by the global Islamic banking sector in 2021 was supported by a recovery in the global economy and less-stringent pandemic-related restriction around the world. In addition to merger and acquisition (M&A) activities in some jurisdictions, new Islamic banks were also established in others. The increase in oil prices also played a part in the growth rate recorded in 2021, especially among systemically important Islamic banking jurisdictions that are also oil exporters. However, the converse is the case in some other oil-importing jurisdictions that continue to bear the burden of the soaring price of oil. Some jurisdictions were also faced with economic turbulence, a high rate of inflation, and exchange rate depreciation arising from sanctions,[15] internal political impasses, low reserves and a high dependence on foreign currencies.[16]

GLOBAL ISLAMIC BANKING SIZE

4Q'18	4Q'19	4Q'20	4Q'21
$1.60 TN	$1.88 TN	$1.97 TN	$2.10 TN

GLOBAL ISLAMIC BANKING GROWTH

	CAGR ^	
ASSETS	**FINANCING**	**DEPOSITS**
2.4%	4.4%	3.7%
	Year-on-Year (4Q'21)	
6.5%	8.1%	7.3%

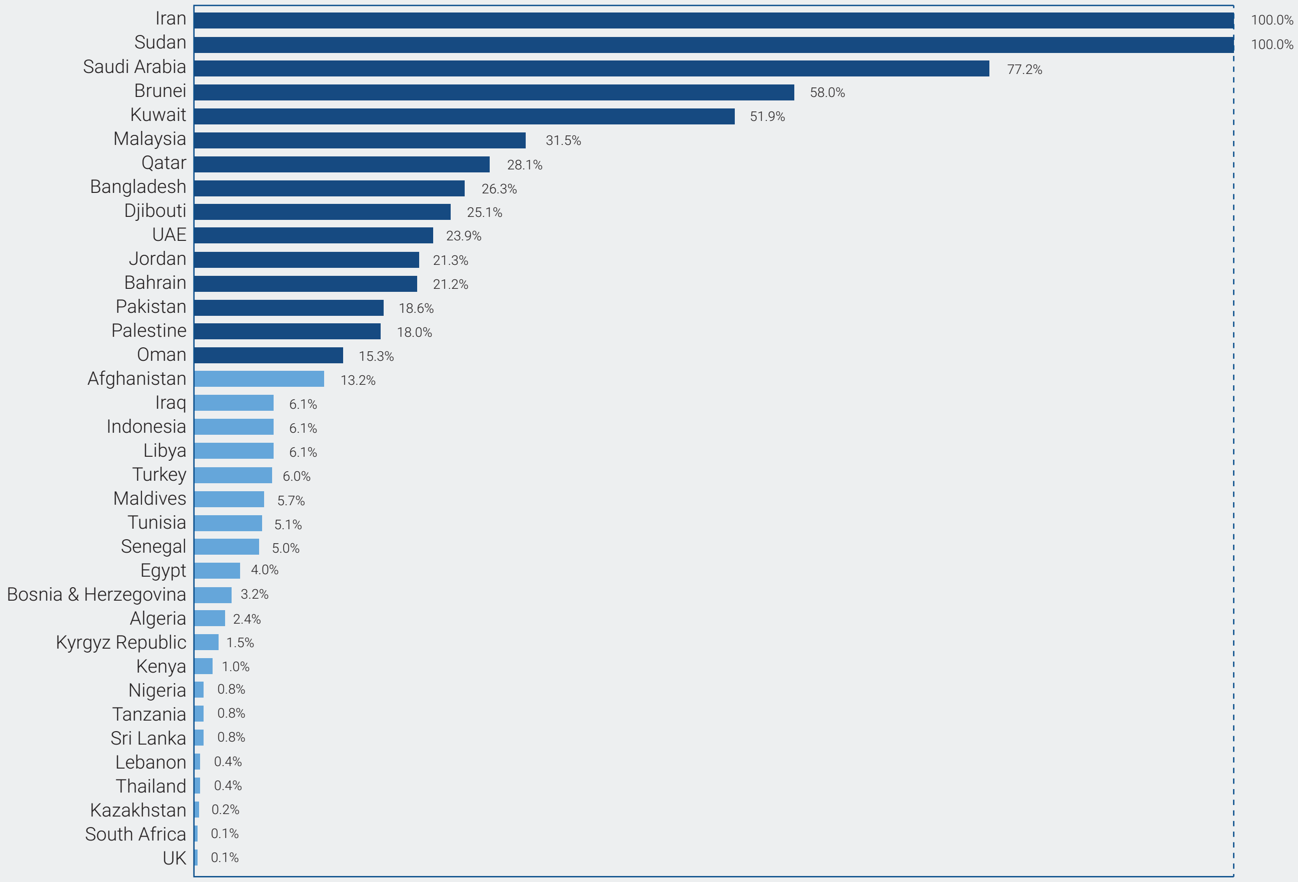
^ Compound Annual Growth Rate (June 2014 – December 2021). Data used in calculating CAGR, as well as growth rates for assets, financing and deposits, were obtained from the IFSB PSIFIs, and include data from both Islamic banks and windows in Afghanistan, Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Saudi Arabia, and (where available) from stand-alone Islamic banks in Bahrain, Brunei, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Nigeria, Palestine, Qatar, Sudan, Turkey, the United Arab Emirates (UAE) and the UK. Some Islamic banking jurisdictions such as Egypt, Iran, Kazakhstan and Lebanon were excluded due to data limitations.

15 A notable example in this regard is Iran with a fully *Sharī`ah*-compliant Islamic banking system and which faced economic sanctions, resulting in high inflation and local currency depreciation.

16 Lebanon is a notable example in this regard.

In USD terms, the compound annual growth rate (CAGR) for Islamic banking assets was 2.4% as at end-4Q'21. Financing and deposits of the global Islamic banking sector also recorded a CAGR of 4.4% and 3.7%, respectively, during the period under review. Specifically, among the countries tracked for the computation of the y-o-y in this year's report, 10 (including seven that are systemically significant Islamic banking jurisdictions) registered slower asset growth, and nine registered either a slower financing growth or a slower deposits growth. Nonetheless, the majority of the countries included in the analyses registered improved performance in key soundness and resilience Islamic banking indicators (see details in Chapter 2).

Chart 1.2.1 Islamic Banking Share in Total Banking Assets by Jurisdiction (%) (2021)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

Notes: The countries shown by dark blue-coloured bars satisfy the criterion of having a more than 15% share of Islamic banking assets in their total domestic banking sector assets and, hence, are categorised as systemically important.

Notably, the number of jurisdictions where Islamic banking has achieved domestic systemic importance[17] remained at 15, the same as at 4Q'20 (see Chart 1.2.1). Collectively, these 15 jurisdictions accounted for a 91.8% share of the global Islamic banking assets and for 82.7% of global *ṣukūk* outstanding as at end-4Q'21 (see Charts 1.2.2 and 1.2.3). The Islamic banking sector experienced an increase in domestic market share in 29 countries (4Q'20: 21 countries). While both Iran and Sudan maintained 100% domestic market shares, five jurisdictions monitored recorded declining market shares (compared to 10 as at end-3Q'20).

[17] This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report uses the Islamic banking segment as the criterion for systemic importance of Islamic finance, since about 68% of Islamic financial assets are held within the banking sector.

Chart 1.2.2 Islamic Banking Assets in Jurisdictions with an Islamic Banking Sector of Systemic Importance (2021)

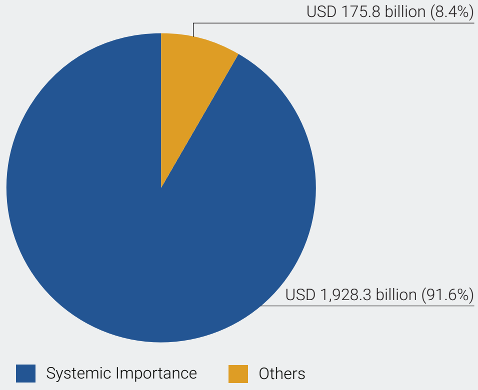
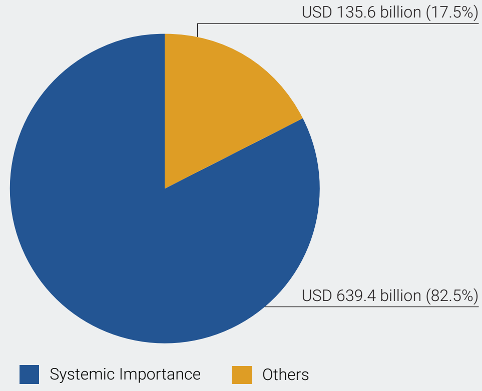


Chart 1.2.3 *Ṣukūk* Outstanding in Jurisdictions* with an Islamic Banking Sector of Systemic Importance (2021)

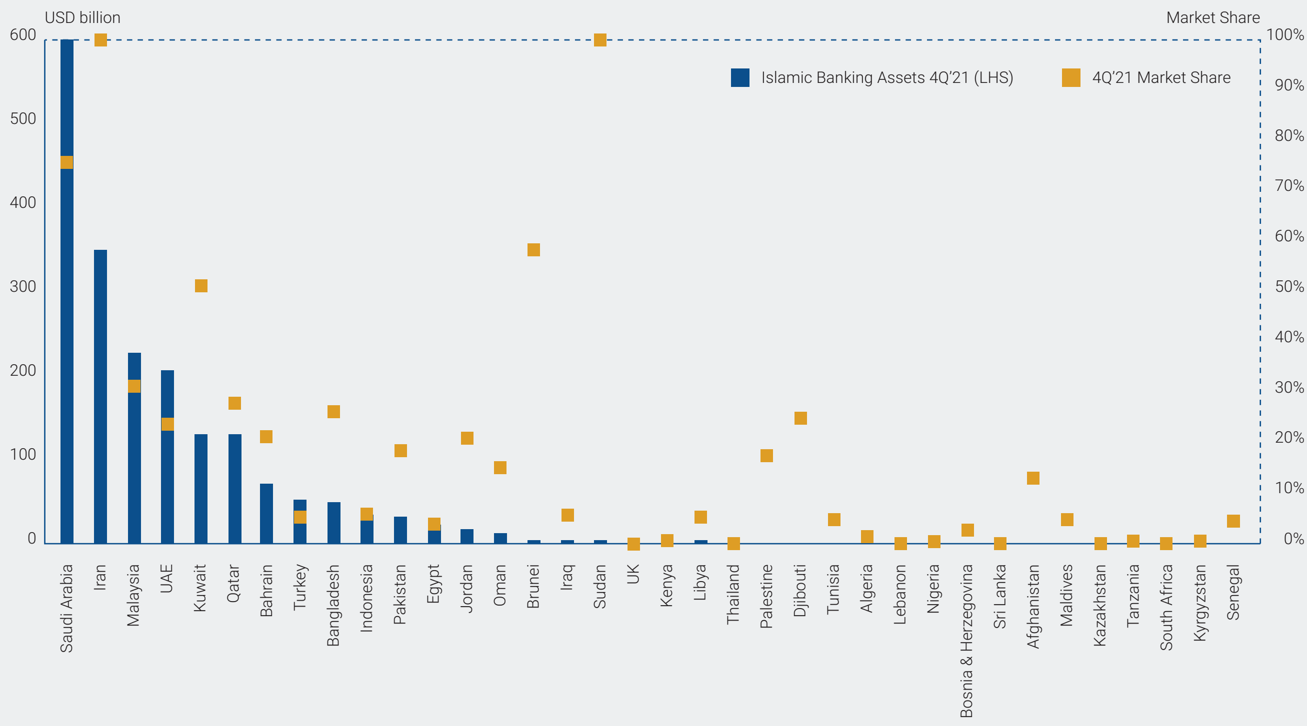


*Based on the domicile of obligors

Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

In terms of USD worth, the Islamic banking sector across jurisdictions registered diverse performances (see Chart 1.2.4). In some key jurisdictions such as Iran, Sudan and Turkey, the USD value of the Islamic banks declined significantly due to exchange rate depreciation. The Islamic banking sector in some other systemically important Islamic banking jurisdictions such as Djibouti and Palestine were valued at much less in USD terms than, for instance, the Islamic banking sectors in Indonesia and Turkey, which are not yet systemically important.

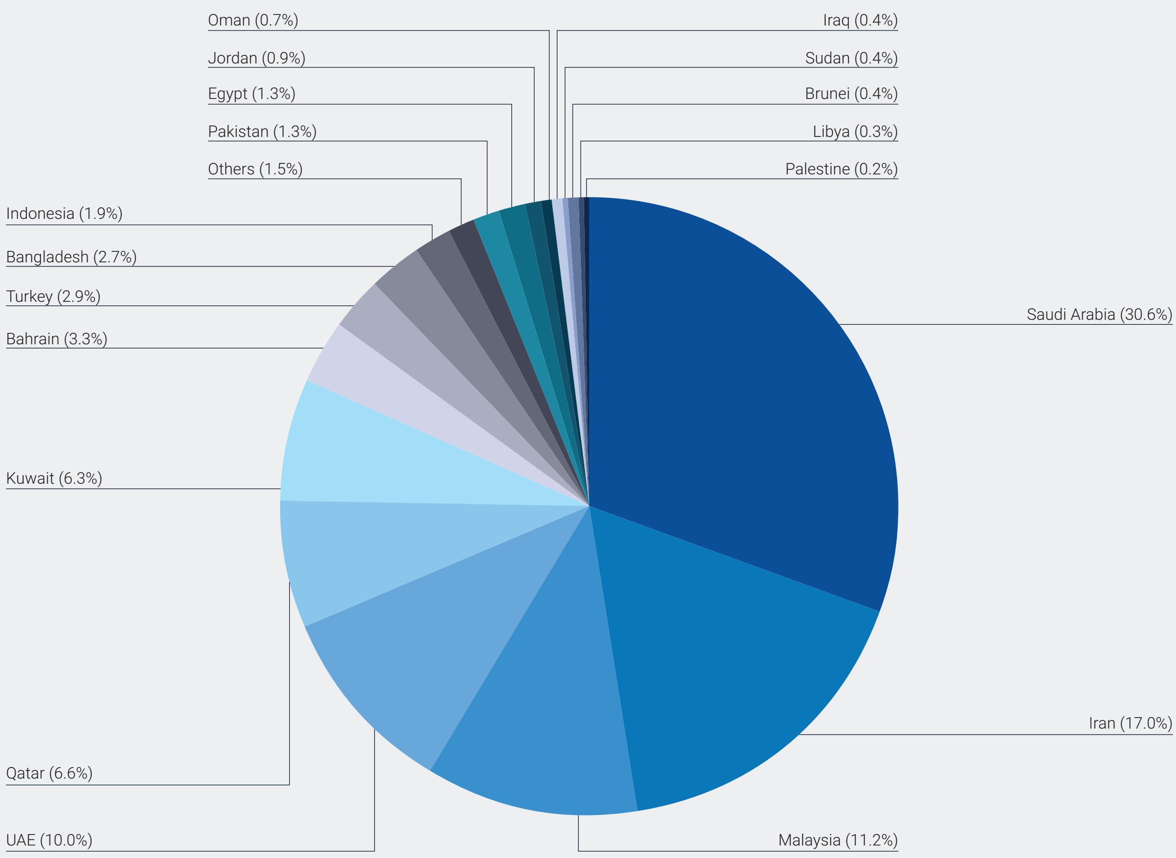
Chart 1.2.4 Domestic Islamic Banking Assets (USD billion) and Domestic Islamic Banking Market Share (%) (2021)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

In terms of Islamic banking assets, the industry is still very much concentrated among the top five jurisdictions. This is despite a decrease in their cumulative share of Islamic banking assets to 75.4% as at end-4Q'21 (4Q'20: 83.0%) due to a decline in the assets figure for Islamic banking in Iran. Saudi Arabia accounted for 30.6% (3Q'20: 28.5%), increasing its relative share and further strengthening its position as the key leading Islamic banking jurisdiction. While Iran's share of global Islamic banking assets dipped and accounted for 17.0% [4Q'20: 28.6%], improvements were recorded in the other three jurisdictions. Specifically, Malaysia accounted for 11.2% (4Q'20: 11.1%), the UAE for 10.0% [3Q'20: 8.7%], and Qatar for 6.6% (4Q'20: 6.1%), making up the top five jurisdictions in 2021. The other countries in the top 10 Islamic banking jurisdictions, in order of share of global Islamic banking assets, were Kuwait, Bahrain, Turkey, Bangladesh and Indonesia (see Chart 1.2.5).

Chart 1.2.5 Jurisdiction Share of Global Islamic Banking Assets (%) (2021)

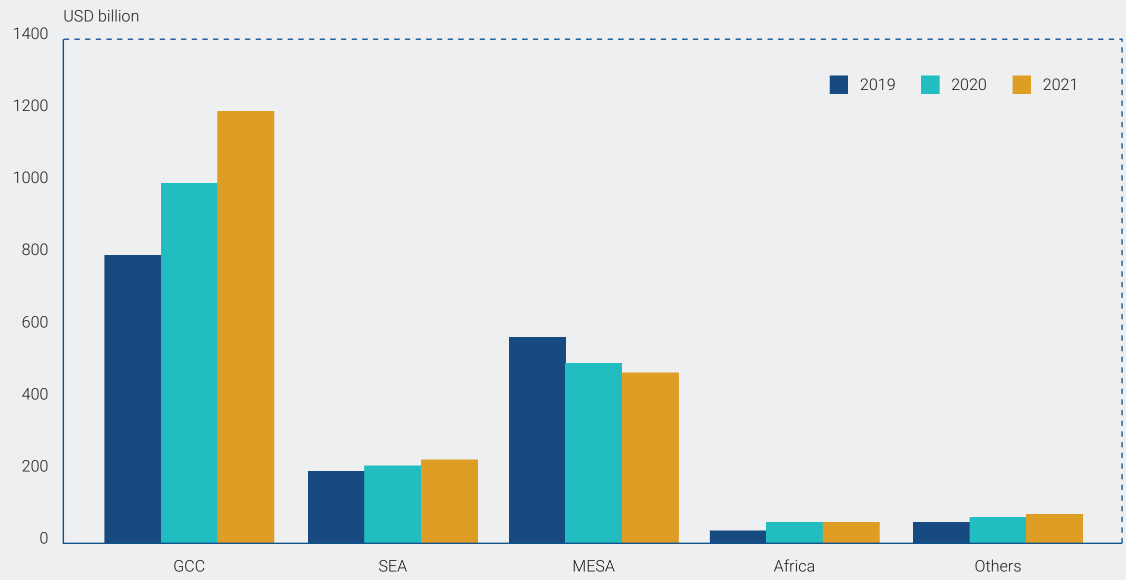


Source: IFSB Secretariat workings.

1.2.1 Islamic Banking Assets Across Regions

The GCC countries' Islamic banking assets share remains the highest and increased to 57.6% (4Q'20: 53.2%) of global Islamic banking assets. The region registered a growth in Islamic banking assets of 23.7% y-o-y to end 4Q'21 with a value of USD 1,212.5 billion (3Q'20: USD 979.9 billion) (see Chart 1.2.6). Except for the UAE, all the GCC countries recorded increased asset size in 2021.[18] The region's dominance is expected as all the GCC countries have a systemically important Islamic banking sector that plays a key role in the various economic transformation and diversification agendas in the region. Moreover, the USD value of the Islamic banking assets has not been affected by exchange rate volatility on account of the fixed peg exchange regime adopted in the region.

Chart 1.2.6 Regional Islamic Banking Assets (USD billion) (2019–21)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

The MESA region's Islamic banking assets value continued its downward trend. Despite increased value of assets in key regional markets such as Bangladesh and Pakistan, the region's Islamic banking assets value of USD 477.1 billion at the end of 4Q'21 (4Q'20: USD 499.0 billion) accounted for 22.7% (4Q'20: 27.1%) of global Islamic banking assets. It declined by –4.4% y-o-y, due mainly to the lower value of Iran's Islamic banking assets following the continuous depreciation of the Iranian Rial.[19] The economic and political situations in both Lebanon and Afghanistan are other factors that affected the Islamic banking asset growth potential in the region.

[18] This excludes assets of the Islamic banking windows in the UAE.

[19] This may ease if the ongoing nuclear negotiations between Iran and the P5+1 (China, France, Russia, the UK, the US and Germany) under the Joint Comprehensive Plan of Action (JCPOA) yield a favourable outcome.

The SEA region's Islamic banking assets value continued its growth at an increased rate of 10.3% y-o-y (4Q'20: 7.4%) to reach USD 287.5 billion at end-4Q'21 (4Q'20: USD 260.6 billion). The region's share of global Islamic banking assets as at end-4Q'21 was 13.7%. The region comprises two systemically important jurisdictions: Malaysia and Brunei. The share of Islamic banking in Indonesia, despite being non-systemically important domestically, remains quite substantial and thus contributed to the total assets value of the Islamic banks in the region. Although the strengthening of the USD against most regional currencies is expected to continue to weigh on the growth of Islamic banking assets in the region, the impact is envisaged to be mild on the back of increased prices for oil, commodities and technological products as the main exports from the countries tracked in the region. Increased digital transformation activities spurred on by the COVID-19 pandemic are also expected to bolster the growth of Islamic banking assets in the region.

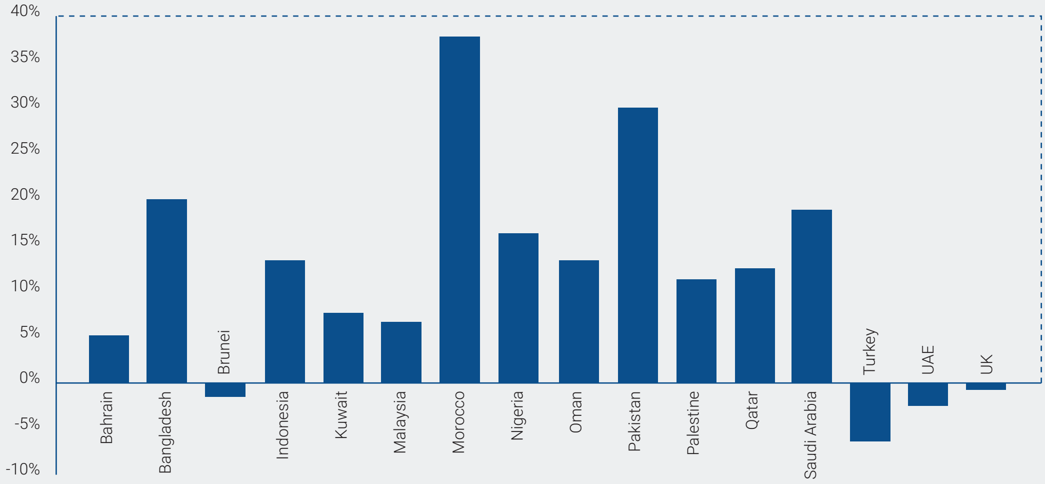
Turkey and the countries from Europe and the CIS region classified as "Others" registered a slower growth of Islamic banking assets of 11.3% y-o-y as at end-4Q'21 (4Q'20: 16.4%). At the end of 4Q'21 the region's assets reached USD 68.8 billion (4Q'20: USD 61.8 billion) and accounted for 3.3% of global Islamic banking assets. This was mainly on account of the slower growth in assets, in USD terms, registered by the participation banking sector in Turkey, which, despite being affected by the depreciation of the Turkish Lira, represented 2.9% of the global Islamic banking assets as at end-4Q'21. The asset value of the Islamic banking sector in the UK and among the CIS countries in USD terms remained flat during the period.

The Islamic banking assets of the Africa region recorded the highest growth rate among the five regions. The region registered a y-o-y assets' growth rate of 35.0% [4Q'20: 27.1%] to end 4Q'21 at USD 58.2 billion (4Q'20: USD 43.1 billion). This was due mainly to the establishment of new Islamic banking institutions and to increasing awareness of Islamic banking, leveraging on the huge untapped market across the region. Nonetheless, the Africa region still accounts for the lowest share of global Islamic banking assets, at 2.8% (4Q'20: 2.3%). Inflation and exchange rate devaluation affected the USD value of Islamic banking assets in the region amid a slow economic recovery from the pandemic.

1.2.2 Overview of Islamic Banking in Key Markets

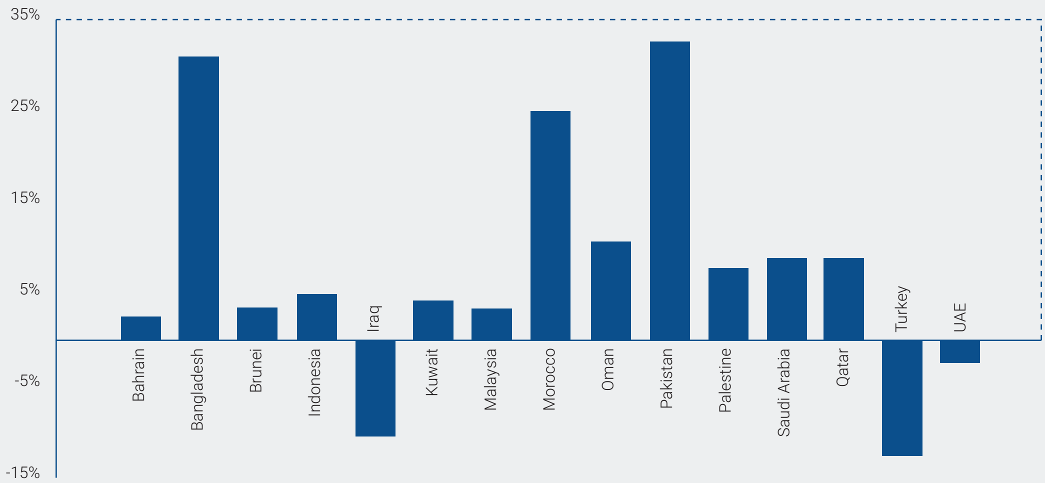
Analysis of country-level annual growth rates shows that, in USD terms, 10 jurisdictions, including seven that are systemically important, out of 19 for which data were available achieved double-digit asset growth rates in the year up to 4Q'21. While Brunei, the UK, and the UAE recorded marginal y-o-y decline, Turkey's participation banking domestic negative asset growth reflected the high depreciation of the Turkish Lira during the period. Both Afghanistan and Sudan registered an extremely high decline in y-o-y Islamic banking assets growth of –73.7% and –58.4%, respectively.[20] A similar pattern in direction, but not necessarily in magnitude, was registered for both financing and deposit growth. While in the former a double-digit increase was registered in three out of 17 countries, in the latter, two digits growth was recorded in seven countries, out of the 17 for which data were available (see Charts 1.2.2.1, 1.2.2.2 and 1.2.2.3).

Chart 1.2.2.1 Islamic Banking Assets Annual Growth Rates for Various Countries (%) (4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

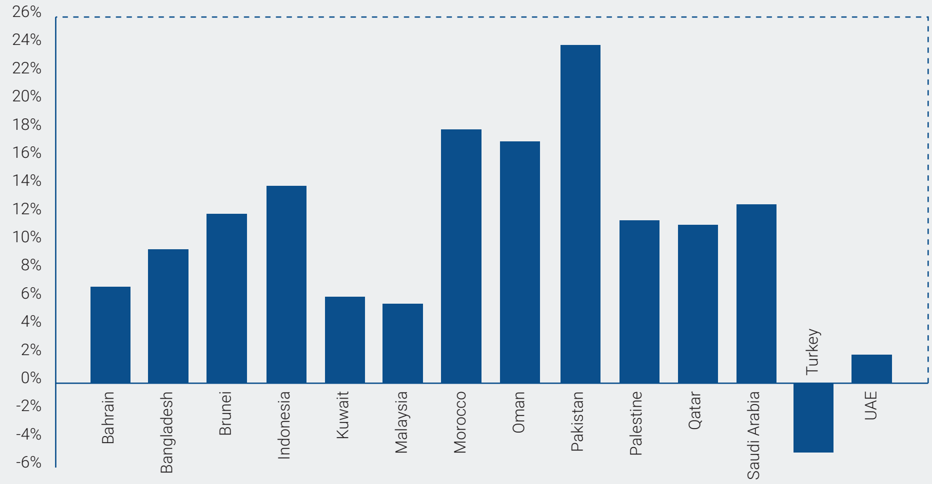
Chart 1.2.2.2 Islamic Banking Aggregate Financing Annual Growth Rates for Various Countries (%) (4Q'20–4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

[20] Afghanistan and Sudan were not included in Charts 1.2.2.1, 1.2.2.2 and 1.2.2.3 due to the scale used. Nigeria was also excluded in Chart 1.2.2.2.

Chart 1.2.2.3 Islamic Banking Aggregate Deposit Annual Growth Rates for Various Countries (%) (4Q'20–4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

GCC Region Countries

Except for the UAE Islamic banking sector, which recorded a negative y-o-y growth of –1.8%, other GCC countries' Islamic banking sectors recorded improvements in assets in USD terms. Specifically, the Islamic banking sector in Saudi Arabia, Oman and Qatar registered double-digit annual growth in assets of 18.2%, 13.3% and 12.6%, respectively. The Bahraini Islamic banking sector recorded a 5.5% y-o-y growth in assets as at end-4Q'21 (see Chart 1.2.2.1). The increased assets in the GCC region were achieved due to, among other reasons, a higher penetration of Islamic banking via digitalisation and a supportive regulatory environment that aligns with the economic diversification vision of the governments in the region.

The GCC region's Islamic banking segment also benefited from relative advancement in terms of technological innovations and supporting infrastructure and regulation. These were helpful in driving the industry's expansion in the midst of adjusting to the COVID-19 lockdown measures. Islamic banking assets in the GCC also grew on account of a number of M&As across the region. For instance, in the UAE, Dubai Islamic Bank fully acquired Noor Islamic Bank; while in Saudi Arabia, notable mergers included those between Saudi British Bank and Alawwal Bank, and the creation of Saudi National Bank from the merger between National Commercial Bank and Samba Financial Group.

In Qatar, there was a merger between Masraf Al Rayan and Al Khalij Commercial Bank. In Oman, there was also the acquisition of Alizz Islamic Bank by Oman Arab Bank in 2020, wherein the former retained the status of an independent full-fledged Islamic bank. The Central Bank of Oman also approved the commencement of due diligence on a proposed merger between Bank Nizwa and Sohar International Bank. The various M&A initiatives enhanced Islamic banks' operational synergies in terms of human capital and digital transformation, as well as the funding requirements needed for their participation in huge corporate deals and large infrastructural projects relating to ESG, technology, healthcare, and the development of small and medium-size enterprises (SMEs) as part of the economic diversification drive in the region.

Specifically, in terms of financing, the Omani Islamic banking sector registered a double-digit growth of 11.6% (see Chart 1.2.2.2). While the Islamic banking sectors in Saudi Arabia, Qatar, Kuwait, and Bahrain registered single-digit growth rates of 8.7%, 4.8% and 1.9% y-o-y, respectively, that of the UAE registered negative growth of –2.2% y-o-y as at end-4Q'21. The fact that assets growth declined in the UAE Islamic banking sector explains the decline in financing. The converse is also true in other GCC countries, where the positive growth rate for financing reflects the positive growth for assets.

Islamic banks in the region also enjoy stable funding, especially from customers' deposits, as consumer spending improved due to the reopening and recovery of the economy. Deposits of the Saudi Islamic banking sector grew by 13.0%, with non-remunerative funding (current account, *wadī`ah*) accounting for a larger chunk. In Oman, deposits also improved, by 16.8% as at end-4Q'21, due to an increase in remunerative deposits via profit-sharing investment accounts (PSIA) (see Chart 1.2.2.3).

SEA Region Countries

The Indonesian Islamic banking sector recorded the highest y-o-y growth rates in the SEA region in terms of assets, finance and deposits. Specifically, assets grew by 12.6% y-o-y in 4Q'21, whereas the Islamic banking sectors in Malaysia and Brunei registered a y-o-y single-digit growth rate of 5.9% and a decline of –1.5%, respectively, as at end-4Q'21 (see Chart 1.2.2.1). The growth in Islamic banking assets in the SEA region was due to the supportive regulatory environment, which offers a level playing field with conventional banking, and to economic reopening and recovery despite the challenging economic environment caused by a resurgence in COVID-19 in the region.

The prospects for further growth of the assets of the SEA Islamic banking sector would be driven by the huge untapped market, especially in Indonesia, via increased digitalisation. Bank Negara Malaysia (BNM) also recently granted operating licenses to five digital banks, including two[21] under the Islamic Financial Services Act 2013. Other favourable factors include the proposed merger between two full-fledged Islamic banks in Malaysia[22] and the establishment of a new *Sharī`ah* bank, PT Bank Syariah Indonesia, and the planned conversion of two regional financial institutions to *Sharī`ah* banks in Indonesia.[23]

In terms of financing, Islamic banks in Indonesia recorded a 5.5% y-o-y growth. In Malaysia and Brunei, financing growth was 4.1% and 4.0% y-o-y, respectively (see Chart 1.2.2.2). Financing growth in the region was driven by the extension of regulatory forbearances. Household and other consumer financing provided mainly on the basis of *murābahah* and *ijārah*, especially for housing financing, increased during the period. The growth of financing to the private sector in general and for working capital in particular remained below their pre-pandemic levels but improved on the back of the reopening of the economy and the relaxation of lockdown measures.

The Islamic banking sector in Brunei and Indonesia also registered double-digit deposit growth of 14.1% and 12.3%, respectively, in contrast to the single-digit growth of 6.0% registered by the Malaysian Islamic banking sector as at end-4Q'21 (see Chart 1.2.2.3). The deposit growth rate was due to the increasing share of remunerative funding sources, mainly *murābahah* and commodity *murābahah* in Malaysia and PSIAs in Indonesia. The deposit growth was also supported by increasing precautionary savings by both businesses and households amid the uncertain business environment due to a resurgence of the pandemic in both countries.

In contrast to the above three SEA countries, in Thailand the sole Islamic banking institution recorded a drop in the Islamic banking asset share, accounting for 0.4% (Q4'20: 0.5%) of the country's domestic banking share. This was due to the impact of COVID-19 on the operational efficiency of the Islamic Bank of Thailand. Being a specialised financial institution with a mandate to cater for Islamic financial services in the country, the Islamic bank has been limited to operating only in areas with a sizeable Muslim population. As such, it has relied on state support to manage its balance sheet challenges over the years through forbearances on non-performing assets and significant liquidity injection by the government.

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21 These are AEON Financial Service Co., Ltd., AEON Credit Service (M) Berhad and MoneyLion Inc. consortium, and KAF Investment Bank consortium.
22 The proposed merger is between Malaysia Building Society (MBSB) and Permodalan Nasional (PNB).
23 Bank Pembangunan Daerah Riau Kepri and Bank Nagari.

MESA Region Countries

The Iranian banking sector remains 100% Islamic and is the second-largest Islamic banking market after Saudi Arabia. In local currency terms, the sector recorded increased assets; however, due to currency translation exposure as a result of economic sanctions that weakened its currency exchange rate, the sector was worth USD 357.42 billion as at end-4Q'21 compared to the USD 405.31 billion reported in *SR 2020*.[24] With the exception of Sri Lanka, countries in the MESA region recorded an increased share of Islamic banking assets as at 4Q'21 compared to a year earlier.

Assets of the Islamic banking sector in Bangladesh, Pakistan and Palestine registered improved double-digit growth performances of 20.9%, 30.6% and 12.1%, respectively, as at end-4Q'21. In Bangladesh, the growth was due mainly to strong public demand. The consequential expansion of the industry was reflected in a 26.6% y-o-y increase, or an additional 389 new branches/windows, as at 3Q'21. Also, policy support by the Bangladesh Bank provided opportunities for Islamic banks to participate in raising funds for infrastructural and industrial projects. In Pakistan, Islamic banking assets growth was due to increased investment, as well as to financing activities that also grew during the period especially in terms of the partnership-based contracts of *mushārakah* and diminishing *mushārakah*.

Specifically, financing by the Bangladesh and Pakistan Islamic banking sectors grew by 30.2% and 32.6% y-o-y, respectively. In contrast, the Palestine Islamic banking sector registered a slower financing growth of 8.0% as at 4Q'21. In terms of deposits, while Bangladesh recorded a slower positive growth of 8.9% y-o-y, Pakistan and Palestine registered increased y-o-y growth rates of 24.2% and 11.9%, respectively, over the same period. It is noteworthy that the State Bank of Pakistan (SBP) unveiled its strategic plan for the Islamic banking industry in that country which, among other objectives, will significantly increase the Islamic banking share of domestic banking to 30% by 2025.[25] In addition, in its bid to enhance liquidity management and investment opportunities for Islamic banks in the country, the SBP also introduced a *Sharī`ah*-compliant standing ceiling facility as well as open market operations.[26] The financing facility, which is based on *mudārabah*, is also meant to enhance the effectiveness of monetary policy.

In contrast to the other MESA countries, Afghanistan recorded a sharp negative growth in assets of –73.0% in 4Q'21. The sector also recorded a negative growth in both financing and deposits of –16.1% and –92.0%, respectively. This deterioration can be attributed to the consequences of the political impasse in the country, which crippled economic activities in many ramifications. This perhaps impeded Afghanistan's Islamic banking sector growth with a share of 13.2% (4Q'20: 12.4%), as it moves closer to becoming a systemically significant jurisdiction. This feat is envisaged to be realised very soon, as some conventional banks in Afghanistan have indicated a keen interest in transitioning to Islamic banking.[27]

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24 To ensure consistency across sectors in this report, the exchange rate used for Iran is that stated by the Securities and Exchange Organization (SEO) in its Iran quarterly fact sheet, available on its website. An exchange rate of IRR/USD = 233,777 for 2Q21 was used.

25 https://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategic-Plan-2021-25.pdf

26 State Bank of Pakistan, Domestic Market & Monetary Management Department (DMMD) Circular No. 24 of 2021. https://www.sbp.org.pk/dmmd/2021/C24.htm#:~:text=In%20exercise%20of%20the%20powers,Institutions%20(IBI)%20and%20enhance%20the

27 Such banks include Afghan United Bank, Afghanistan Commercial Bank and First Microfinance Bank Afghanistan (FMFB-A). https://www.islamicfinancenews.com/daily-cover-story-afghan-commercial-bank-prepares-for-full-islamic-conversion-of-portfolio.html

Africa Region Countries

The share of Islamic banking assets in the Africa region was relatively low in 2021, although it also registered an increase. The region has witnessed several developments highlighting its significant potential for the Islamic banking industry. While new full-fledged Islamic banks are being licensed to commence operation, a few notable conventional banks have also established Islamic banking windows. Currently, there are over 80 institutions offering Islamic financial services in Africa.[28]

The Sudanese Islamic banking sector was worth USD 9.1 billion as at end-4Q'21, compared to USD 14.3 billion as at end-4Q'20. Specifically, the Sudanese banking sector also registered a sharp decline of –58.4% in asset growth, while financing declined by –66.2% and deposits by –59.7, in 4Q'21. This negative growth in the Sudanese banking industry was due to depreciation of the exchange rate from 55 Sudanese Pounds to the USD to around 375 Pounds at the start of 2021, as well as to the political impasse in the country that affected economic recovery along with a low vaccination rate.

The Islamic banking sector in Libya, and the non-interest banking (NIB) sector in Nigeria, recorded asset growths of 10.0% and 38.3% y-o-y in 4Q'21, respectively. In the case of the latter, asset growth was driven by the establishment of Lotus Islamic Bank which was granted an operational licence in 2021 by the Central Bank of Nigeria (CBN). The fact that the Islamic banking sectors in both Nigeria and Libya are still in a nascent stage and account for a small share of domestic banking perhaps explains the sector's slower growth despite the increased revenue from oil during the period under review. The NIB also registered increased growth in terms of financing, at 64.6% y-o-y, and in deposits, at 68.3% y-o-y, as at end-4Q'21. The growth rate was achieved despite depreciation of the Nigerian currency, as the economy gradually reopened and recovered amid an increasing rate of COVID-19 infection due to the Delta variant and the low vaccination rate.[29]

Europe and the CIS Region Countries

In Turkey, the share of the participation banks continued to grow in Turkish Lira terms, with participation banking assets, financing and deposits recording double-digit y-o-y growth. This is due mainly to the fast growth registered by the state-owned participation banks. However, unlike in the previous year when the sector recorded an asset growth rate of 23.8% in USD terms, Turkish participation banks registered a negative growth of assets of –8.2% in 4Q'21. As at end-4Q'21, the sector's value of USD 54.4 billion (4Q'20: USD 59.3 billion) represented 5.9% (4Q'20: 7.2%) of the total domestic banking assets. Similarly, the financing and deposit growth rates of 31.5% and 20.1%, respectively, reported in 4Q'20 contrast to the –15.4% and –3.1%, respectively, recorded in 4Q'21.

Within the Central Asia region, the Islamic banking sector in Kazakhstan constitutes 70% of the region's total Islamic banking assets. However, domestically and as in 2020, Islamic banking assets still account for less than 1% of the total Kazakhstan banking industry as at end-Q4'21. Digitalisation and strong government support are expected to provide a major boost to Islamic banking in the country. Attention to the development of a regulatory framework for Islamic banking has also been a key focus in the Kyrgyz Republic. Improvements in the legal and regulatory frameworks, such as in areas of risk management and corporate governance, have supported the growth of Islamic banking assets. Such developments contribute to a positive outlook in the republic for stable growth of the Islamic banking sector to improve its existing 1.5% market share.

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[28] Moody's Investors Service (2020), Cross-Sector – *Islamic Finance: GCC and Malaysia Will Drive Growth across Sharī`ah-Compliant Products in 2020*, March, pp. 1–19.

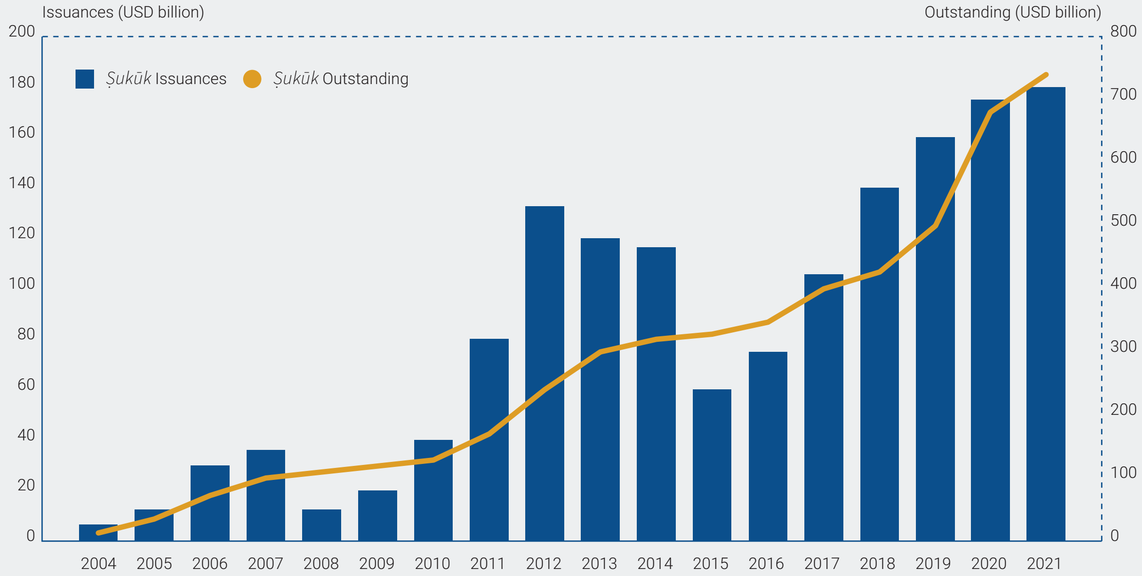
[29] As at 3Q'21, confirmed cases of COVID-19 infection increased by 20.4% q-o-q, while only 0.9% of Nigeria's population was fully vaccinated.

1.3 Islamic Capital Market: Sustained Resilience Amid Retained Concentration

1.3.1 *Ṣukūk*

The *ṣukūk* market continued a steady upward growth trajectory in 2021, supported by a resilient global risk appetite and favourable external conditions, despite the emergence of fast-spreading variants of COVID-19. *Ṣukūk* outstanding reached USD 775 billion in 2021 (see Chart 1.3.1.1), representing a y-o-y growth of 12.5%. The overall issuances by end-2021 also maintained momentum, with a y-o-y growth of 4%, reaching USD 185.4 billion. While there were country-specific variations in the level of issuances in 2021, the overall global trend for the *ṣukūk* market remained positive.

Chart 1.3.1.1 Global *Ṣukūk* Issuances and *Ṣukūk* Outstanding Trends (USD billion) (2004–21)*



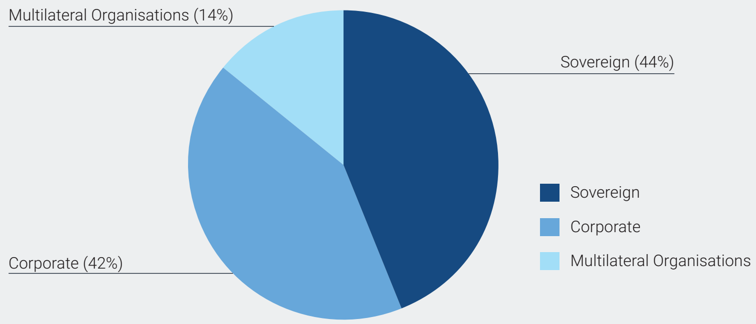
Source: Refinitiv.

*2020 figure restated

The increase in global *ṣukūk* issuances was supported by an increase in corporate *ṣukūk* issuances, while sovereign issuances slowed slightly (see Chart 1.3.1.2). While sovereign issuances have consistently dominated the *ṣukūk* market, with the corporate market generally less active in most countries with the exception of Malaysia, the trend has been changing in recent years. The corporate market has seen strong growth momentum, although issuance rates have been affected by the pandemic, and the gap between sovereign and corporate issuances is rapidly closing, indicating a potential for corporate issuers to outpace sovereign issuances in the medium term.

The growth trend for corporate issuances has been influenced by a number of factors. First, issuers have been looking to take advantage of the current global liquidity before monetary tightening policies come into effect. Second, it is indicative of an improvement in the challenges facing corporates in issuing *ṣukūk*, including some jurisdictions providing incentives or a more facilitative environment for the issuance of *ṣukūk*.

Chart 1.3.1.2 *Ṣukūk* Issuances by Issuer Type (%) (2021)



Source: IFSB estimates based on data from Refinitiv.

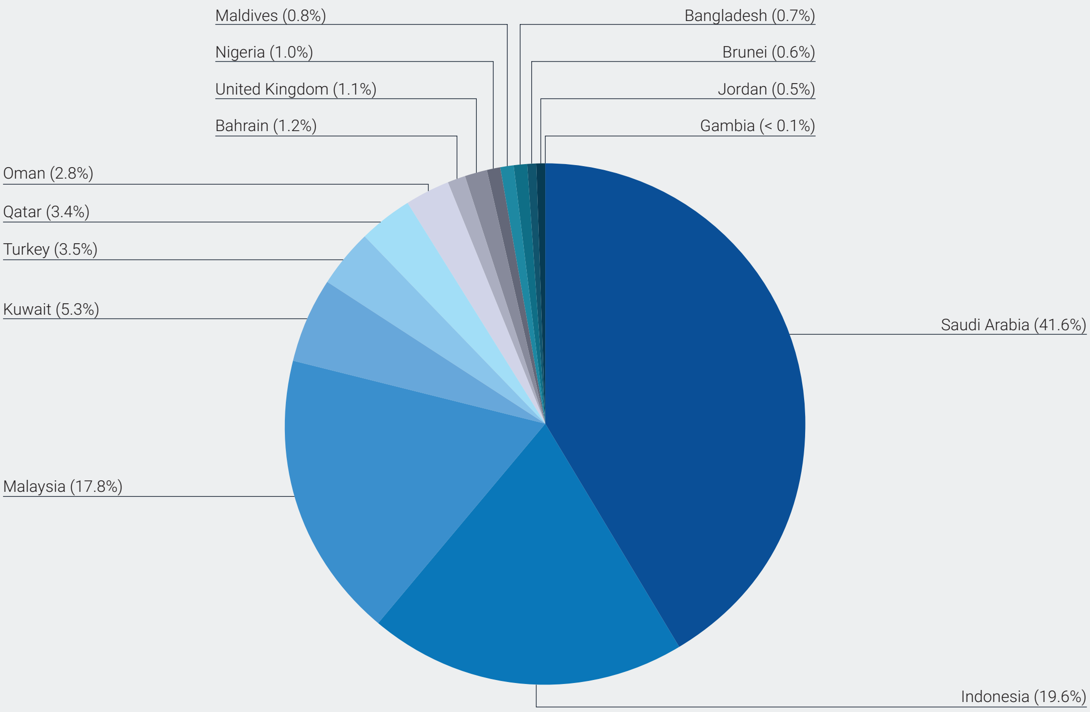
The main hindrances for corporate issuers have generally been the higher cost of issuance of *ṣukūk*, the smaller size of corporate issuers, the complexity of the issuance process when compared to bonds, and reliance on bank-based finance rather than the capital markets. Corporate *ṣukūk* issuance tends to be stronger in jurisdictions where there is a facilitative environment, such as the Malaysian market, where *ṣukūk* account for 70% of total corporate bond/*ṣukūk* issuances in the country since 2017.

The increasing number of corporate issuances may also be due to the low-interest rate environment as well as to higher funding needs for corporates during the pandemic, which also saw a boom in corporate bond markets, as larger corporates sought to secure funds to meet short-term liquidity shortfalls and cover operational expenses, amid declining revenues. *Ṣukūk* issuances from multilaterals also increased. This included short-term issuances from the International Islamic Liquidity Management Corporation (IILM) to support liquidity management in the IFSI, and medium-term issuances from the Islamic Development Bank (IsDB) that will be utilised for the development mandate of the bank – for instance, its wide-ranging response to financing the recovery from the pandemic for its member countries. The IsDB's sustainability *ṣukūk* will be used to finance/refinance green and social development projects.

The largest sovereign issuers by domicile remain the same as in the previous year, with Saudi Arabia continuing to be the biggest sovereign issuer in 2021, followed by Indonesia, Malaysia and Kuwait (see Chart 1.3.1.3(a)). While the volume of sovereign issuances from Saudi Arabia saw an increase in 2021, issuances from Indonesia, Malaysia and Kuwait saw a decline compared to 2020. The contraction in sovereign issuances in some jurisdictions may be attributable to recovering economic activity and lower pandemic-related spending and higher oil prices. However, some government funding needs still remain to support economic recovery, and infrastructure and economic development projects.

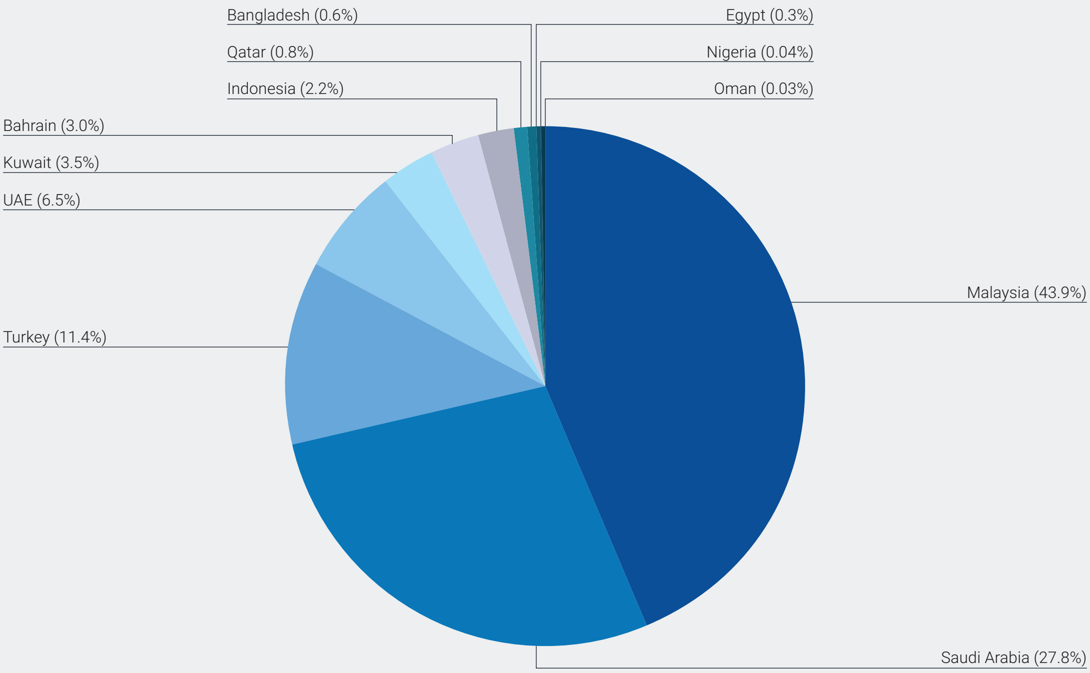
Exceptionally, Saudi Arabia, Qatar and Oman increased their sovereign issuances in 2021, while Bahrain, Kuwait and the UAE saw a more subdued issuance. Saudi sovereign issuance has, in particular, been reinforced by the launch of the country's "*Ṣukūk* Issuance Program" in 2017 to help diversify the state budget funding base. Overall, sovereign issuances are expected to remain significant, as maturing *ṣukūk* will need to be refinanced particularly by the top three *ṣukūk* issuers, which will lead to an increase in overall gross issuance.

Chart 1.3.1.3(a) Sovereign *Ṣukūk* Issuances by Jurisdiction of the Originator (%) (2021)



Source: IFSB estimates based on data from Refinitiv and regulatory authorities (excluding Iran, due to data limitations).

Chart 1.3.1.3(b) Corporate *Ṣukūk* Issuances by Jurisdiction of the Originator (%) (2021)



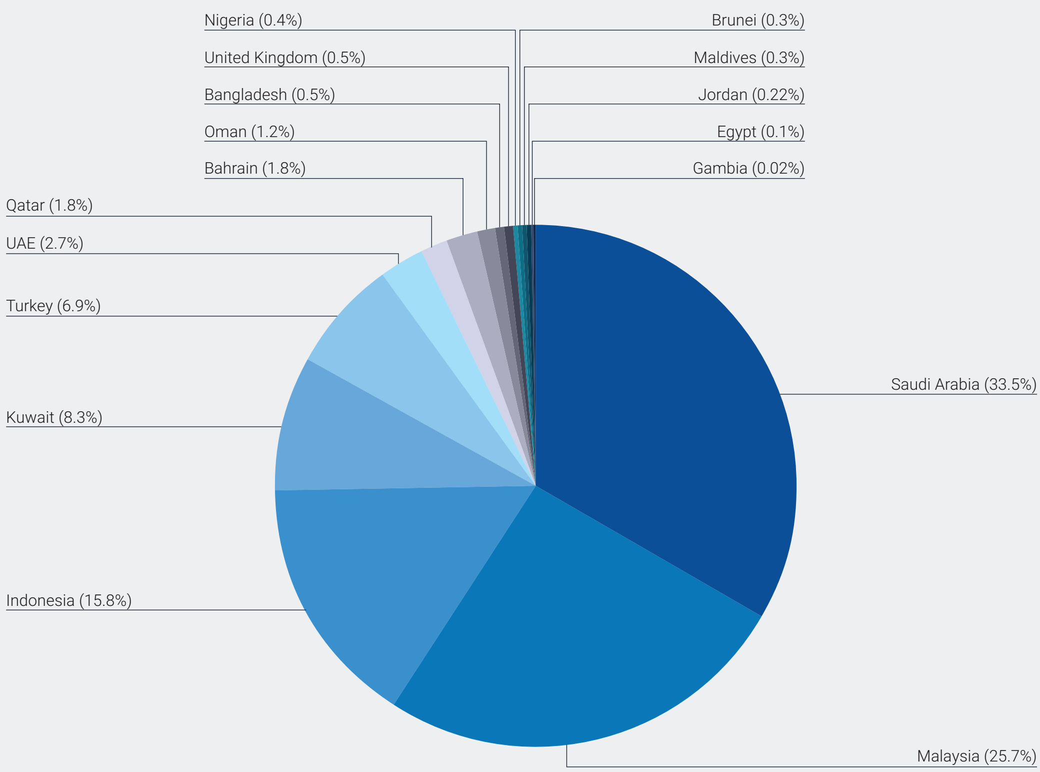
Source: IFSB estimates based on data from Refinitiv and regulatory authorities (excluding Iran, due to data limitations).

There were a number of new entrants to the market in 2021 and the return of issuers from jurisdictions that are not core Islamic finance markets (see Chart 1.3.1.3(a)). The Government of the Maldives issued its debut international sovereign *ṣukūk* amounting to USD 200 million, with a five-year maturity. The United Kingdom issued its second sovereign *ṣukūk* in 2021, valued at USD 653.9 million with a five-year maturity. The UK's first sovereign issuance was in 2014. Nigeria also returned to the sovereign market with a USD 600 million issuance. Bangladesh, which issued its maiden sovereign *ṣukūk* in December 2020, continued sovereign issuances in 2021.

Corporate issuance volume increased in 2021. Malaysia remains the largest corporate issuer in terms of overall volume of issuances, followed by Saudi Arabia and Turkey (see Chart 1.3.1.3(b)). On the whole, across most jurisdictions, corporate issuances saw an increase in 2021. In terms of new entrants, 2021 saw the first corporate issuance from Nigeria, a USD 24 million, seven-year *ṣukūk*.

Overall, Saudi Arabia was the leading *sukūk* issuer in 2021, followed by Malaysia and Indonesia (see Chart 1.3.1.4). Regionally, the GCC accounted for about 48% of the total volume of issuances in 2021, supported by the increase in issuances from Saudi Arabia, overtaking South-East Asia as the largest regional issuer, the latter accounting for 42% of issuances due to a drop in issuances across the three main issuers from the region as well as from issuers outside of these two main regions (2020:[30] SEA – 44%, GCC – 44%). Collectively, the two regions account for 91% of global *ṣukūk* issuances in 2021 (2020: 83%; 2019: 84%).

Chart 1.3.1.4 Total *Ṣukūk* Issuances by Domicile* (%) (2021)

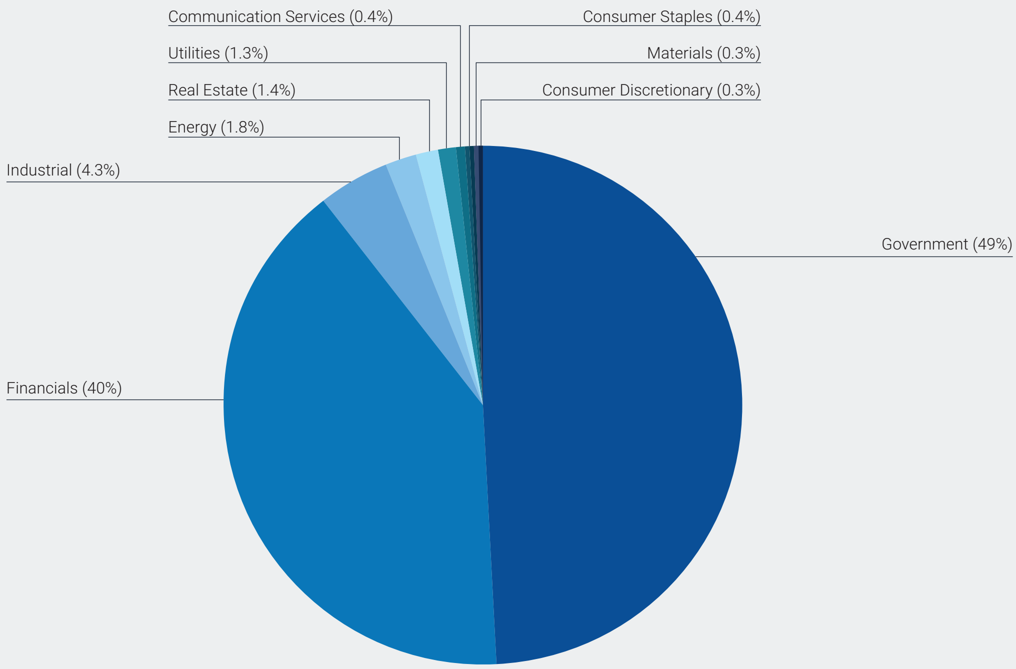


Source: IFSB estimates based on data from Refinitiv and regulatory authorities (excluding Iran, due to data limitations).

**Excludes issuances by multilaterals.*

[30] For comparability, 2020 references have been adjusted to exclude Iran, due to limited data availability in 2021.

Chart 1.3.1.5 Global *Ṣukūk* Issuances by Sector (%) (2021)

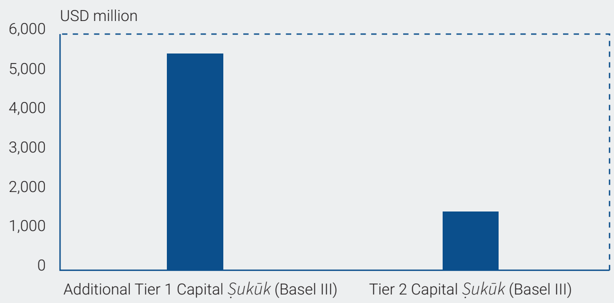


Source: IFSB estimates based on data from Refinitiv and regulatory authorities.

The volume of investment-grade[31] international *ṣukūk* issuances is also increasing, with investment-grade issuances in 2021 comprising USD 39.6 billion or 33% of total *ṣukūk* issuances, compared to USD 25.9 billion or 16% of total issuances in 2020. This total included issuances from Indonesia, Malaysia, Bahrain, UAE, Saudi Arabia and multilateral organisations. About 17% of investment-grade *ṣukūk* were USD-denominated international issuances. High-yield international issuances amounted to around 7% of total volume of issuances in 2021 compared to 4% in 2020.

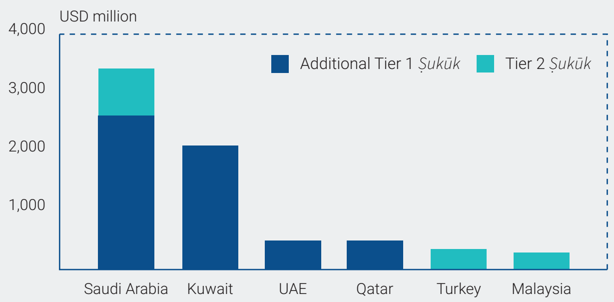
The sectoral distribution for *ṣukūk* issuers has not changed significantly, with financial sector issuers still making up the largest proportion of *ṣukūk* issuers next to issuances by governments. The collective issuance across these two sectors continues to comprise 90% of total issuances during the year (see Chart 1.3.1.5). Out of the financial sector issuers, around 14% are Basel III regulatory capital *ṣukūk* issuances by banks, of which 91% were issued from the GCC region (see Charts 1.3.1.6(a) and 1.3.1.6(b)).

Chart 1.3.1.6(a) Basel III-Compliant *Ṣukūk* Issuances (USD million) (2021)



Source: IFSB estimates based on data from Refinitiv.

Chart 1.3.1.6(b) Basel III-Compliant *Ṣukūk* Issuances by Country (USD million) (2021)



Source: IFSB estimates based on data from Refinitiv.

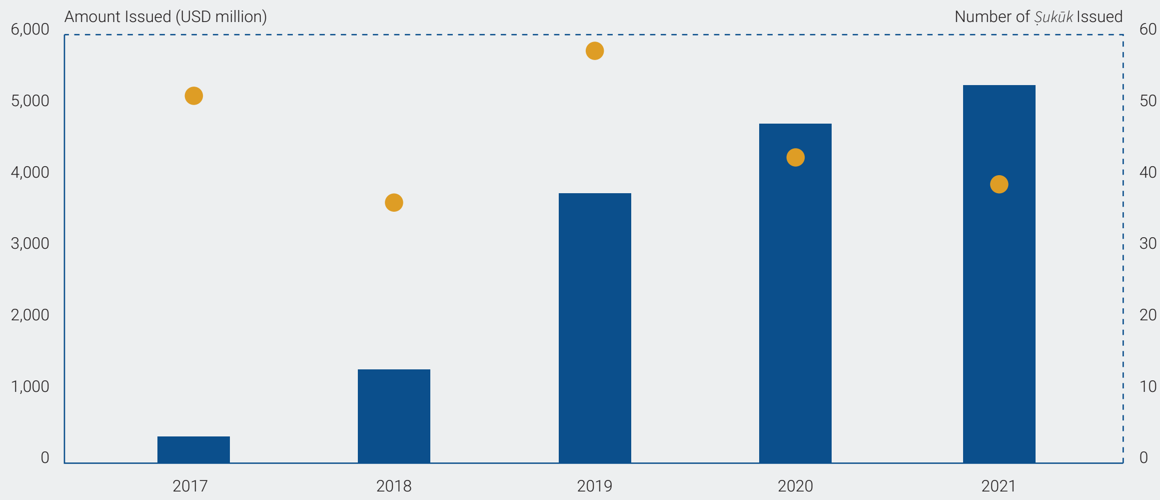
[31] The common definition for investment-grade issuances is a BBB or higher rating on S&P and the equivalent from other agencies. The volume of investment-grade issuances was determined as per the classification on the Refinitiv database.

The secondary market still faces liquidity challenges, although the outstanding value of *ṣukūk* has risen to USD 776.2 billion. The supply–demand gap for *ṣukūk* still persists in most markets due to institutional investors following buy-and-hold strategies for *ṣukūk* investments, which limits liquidity in secondary markets. However, the continued growth of the primary *ṣukūk* market has the potential to close this gap and to improve liquidity in secondary markets over the long term.

1.3.1.1 Sustainability-Related *Ṣukūk*

Sustainability-related *ṣukūk* issuances[32] have continued to grow in both existing and new markets. Sustainability-related *ṣukūk* amounted to USD 5.3 billion, of which USD 1.6 billion or 29% were green *ṣukūk*. While the number of sustainability-related *ṣukūk* issued was lower than in the previous two years, the overall size of issuances was significantly higher. On the other hand, the number of green *ṣukūk* issuances increased compared to 2020 (see Chart 1.3.1.1.1). Green *ṣukūk*[33] comprised 34 out of the 38 sustainability-related issuances in 2021, but with relatively smaller average issuance sizes, making the total size of green *ṣukūk* issuances lower than in the previous year. *Ṣukūk* outstanding reached USD 775 billion in 2021 (see Chart 1.3.1.1), representing a y-o-y growth of 12.5%. The overall issuances by end-2021 also maintained momentum, with a y-o-y growth of 4%, reaching USD 185.4 billion. While there were country-specific variations in the level of issuances in 2021, the overall global trend for the *ṣukūk* market remained positive.

Chart 1.3.1.1.1 Sustainability-Related *Ṣukūk* Issuances (2017–21)

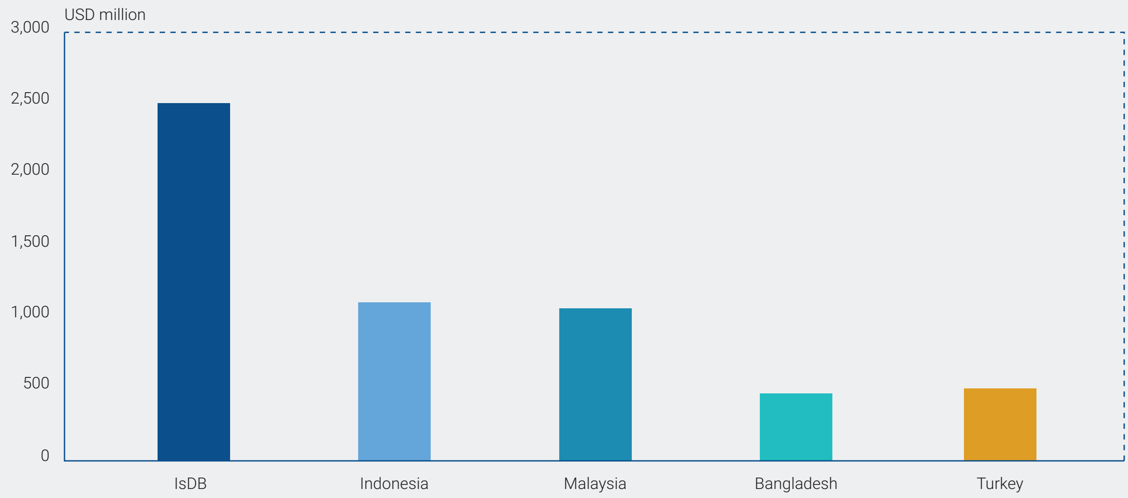


Source: Refinitiv.

Sustainability-related *ṣukūk* issuances were led by the IsDB, Indonesia and Malaysia[34] (see Chart 1.3.1.1.2). The IsDB issued a USD 2.5 billion *ṣukūk* the proceeds of which are intended to be used to finance green and social development projects. The Malaysian government also issued its maiden sustainability *ṣukūk*, amounting to a total of USD 1.3 billion, which included a USD 800 million sustainability tranche, that was also the first USD sustainability *ṣukūk* issued by a sovereign. The proceeds of the *ṣukūk* are intended to be used for eligible social and green projects aligned to the UN's Sustainable Development Goals (SDGs).

32 Sustainability-related *ṣukūk* as referred to in this report include any type of *ṣukūk* instrument that is issued to achieve predefined sustainability or ESG objectives, also including green *ṣukūk* issuances.
33 *Ṣukūk* issued specifically to support climate-related or environmental projects
34 See Box Article 1.

Chart 1.3.1.1.2 Sustainability-Related *Ṣukūk* Issuers (USD million) (2021)



Source: IFSB estimates based on data from Refinitiv.

Indonesia issued a USD 750 million green tranche as part of its USD 3 billion issue in the first half of 2021. New sustainability-related issuers in 2021 also included Bangladesh and Turkey. A Turkish bank issued a USD 350 million sustainability-related Tier 2 *ṣukūk*, the world's first regulatory capital Tier 2 ESG *ṣukūk*. The net proceeds of the issuance are intended to be used to finance and/or refinance eligible green and social projects in accordance with the bank's Sustainable Finance Framework. A corporate in Bangladesh also issued that country's first green *ṣukūk* in 2021 (also its largest ever private-sector *ṣukūk* issuance), the proceeds of which will fund solar projects.

Demand for sustainability-related investments is increasing, further supporting more *ṣukūk* issuances by both sovereign and corporate issuers. Additionally, the need to fund green and sustainability transition projects will spur the increasing issuance of sustainability-related *ṣukūk* in the near future.

During 2021, sovereign entities in Saudi Arabia and Oman introduced sustainability-related debt frameworks. Saudi Arabia's sovereign wealth fund also announced its plans to issue its first green debt deal, with borrowing linked to sustainability. The Capital Market Authority of Oman, in July 2021, issued a framework for sustainable and responsible investment (SRI) bonds and *ṣukūk*, with the aim of consolidating and enhancing earlier regulations. The rules are intended to enable the issuance of sustainability-related, green, blue[35] and social *ṣukūk*, as well as of waqf-linked *ṣukūk*. These developments are likely to encourage sustainability-related issuances from Oman.

Moreover, the Qatar Financial Centre indicated that sovereign green bond and *ṣukūk* issuances can be expected soon, while the Turkish Ministry of Treasury and Finance is also in the midst of developing a sustainable finance framework to facilitate the issuance of ESG bonds and *ṣukūk* in international markets.

Other newer *ṣukūk* issuers such as Egypt may also enter this market, with that country's Financial Regulatory Authority recently approving amendments to the Capital Market Law to include the regulation of bonds and *ṣukūk* related to SDGs, as well as granting a 50% reduction in regulatory fees for the issuance of SDG-related debt.

35 *Ṣukūk* issued to raise capital to finance marine and ocean-based projects that have positive environmental, economic and climate benefits.

Malaysia also has a number of well-established incentives in place to encourage green financing, through the SRI *Ṣukūk* and Bond Grant Scheme by Malaysia's Securities Commission (SC) to cover the costs incurred by issuers for independent review of *ṣukūk* issuances under the SC's SRI *Ṣukūk* Framework and bond issuances under the ASEAN Green, Social and Sustainability Bond Standards. A tax deduction is also provided to issuers for the costs of issuing *ṣukūk* under the SRI Framework. These initiatives have supported significant green and SRI *ṣukūk* issuance by corporates in Malaysia.[36]

In January 2022, the Saudi National Bank issued a USD 750 million debut sustainability *ṣukūk*, the proceeds from which will go towards projects that meet the criteria of the bank's Sustainable Finance Framework, including renewable energy facilities. This was followed by Saudi Arabia's Riyad Bank, which issued a USD 750 million sustainability *ṣukūk* as part of its ESG programme. Riyad Bank's sustainability *ṣukūk* was also an Additional Tier-1 *ṣukūk*, which is the first of its kind globally (following Turkey's Tier-2 ESG *ṣukūk* in 2021), and saw 4.3 times oversubscription, with demand reaching USD 3.2 billion.

The Capital Markets Board of Turkey (CMB) issued "Guideline on Green Debt Instruments, Sustainable Debt Instruments, Green *Ṣukūk* and Sustainable *Ṣukūk* in February 2022. The Guideline is based on the International Capital Markets Association's (ICMA's) Green Bond Principles. It will be applicable for sustainability-related, green and blue issuances. In order to promote the market, CMB has also granted a 50% reduction in its regulatory fees for issuances in accordance with the Guidelines.

36 See Box Article 2.

Box Article 1:

Islamic Finance, SDGs and Climate Change – An Aligned Spectrum

Contributed by: **ISLAMIC DEVELOPMENT BANK**

IsDB

البنك الإسلامي للتنمية

Islamic Development Bank

The Islamic Development Bank (IsDB) recognises that climate change is one of the major challenges in the way of achieving sustainable development and has made climate change action one of its key institutional mandates.

In 2019, the IsDB made an ambitious commitment that **by 2025, at least 35% of IsDB operations will be in climate finance**. Already, during the period 2013–17, IsDB climate finance amounted to USD 4.72 billion, accounting for 19% of total IsDB approvals during this period. In 2018 and 2019, 42% and 25%, respectively, of IsDB project financing were committed to climate finance.

The commitment from IsDB to reach at least 35% of climate finance by 2025 involves green infrastructure investments, notably in renewable energy, climate-resilient agriculture, and urban, water and transport sectors.

Islamic Finance to Address SDGs and Climate Challenges

Islamic principles in general promote social trust, cooperation and solidarity. Following such principles, *Sharīʿah*-compliant finance products have been developed over time to ensure that all investments are good for the community and do not cause harm. Hence, Islamic finance products are well suited to sustainable development goals (SDGs) impacts. These products' characteristics, which include being asset-backed, ethical, sharing risks equitably and being subject to good governance, are in line with the environmental, social and governance (ESG) considerations that are increasingly taken into account by financial institutions to ensure responsible investments and the sustainability and societal impact of their investment.

Game-changing Islamic finance instruments include *ṣukūk*, instalment sales, *istiṣnāʿ*, leasing (*ijārah*), *takāful* and Islamic social financing instruments such as *sadaqah*, *waqf*, *zakāh*, and also Islamic microfinance which can be used as a means to address SDGs and Paris Agreement goals.

The IsDB published in 2019 its Sustainable Finance Framework, which provides a model for Islamic banks and financiers seeking to align their financing with the SDGs across their financing portfolios. This innovative framework was developed in accordance with the four components of the Green Bond Principles 2018, Social Bond Principles 2018 and Sustainability Bond Guidelines 2018, and has allowed the bank to successfully issue a one billion-euro green *ṣukūk* (Islamic equivalent of bonds) in 2019 for low-carbon, climate-resilient green and social investments and operations in IsDB member countries, and a USD 2.5 billion sustainability *ṣukūk* in 2021, the largest of their kind. To compare, the total ESG *ṣukūk* issuance in 2020 was a record USD 4.6 billion.

A new generation of Islamic finance institutions is seeking to provide a range of products to accompany vulnerable communities in SDG-aligned projects through economic empowerment, while ensuring that these communities are adequately equipped and empowered. This is done by strengthening their capacities, identifying and addressing climate risks in their activities, accessing markets or building partnerships. By funding economic empowerment projects with high potential value chains and calibrating the intervention points in order to reach the greatest number of beneficiaries, these institutions can build resilience at the local level and address climate vulnerabilities through customised projects.

Direct investments through IsDB's traditional financial products such as instalment sale, *istiṣnāʿ* or leasing (*ijārah*) have helped the bank to finance renewable energy, clean transportation, energy efficiency, climate-smart agriculture and agroforestry, sustainable water and wastewater management, and creation of green jobs, among others. These green assets can be further utilised to back up the issuance of future green *ṣukūk* to sustain the momentum of a "virtuous cycle" of greening the financial system.

Another promising area for environmentally and socially responsible Islamic finance is venture capital financing (restricted *muḍārabah*) for micro and small businesses, which had been pioneered by IsDB through the Youth Employment Support (YES) programme which facilitated financing to youth micro and small businesses through a risk-sharing model. Economic empowerment for poverty alleviation provides opportunities to fulfil *Sharīʿah* principles by achieving the SDGs, while reducing environmental and climate vulnerability of poor people.

Islamic Social Financing (ISF)

ISF broadly comprises charitable traditional Islamic instruments such as sadaqah (charitable giving), waqf (endowments and trusts) and *zakāh* (obligatory almsgiving). The Islamic Development Bank Institute (IsDBI) (formerly the Islamic Research and Training Institute) has led efforts to develop a model law of waqf for Muslim countries, which has already formed the basis of *waqf* legislation in Senegal and will be replicated in countries that plan to have dedicated waqf laws. In the field of *zakāh*, IsDBI has helped Maldives design a legal framework for zakat mobilisation and distribution in recent years.

ISF represents an enormous potential to address SDGs and alleviate the impacts of climate change. For instance, it has been estimated that the annual *zakāh* contributions only amount to around USD 300 billion resources across the Islamic world. The Global Muslim Philanthropy Fund for Children (GMPFC) was launched in 2019 and is the first fund focused on Muslim giving launched by the United Nations Children's Fund together with the IsDB. The fund is specifically designed to finance life-saving humanitarian aid and is in response to the child-related SDGs, including climate action, in the 57 member countries of the Organization of Islamic Cooperation.

Waqf constitutes a potentially important source for more climate and environment friendly finance. "Green" *waqf* could help directly engage in the provision of goods and services for climate change mitigation and adaptation and could be established as dedicated entities for conservation of natural resources, waste management and other such activities. They can also be dedicated for research and development purposes to advance technological improvements and associated cost benefits or be used to help increase consumer awareness and action on climate change.

The *Awqaf* Properties Investment fund (APIF) is a fund managed by IsDB which participates in the financing of waqf income generating commercial and residential real estate properties to enhance the financial sustainability of its beneficiaries and support their social and charitable activities. An example is the *Fujairah* Welfare Association (FWA), which approached APIF to finance the building of the Nama Commercial and Residential Building (NCRB) in the UAE. Revenues from rentals of the building not only helped pay out the loan provided by APIF, but also funded many humanitarian projects and benefited over 9 million victims of poverty, unemployment and natural disasters.

Islamic microfinance institutions (MFIs) are already financing clean energy products and low-cost climate adaptation measures to address flood, water scarcity or agriculture needs. Islamic MFIs have specifically relied on *zakāh*, *sadaqah* and *waqf* to absorb administration costs to make their loans affordable to clients. These Islamic social funds can become substitutes for subsidies in absorbing the incremental costs when financing clean technologies and adaptation measures for the poor, hence providing Islamic green lines of finance. Some MFIs are also using *zakāh*-based guarantee funds to mitigate their risks. This was pioneered by the Islamic Corporation for the Development of the Private Sector (ICD).

Lastly, fintech has the potential to contribute to addressing climate hazards and natural disasters. Islamic fintech companies are increasingly present in the ecosystems, although there are some barriers that need to be lifted for wider spreading. Examples include crowdfunding platforms that match *sadaqah*, *zakāh* and *waqf* donors with credible charity partners. Campaigns funded through such platforms include activities that are eligible for climate finance, such as borehole construction in water-stressed areas, or access to low-cost, clean energy. Remittances through Islamic fintech can also support households in adapting to climate hazards or acquiring low-cost clean energy technology.

Here again, the IsDBI is leveraging its intellectual capital and collaborations to develop blockchain-based innovative solutions guided by the principles of Islamic economics to enable suitable development in IsDB member countries. In the fintech sphere, following the successful awarding of three fintech patents, and a fourth patent under development, the Institute in 2021 started exploring the capitalisation of the awarded patents:

1. An innovative blockchain system that seamlessly integrates credit reporting, credit rating, credit insurance and incentives for repayment.
2. A blockchain-based voucher (or token) that allows governments, for example, to privatise selected public services (such as schools and hospitals) and directly subsidise disadvantaged groups while maintaining their inclusive support.
3. An innovative and environment-friendly consensus algorithm as a major infrastructure component of a highly efficient and secure blockchain platform, allowing members to validate the transactions of other members in return for others validating theirs.
4. A stabilisation system for financial assets and cryptocurrencies as a proactive, self-sustaining solution, expected to incorporate different technologies such as blockchain and artificial intelligence (AI).

Tools and Metrics for Climate Risks Management and Impact Measurement

To better communicate on results and scale up impact financing, it will be important to ensure that SDG impact metrics and reporting are agreed upon that are both *Sharī`ah*-compliant and in line with international standards. By developing tools to support the measurement of SDG impact indicators, including GHG accounting or climate risks screening tools for SDG13, Islamic financial institutions will be in a better position to demonstrate the impact of their investments and attract borrowers for their different financial products.

With a mandate involving advisory services on Islamic finance, IsDB has an excellent opportunity to promote ESG standards, greenhouse gas (GHG) accounting, and climate risk management frameworks in developing countries' commercial and Islamic finance institutions. This will support the deployment of billions of dollars in green Islamic finance for communities and small and medium-size enterprises.

Already, the IsDB is supporting the General Council for Islamic Banks and Financial Institutions (CIBAFI) in reinforcing the role of IFIs in supporting climate action by developing tools suitable to IFIs to track and monitor GHG emissions of their operations. In the future, further support could be provided to help identify their exposure to climate risks, which would allow them to draw up strategies and action plans to address and manage IFIs' exposure to such risks and to develop or strengthen their overall ESG frameworks.

Box Article 2:

Sustainability *Ṣukūk* in Malaysia

Contributed by: **SECURITIES COMMISSION MALAYSIA**

Suruhanjaya Sekuriti
Securities Comission
Malaysia

Over the past 30 years, Malaysia has made tremendous progress in cementing its position as a global centre for Islamic finance. The country positioned Islamic finance as a key focus area and, in the process, Malaysia has built a distinguished track record for innovative Islamic finance products and services. With the concerted efforts of various stakeholders such as the government, financial regulators and industry players, the Islamic finance landscape in Malaysia has progressed from a domestically driven industry to a prominent international centre.

On that journey, the Securities Commission Malaysia (SC) had propagated early on the role of the capital market in supporting the sustainability agenda. The importance of sustainable development has been globally recognised, as reflected by the ongoing initiatives and commitments undertaken to address social and environmental issues by various nations, including Malaysia. To this end, the efficient mobilisation of funds and investments for sustainability in the capital markets plays a vital role in ensuring the global sustainable development needs are adequately supported.

The SC has long been cognisant of the need to promulgate and develop sustainable finance, and, along with the increasing awareness of sustainable investments and financing, this augurs well for Malaysia, as Islamic finance – and, in particular, the Islamic capital market (ICM) – has been a natural fit for sustainability. This is evidenced by the commonalities underlying sustainability and Islamic finance principles such as social responsibility, inclusiveness, equitable sharing of risks and shared societal benefits among others. Acknowledging this unique proposition, the SC has introduced several regulatory initiatives to establish an ecosystem conducive for the development and growth of sustainable finance including green financing through the ICM. The SC also continue to play an active role in developing Sustainable and Responsible Investment (SRI) at the regional level.

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One of the most significant developments of the sustainability agenda in Malaysia, is the introduction of the SC's SRI *Ṣukūk* framework in 2014, which is widely considered as a pioneering regulatory development that integrates Islamic principles with those of SRI. The SRI *Ṣukūk* framework facilitates the financing of eligible SRI projects encompassing natural resources, renewable energy and energy efficiency, community and economic development and *Waqf* properties or assets. Given that *Waqf* is unique to Islamic finance and a key priority for the SC, the SRI *Ṣukūk* framework provided the catalyst to elevate Waqf by including it as one of the eligible SRI projects. The SRI *Ṣukūk* framework also forms part of the SC's developmental agenda to facilitate the creation of an ecosystem conducive for SRI investors and issuers which is aligned to the rising trend of green and social impact bonds that have been introduced globally to promote SRI.

Following the launch of the SRI *Ṣukūk* framework, Malaysia witnessed key "firsts" comprising the issuance of the inaugural social *ṣukūk* in 2015, which was aimed at improving the quality of education by funding the development of trust schools in Malaysia, and the launch of the world's first green *ṣukūk* in 2017 to finance the construction of large-scale solar photovoltaic power plants. This led to greater traction in issuers seeking funding for projects especially in the green sector. SRI *ṣukūk* in Malaysia have been issued to finance a range of projects, mainly green buildings, hydropower and water treatment.

To complement the SRI *Ṣukūk* framework and accelerate the issuance of SRI *Ṣukūk* as a fundraising instrument for sustainable projects, the following incentives were introduced:

- **Tax deduction:**
  Tax deduction of the expenditure incurred on the issuance or offering of SRI *Ṣukūk* approved or authorised by or lodged with the SC for the year of assessment 2016 until the year of assessment 2025.

- **The Green SRI *Ṣukūk* Grant Scheme (2018):**
  The MYR 6 million (USD 1.44 million) grant was established by the SC to assist issuers in defraying up to 90% of the external review costs for green SRI *ṣukūk*, subject to a maximum of MYR 300,000 (USD 71,778.96) per issuance.

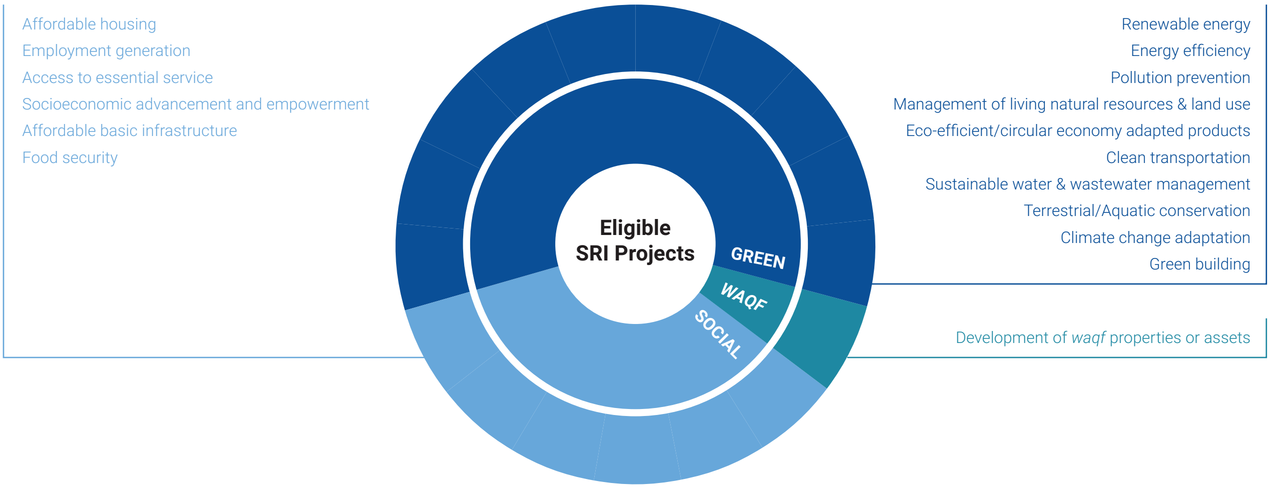
- **Expansion of Green SRI *Ṣukūk* Grant Scheme (2021):**
  The grant was expanded to also include all *ṣukūk* issued under the SRI *Ṣukūk* framework and bond issuances under the ASEAN Green, Social and Sustainability Bond Standards and renamed as SRI *Ṣukūk* and Bond Grant Scheme.

To further strengthen the SRI ecosystem, the SC developed the Sustainable and Responsible Investment Roadmap for the Malaysian Capital-Market (SRI Roadmap). The SRI Roadmap charts the strategic direction to drive domestic and regional efforts to build greater momentum for the SRI segment. The five-year SRI Roadmap identified 20 strategic recommendations to facilitate a vibrant SRI ecosystem towards positioning Malaysia as a regional SRI centre. This consists, among others, of widening the range of SRI instruments, increasing the SRI investor base, building a strong SRI issuer base, instilling strong internal governance culture, and designing an information architecture in the SRI ecosystem.

Following the issuance of the SRI Roadmap, the SRI *Ṣukūk* framework was revised to ensure greater alignment with international standards in terms of enhanced disclosure, reporting requirements and the role of the external reviewer. Central to the revision is the expansion of eligible SRI projects. The revised SRI *Ṣukūk* framework is designed to be versatile, as it provides for the issuance of green, social and sustainability *ṣukūk* and, hence, provides greater financing options for issuers. The following are details of the eligible SRI projects under the revised SRI *Sukūk* framework:

OBJECTIVES

- Conserve the use of energy
- Improve the quality of life of the society
- Preserve and protect the environment and natural resources
- Promote the use of renewable energy
- Reduce greenhouse gas emission
- Address or mitigate a specific social issue or seek to achieve positive social outcomes



Globally, Malaysia is a leading issuer of corporate SRI *ṣukūk*. There have been 21 SRI *ṣukūk* issuers between 2015 and 2021 in Malaysia, with total corporate SRI *ṣukūk* issuances amounting to approximately MYR 8.3 billion (USD1.99 billion).

In light of the various commitments made by Malaysia towards sustainable economic development, including being a signatory to the Paris Agreement, the country continues to support sustainable projects through sovereign *ṣukūk* issuances. In 2020, the Government of Malaysia had issued the first-of-its-kind, fully digital *Ṣukūk* Prihatin, initiated in response to the Malaysian public's interest in participating in the rebuilding of the country during the COVID-19 pandemic, including for social causes. This issuance was also a landmark transaction, bringing financial technology (fintech) to the public and corporates as the facility allowed the public and corporates to subscribe via online banking channels, making it seamless for Malaysians to contribute through digital modes. The issuance is testament to the country's aim to accelerate a transformative change towards an inclusive economy through the ICM, while utilising the advent of fintech for increased efficiency. In 2021, Malaysia also issued the world's first sovereign USD sustainability *ṣukūk* to fund sustainability projects. The proceeds are used for eligible social and green projects aligned to the United Nations' Sustainable Development Goals.

The role of Islamic finance and the ICM in economic growth and development has become increasingly pronounced, especially over the past three decades, and is expected to remain as the country charts its recovery path to build a sustainable future. There remains a tremendous opportunity for investments and funding as Malaysia pursues its net-zero greenhouse gas (GHG) emission aspiration by 2050 as announced at the United Nations Climate Change Conference (COP26) in 2021.

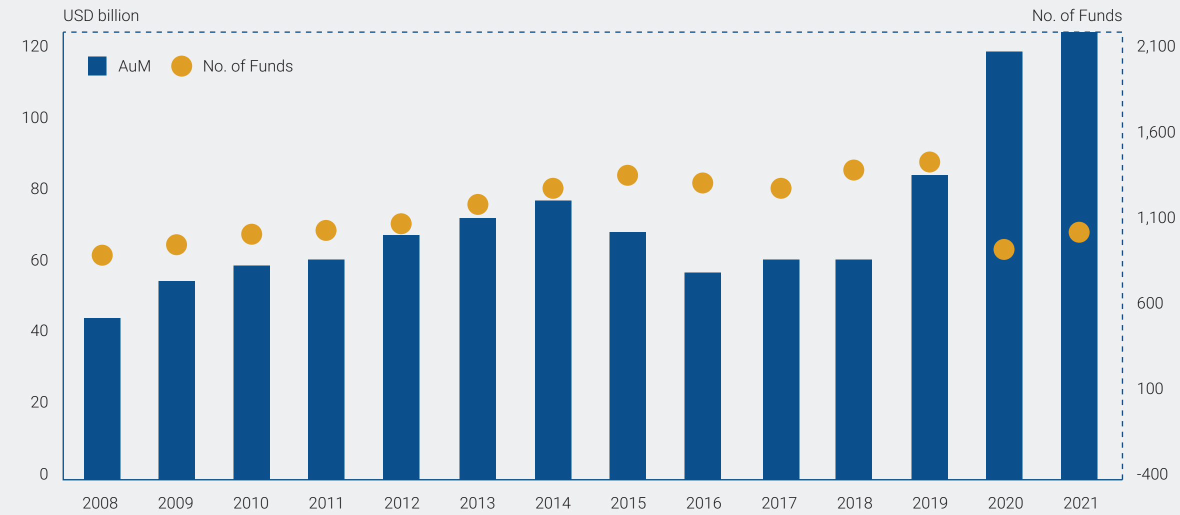
Moving forward, the SC will continue to leverage on the strength and advances of the Malaysian capital market to further harness its potential. The Capital Market Master Plan 3 (CMP3) will serve as a strategic framework for the capital market's growth, taking into consideration the next phase of development that includes, among others, transforming Malaysia into a regional SRI hub, which is aligned with the ICM agenda to establish the country as a regional centre for Shariah-compliant SRI. In this aspect, the CMP3 has placed emphasis on expanding the reach of the ICM to the broader stakeholders of the economy by way of supporting the sustainable development agenda through building an enabling ICM ecosystem for Islamic social finance as well as impact investing. The ICM holds much potential for sustainability sukuk as SRI *Ṣukūk* innovations in the past have demonstrated ICM's capability in facilitating the intermediation of capital formation for commercial purposes, while also contributing to positive outcomes for society and the environment.

1.3.2 Islamic Funds

The total assets under management (AuM) of Islamic funds grew by 6% from the previous year (see Chart 1.3.2.1). There was also a 30% increase in sustainability-related Islamic funds from 2020, comprising USD 6.9 billion in AuM. In terms of the size of AuM versus the number of funds, the improvement in the scale of Islamic funds that was observed in 2020 continued into 2021, although there is significant room for further development in this regard. In 2021, about 0.1% of total Islamic funds held USD 1 billion or more, collectively comprising 38% of total AuM, whereas about 42% of Islamic funds held less than USD 10 million, collectively comprising only 1.1% of total AuM.

While the growth rate of Islamic funds was moderate, with only single-digit growth in 2021, Islamic funds have seen an overall higher growth rate compared to conventional funds. For example, over a five-year period, Islamic funds had an 84% nominal and 13% annualised growth rate compared to a 68% nominal and 11% annualised growth rate for conventional funds over the same period.[37]

Chart 1.3.2.1 Growth in Assets under Management and Number of Islamic Funds (2008–21)



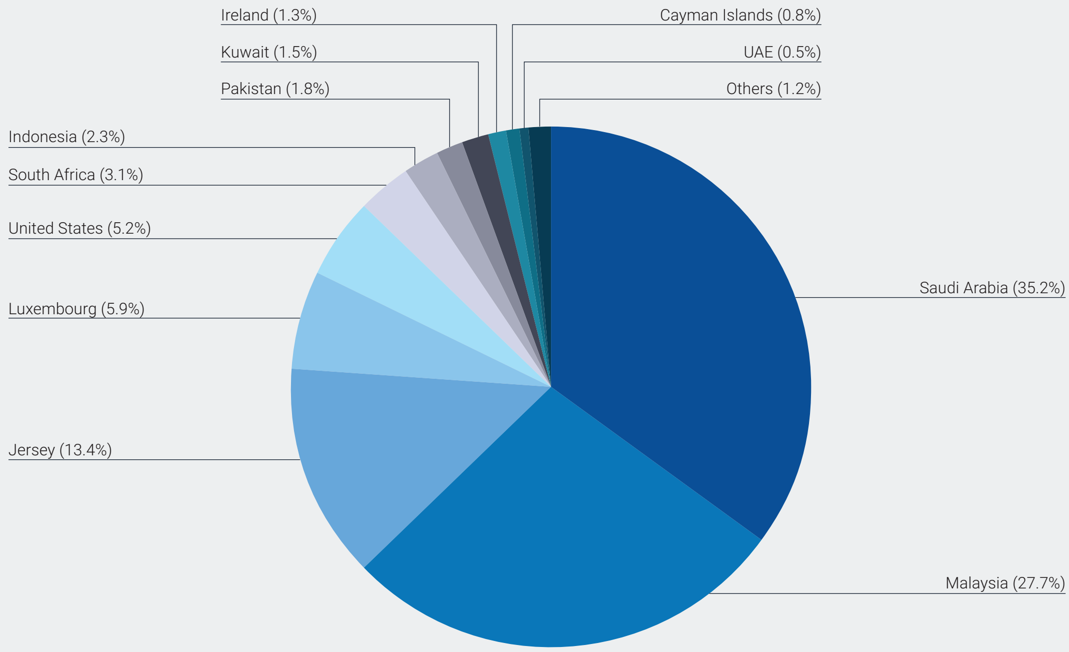
Source: IFSB estimates based on data from Refinitiv for 2019–21.[38] Data for the years 2008–18 are from Bloomberg database as per previous reports. Data from Iran are excluded due to limited data availability.

Core domiciles for Islamic funds remain unchanged, although the overall share of core markets has contracted slightly, signalling the growing size of other markets. Offshore markets such as Jersey and Luxembourg are also growing, with funds in the third-largest domicile for Islamic funds – Jersey – including a series of *Sharīʽah*-compliant commodity exchange-traded funds (ETFs). On the whole, growth prospects in Islamic AuM in both well-established and new jurisdictions remain strong as the global appetite for Islamic funds continues to rise. Some non-core Islamic finance countries such as Canada, Australia, Russia and the US are welcoming newly established Islamic ETFs within their jurisdictions.

37 Fitch Ratings

38 Islamic funds data excludes pension funds and insurance funds.

Chart 1.3.2.2 Islamic Fund Assets by Domicile (%) (2021)



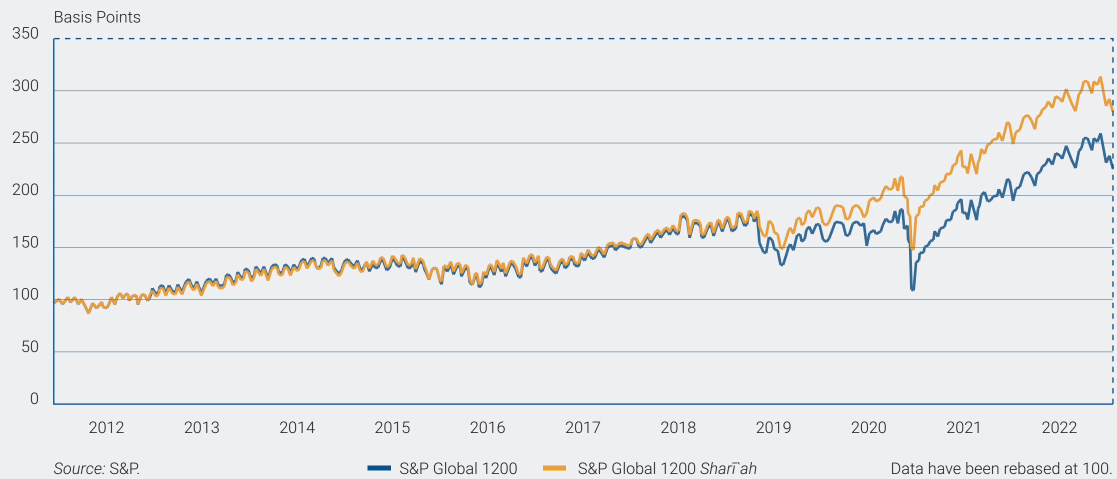
Source: IFSB estimates based on data from Refinitiv and regulatory authorities. Data for Iran are not included due to limitations in data availability.

1.3.3 Islamic Equity Markets

The global equity markets, for the most part, experienced constant growth in 2021, although with occasional pull-backs. Although uncertainties continued in 2021 alongside persistently high inflation and a supply chain crisis, the equity markets "climbed a wall of worry", with investors driving up asset prices. Major indices ended the year at all time-highs despite continued uncertainties related to the emergence of new variants of COVID-19, inflation, policy direction and other geopolitical factors. Major indices rose by double digits, with the S&P 500 closing at a weekly all-time high on 24 occasions.

One key trend in the equity markets in 2021 was a sector rotation from growth to value stocks, as investor sentiment moved away from high-growth stocks in the technology sector, which did well during the pandemic, towards defensive and cyclical stocks in sectors beyond technology, which performed better in 2021 than they had in the past. The rotation is still ongoing, with growth stocks being abandoned while cyclical and defensive sectors such as energy and finance were performing at record highs in early 2022.

Chart 1.3.3.1 Ten-Year Historical Performance (2012 – Feb 2022)

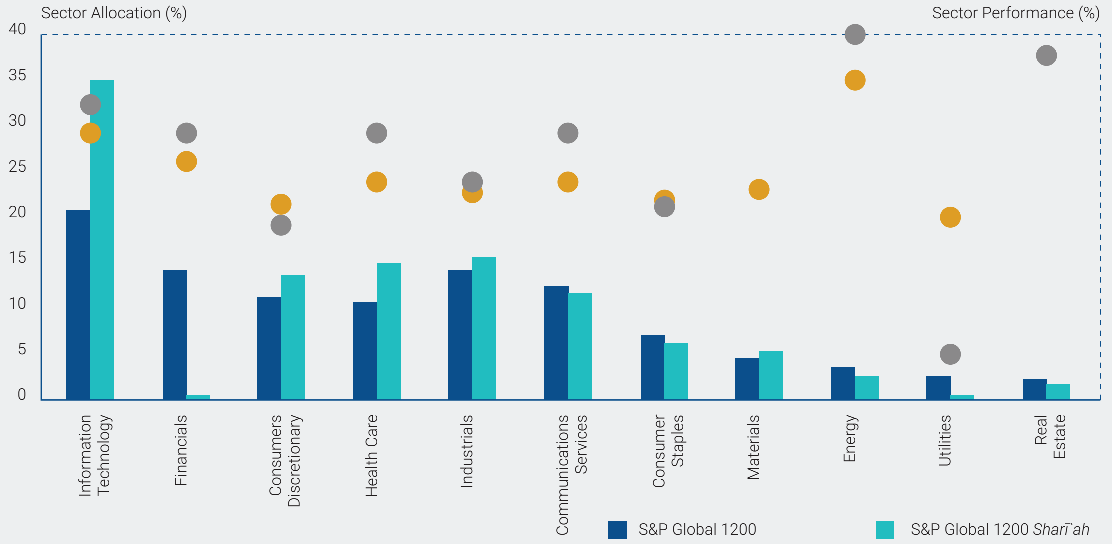


Source: S&P. Data have been rebased at 100.

Islamic indices experienced similar movements to the conventional market, but again outperformed their conventional counterparts in 2021, further increasing the gap between the returns of Islamic and conventional indices (see Chart 1.3.3.1). The growing differential between the performance of Islamic and conventional indices has been bolstered by the strong performance of the technology sector during the pandemic, to which *Sharīʿah* indices have the biggest exposure (over a third, or 35%, of the components of *Sharīʿah* indices are comprised of technology stocks), as well as due to the constituents of Islamic funds being generally less leveraged.

In terms of sector performance for *Sharīʿah* indices, the energy sector (which was the worst-performing sector in 2020) had the highest returns in 2021, followed by the real estate and information technology (IT) sectors. Sector-wise, across most sector-specific indices, the *Sharīʿah* indices performed better than the equivalent conventional indices, the sole exceptions being the consumer discretionary and consumer staples sectors. The impact of the ongoing rotation in the equity markets, particularly on the comparative performance of Islamic versus conventional indices, remains to be seen.

Chart 1.3.3.2 Sector Allocation and Sector Performance (2021)



Source: S&P.

The performance of equity markets in 2022 depends on the materialisation of downside risks or the easing of current global challenges. Emerging market equities face a number of potential downside risks, including the slowdown in China, monetary tightening across other emerging market economies to contain inflationary pressures, and the impact of the Russia–Ukraine war.

1.3.4 Islamic Capital Market Growth Outlook in 2022

While the beginning of 2022 has been characterised by higher oil prices and lower fiscal deficits for the GCC, sovereigns from the region are still expected to continue to issue *sukūk* to fund economic diversification and climate-transition projects, among other programmes. Banks and corporate issuers are also expected to continue to support the growth of the *ṣukūk* market, as investor appetite for *ṣukūk* remained robust even during the pandemic. Sustainability-related issuances are also expected to grow, as an increasing number of Islamic finance jurisdictions have introduced frameworks to support such issuances. In 2020 and 2021, corporate activity in some jurisdictions that typically had strong corporate issuances had more subdued issuances, due to the effects of the pandemic. As the pandemic restrictions ease in 2022 and countries return to normal, more companies are expected to tap into the Islamic capital markets. In addition, about USD 80 billion-worth of *ṣukūk* will be maturing in 2022, which are likely to be refinanced.

1.3.4 Islamic Capital Market Growth Outlook in 2022

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Going into 2022, the global economy continues to adjust to continuing challenges such as rising inflation and supply chain crises. Within this broader context, while Islamic finance continues to develop on several fronts, it is also faced with several downside risks. Supply chain disruptions and energy price volatility, among other things, create greater uncertainty around inflation and policy direction. As advanced economies lift policy rates, risks to financial stability and to the capital flows, currencies, and fiscal positions of emerging market and developing economies (where most Islamic finance markets are concentrated) may emerge, especially with a significant increase in debt levels in the last two years due to the pandemic.

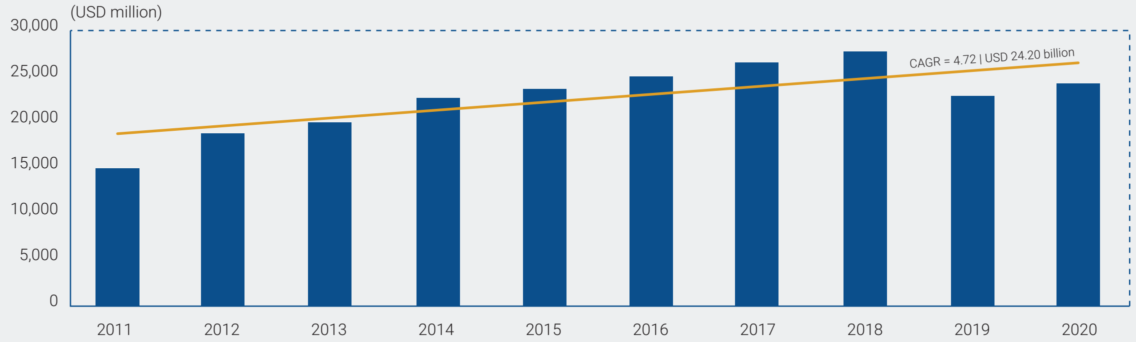
Tighter external financial conditions due to less accommodative monetary policies by advanced economies in 2022 could result in capital flows away from emerging markets and developing economies. Without corresponding tightening, it will also increase the burden on foreign currency issuers, both public and private. Other global risks may also emerge given that geopolitical risks remain high, including the impact of the Russia–Ukraine war which caused an immediate spike in global oil prices, as well as an increasing incidence of cyber risk and climate-related risks such as major natural disasters. Factors affecting the stability and resilience of the Islamic capital market are discussed further in Chapter 2.

1.4 *Takāful*: Sustained Growth and Contribution

1.4.1 *Takāful* Market Growth Trends[39]

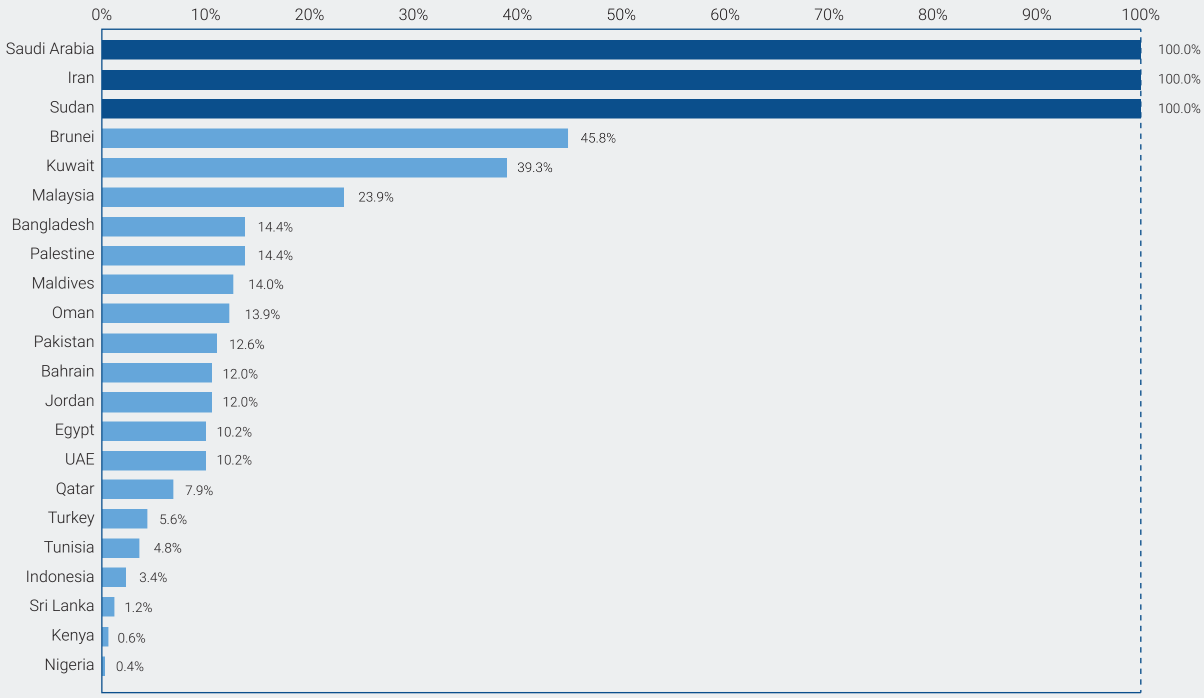
The overall *takāful* sector's direct contributions increased by 4.8% y-o-y to USD 24.2 billion[40] in 2020,[41] after a significant decline (–14.8%) in 2019. The decline was attributed to significant changes in the exchange rate (USD) used to denominate Iranian data.[42] Over the past 10-year period (i.e. 2011–20), global *takāful* contributions have grown by an estimated compound average rate of 4.72% (see Chart 1.4.1.1).

Chart 1.4.1.1 Trend of Global *Takāful* Contributions (USD million) (2011–20)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of *takāful* firms and other publicly available sources.

Chart 1.4.1.2 Share of *Takāful* Sector's Business Relative to Insurance Sector (%) (2020)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of *takāful* firms and other publicly available sources.

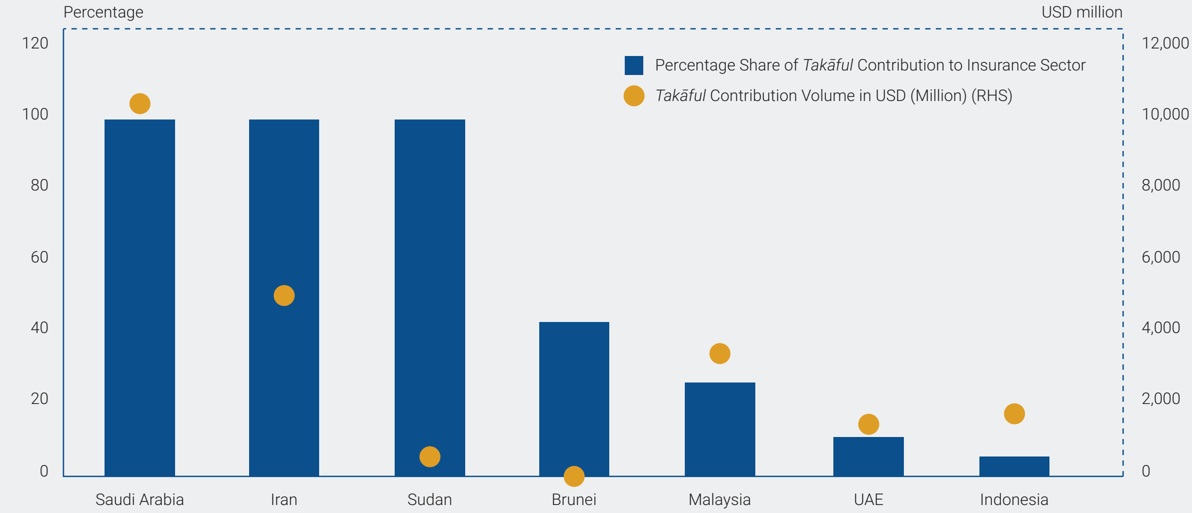
39 The *takāful* market includes Saudi Arabia (which is based on the cooperative model), Iran and Turkey, whose country authorities have declared the model adopted to be *Sharī`ah*-compliant.

40 The estimated amount includes contributions written from primary *takāful* companies, including *takāful* windows wherever it exists, but excludes *retakāful* contributions.

41 The estimate is derived from the country-level data collected from the IFSB's PSIFIs database, which provides a standardised set of data collected from the *takāful* sector's supervisors of its members. For those jurisdictions whose data are not available in the database, we used data from publicly available sources. In this regard, this report uses what the IFSB judges to be the best and most complete available data from a total of 24 jurisdictions.

42 Iran suffered significant foreign exchange depreciation and inflation in 2019 as a result of sanctions. This affected, to some extent, the value of contributions reported after being denominated in USD to allow for cross-country comparisons.

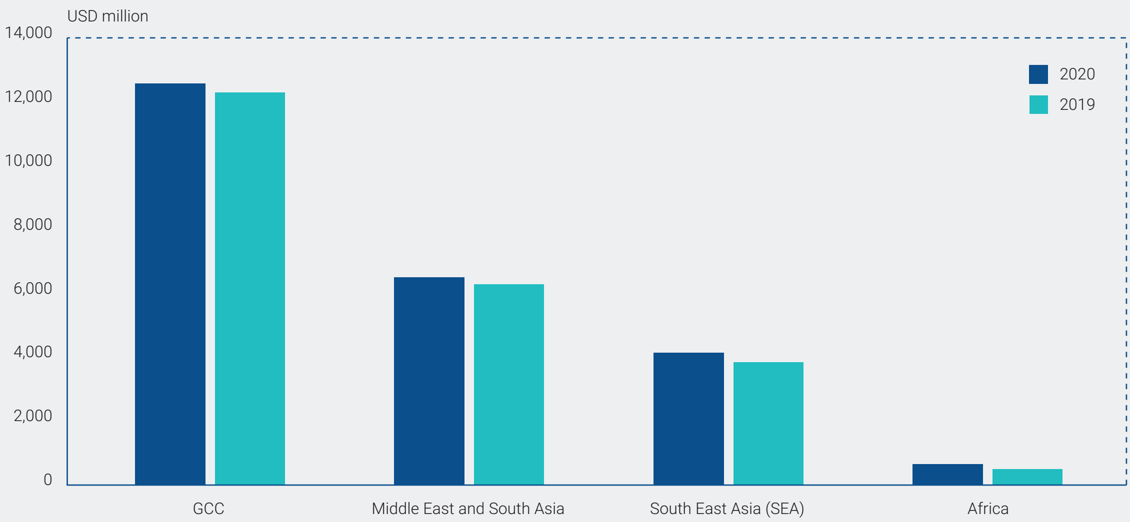
Chart 1.4.1.3 Contribution of Top Seven *Takāful* Markets (2020)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of *takāful* firms and other publicly available sources.

Chart 1.4.1.2 illustrates countries where *takāful* direct contributions as a percentage of the insurance sector's total premium were above 2% in 2020. The chart also indicates that three countries – namely, Iran, Saudi Arabia and Sudan – operate a wholly Islamic insurance market, whereas other countries operate Islamic insurance alongside the conventional insurers. The top seven markets, which generated roughly 95% of the overall contributions, are Saudi Arabia, Iran, Sudan, Brunei, Malaysia, UAE and Indonesia (see Chart 1.4.1.3). General *takāful* constitutes the lion's share (82.6%) of total contributions in 2020, estimated at USD 22.4 billion.

Chart 1.4.1.4 *Takāful* Contributions by Key Region (USD million) (2019–20)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of *takāful* firms and other publicly available sources.

Chart 1.4.1.4 illustrates *takāful* contributions and the market share in four regions – namely, the GCC (43.2%, USD 12.72 billion), the Middle East and South Asia (42.0%, USD 11.36 billion), South-East Asia (11.2%, USD 3.02 billion) and Africa (2.03%, USD 0.55 billion).

Saudi Arabia accounted for the largest share of the GCC *takāful* market in 2020. Due to COVID-19 pandemic constraints, the *takāful* sector in the GCC experienced a marginal growth of 1.5% in gross contributions written, worth USD 12.72 billion in 2020.[43] Although the region maintained its prominence as the largest *takāful* market in 2020 with a share of 52.3% of the overall contributions, the underlying factors and the scale of this growth vary across the countries. Kuwait registered the highest contributions growth (5%) in 2020 among those countries that recorded a slight growth in contributions written – namely, Saudi Arabia (2.3%), Oman (1.1%) and Qatar (0.1%) – whereas *takāful* contributions fell marginally in the UAE (–0.5%) and Bahrain (–0.3%).

The motor and health lines of business represent a large part of *takāful* operators' portfolios in the region, accounting for over 80% of total gross contributions in 2020.[44] Contributions from the motor line fell in 2020 when compared to previous periods due to a fall in the sale of new cars and consumers' preference to convert motor comprehensive cover to third-party cover or to reduce add-on cover.[45] *Takāful* operators in the majority of the GCC countries expanded their coverage to the holders of health policies to cover all tests and treatment costs of COVID-19 patients. Saudi Arabia, the largest *takāful* market in the region, recorded a 2.9% decrease in contributions from the motor line, whereas the health line grew but at a slightly slower pace (1.6%) during the period.

Family *takāful* is relatively small compared to the general *takāful* business in the GCC. In 2020, family *takāful* accounted for less than 20% of total *takāful* contributions, and for 0.3% of the penetration rate reported for life insurance in the GCC. In Saudi Arabia, the share of total contributions derived from family *takāful* business (known as protection and savings) increased to 19.5% in 2020 (2019: 17.9%). Similarly, Oman reported a significant growth in family *takāful* contributions of 28.7%, to USD 31.6 million (RO 12.158 million), in 2020, compared to USD 24.5 million in 2019. In the post-pandemic era, business lines that offer a class of long-term protection and savings products have become more relevant to families in the region, following increased awareness of the need for families to prioritise financial protection, security and stability.

The *takāful* sector's performance in 2020, to a large extent, reflected the market scenarios after 1Q'20 and a series of regulatory and supervisory initiatives and stimulus packages addressed to the sector to overcome the consequences of the pandemic. In addition, the sector's performance showed the ability of individual operators to implement contingency plans to counter the repercussions of COVID-19, to support resilience and to ensure business continuity. The operators in these countries have improved their financial performance and profile significantly over the past few years due to changes in motor ratings brought about by new regulations and mandatory medical/health covers for all citizens, residents and visitors.

The regulatory framework for the *takāful* sector has improved in the majority of the countries in the region in recent years. Different measures are being introduced. In particular, the introduction of risk-based capital regimes in some of these countries has prompted a greater emphasis on technical profitability, as volatile equity and property investments could require higher solvency capital charges. In Saudi Arabia, the pressure on solvency, which is creating uncertainty about the ability of some operators to continue as a going concern, has led the sector's supervisory authority (Saudi Central Bank) to increase minimum capital requirements for operators to USD 133.3 million (SAR 500 million).[46] However, various strategic options, including capital restructuring and a possible-

43 According to calculations from the IFSB Secretariat.
44 Ibid
45 The GCC *takāful* sector's performance report 2021, Moody's Investors Service
46 Eleven of the 29 cooperative insurance companies registered accumulated loss ratios to paid-up capital ratios of over 20% at the end of 2021.The solvency ratio of some of the insurers reached a negative 48.08% at the end of 2021 (31 December 2020: 45%).

merger, were considered by those companies' boards of directors. Essentially, the measure has triggered M&A negotiations involving 10 companies, as a result of which two mergers came to fruition in 2020 and another was concluded in February 2021.[47] Similar high-profile M&A activities have occurred recently in other parts of the region – namely, UAE[48] and Bahrain.[49] It is thought that the various M&A deals will be positive for the stability of the industry and that stronger players would emerge.

Kuwait's insurance sector has seen the introduction of new regulations and the establishment of an Insurance Regulatory Unit effective from 1Q'20, which is expected to help improve oversight of the sector and support its growth over the medium term. The impact of the pandemic on the assets portfolios of Kuwaiti operators was substantial following the volatility of financial markets in 1Q'20, to the extent that cash collection and liquidity are areas of concern in 2Q'20. Likewise, the Capital Market Authority (CMA) of Oman has introduced two frameworks to its regulatory regime – namely, the Risk Based Capital Framework and a comprehensive *Sharī`ah* Governance Framework for institutions offering Islamic financial services (IIFS) in the country. These regulations, among others, require *takāful* operators to reinsure with *retakāful* companies unless a prior approval is obtained from the *Sharī`ah* Supervisory Committee and the CMA. In addition, the CMA's supervisory regime includes a set rule that differentiates payments of contributions/premiums between corporate and retail customers.

Oman is unique among the GCC countries in respect to catastrophic risks. Climate-driven catastrophic events have become both more frequent and more severe in recent times. For instance, in October 2021, Cyclone Shaheen caused loss of life, and damage to infrastructure and properties estimated at around USD 130 million.[50] The frequency and scope of economic losses in recent years present an opportunity for an uptake of risk by *takāful* operators in Oman.

Overall, the GCC has over 75 *takāful* operators, including 31 Saudi-listed cooperative insurers and 12 operators in the UAE. The prospects for these operators are nonetheless healthy, supported by an improving regulatory and supervisory regime, an increase in oil prices, infrastructure development, and a widening of compulsory retail covers, particularly in the case of motor and medical/health lines, as well as a growing demand for family protection products post-pandemic.[51] Moreover, the reopening of the tourism sector and the hosting of mega-events, such as Expo 2020 and the FIFA World Cup 2022, are factors that will set the market on the path of steady growth for the foreseeable future. The average insurance penetration in the region of roughly 1.1% of GDP indicates potential for growth, especially in the family business segment which is still underpenetrated.

47 https://www.sama.gov.sa/en-US/EconomicReports/Financial

48 In the UAE, Gulf Insurance Group's acquisition of AXA's Middle East business and Dar Al Takaful's acquisition of Noor Takaful.

49 In Bahrain, the merger between Solidarity and t'azur (Bahrain operations only), which was completed in 2021. In 2018, BKIC increased its stake in Takaful International by acquiring an additional stake to reach 81.94%. In an earlier deal (late 2016), Solidarity Bahrain acquired Al Ahlia Insurance by purchasing a majority stake in the firm for USD 28.4 million (BHD 10.7 million).

50 The estimated damage from Cyclone Shaheen was less than that caused by Cyclone Gonu in 2007 and Cyclone Mekunu in 2018.

51 Am Best's Market Segment Outlook, "Gulf Cooperation Council Insurance", November 2021.

In the Middle East and South Asia region, contributions were up marginally (by 1.29% y-o-y) in 2020 (USD 11.36 billion), representing 42.0% of the overall contribution. The constituent countries are diverse – namely, Iran, Jordan, Palestine, Pakistan, Bangladesh, Sri Lanka and Maldives. Iran is the largest market in the region, with contributions rising slightly (by 2%) in 2020 y-o-y to USD 4.96 billion, representing 88.7% of the region's total contributions for the year.[52] Iran had suffered significant foreign exchange depreciation and inflation in 2020 as a result of economic sanctions imposed on the country in recent years. Invariably, this has affected the value of contributions and growth reported after being denominated in USD to allow for cross-country comparisons.[53]

Besides Iran, only Sri Lanka experienced a slight growth (+0.6%) in contributions in 2020; contributions shrank in Jordan (–2.8%), Pakistan (–3.9%), Palestine (–4.1%), Maldives (–8.2%) and Bangladesh (–8.6%). Mandatory third-party auto policy (MTPL) tops the list, accounting for one-third of the total contributions in 2020 in Iran, Jordan, Palestine, Sri Lanka and Maldives. In Iran, for example, mandatory MTPL has been a vital source of income for insurance companies; in the year under review, it grew in value by 30%, with a 5.45% increase in the number of policies. MTPL was followed by health and long-term family business (life). In contrast, contributions generated from family business constituted a large proportion of total contributions in Bangladesh (at 92%) and Pakistan (at 69%). On the other hand, the significant drop in *takāful* contributions experienced in Bangladesh was due mainly to the decision to make MTPL optional rather than mandatory, despite being the major source of contributions in the general business segment.

In Pakistan, the decline in contributions can be associated with higher cost of the business. The surge in market share of family *takāful* contributions in Iran, Jordan and Pakistan may well indicate a change in consumer behaviour during the pandemic.[54] *Takāful* companies in these countries took several measures to support consumers and businesses against the financial and health difficulties caused by the COVID-19 pandemic. For instance, the sector's supervisors in Iran mandated that operators extend medical and health protection coverage to COVID-19–related medical bills, leading to payment of USD 63 million (IRR 16.7 trillion). This has led to a surge in the market share of family business by 3 pp to USD 364 million (IRR 109.2 trillion) from 4.5 million policies in the year under review.

Similarly, in Jordan, the priority given to personal financing by Islamic banks and institutions as part of the support measures during the lockdown period contributed to the marginal growth in family *takāful*. Further, the 8.1% growth in family business reported in Pakistan in 2020 is largely attributed to significant increases in contributions due to the renewal of policies by window *takāful* operators.

[52] The exchange rate quoted by the Securities & Exchange Organization of Iran for Q4'20 (USD / IRR: 268,254 / 820,289) is used to denominate total direct contributions as at year ended 2020 (IRR 820,289 billion). See https://en.seo.ir/Upload/Editor/Files/FactSheet-2020-Q4%20-%20Final.pdf

[53] Actually, in the local currency, the Iranian market contributions increased by 37.9% y-oy during the fiscal year 2020–1 to IRR 820,289 billion (from IRR 602,201 billion in 2019).

[54] Central Insurance of Iran, Annual Report 2020/21; Jordan Insurance Federation, Annual Report 2020; "Growth of Family *Takāful* Business Post-Pandemic in Pakistan and Beyond", IFN News, 17 February 2021.

The SEA Region

Countries with a prominent *takāful* sector in South-East Asia are Malaysia, Brunei Darussalam and Indonesia. *Takāful* contributions in these countries grew by 7.1% in 2020, reaching USD 4.69 billion (2019: USD 4.38 billion). The 2020 growth rates for these countries are: Brunei, 10.9%; Malaysia, 8.5%; and Indonesia, 3.1%.[55] Malaysia dominates the *takāful* sector in this region, with contributions representing 71% of the total contributions, estimated at USD 3.34 billion in 2020.[56] During the same period, the 9.2% surge in contributions from family *takāful* business, to USD 2.48 billion, generated close to three-quarters of *takāful* contributions in Malaysia. Similarly, family *takāful* contributions in Indonesia grew by 5.1% to USD 1.05 billion in 2020, representing 86% of total contributions. These growth rates outstripped the 3.1% y-o-y growth reported by their conventional counterpart.[57]

General *takāful* business in Malaysia grew by 6.6% y-o-y in 2020 with contributions of USD 862 million. In contrast, contributions from the same segment in Indonesia experienced a decline due to a contraction (29.6%) in the motor business line, being the consequence of a significant dip (48.3%) experienced in automotive sales in Indonesia in 2020.[58] Motor and fire coverages have remained the dominant class of business in Malaysia, rising by 6.4% and 4.6% y-o-y, respectively, in 2020. Other classes of business with a modest share of contributions are medical and health (9.5%), engineering (2.8%) and liability (1.1%).

In Brunei, unlike in other countries in the region, general *takāful* dominates the sector, accounting for 80% of the total contributions in 2020. Motor lines in Indonesia showed a marginal decline (–0.4%), due to a contraction of the comprehensive motor business in that country, while the health line, the country's second-largest business line (23.8%), fell by –6.8% in 2020. Property and fire showed 9.4% growth; while marine, aviation and transportation were the highest contributors to growth, with 44.3%.[59]

The sustained growth recorded in each of the constituent countries in the region is the positive outcome of supervisory relief measures and forbearances taken in the wake of the pandemic outbreak, and subsequently. Measures taken in this regard include options to defer payment of family *takāful* contributions for three months, restructuring of *takāful* contracts, waivers of fees and charges, and accelerated claim processes.[60] These measures were extended beyond 2020, and new ones were introduced to further reduce the financial burden on takāful participants and to help consumers gradually resume their contributions payments.[61]

Growth of the *takāful* sector in Malaysia is expected to remain steady in 2022 and beyond, with continuous supportive policies and increasing awareness and understanding of *takāful* products among the Muslim-majority population.[62] The rise of digital channels has presented opportunities for other *takāful* product lines to reach wider segments of the community, beyond the motor line which shows a 22% growth in the online channel in 2020 and represents 96% of all *takāful* products bought online.[63] Similarly, in Indonesia and Brunei, the adoption of a digital model will continue to play an important role in making *takāful* products more accessible.

Furthermore, the Indonesian authority is pursuing the *Sharī`ah* Unit Separation Work Plan, under which the *Sharī`ah* business units (SBUs) of conventional insurers are expected to completely spin-off by 2024. This will help to address the structural constraints facing the sector, which at present is highly fragmented, comprising 42 *takāful* SBUs and three *retakāful* windows operating alongside 13 full-fledged *takāful* companies and one *retakāful* company.

55 The figures are estimated based on data compiled from the Monthly Highlights and Statistics of the respective supervisory authorities (Bank Negara Malaysia, Otoritas Jasa Keuangan and Brunei Darussalam Central Bank).
56 IFSB Secretariat workings.
57 The figures are estimated based on data compiled from the Monthly Highlights and Statistics of OJK, the Indonesian supervisory authority.
58 The Association of Indonesia Automotive Industries (GAIKINDO), 2020.
59 Otoritas Jasa Keuangan (OJK), *Indonesia Insurance Statistics 2020*.
60 Bank Negara Malaysia, *Annual Report 2020*; OJK, *Annual Report 2020*; and Brunei Darussalam, *Annual Report 2020*.
61 Bank Negara Malaysia, *Annual Report 2020*.
62 Fitch Ratings Indonesia, *Takaful Dashboard, 2021*.
63 Malaysia Takaful Association, *Annual Report 2021*.

The Africa Region

The African market is dominated by Sudan[64] and, to some extent, Egypt, although there are smaller presences in Tunisia and Kenya, Nigeria, Senegal, South Africa, the Gambia, Mauritania, Zambia, Libya and Algeria.[65] *Takāful* contributions in Egypt experienced a double-digit growth of 32.14% y-o-y in 2020 to end at USD 137.11 million (2019: USD 103.76 million).[66] Similarly, *takāful* contributions in Tunisia grew by 10% to USD 48.25 million (TND 130.5 million) in 2020, despite a 3% decline in the overall economy. The sector's growth may be explained by measures taken by countries' supervisory authorities to preserve its growth trend during the COVID-19 crisis.

General *takāful* is the dominant business in both the Egyptian and Tunisian markets, accounting for more than two-thirds of the total contributions in 2020, whereas family business constituted roughly one-third of the total contributions for the year. The FRA projected that the *takāful* market in Egypt will improve over the foreseeable future, given a large population of 100 million with low insurance penetration of 0.6% in 2019 (one of the lowest rates in the emerging markets market) combined with an improved regulatory environment. The FRA's new Unified Insurance Law, which repealed the existing law issued in 1981 and 1975, regulates insurance activities and the supervision and control of insurance companies.

Morocco's *takāful* sector supervisory authority (ACAPS) has published regulations relating to Islamic insurance which have taken effect since October 2021. The authority has licensed two additional *takāful* operators, increasing the number of *takāful* operators to five (four *takāful* subsidiaries and one reinsurance window). The creation of a window is only permitted for reinsurance companies in the case of *takāful*. Meanwhile, Algeria's insurance authority (CNA) has granted two *takāful* licenses following the new regulation that sets out the conditions and modalities for operating *takāful* business.[67] The regulation allows *takāful* business to be conducted either by an insurance company carrying out such business exclusively or by an insurer opening a *takāful* window. *Takāful* operators or windows must have certificates of compliance for Islamic insurance products issued by the National *Sharī`ah* Fatwa Authority for the Islamic finance industry.

The four *takāful* companies that have operated in Nigeria over the past four years still account for less than 1% of the insurance sector premium in 2020, a lower percentage than what was reported for Kenya where there is only one *takāful* operator but a larger insurance market overall. Nigeria has a very low insurance penetration, even by the standards of economies with a similar per-capita GDP. The growth in premiums in recent years has not kept up with inflation. The sector is also undergoing major restructuring, following new capital requirements announced by the regulator that have come into effect since 31 December 2020.[68] As a result, six insurers announced their intention to merge and a further seven announced they would raise new capital.

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[64] Sudan data were also not available, but because they are material to the overall total, we made use of estimated data based on 2018 data and projected growth trends based on the previous years' data (i.e. after adjusting for inflation), solely for the purpose of arriving at the overall total.

[65] Quantitative information was not available for many of these countries and was therefore not included in this report.

[66] According to data from the Egyptian Financial Regulatory Authority's (FRA) *Annual Report, 2020*.

[67] The new regulation was set in Executive Decree No. 21-81 of 23 February 2021.

[68] National Insurance Commission, Nigeria.

Other Markets

The *takāful* sector in Turkey has shown resilience to economic challenges amid the COVID-19 pandemic. Total contributions from the *takāful* sector, otherwise known as participation insurance, increased by 24.2% to USD 573.5 million (TRY 4.27 billion) in 2020, albeit still a low market share of 5.2% of the overall insurance sector total premium income (TRY 85.58 billion). The Turkish insurance sector mirrors the economy. The Turkish economy grew by 1.8% in 2020, ranking it as the second-fastest-growing G20 country after China. This growth was attributed to a large economic stimulus programme offered through credit channels, together with loose monetary policy and regulatory measures.

General *takāful* accounted for 92.4% of the contributions, while the remaining 7.6% was accounted for by family *takāful*. Motor was the most dominant line of business as of 2020, representing 61% of the total contributions, followed by general losses at 19.7% and accident and health at 7.1%. The sector's growth momentum in terms of contributions has been increasing since 2015, with CAGR estimated at 21%. However, the same policies (i.e. loose monetary policy and a large economic stimulus programme) that contributed to a strong recovery undoubtedly also gave rise to high inflation and currency depreciation. The impact of the currency devaluation on the market was significant, contributing to a slowdown in contributions growth on a USD basis compared to previous years.

Compared to EU benchmarks, Turkey's insurance market is largely underpenetrated and lags in density.[69] The sector possesses the right opportunities for improvements over the coming years, supported by the country's young and growing population amid sustained economic growth. The Islamic private pension system (IPPS), a new development in the Islamic insurance sector in Turkey, reached 12.6 million participants and a fund size (including the state contribution) of TRY 170.1 billion as at end-2020.[70] As of the same date, the share of Islamic pension funds of total pension mutual funds in Turkey was approximately 18%.

Presently, there are six full-fledged Islamic insurance companies,[71] two full-fledged Islamic pension companies, and one Islamic reinsurance company operating in the sector. In addition, there are 10 private pension companies that offer both Islamic pension and other funds services. The Insurance and Private Pension Regulation and Supervision Authority (IPRSA) is currently considering a proposal for the establishment of a new Islamic insurance company in 2022. By the end of 2022, it is expected there will be 12 private pension companies, seven Islamic Insurance companies and four insurance pools operating in the Islamic insurance and pension sector.

[69] In Turkey, non-life penetration is only 1.1%, compared to the EU average of 3.1%, while lags in density is USD 110 in Turkey compared to the European average of USD 983.
[70] This include 6.9 million participants and a fund size of TRY 158.3 billion (including the state contribution), in addition to the 5.7 million employees and a fund size of TRY 11.8 billion (including the state contribution) that were automatically enrolled into the system.
[71] Application for Islamic insurance window operation ended in Turkey in 2021.

Box Article 3:

Global Islamic Financial Industry Outlook in 2022

Contributed by: **FITCH RATINGS**

FitchRatings

The Islamic finance industry continues to be a growth story, with its size estimated to have crossed USD 3 trillion at end-2021.

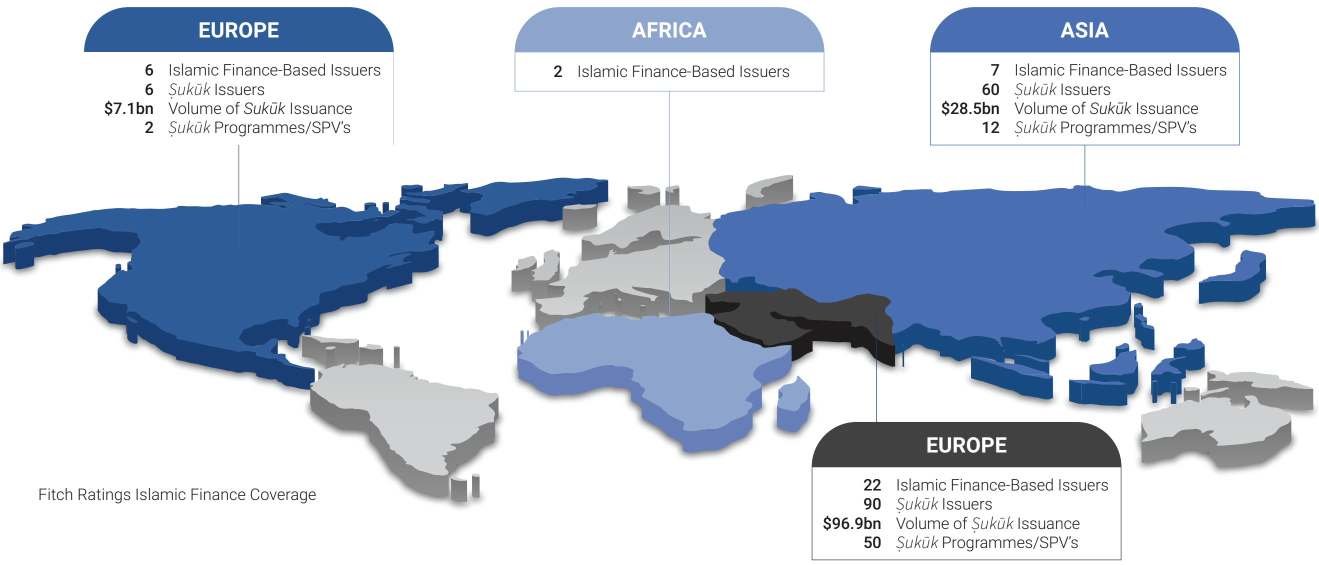
The industry is also expanding and diversifying its products offering, including ESG-linked *ṣukūk*, which speaks to its rising maturity. Regulators in a number of countries are also increasingly focusing on *Sharīʿah* governance. However, the industry continues to face challenges which, depending on the jurisdiction, include limited public awareness and confidence in the *Sharīʿah*-compliance of Islamic products, limited product offering, regulatory hurdles, lack of standardisation and lack of Islamic liquidity management products, along with other macroeconomic and industry-specific headwinds.

In this article, we aim to share Fitch's outlook on the key pillars of the Islamic finance industry: *Ṣukūk*, Islamic banks, Islamic funds and *takāful* (Islamic insurance). We also have a special focus on ESG-linked *ṣukūk* and developments in key markets. Please note the figures reported in this article are based mainly on Fitch Ratings' data sources and calculations which may be different in some aspects from the main data used in this report.

Global *Ṣukūk* Market: A Resilient Trajectory

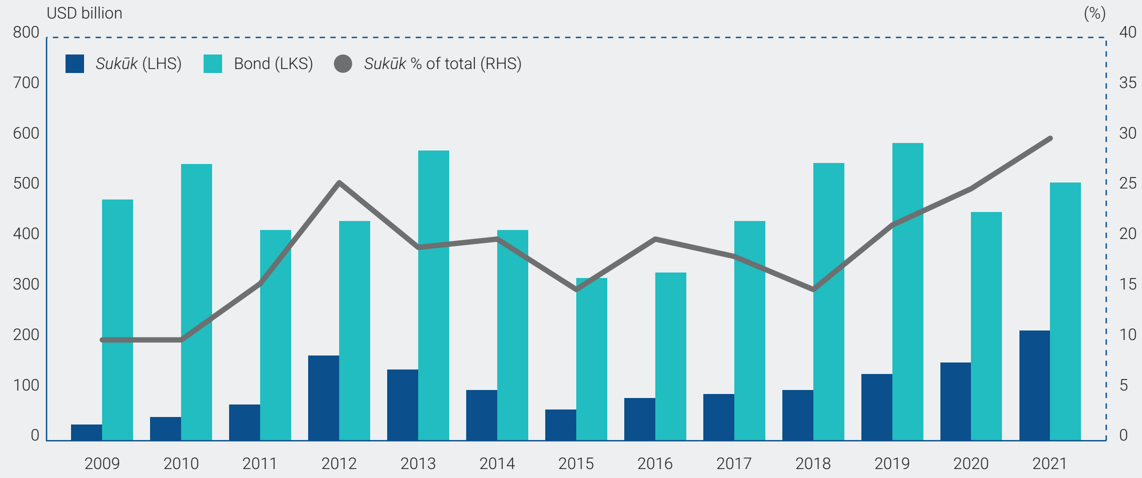
Ṣukūk volumes in 2022 are expected to grow and remain a key financing source in core Islamic finance markets. Growth will be anchored by robust Islamic investor appetite, funding diversification goals, and Islamic-finance development agendas in a number of countries. Downside risk stems from higher oil prices reducing a number of sovereigns' funding needs, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)-standards compliance complexities, traditional risks such as interest-rate rise, lower global investor appetite for emerging-market debt, and political risk.

Total *ṣukūk* issued in 2021 grew by a strong 36.1% y-o-y. Central banks, governments and multilateral institutions dominated issuance. The growth was despite AAOIFI standards implementation challenges, COVID-19 disruptions, and higher oil prices. Non-core market sovereigns such as the UK, Maldives and Nigeria also issued *ṣukūk*.



Fitch Ratings Islamic Finance Coverage

Ṣukūk, Conventional Bonds Issuance in Key Islamic Finance Jurisdictions



Source: Fitch Ratings. Bloomberg

Fitch-rated outstanding *ṣukūk* volumes increased by 15% CAGR between 2015 and 2021, reaching USD 132.4 billion. About 80.1% of Fitch-rated *ṣukūk* were investment grade. The overall outlook also improved with the share of *ṣukūk* issuers on Negative Outlooks falling to 8.8% in Q4'21 (Q4'20: 23.4%).

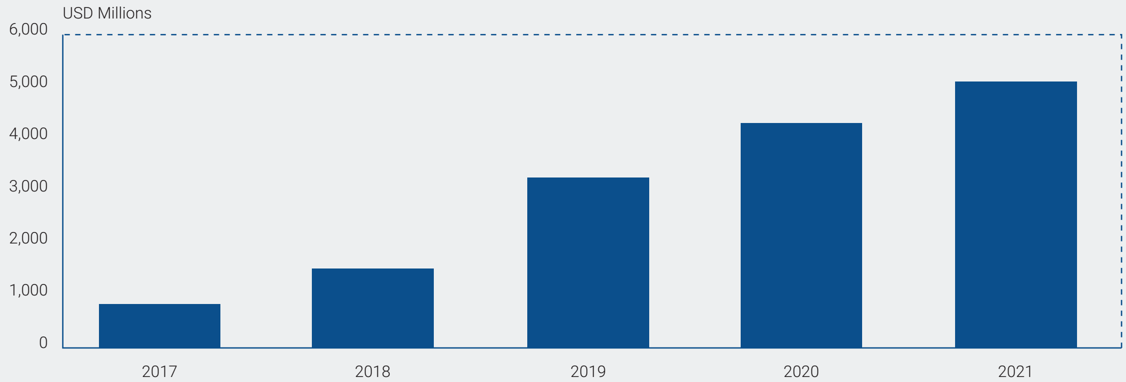
Defaulted *ṣukūk* volumes remain tiny at 0.2% of gross *ṣukūk* issued as at end-2021 and include the 2021 *ṣukūk* default by Serba Dinamik Holdings Berhad (Fitch: RD) and PT Garuda Indonesia (unrated by Fitch). Legal precedent for effective enforcement is lacking in many *ṣukūk*-issuing jurisdictions, with *Sharī`ah* requirements potentially adding complexities to default resolution.

A key development in 2021 was that revised terms and clauses were added to new and existing *ṣukūk* documents to comply with AAOIFI standards. The changes have credit implications that could affect issuers' liquidity, credit profiles and ratings. While standardisation may be achieved in the medium to long term, these changes have added complexity to the already complicated *ṣukūk* instrument. AAOIFI-linked changes have broadly stabilised since Q3'21, but it is uncertain if there will be more changes in 2022.

The Rise of ESG-Linked *Ṣukūk*

The nexus between the world of ethical finance and Islamic finance is strengthening with innovative issuances seen, such as green, sustainable and transition *ṣukūk*. In 2021, ESG-linked *ṣukūk* volumes expanded by 17.2%, reaching USD 15 billion, or 2.4% of global *ṣukūk*. Fitch rates more than 90% of all hard-currency ESG-linked *ṣukūk*, with 97% of rated-volumes being investment grade.

Green & Sustainability *Ṣukūk* Issuance by Year (USD million)



Source: Fitch Ratings. Bloomberg

ESG-linked *ṣukūk* are likely to remain a prominent theme in 2022–3, with volumes driven by the number of sovereigns in Muslim-majority countries and by multilateral development banks – in particular, the Islamic Development Bank. Growth will be anchored by funding diversification goals and by issuers seeking to tap into rising global investor demand for ESG-linked bonds and *ṣukūk*.

The *ṣukūk* format is preferred by issuers over the conventional bonds format to attract the significant Islamic investor base in regions that can only invest in *Sharīʿah*-compliant securities. However, so far, an issuer's decision to launch an ESG-linked product is driven mainly by the international investor appetite for such products and is not yet driven primarily by local or regional investor considerations.

A number of Muslim-majority countries such as Saudi Arabia, Malaysia, UAE, Bahrain and Turkey have also set net-zero emissions targets as part of the 2021 United Nations Climate Change Conference (COP26). If followed up with policy actions, this would require sizeable funding, part of which could be met through ESG-linked *ṣukūk*.

The segment faces key challenges in core markets, including a lack of cost incentives for ESG-linked *ṣukūk* and bond issuers and an immature ecosystem, with regulations and market infrastructure still being developed. To ignite growth, especially in the GCC region, government support in the form of cost incentives, supportive regulations, increased awareness and adequate infrastructure are required.

Incentives from the government can support growth. A notable example is Malaysia, where sustainable and responsible investment (SRI) *ṣukūk* issuers are granted cost and tax incentives under the SRI *Ṣukūk* and Bond Grant Scheme, which was expanded in 2021. Supported by the scheme, Malaysia houses the largest number of active ESG-linked *ṣukūk* globally, at 156 instruments out of 167 ESG-*ṣukūk* globally, at end-2021 (93% of all issues).

Islamic Banking Outlook

GCC Islamic Banks: Fitch Ratings' outlook for the GCC Islamic banks is neutral, reflecting a modest economic recovery and higher oil prices. Fitch expects continued profitability pressures. Asset quality is not expected to deteriorate sharply following the end of forbearance measures. Capital buffers and liquidity are expected to remain stable and adequate for the risks.

All Long-Term Issuer Default Ratings (LT IDRs) assigned by Fitch to Islamic banks in the GCC are investment grade; 88% are driven by potential sovereign support, reflecting the strong record of sovereign support in these countries and the sovereigns' relatively high ratings; 12% by the banks' stand-alone creditworthiness as of December 2021. Differences in IDRs mostly reflect differences in sovereign ratings.

We expect further M&A activity as many Islamic banks have weak franchises, lacking strong competitive advantages, particularly in pricing, the cost of funding and growth opportunities. M&A may also create new Islamic national or regional champions. Most Islamic banks globally will be affected by the transition from interbank offered rates (IBORs) to overnight risk-free rates (RFRs).

Islamic banks will face uncertainties similar to those faced by conventional banks. However, Islamic banks will face the additional complexity of needing to ensure *Sharīʿah*-compliance throughout the transition process.

Saudi Arabia in Focus: Saudi Arabia has the largest proportion of Islamic banks' financing (82%) of any country that allows conventional banks to operate alongside Islamic banks. We expect the banking sector to remain well capitalised and liquidity to remain strong. Saudi Islamic banks remain well placed in the banking sector with larger retail franchises supporting higher margins, a lower cost of funding and better asset quality.

Higher oil prices and still soft lending growth should ensure that liquidity remains at reasonable levels in all GCC banking systems in 2022, particularly in Saudi Arabia and the UAE, although there will not be a return to the levels seen before the 2014 fall in oil prices. Fitch's downgrades of Saudi Arabia have reflected increased regional geopolitical and military tension and a revised assessment of the vulnerability of its economic infrastructure. Rare upgrades have been linked to acquisitions by stronger banks.

Bank funding represented nearly 98% of Saudi corporates' capital structure in 2021, with the remainder being funded by equity and debt instruments. The share of Islamic lending in bank funding to corporates was 85% in 2021. We expect the large Islamic banking sector to drive domestic *ṣukūk* issuance growth. Islamic banks benefit from the Ministry of Finance's Saudi riyal-denominated *ṣukūk* programme in deploying their excess liquidity.

Bahrain in Focus: Bahrain's Islamic banking sector growth (including Islamic windows) is expected to continue apace in 2022–23, following strong momentum in 2021, likely driven by the steadily rising public demand for Islamic products and the expected improvement in the operating environment. This follows rising oil prices, higher real GDP growth, the easing of COVID-19-related restrictions and the expected rises in interest or profit rates.

Islamic banking continues to have significant importance in Bahrain, with its market share rising to 38.8% of domestic banking system assets and 17.8% of total banking system assets (including foreign assets) at end-2021. Islamic banks' total assets expanded by 8.1% in 2021, at a faster pace than conventional banks' total asset growth of 4.2%. The total Islamic banking sector assets reached USD 38.6 billion, or about 100% of Bahrain's GDP, supported by the mainstream relevance of Islamic products, increasing residential mortgage financing, a wide branch and digital banking network, a supportive Islamic finance ecosystem and the presence of Islamic liquidity-management tools.

Mergers and acquisitions continue to be prominent in Islamic banks. Bahrain's share of global Islamic banking assets remains small at 3.5% at end-Q3'20, according to the Islamic Financial Services Board (IFSB), due mainly to the economy's small size. However, it was higher than Indonesia's (2.1%) and Turkey's shares (3%), both of which have larger economies.

Oman in Focus: The Islamic banking sector in Oman is likely to sustain its positive trajectory in the short to medium term despite a number of structural challenges. Growth will be driven by growing awareness, strong retail demand for Islamic products, supportive regulations, and a strong push from the Islamic windows of conventional banks. An improving operating environment, expected positive real GDP growth, higher oil prices, the easing of coronavirus restrictions, and the rise in interest or profit rates will also support growth in both Islamic and conventional banking.

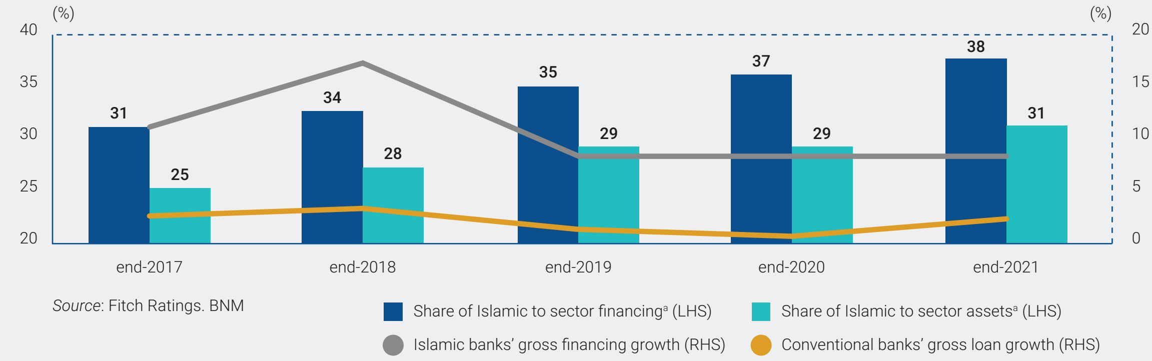
The Islamic banking sector's financing growth topped 11.6% y-o-y in 2021, in contrast to the conventional banking sector's 3.1%, with a compounded annual growth rate of 9% in 2017–21. Surging public demand and the low-base effect propelled the growth. As a result, the market share of Islamic banking and Islamic windows increased to 15.2% at end-2021 (end-2020: 14.3%), with total assets of OMR 5.9 billion (USD 15.3 billion). The Central Bank of Oman is developing a medium-term strategy for the Islamic banking sector, including a lender of last resort facility for Islamic banking entities, with a *Sharī`ah*-compliant deposit insurance scheme.

Key structural challenges persist mainly due to Islamic liquidity management products, as well as non-availability of a *Sharī`ah*-compliant lender of last resort facility and deposit insurance.

Malaysia in Focus: Fitch Ratings expects the growth of Islamic financing in Malaysia to pick up modestly in 2022 as the economic recovery accelerates (2022F GDP growth: 6.5%, 2021E: 3.6%) and as asset quality becomes clearer as COVID-19 pandemic relief measures are unwound. Adequate loss-absorption buffers supported by further profitability recovery should keep Islamic banks' credit profiles stable. Substantial public demand for Islamic products and long-standing government and regulatory support will also continue to support the sector in 2022.

Islamic financing continued to underpin the Malaysian banking sector's growth in 2021, expanding at a faster pace than conventional loans (8.3%, compared to 2.3%). Growth was driven primarily by mortgages and other household financing, while demand for working-capital financing across sectors has also improved as the economy has reopened – a trend we expect to continue in 2022.

Islamic Banks' Market Share Rose Further

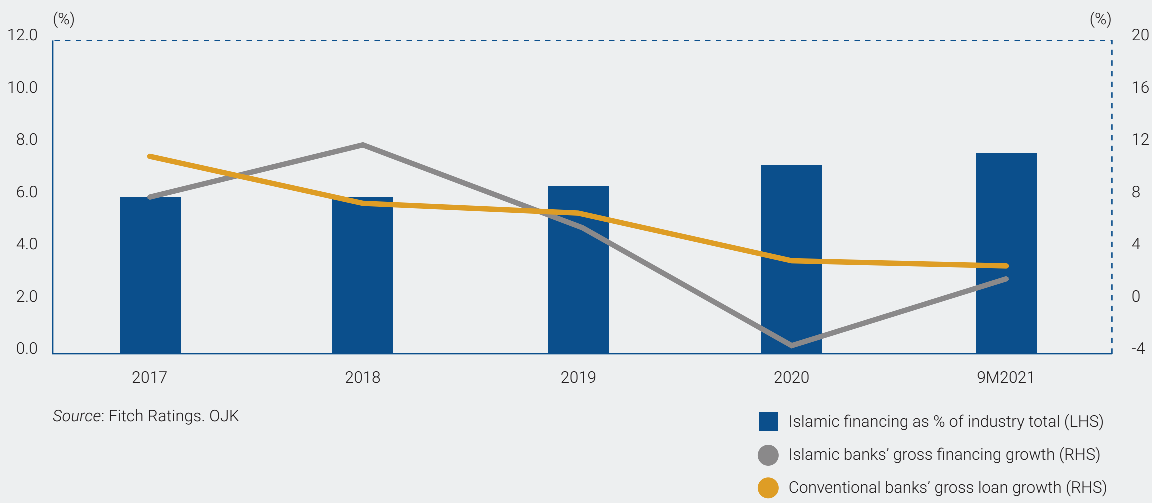


Source: Fitch Ratings. BNM

Bank Negara Malaysia's (BNM) Financial Sector Blueprint 2022–6 targets wider adoption of sustainable financing, which is also referred to as value-based intermediation (VBI) financing in Malaysia. Islamic banks have led in this segment, with VBI-aligned financing accounting for 26% of Islamic financing approved during 2017–20. We expect the proportion to increase in line with growing public attention on VBI.

Indonesia in Focus: We expect the Shari'ah banking sector's financial performance to improve in 2022, helped by a recovery in economic activity and extended regulatory forbearance on loan classifications to end-Q1'23. This will support the banks' asset quality and profitability metrics by giving them more time to deal with lingering problem financing caused by the pandemic. Medium-term growth drivers include continued support from government policies and regulations, the greater availability of Islamic liquidity-management products and increased digitalisation.

Resilient Financing Growth



Source: Fitch Ratings. OJK

The plan to convert three regional Indonesian lenders into *Sharī`ah* banks in 2022 will raise the market share of Islamic banks in the near term. We estimate the conversions could raise the proportion of *Sharī`ah* financing to around 9% of the banking industry from 7.1% – equivalent to USD 28.1 billion – at end-Q3'21.

Key challenges to sector development include the limited awareness, understanding and demand for Islamic products, even though Indonesia has the world's largest Muslim population. The smaller capital base of Islamic banks, limited product offerings, still-developing branch and digital banking networks, and limited skilled staff are other obstacles.

Turkey in Focus: Islamic (participation) banks in Turkey accounted for 7.8%, 6.9% and 10.5% of end-2021 banking sector assets, loans (financing) and deposits, respectively. Market shares have risen in recent years with the entry of three state-owned Islamic banks and the segment's above-sector-average growth. Medium-term prospects are reasonable given the strategic importance of Islamic banking in Turkey and its large, untapped Muslim population. The government's aim is for participation banking to account for 15% of banking sector assets by 2025. Growth could be supported by a possible new participation law targeting product standardisation.

Fitch-rated Turkish Islamic banks' ratings are sensitive to a sovereign downgrade and our view of government intervention risk. The operating environment also remains a key sensitivity given high segment dollarisation and pressure on capitalisation amid market volatility.

Bangladesh in Focus: A recent policy push by the government to develop Islamic finance could, if sustained, spur the industry's growth. We believe the Islamic finance sector has the potential for significant growth over the medium term, supported by strong bottom-up public demand for Islamic products and the country's robust economic prospects.

Bangladeshi authorities have approved a number of conventional banks for conversion into Islamic banks in the last few years, stimulating the sector's expansion. Islamic banks (by total assets) constitute over 95% of the country's Islamic finance industry, which we estimate reached over USD 48.1 billion by end-Q2'21. Within Bangladesh's banking sector, Islamic banks accounted for around 27% of deposits, 28% of loans and advances, and 49% of remittance handling.

However, long-standing constraints have posed challenges to Bangladesh's Islamic finance sector. These constraints include the lack of comprehensive regulations governing the industry and weak enforcement of financial regulation in general, a dearth of Islamic liquidity-management and investment products, limited incentives from regulators for *ṣukūk* issuers, a lack of standardisation in the country's Islamic finance sector, limited skilled human capital, and inadequate use of fintech solutions by stakeholders.

Nigeria in Focus: Islamic banking, referred to as non-interest banking (NIB) in Nigeria, is a niche but growing segment with its market share rising to 0.7% in Q3'20 (Q3'19: 0.3%) and total assets of about USD 732 million, according to the IFSB. The rising market share is stimulated by Central Bank of Nigeria (CBN) approving the establishment of a number of NIBs in the last few years. In 2021 and 2019, the CBN granted licences to Lotus Bank Limited and TajBank Limited to operate as NIBs which, along with Jaiz Bank (B-/Stable), brings the number of full-fledged Islamic banks to three.

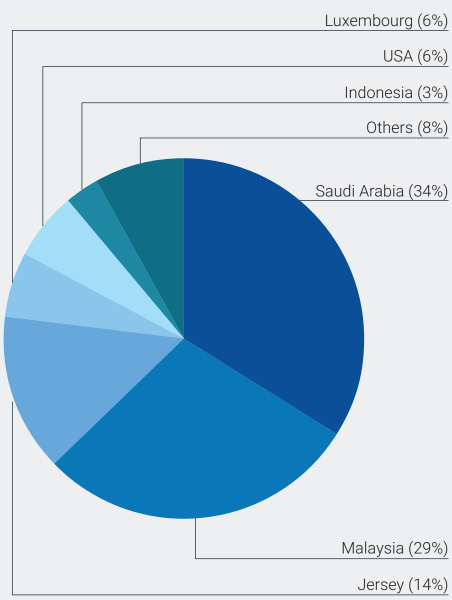
The number of NIBs is set to rise. In 2021, CBN granted approval-in-principle for Sterling Bank Plc to spin off its Islamic window into a stand-alone NIB. Fitch has a neutral outlook for Nigerian banks. Business volumes and earnings will continue their slow recovery in 2022, driven by moderate loan growth buoyed by gradually improving operating conditions. Fitch forecasts real GDP growth of 2.8% in 2022 compared with an estimated 2% in 2021 and –3% in 2020. These developments are expected to moderately support Islamic-banking growth in Nigeria.

The Islamic finance industry in Nigeria is expected to continue its moderate growth trajectory in 2022–3. Growth will be driven by top-down government support for the sector, asset growth by newly established Islamic banks, *ṣukūk* issuance by the federal government, and enabling regulations. The industry is, however, still nascent and the key to cementing its market share is to address long-standing constraints, including limited bottom-up public demand, the Islamic banks' small capital base, and the limited branch and digital banking network. Demand is also impeded by segments of the public strongly opposing the government's use of Islamic products.

Islamic Funds Outlook

Assets under management (AUM) in Islamic mutual funds have increased substantially, having peaked at around USD 130 billion at end-Q2'21 before slipping to around USD 120 billion at end-2021. Fitch Ratings estimates that the growth rate of Islamic funds (84% nominal/13% annualised) has exceeded that of the broader global mutual fund industry (68% nominal/11% annualised), based on the latest comparable data from Lipper and ICI Global for the five years to end-Q3'21.

Saudi Arabia, Malaysia Dominate Islamic AuM



4Q21 figures on USD terms | *Source*: Fitch Ratings. Lipper

Saudi Arabia and Malaysia remain the pre-eminent Islamic fund domiciles worldwide, reflecting strongly established local markets. Offshore markets, such as Jersey and Luxembourg, also have nascent Islamic fund markets relative to the conventional funds market. Jersey is an Islamic exchange-traded fund (ETF) hub, where multiple commodity ETFs (notably gold ETFs) claim *Sharī`ah* status. Luxembourg has a broader Islamic mutual fund base.

Luxembourg in Focus: We expect the Luxembourg Islamic mutual funds industry's (MFI) strong growth momentum will continue in the short to medium term, supported by the government's consistent promotion of Luxembourg as a Western hub for Islamic finance and as an international financial centre in general. The country's favourable regulatory, legal and tax framework supports the establishment, administration and cross-border distribution of Islamic funds and augments their growth.

Luxembourg is leading the European Islamic fund industry, with 30 *Sharī`ah*-compliant funds by end-Q3'21, composed of mainly mutual funds. In contrast, Ireland has 16 Islamic funds, consisting of both mutual funds and ETFs, and the UK has about five funds, mainly pension funds. The Islamic MFI in Luxembourg has grown by 122% over the past six years, with total AUM of USD 6.7 billion by end-Q3'21, making Luxembourg one of the top five countries in this segment globally.

Takāful Outlook

Takāful remains the smallest segment of the global Islamic finance industry, with its share of the total worth of the global IFSI reaching 0.8% in 2020 based on IFSB data. In a number of markets, *takāful* contributions and its domestic market share have been growing over the last few years.

Takāful and insurance in general are at different stages of development in various Islamic finance markets, and practices differ from one country to another. For example, in Saudi Arabia, insurance is provided by insurance companies operating in accordance with the principles of cooperative insurance, which states that the provisions of the-articles of incorporation should not be inconsistent with the provisions of the Islamic Shari'ah. But in the UAE, Malaysia and Pakistan, *takāful* is the dominant form of Islamic insurance. *Takāful* growth is mostly driven by regulatory push – for example, health and motor insurance in Saudi Arabia and the UAE.

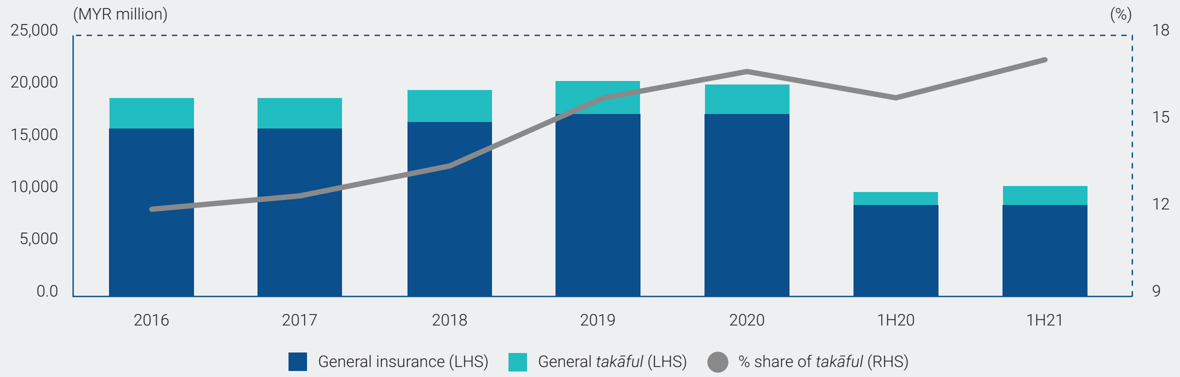
Takāful companies face a variety of challenges that vary from one country to another. Some of these challenges include *Sharī`ah* standardisation, developing regulatory and governance frameworks for *takāful*, lack of political will, confidence and awareness of Islamic finance in general and *takāful* specifically, and the availability of *retakāful* (Islamic reinsurance). *Takāful* companies also continue to - face competition from conventional insurance companies, many of which are more established.

This is in addition to the challenges that the insurance industry in general faces, which is in its early stages of development in most Organization of Islamic Cooperation (OIC) countries compared to developed markets.

Nevertheless, the *takāful* sector has potential to keep growing over the medium to long term driven by rising maturities of the insurance market in general and growing awareness of takaful, especially given its low penetration rate in many countries where Islamic finance is active.

Malaysia in Focus: Malaysia is the third-largest *takāful* market globally, according to the IFSB, with a vibrant Islamic finance ecosystem that includes Islamic banks, *Sharī`ah*-compliant corporates, Islamic fund managers and halal industries that seek takaful products. We expect the country's *takāful* industry to continue its sound growth in 2022 and to improve penetration rates, business models and technology capabilities amid higher takaful awareness, digitalisation innovation and government initiatives.

General Takaful vs Conventional Market Share



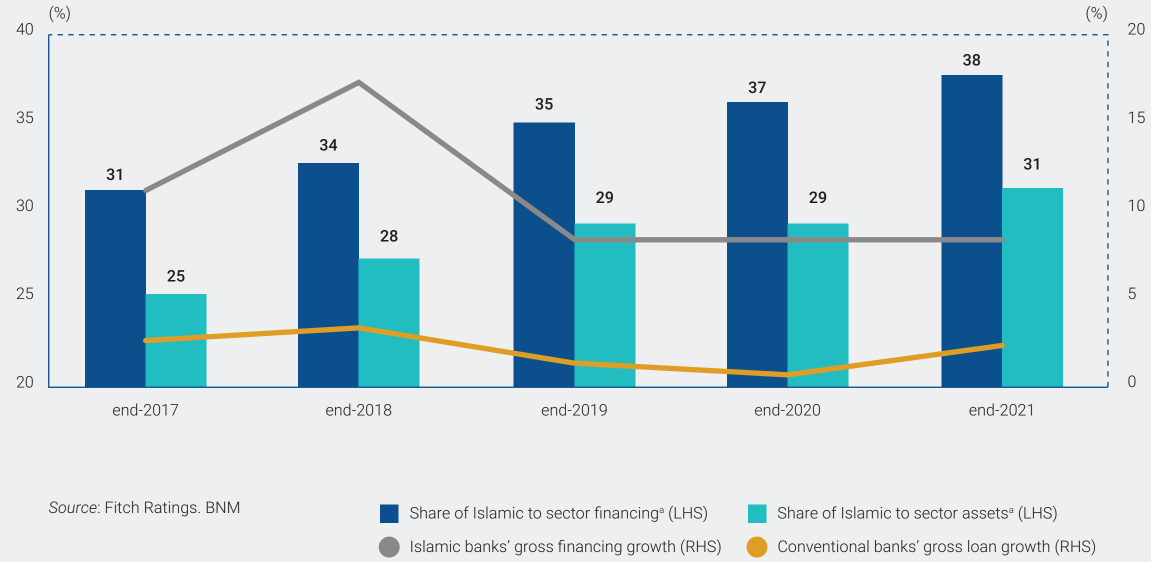
Note: based on gross direct premiums/contributions

Source: Fitch Ratings. BNM

The *takāful* industry's sound contribution growth has been led by family *takāful*, rising by 46.7% in H1'21 (2020: 7.08%). General *takāful* grew by 13.5% in H1'21 (2020: 4.61%). Family and general *takāful* outpaced life and non-life insurance growth of 23.9% and 3.5%, respectively. A boost in public awareness of *takāful* products, supportive government initiatives, the easing of COVID-19 movement restrictions and a recovering economy propelled the sharp growth in contributions. Market shares of general and family *takāful* were 17.3% and 41.9%, respectively.

Indonesia in Focus: Indonesia's *takāful* sector continues to expand, with market share at 9.0% of the country's overall insurance market in November 2021 (November 2020: 7%). The large rise in *Sharī`ah* insurance market share was caused by a 41% y-o-y increase in life *Sharī`ah* products. In contrast, conventional life insurance expanded by only 3%. The increase in the share of *Sharī`ah* insurance was propelled by growing awareness and demand for *takāful* products, government support for the Islamic finance industry, the easing of COVID-19 movement restrictions, and a recovering economy.

***Sharī`ah* Insurance Market Share**



Source: Fitch Ratings. BNM

We believe the long-term growth potential is positive, reflecting Indonesia having the largest Muslim population globally, government support, low insurance penetration (2020: 3.2%), growing awareness and an economic recovery. (Fitch forecasts real GDP growth of 6.8% in 2022.) We expect *takāful* operators to maintain sufficient capitalisation given business expansion through the economic recovery and the upcoming ASEAN Framework Agreement on Services, while also managing claims and strengthening *takāful* capacity amid the pandemic.

For further information on Fitch's Islamic finance ratings, visit fitchratings.com/site/islamicfinance

2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

2.1 Islamic Banking: Recovery Amid Uncertainty

This first section of the chapter assesses the soundness and resilience of Islamic banking for the period 4Q'20 to 4Q'21 across IFSB member jurisdictions.[72] In many cases, across many financial soundness indicators and jurisdictions, there were notable improvements; in some cases, levels that hadn't been seen since before the pandemic were recorded – a testament to the effectiveness of the various COVID-19 policy support measures introduced since 2020. While some of these measures have been either partially or completely withdrawn, the Islamic banking sector sustained its recovery momentum in 2021 due to economic reopening in many jurisdictions and the generally improving global economic condition.

Nonetheless, the resilience of the global Islamic sector needs to be viewed with a cautious optimism given the uneven economic recovery and heightened uncertainty. Notable tailwinds include increasing potential for a further resurgence in the pandemic amid uneven access to and distribution of COVID-19 vaccines, and the effect of any escalation in the military conflict between Russia and Ukraine. Other factors include rising inflation and further financial tightening and other prudential and structural peculiarities along both country and regional divides.

The following subsections present a global analysis, as well as region-by-region analyses, of the soundness of the Islamic banking industry across IFSB member jurisdictions. The analysis is based on various key indicators[73] from the IFSB PSIFIs database highlighted in Figure 2.1.1.

Figure 2.1.1 Key Indicators for the Assessment of Islamic Banking Resilience

Profitability	• Return on Assets • Return on Equity • Net Profit Margin • Cost-to-Income Ratio
Liquidity	• Financing to Deposit Ratio • Liquid Assets to Short-term Liabilities Ratio • Liquidity Coverage Ratio • Net Stable Funding Ratio
Funding Structure	• Foreign Currency Funding to Total Funding • Foreign Currency Financing to Total Financing
Financing Exposures	• Economic Sector Exposure of Financing
Asset Quality	• Non-Performing Financing • Non-Performing Financing Coverage
Capital Adequacy	• Capital Adequacy Ratio • Tier-1 Capital to Risk-Weighted Asset Ratio
Leverage	• Leverage Ratio

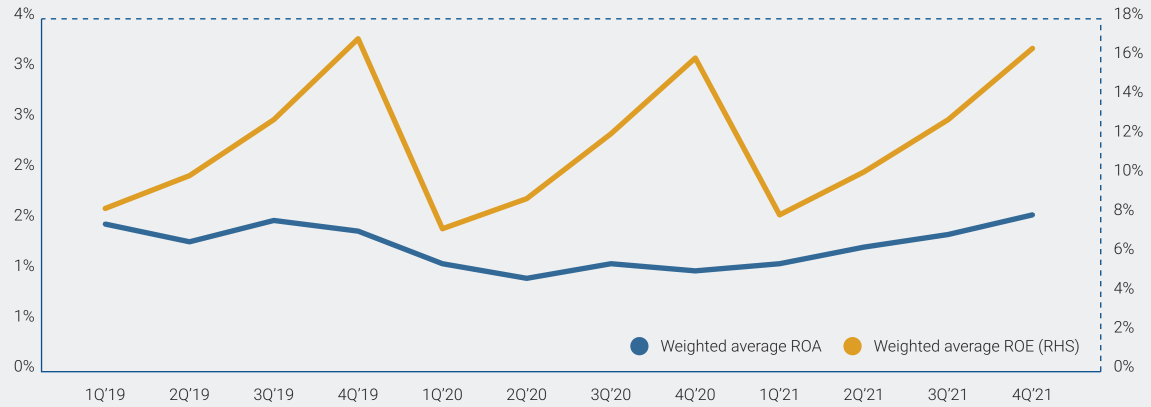
[72] Differences may be observed in the figures contained in this section and those reported in IFSI Stability Reports of previous years. Such differences arise from backdated inclusion of data from new jurisdictions in this year's report, as well as from revisions of previously reported data in PSIFIs by some jurisdictions.

[73] In a few instances, indicators data based on calculations by respective RSAs have been used where such are available and more current. Due to non-availability, some key jurisdictions are not included in the assessment.

2.1.1 Profitability

The profitability level of the global Islamic banking industry improved further in 4Q'21, surpassing its pre-pandemic level. This improvement was due to diverse reasons across jurisdictions, including normalisation of operating income, relatively low y-o-y provisions for credit losses, increasing demand for Islamic banking products, etc. Specifically, on average, the stand-alone Islamic banks[74] recorded a rate of 1.6% as at 4Q'21 (4Q'20: 1.5%) for return on assets (ROA) and 16.7% as at 4Q'21 (4Q'20: 13.9%) for return on equity (ROE) (Chart 2.1.1.1). Both the average ROA and ROE of global Islamic banking compare favourably with those of conventional banks[75] in the various IFSB jurisdictions, as well as with banks in the advanced economies. For instance, as at end-4Q'21, the ROA of banks in the United States remained flat at 1.1%, while ROE increased by 1.5pp to 11.0%.[76]

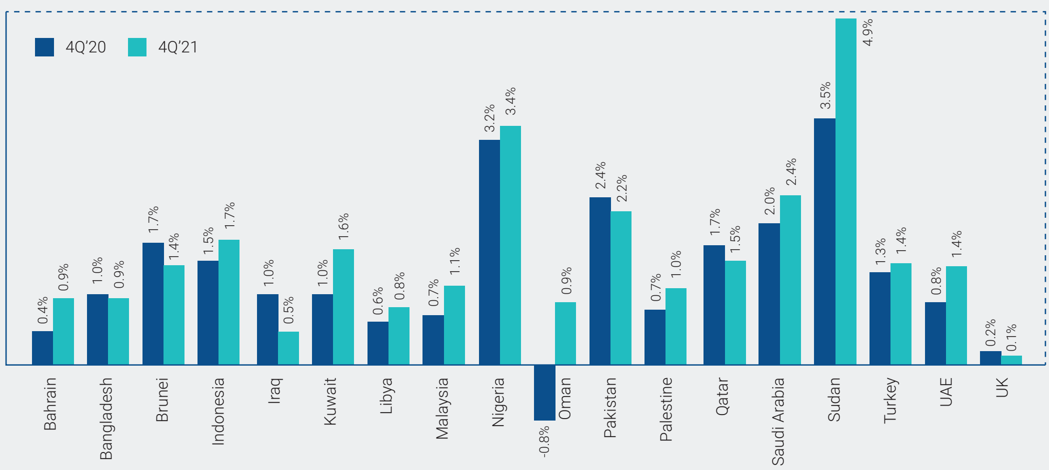
Chart 2.1.1.1 Global Islamic Banking Weighted Average ROA and ROE (1Q'19–4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

Four indicators were used to assess the aggregate profitability performance of the Islamic banks across jurisdictions. These include ROA and ROE for the full-fledged Islamic banks only, and net profit margin (NPM) and cost-to-income (CTI) ratios for the entire Islamic banking sector in the countries covered (see Charts 2.1.1.2 to 2.1.1.5).

Chart 2.1.1.2 Islamic Banking Average ROA for Stand-Alone Islamic Banks by Country (4Q'20 and 4Q'21)



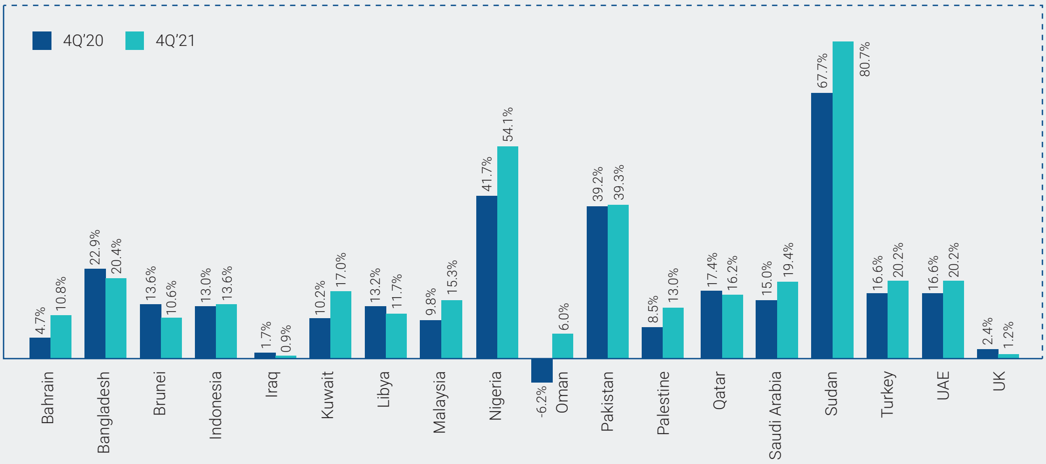
Source: PSIFIs.

[74] "Stand-alone Islamic banks" refers to full-fledged Islamic banks and Islamic subsidiaries of conventional banks but excludes Islamic windows of conventional banks.

[75] This comparison does not control for the likely effects of whether PSIAs are treated as on-balance-sheet or off-balance-sheet, nor for the effects of applying the IFSB alpha on the equity of Islamic banks on the required equity capital as the denominator in the computation of the ROE. For the sake of further clarity, in general, restricted profit-sharing investment accounts (RPSIA) are off-balance-sheet because they are not considered an element of the Islamic bank's financial position since the Islamic bank does not have an unconditional right to use or dispose of these funds. However, in accordance with new consolidation standards in International Financial Reporting Standard 10 (IFRS 10), RPSIA that are controlled by institutions offering Islamic financial services (IIFS) and which affect the income of the IIFS as a result of that control should be treated as on-balance-sheet.

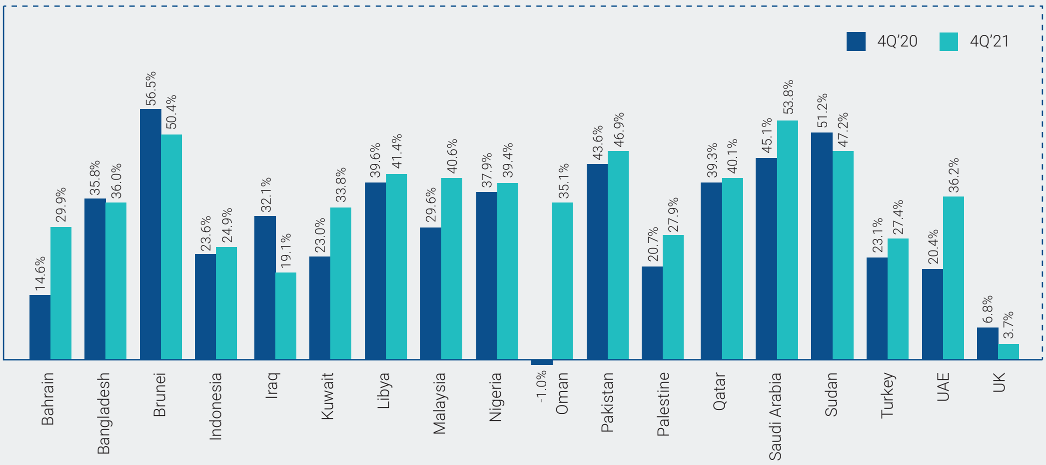
[76] https://www.bankregdata.com//allIEmet.asp?met=ROE&den=aa

Chart 2.1.1.3 Islamic Banking Average ROE for Stand-Alone Islamic Banks by Country (4Q'20 and 4Q'21)



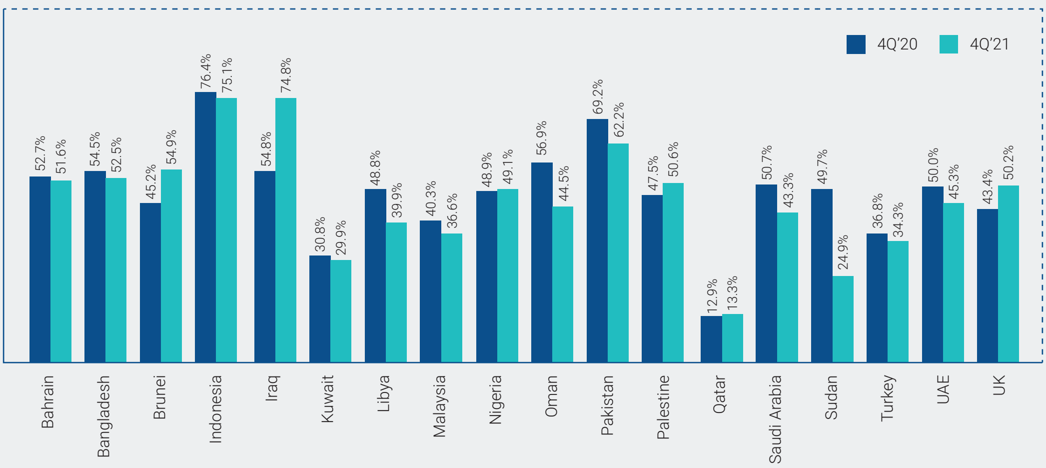
Source: PSIFIs.

Chart 2.1.1.4 Islamic Banking Net Profit Margin by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

Chart 2.1.1.5 Islamic Banking Cost-to-Income Ratio by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

The Gulf Cooperation Council (GCC) Islamic banks registered improved y-o-y earnings performance as at 4Q'21,[77] in most instances surpassing their pre-pandemic levels. This was due (among other reasons) to the growth in non-funded income and reduction in the cost of risk, provisioning and impairment losses as the general economic situation in the region improved due to reopening of economic activities amid increasing revenue from oil and the lower impact of inflation.

In contrast, the Islamic banking sector in the Middle East and South Asia (MESA) region faced profitability pressure arising from the effects of the pandemic, reduced earnings from remittances, and rising inflation and operational costs. Specifically, while the full-fledged Islamic banks in Pakistan saw a decline in terms of ROA, ROE and NPM, those of Afghanistan and Iraq registered worsening profitability based on all four indicators during the period under review. Both of these jurisdictions had fragile economies prior to the pandemic and have been faced with its effect along with political uncertainty, falling output, inflation and increasing poverty.

In the South-East Asia (SEA) region, Islamic banking's profitability performance improved in both Malaysia and Indonesia. This is despite the fact that provisioning increased in anticipation of increased post-forbearance credit defaults and weakened economic activity amid the imposition of nationwide containment measures to curb the resurgence of COVID-19. The improved earnings performance was due to the normalisation of income, increased revenue (especially on both financing and fee-based activities), and improved efficiency due to lower funding costs – a reflection of customers' increasing preference for liquid deposits. The only exception is the Bruneian Islamic banking sector, which registered a declining profitability performance due to increased operating cost as reflected in the CTI, thus subsuming the effect of increased revenue and reduced provisioning within the same period.

The profitability performance of the jurisdictions in the Africa region was mixed. The profitability performance was driven by reduced provisioning and a moderate growth in revenue, especially on financing, as economic activity gradually gathers momentum in Nigeria. In addition to an increase in provisioning, the political impasses in Sudan and Libya, along with the effects of the pandemic, also affected profitability performance.

In contrast to those of the Islamic banking in the United Kingdom, the participation banking sector in Turkey registered improved performance across all four profitability indicators. This performance was driven mainly by increased provisioning, increased funding costs, repricing of financing, modest growth in net operating income (especially fee-based), and the moderate course of deposit rates.

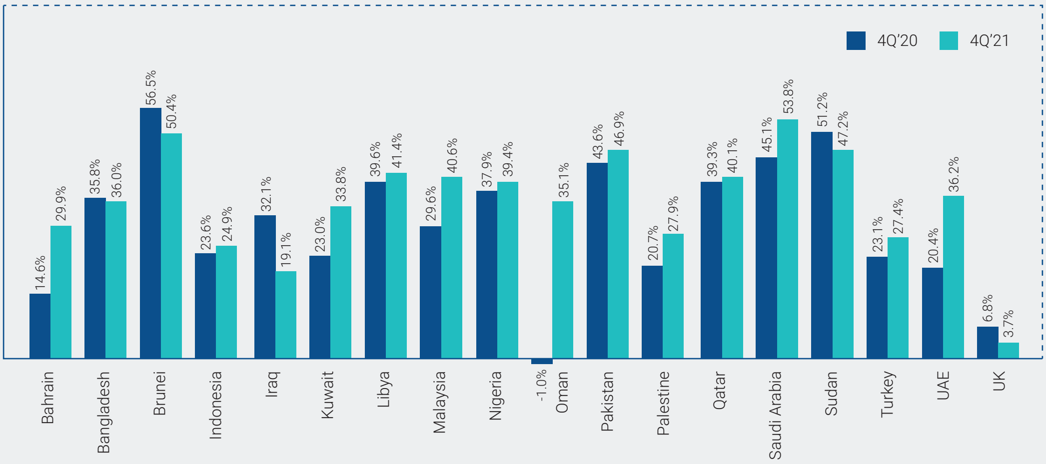
77 Except for the Islamic banking sector in Qatar in terms of ROA, ROE, and CI.

2.1.2 Liquidity

The liquidity position of the Islamic banking sector fluctuated but remained strong across various jurisdictions during the review period. In many cases, liquidity indicators improved y-o-y, satisfying regulatory thresholds, and in some instances were back to their pre-pandemic levels. This was due to the positive outcome of the various liquidity support measures adopted across jurisdictions to mitigate the effect of liquidity pressure due to the pandemic, reopening and recovery of the economy, increased public-sector deposits, and cash inflows from both households and businesses due to the gradual suspension of payment moratoria.

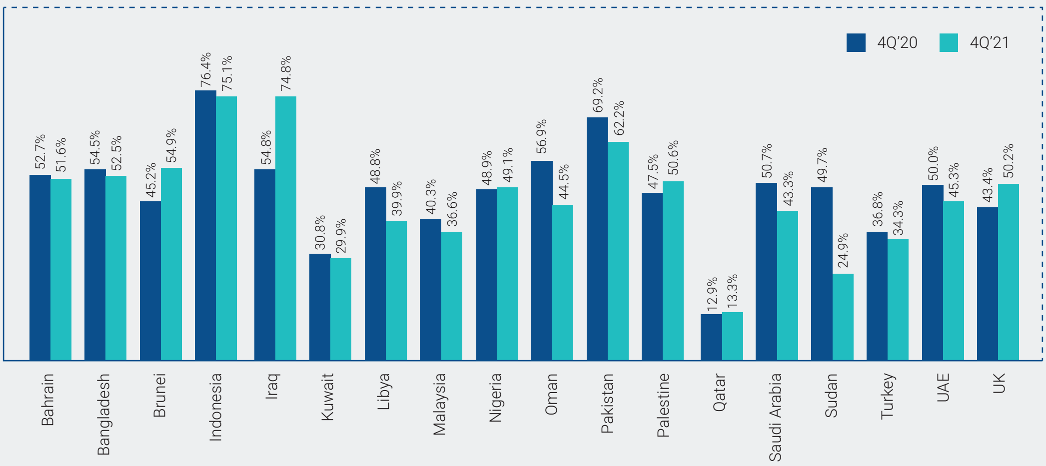
Some jurisdictions, especially those with a healthy pre-pandemic liquidity buffer, were also able to manage liquidity pressure arising from the reintroduction of lockdown measures due to another wave of COVID-19. In contrast, some other jurisdictions experienced tightened liquidity due to rising inflation and slow economic recovery amid low vaccination rates and an increasing rate of COVID-19 infections, political uncertainty and the lack of liquidity management instruments. Four indicators[78] were used to assess the aggregate liquidity performance of the Islamic banks across jurisdictions (see Charts 2.1.2.1 to 2.1.2.4).

Chart 2.1.2.1 Liquidity Coverage Ratio for Stand-Alone Islamic Banks by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

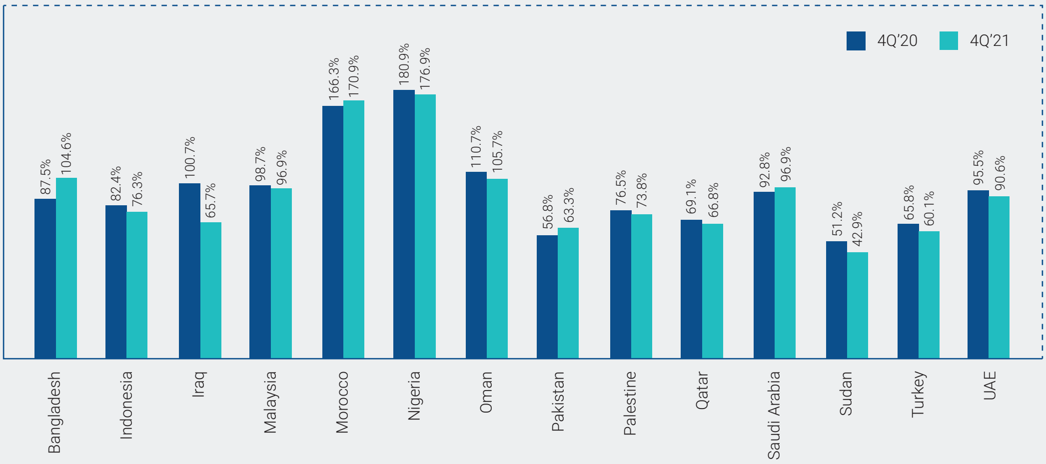
Chart 2.1.2.2 Net Stable Funding Ratio for Stand-Alone Islamic Banks by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

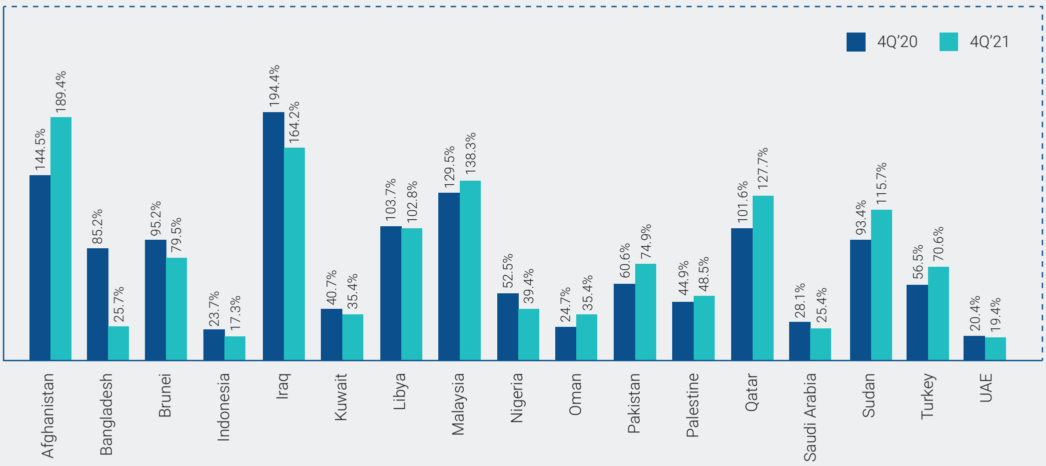
78 These include the liquidity coverage ratio (LCR), net stable funding ratio (NSFR), financing-to-deposit ratio (FDR), and liquid assets to short-term liabilities ratio (LASLR) for the entire Islamic banking sector.

Chart 2.1.2.3 Financing-to-Deposit Ratio by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

Chart 2.1.2.4 Liquid Assets to Short-Term Liabilities Ratio by Country (4Q'20 and 4Q'21)



Source: PSIFIs.

The GCC Region

In the GCC region, the liquidity position of the Islamic banks remained healthy in 2021. This was due to the stable funding from non-profit deposits, especially from the public sector amid increasing government revenue from rising oil prices, and a retail focus that reduced funding concentration. The reopening and recovery of economies across the countries in the region also boosted deposit growth.

Specifically, both the LCR and NSFR of the GCC countries[79] were above the 100% threshold. Some of these countries also have a high FDR, which, while indicating their active role in financial intermediation, may also suggest the susceptibility of their Islamic banking sectors to liquidity pressure in the event of unexpected contingencies. While Islamic banks in both Qatar and Oman registered a y-o-y increase in LASLR, those of Kuwait, Saudi Arabia and the UAE recorded a y-o-y decline. This may not necessarily be a reflection of the short-term structural funding gap experienced, as the ratio fluctuated during the period.

Overall, the liquidity position of the GCC Islamic banks is expected to remain stable on the back of healthy liquidity buffers and a sizeable high-quality liquid asset (HQLA) that can be easily deployed to meet short-term liquidity needs. The GCC Islamic banks also enjoy stable sovereign funding support amid an increase in oil revenues, further economic reopening globally, and the growth of the non-oil economy in the region. Moreover, in Oman, the initiative of the Central Bank of Oman (CBO) to create central bank *Sharī`ah*-compliant liquidity tools, including a lender-of-last-resort facility for Islamic banking entities, is expected to enhance liquidity management and the design of a *Sharī`ah*-compliant deposit insurance scheme to boost deposit growth. Also, in the UAE, the liquidity position of the Islamic banking sector will strengthen due to the extension of the Zero Cost Funding (ZCF) facility to June 2022.[80]

The SEA Region

In the SEA region countries, the Islamic banking sector's liquidity situation remained stable and supportive of their intermediation role. Although the FDRs for both Malaysia and Indonesia declined marginally y-o-y, they remained high during the period. The LASLR also declined in Brunei and Indonesia but increased in Malaysia. All banks in Malaysia were also reported to have met the threshold of 100% for the LCR and to have increased their holdings of HQLA.[81] Similarly, banks in Indonesia were reported to have registered LCR and NSFR results above the regulatory minimum, with Islamic banks well surpassing the 4.5% macroprudential liquidity buffer threshold in the country and investing their surplus funding in HQLA such as tradable government securities.[82]

Banks in the region remained highly funded by customer deposits, which increased due to the preference of businesses and households for liquid deposits and precautionary savings amid the economic uncertainty brought about by new waves of the COVID-19 pandemic. The Islamic banks also maintained a high liquidity buffer and have benefited from various liquidity support initiatives by the government to reduce liquidity pressure.

The liquidity outlook of the Islamic banks in the region is expected to remain resilient. This is hinged on an expected increase in deposits as a stable source of funding. Moreover, the economies in the region have been gradually reopening and recovering from the impact of the resurgence of the pandemic and repayment moratoria-

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79 Relevant data was only available for Kuwait, Oman and Saudi Arabia.

80 The TESS programme also allows banks to reduce NSFR to 90%, to increase the advances to stable resources ratio (ASRR) to 110%, and to treat the ZCF facility as a stable funding source.

81 Bank Negara Malaysia, *Financial Stability Review Second-Half 2021*. bnm.gov.my.

82 Bank Indonesia, *Financial Stability Review No. 37*, September 2021. https://www.bi.go.id/en/publikasi/kajian/Documents/Financial-Stability-Review-No.37-September-2021.pdf

are gradually being suspended. Also, the Islamic banks in the region rely less on an external deposit funding structure and, as such, are less susceptible to the effects of financial tightening of foreign currency and exchange rate volatility, especially due to the implications of the conflict in Ukraine.

RSAs in the region have also put in place measures to further strengthen Islamic banking liquidity. For instance, Bank Negara Malaysia's decision to lower the statutory reserve requirements (SRR) ratio by 100 basis points to 2%, as well as to permit principal dealers to use both Malaysia Government Securities (MGS) and Malaysia Government Investment Issues (MGII) of up to MYR 1 billion for the purpose of meeting SRR requirements, have been extended until 31 December 2022.[83] The planned implementation of stable funding requirements by the BNM was also phased in order to avert potential disruptions to lending activities.

Both Bank Indonesia (BI) and Otoritas Jasa Keuangan (OJK) are committed to providing support to the Islamic banks in Indonesia via a short-term liquidity assistance programme offered by the RSAs. This is in addition to quantitative easing via liquidity injection into the banking industry and other initiatives aimed at deepening the financial market. In Brunei, the liquidity position of the sector is expected to improve due to the I-Bills, which are also eligible as collateral under the Brunei Darussalam Central Bank (CBDC) *Sharī`ah*-compliant funding facilities.[84]

The MESA Region

In the MESA region, the liquidity position of the Islamic banking sector in Bangladesh, Pakistan and Palestine remained healthy, with both LCR and NSFR above the 100% threshold. In Pakistan, despite recording a decline in both LCR and NSFR, the Islamic banking sector in the country recorded improvement in FDR. The improvement was due to growth in deposits as both households and businesses reduced their spending and increased precautionary savings amid economic uncertainty. Moreover, the State Bank of Pakistan's initiative of providing an efficient banking service for Pakistanis in the diaspora via the Roshan Digital Account (RDA) has been very effective, attracting about USD 1.3 billion as at 2Q'21.[85] The effect of the SBP policy to reduce the liquidity reserve requirement is another factor contributing to the improved performance.

Both Bangladesh and Iraq registered slow growth in liquidity performance of their Islamic banking sector in 2021. In Bangladesh, this was due to (among other things) the decline in remittances (especially from the GCC) following the outbreak of the Delta variant of COVID-19 which necessitated travel restrictions for migrant workers in the GCC, Malaysia and Indonesia. In Iraq, the FDR declined the relatively low financing growth compared to deposit growth, which was facilitated by significant growth in the profit-sharing investment account. Unlike in other MESA jurisdictions, and due to the excess liquidity in the Islamic banking sector, the FDR of full-fledged Islamic banks in Afghanistan as at 4Q'21 is the lowest among the jurisdictions covered in this report.

The outlook for the liquidity position of the Islamic banking sector in the region is mixed. In Pakistan, Palestine and Bangladesh, the outlook seems favourable on the back of an excess liquidity buffer as reflected in both the LCR and NSFR figures. Moreover, in both Pakistan and Bangladesh, remittances inflow is expected to increase as the economic recovery in the GCC improves further due to rising oil revenue to fund huge infrastructural projects. The Islamic banks in both countries also have limited foreign currency exposure; as such, exchange rate volatility may not pose an immediate funding threat. Bangladesh Bank's (BB) recent issuance of sovereign investment *ṣukūk* on behalf of the government also provides a needed additional tool[86] for liquidity management by the country's Islamic banks.

[83] This policy has created a liquidity injection of about MYR 46 billion into the banking system.
[84] These facilities have a 14-day tenor and are issued weekly to licensed banks only at a zero-coupon based on the *ṣukūk wakālah bil ujrah* structure.
[85] State Bank of Pakistan, Mid-Year Performance Review of the Banking Sector. https://www.sbp.org.pk/publications/HPR/H1CY21.pdf
[86] Hitherto, the Islamic banks in Bangladesh could only participate in the Bangladesh Government Islamic Investment Bond (BGIIB) to meet a liquidity shortage by selling the securities via mudārabah short-notice deposit accounts at a provisional rate which is subject to adjustment after the finalisation of accounts and rate of profit of concerned Islamic banks. The Bangladesh government, on the other hand, could not borrow from the Islamic banks via the BGIIB due to the lack of *Sharī`ah*-compliant investment projects.

The challenging liquidity position of Afghanistan's Islamic banks may also persist. This is due to the pre-existing liquidity challenges in the Islamic banking sector in Afghanistan given the maturity mismatch between PSIAs and non-remunerative deposits – often on a short-term basis – as the main source of funding on the one hand, and the relatively long-term nature of financing on the other. The lack of money market instruments – and especially of sovereign *ṣukūk* – which can play an effective role in mopping up excess liquidity in the Islamic banking sector may aggravate the liquidity management problem in the period ahead. Other factors include a domestic political impasse, international economic and political sanctions despite a high reliance on external funding, the effect of tightening financial policies in developed economies amid low domestic economic recovery, and the impact of the conflict in Ukraine.

In Palestine, despite the improved liquidity performance, the limited intervention capability of the Palestine Monetary Authority in the absence of a national currency and comprehensive monetary policy tools will continue to challenge the ability of the Islamic banking sector to cope with the economic implications of the COVID-19 pandemic. Moreover, the irregular remittance of clearance revenues by the Israeli government to the Palestinian government, and the decision of the latter not to receive incomplete clearance funds from the former due to political disagreements on a number of issues, may continue to place a severe liquidity strain on the economy.

In Pakistan, the government's increased reliance on banks to finance its budget will provide more investment opportunities in government securities for Islamic banks as they manage their excess funding. The fact that Iraq is also an oil-dependent economy should, ideally, provide a favourable outlook, as oil revenue increases due to the conflict in Ukraine. However, the fact that there are currently no *Sharī`ah*-compliant liquidity instruments in its Islamic financial market that could be leveraged on in the event of a liquidity shock highlights the country's liquidity vulnerability.

Among the Africa region countries, the FDR for the NIB sector in Nigeria was among the highest in the report. The LASLR, on the other hand, declined as at 4Q'21. The high FDR perhaps reflects improvement in both deposit and *Sharī`ah*-compliant financing due to a gradual reopening and recovery of the economy. However, the NIB sector's liquidity management capacity was also impeded by the lack of *Sharī`ah*-compliant instruments, which puts it at a disadvantage compared to the country's conventional banks. Nonetheless, as the NIBs are mainly funded by retail deposits, the outlook is favourable as the economy reopens and recovers amid increasing oil revenue and a hugely untapped market. The NIB sector, being nascent, also has limited exposure to foreign currency liquidity shocks despite the high volatility that may result from a tightening financial condition due to the conflict in Ukraine and soaring global inflation.

In Sudan, the FDR registered a decline due to the negative growth of both deposits and financing in 2021 as a result of slow economic recovery, political instability and the strain of so many years of currency overvaluation. The high dependence of the Sudanese Islamic banking sector will also put further strain on its liquidity as global financial conditions tighten. The expected liquidity and investments from the entry of foreign banks and investors into the country's banking system based on the Central Bank of Sudan's announcement in early 2021 of the commencement of conventional banking in the country has been greeted with hesitation on account of the political impasse and economic uncertainty due to the pandemic.

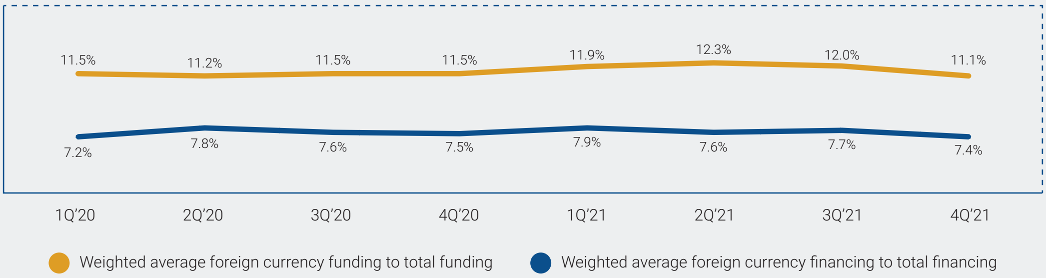
The “Others” Region

The Turkish participation banking sector registered a high and improving liquidity position. Both the LCR and LASLR recorded y-o-y improvements, although the FDR recorded a decline. The Turkish participation banking sector has strong liquidity buffers against possible liquidity shocks, and their balance sheet structures are sturdy enough to manage any interest and exchange rate risks. The increase in banks' total and foreign exchange (forex) liquid assets continues to support the liquidity outlook of the sector. Forex liquid assets of the banking sector have a high capacity to cover short-term forex foreign debts.

2.1.3 Foreign Funding and Financing Structure

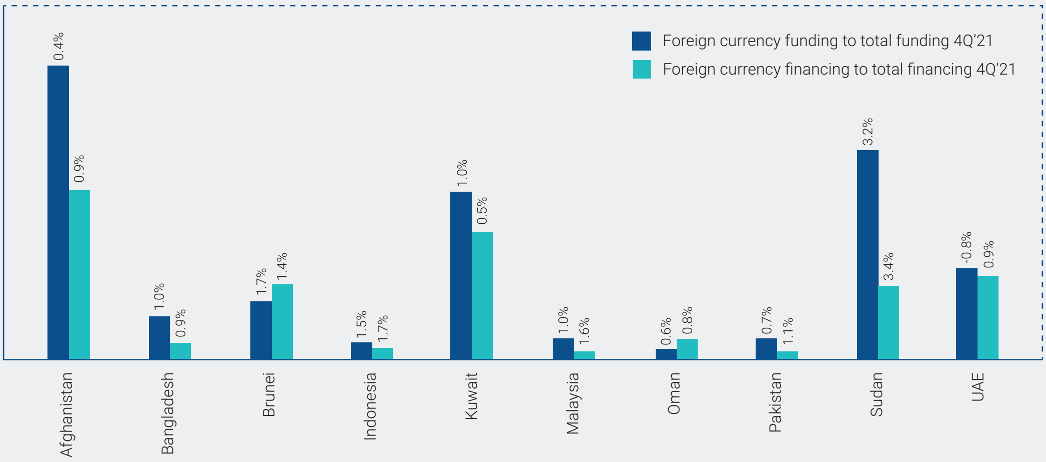
The proportion of both foreign currency funding and foreign currency financing vis-à-vis the total funding and total financing of the global Islamic banks, respectively, remained relatively unchanged during the period under review. The marginal difference observed between the foreign exchange funding and financing proportions in 4Q’20 has only marginally narrowed as at 4Q’21 (see Chart 2.1.3.1). This narrowing gap, albeit marginal, reflects the diverse net foreign exchange exposures across jurisdictions moderated by their state of economic recovery, exchange rate regimes, political stability, remittances incentives and digitalisation, and the effectiveness of the stabilisation measures to ensure capital inflows across jurisdictions. Chart 2.1.3.2 shows the proportion of foreign currency funding (financing) in total funding (financing) in the various jurisdictions indicated.

Chart 2.1.3.1 Global Islamic Banking Average Foreign Currency Funding and Financing as a Proportion of Total Funding and Financing (1Q’20 and 4Q’21)



Source: PSIFIs.

Chart 2.1.3.1 Global Islamic Banking Average Foreign Currency Funding and Financing as a Proportion of Total Funding and Financing (1Q’20 and 4Q’21)



Source: PSIFIs.

In the GCC region, the Islamic banking sector in both Kuwait and the UAE registered an increased proportion of foreign currency funding compared to foreign currency financing as at 4Q'21. The Omani Islamic banks have the lowest foreign exchange exposure in the GCC, and in contrast, a higher proportion of foreign currency funding compared to foreign currency financing. The net foreign exchange positions of the banks in the GCC are not expected to generate any significant foreign exchange risk given that the local currencies are pegged to the USD. Moreover, the central banks in the region ensure that unhedged foreign currency positions beyond a solvency- or liquidity-threatening threshold for any bank are subject to regulators' approval.

In the MESA region specifically, and generally for all the countries indicated, Afghanistan's Islamic banking sector registered the highest foreign currency funding and financing levels. This foreign exchange funding level reflects a forex position above the ±40% limits for overall forex position and the ±20% limits on individual currency position set by the Da Afghanistan Bank (DAB). It is important that the bank's foreign position is brought to within the regulatory limits, especially given the volatility of its currency, the Afghanistan Afghani, given the political instability and economic sanctions facing the country.

Bangladesh Islamic banks recorded a higher proportion of foreign currency funding's share of total banking sector funding. This was due to the increase in remittance inflows from the GCC and Europe as economic recovery in both regions improved. Moreover, there were also incentives to encourage wage earners to use formal channels of remittances to ease the effect of the diversion experienced in the early days of the pandemic when informal remittance channels proliferated.

Pakistan's Islamic banks, on the other hand, recorded a lower share of foreign currency financing of the total banking sector financing in the country. This was notwithstanding the SBP's streamlining of the procedure and simplifying the regulatory requirements involved in foreign exchange matters. For instance, the SBP launched the foreign exchange Regulatory Approval System (RAS) as a one-stop digital platform for both the banks and their customers to conduct their forex transactions in a seamless and efficient manner. The proportion of foreign currency funding of the Islamic banks, compared to total Islamic banking sector funding, remains one of the lowest among countries covered in the report. This was notwithstanding the increase in remittances inflow, especially from the GCC, on account of the economic recovery in the region and the initiatives by the SBP (e.g. exempting inflow remittances from withholding tax) and by the RDA to aid a hassle-free banking service for Pakistanis in the diaspora.

In the SEA region, the Islamic banking sector in Brunei registered the highest proportion of foreign exchange funding and financing in relation to the entire domestic banking industry in the country. The pegging of the local currency to the Singaporean dollar[87] has, nonetheless, kept foreign exchange risks manageable by leveraging on Singapore's deep and developed financial markets.

In both Indonesia and Malaysia, excessive forex volatility was mitigated via foreign exchange interventions and necessary adjustments to external shock through a foreign exchange net open position. In Indonesia, for instance, the foreign currency net position is expected to strengthen on the back of BI's stabilisation measures to ensure foreign capital inflows to provide foreign currency liquidity through reduced foreign currency reserve requirements, relaxing the threshold on spot transactions with an underlying worth increased from USD 25,000 to USD 100,000 per month to attenuate foreign currency liquidity pressure.

In Malaysia, the foreign exchange net open position is expected to be sustained given the reforms going on in the country's foreign exchange market – for instance, the exemption granted to exporters from converting forex proceeds below MYR 200,000 per transaction, and permission to extend hedging of foreign financing obligations from the previous maximum period of 12 months to the duration of the underlying tenure.

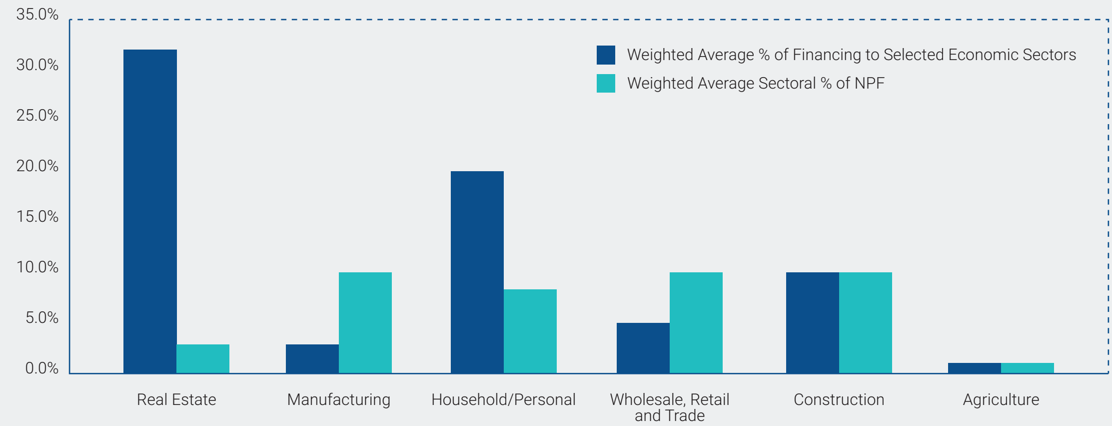
[87] The Currency Interchangeability Agreement (the Agreement) between Brunei Darussalam and Singapore was established in 1967 to promote monetary cooperation between the two countries.

Sudanese Islamic banks registered one of the highest y-o-y changes in foreign currency funding. Sudan, which moved to a market-determined exchange rate, has also been faced with political instability that grounded economic activities during the period. These high figures are worrying, as they could potentially stymie the intermediation role of Islamic banks in Sudan to fund economic growth. This is because mobilising foreign currency funding and financing may prove more difficult as global financial conditions tighten and foreign exchange flows may be directed to jurisdictions considered to be safe havens.

2.1.4 Financing Exposure

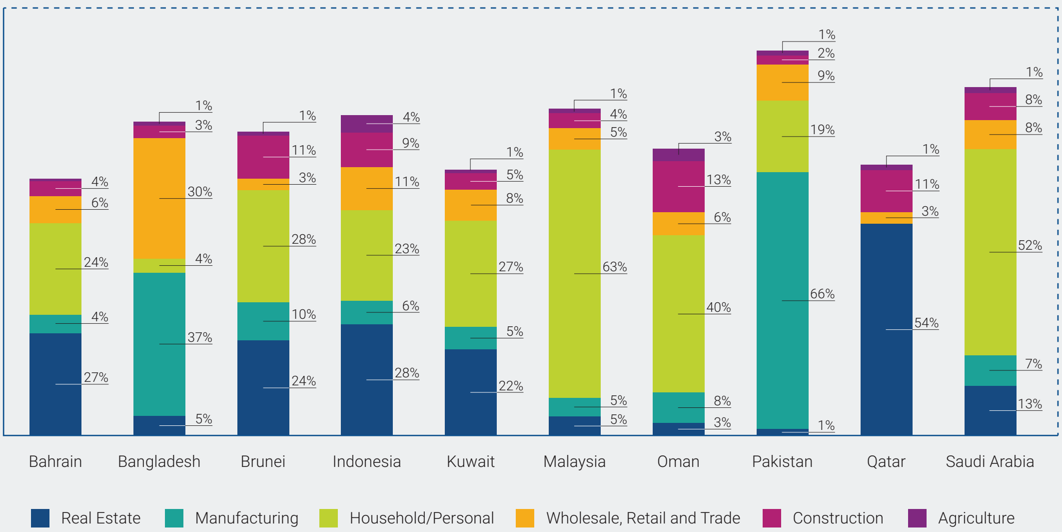
The pattern of the full-fledged Islamic banks' and Islamic banking windows' financing activities remained largely similar to that witnessed since 2018. Except for a slight switch in proportion, the financing exposure remained concentrated in the real estate, household, and wholesale and retail trade sectors, followed by the construction sector. (See Charts 2.1.4.1 and 2.1.4.2 for the sectoral composition of financing exposure by country.)

Chart 2.1.4.1 Weighted Average Percentage of Financing and Non-Performing Financing to Selected Economic Sectors (4Q'21)



Source: PSIFIs and IFSB Secretariat workings.
Note: Countries included: Bahrain, Bangladesh, Indonesia, Kuwait, Malaysia, Oman , Pakistan and Saudi Arabia.

Chart 2.1.4.2 Islamic Banking Sectoral Composition of Financing by Country (4Q'21)



Source: PSIFIs and IFSB Secretariat workings.
Values shown in chart 2.1.4.2 are rounded up to the nearest whole number.

In the GCC region, Islamic banking sector financing exposure remained concentrated mainly in the household and personal financing sector in Bahrain, Oman, Saudi Arabia and Kuwait. While financing exposure to the real estate sector remained one of the key sectors receiving financing in the other GCC countries covered, it is highest in Qatar (see Chart 2.1.4.2). The Qatar real estate market has since rebounded from the slowdown due to COVID-19. The recovery is expected to improve due to the reopening and recovery of the economy, supportive government legislation to protect the rights of residential building investors, expanding population due to an influx of expatriates attracted by job opportunities, and the positive effect of the hosting of the FIFA World Cup in 2022.

As at 4Q'21, the concentration of financing facilities by the Islamic banks in Bahrain to specific sectors continued the trend from the previous year, with real estate still the highest-financed sector (26.7%). This result was due to a relaxation of the financing-to-value ratio for new residential houses during the period as part of measures by the Central Bank of Bahrain (CBB) to support lending activities by the banks at the outbreak of the pandemic. Compared to Q3'20, financing to the real estate sector increased by 8.7% y-o-y. Financing to the household sector accounted for 23.9% (Q3'20: 16.8%), while the wholesale and retail trade and manufacturing sectors received a lower 3.7% (Q3'20: 11%) of total financing in the Bahraini Islamic banking sector. *Murābahah* remained the main financing instrument used by both the retail and wholesale Islamic banks in the country, at 51.0% and 65.3%, respectively. The retail Islamic banks also used *ijārah* for 28.6% of their financing during the period.

In Oman, 39.7% of the financing exposure of Islamic banks was to the household and personal financing sector (also called the retail sector) as at end-4Q'21. The main component is housing finance for individual use, which is less risky and collateralised by the underlying property. Although the real effect of the economic contraction on such borrowers will become discernible once forbearances are unwound, the CBO expects it to be within an acceptable range on the back of the favourable economic condition brought about by an oil price surge and economic reopening and the return of expatriates to the country. The construction sector accounted for the second-highest portion of *Sharī`ah*-compliant financing among Omani Islamic banks, at 13.2%, while the manufacturing sector accounted for 8.1%. Although financing to both the construction and manufacturing sectors declined, no significant vulnerability of the Omani Islamic banks to the sectors is envisaged. Both sectors are key to the country's economic transformation agenda, which is expected to gather steam due to increased oil revenue. The main Islamic financing instruments used by the Islamic banks in Oman during the period were diminishing *mushārakah* (49%), *ijārah* (24%) and *wakālah* (14%).

In Saudi Arabia, the household and personal financing sector accounted for 52.2% of *Sharī`ah*-compliant financing as at end-4Q'21, representing a 6.7% y-o-y increase. A rapidly expanding demand for mortgage financing by households as per the government's "Vision 2030" project is expected to further attract financing to this sector in the years ahead. The real estate sector, as expected, also accounted for an increased 13.1% of total financing as economic activity picked up due both to supportive government initiatives to increase home ownership and to the benefits from the introduction of the real estate transaction tax (RETT)[88] introduced in the kingdom. While the manufacturing sector accounted for 7.3% of total financing, the wholesale and trade financing and construction sectors accounted for 7.5% each. Both sectors are also expected to build momentum as the economy further reopens and in line with the sustainability of and diversification to a non-carbon economy. The main financing instruments used by the full-fledged Islamic banks in Saudi Arabia were *murābahah* (69%), *tawwaruq* (19%) and *ijārah* (11%). The Saudi Islamic banking windows, on the other hand, used *tawarruq* for 59% of their financing, 27% via *murābahah* and 11% through *ijārah*.

[88] The RETT, which is intended to give a boost to the real estate sector, is fixed at 5% of real estate transactions and applies to all such transactions in lieu of the value added tax. The government gave a commitment to pay the RETT on behalf of Saudi nationals who are buying their first home worth up to SAR 1 million.

In Kuwait, the household and personal financing sector accounted for a 27.4% share of the financing exposure of Islamic banking in the country as at 4Q'21. This was due to increasing consumption and travel as the economy reopens and recovers from the pandemic. Moreover, a large proportion of the workforce is employed in the public sector, whereby job security and a stable household income helped to prevent default, thus creating lower perceived risk of the sector. Also noteworthy is the effect of the extension of payment moratoria to those affected by the pandemic and of the passage of the loan guarantee law in the country in 2021. The real estate sector accounted for a 22.2% share, as it benefited most from the financing extended to the corporate sector. Moreover, it recovered from a decline in terms of the number of residential and commercial apartments sold due to the pandemic as a result of generational shift and increasing disposable income. The wholesale and retail trade financing sector accounted for 8.1% of the financing exposure of the Islamic banks in the country and improved marginally during the period due to the risk perception, notwithstanding the passage of the loan guarantee law in the country.

In the SEA region countries, financing exposure was mainly to both the household and real estate sectors in 2021. Specifically, the financing exposure of the Islamic banking sector in Brunei as at 4Q'21 was 28.3% to the household sector and 24.4% to the real estate sector. The pick-up in the real estate sector was due to the increase in housing purchases and structural home improvements observed since 2019, and which has since further improved due to the full economic reopening since Q2'20, given that Brunei has recorded only a few imported cases of COVID-19 since then. Other sectors to which the Islamic banking sector in Brunei has a notable exposure include construction (11.1%) and manufacturing (9.6%).

Financing provided to the real estate sector dominated the Indonesian Islamic banking sector as at 4Q'21. Specifically, 28.5% of the total *Sharī`ah*-compliant financing was advanced to this sector. The distribution could be explained by BI's campaign that urged the country's banks to continue to lower their financing rates in order to help stimulate economic activity. Moreover, financing-to-value on housing financing was increased to 100% on both residential and business properties. The sector also benefited from the eased restrictions on the operation of malls prior to the resurgence of the Delta COVID variant in Q3'21, which had a temporary effect on the improvement in real estate rentals and financing repayments for that property segment experienced since Q2'20. The household sector also received a share of 22.7% as at 4Q'21, an increase of 12.9% y-o-y which was due to the relaxation of down-payment requirements on automotive financing from March to December 2021. The wholesale and trade financing sector also attracted a 10.9% share as at end-4Q'21 on account of the effect of the government's placement of funds in selected commercial banks to increase financing to the SMEs and other labour-intensive firms affected by the pandemic.

The household sector remains that to which the Islamic banks in Malaysia have the most financing exposure as at end-4Q'21. Specifically, 63.2% of the Islamic banks' financing was extended to the household sector. This was due to the increase in personal financing on account of the automatic financing repayment moratorium, and to increased auto and mortgage financing. For instance, sales and service tax incentives were granted for auto purchases from 15 June 2020 until 30 June 2021. Although the complementary effects of the repayment assistance facility on the debt-servicing capacity of borrowers cannot be discountenanced, the fact that households' financial asset growth is higher than that of debt also indicated that their repayment capacity had been influenced by other means. Up until Q3'21, the commencement of a COVID vaccination campaign and the low number of cases of new infections recorded led to the relaxation of the movement control order. Consequently, improvements were recorded in the manufacturing and wholesale and retail trade sectors, which jointly accounted for 10% of the financing exposure of Islamic banks in Malaysia, while exposure to the construction and real estate sectors as at end-3Q'21 stood at 4.6% and 4.4%, respectively. The front-loaded provisions and the financial stability of the Islamic banks ensured that continuous financing was provided to both households and businesses during the resurgence of the Delta variant in Q3'21.

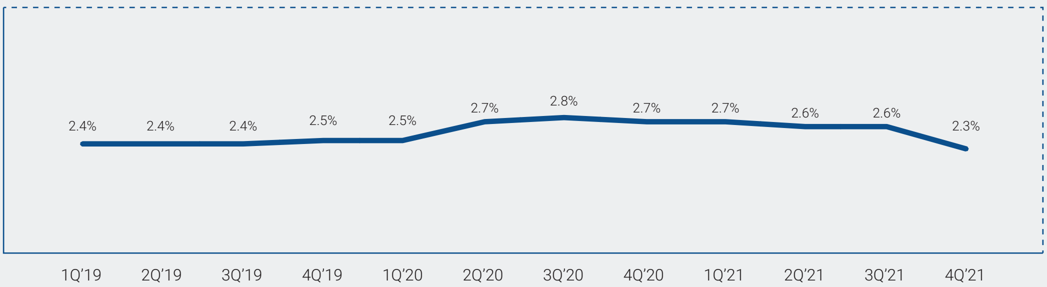
**In the MESA region, especially among the Islamic banks in Bangladesh and the full-fledged Islamic banks in Pakistan, the manufacturing sector accounted for the largest share of *Sharī`ah*-compliant financing**. Specifically in Bangladesh, the manufacturing sector accounted for 36.8% of *Sharī`ah*-compliant financing as at 4Q'21. This was due to the prominence of the sector for the country's economic development on the back of competitive labour costs, large quantity of garment exports, and expansion into the leather, automobile and pharmaceutical industries. The wholesale and retail trade sector accounted for 30.4% of total *Sharī`ah*-compliant financing as at end-4Q'20 amid economic reopening and recovery. The most-used Islamic financing instruments during the period were *murābahah* (45.1%) and *bai-muajjal* (23.5%).

**A similar pattern is observed in Pakistan, where the largest share of the *Sharī`ah*-compliant financing of the Islamic banks was to the manufacturing sector, at 66.5% as at 4Q'21**. The household sector accounted for 18.6% of *Sharī`ah*-compliant financing, while the wholesale and retail trade sector also recorded a marginal improvement to end-4Q'21, with a share of financing of 8.9%. These sectors were very central to the economic recovery measures of the SBP. In fact, as part of its policy responses to COVID-19, an Islamic Temporary Economic Refinance Facility scheme was launched in March 2020 to provide concessionary *Sharī`ah*-compliant financing to stimulate investment in manufacturing activities with the exception of the power sector. Diminishing *mushārakah* was the most-used financing instrument and accounted for 30.8%, while *mushārakah* and *murābahah* accounted for 22.2% and 9.1%, respectively.

2.1.5 Asset Quality

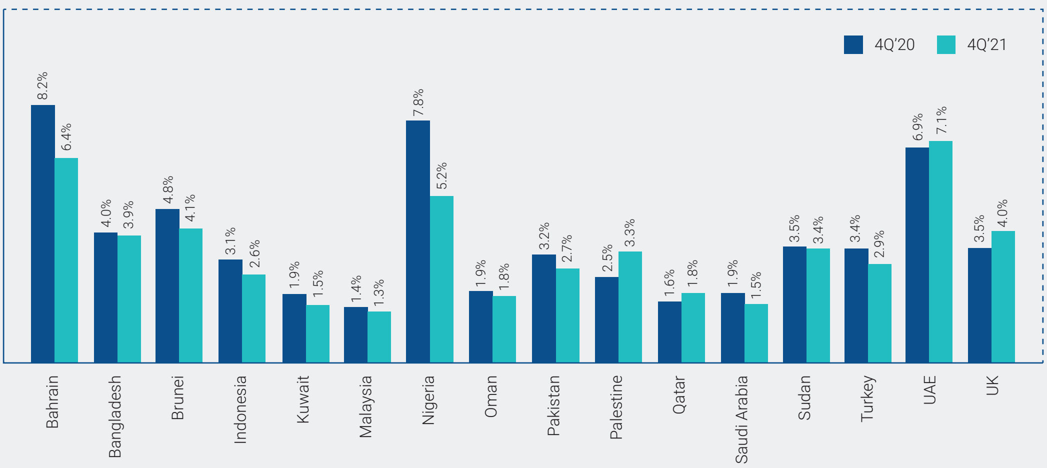
Due to the various forbearance measures put in place across jurisdictions, the asset quality of Islamic banks and windows measured by the average non-performing financing (NPF) ratio remained somewhat flat for most of the period from Q2'20 to Q2'21 (see Chart 2.1.5.1). However, this should be viewed with caution as implying a true reflection of the cost of risk, as the NPF marginally improved to 1.9% in 4Q'21. As highlighted in later sections of this report for each country, declining or stable NPF may also portend hidden vulnerability to asset quality issues. These issues may only start to manifest as forbearance measures are suspended and could morph into structural legacy problems that could both infringe the resilience of the global Islamic financial system and stymie the speed of economic recovery across jurisdictions, especially those where Islamic banking is systemically important.
The sectoral composition of both financing and NPF varied greatly between countries and regions, and the weighted average may not reflect a balanced view of global economic sector exposures for Islamic banking across different jurisdictions. Such specific exposures are shown on a country-by-country basis in Chart 2.1.5.2.

Chart 2.1.5.1 Global Islamic Banking Average Gross Non-Performing Financing to Total Financing (1Q'19–4Q'21)[89]



Source: IFSB Secretariat workings based on PSIFIs..

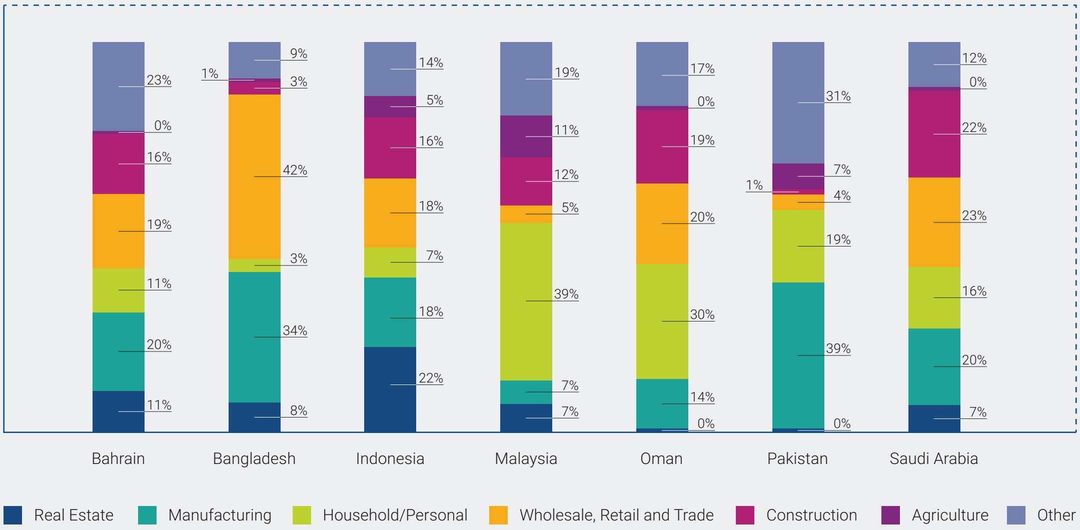
Chart 2.1.5.2 Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (4Q'20–4Q'21)



Source: PSIFIs.

[89] Average non-performing financing to total financing calculation is based on data from jurisdictions contributing to the IFSB's PSIFIs database (excluding Afghanistan, Egypt, Iran, Iraq, Jordan, Kazakhstan, Lebanon and Libya) due to data limitations.

Chart 2.1.5.3 Sectoral Composition of NPF of Islamic Banking by Country (4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.
Values shown in chart 2.1.5.3 are rounded up to the nearest whole number.

In Bahrain, the asset quality of the Islamic banks sustained its improvement recorded since 4Q'20 through 4Q'21 with the non-performing financing ratio[90] declining to reach 6.4%, as at end-4Q'21. The improvement in asset quality was a result of improved economic conditions amid increasing oil price revenue and the country's reopening of its economy. Bahrain's real estate and household sectors jointly accounted for 22% of NPFs, while the wholesale and retail trade and manufacturing sectors accounted for 19% and 20%, respectively, of the total NPF of the Bahraini Islamic banks. The stress testing conducted by the CBB to assess the likely effect of the deferral scheme in Bahrain reveals that the impairment in deferred financing will start to accumulate a month after the forbearance measure is withdrawn.

The asset quality of the Omani Islamic banking sector continued its gradual improvement streak, seen since Q3'20. Although commencing from a relatively low base compared to other GCC countries such as Bahrain and the UAE, Oman's NPF decreased every quarter up to 4Q'21 to reach 1.81% (Q3'20: 1.93%). The provision for NPF has also seen a significant increase during the period. The real estate sector accounted for the largest share of the NPF at 23%. Furthermore, as in other countries in the Middle East and the GCC region, most non-contact-intensive sectors such as manufacturing, construction, and wholesale and retail trade, which accounted for up to one-fifth of total Islamic banking NPF in Oman, have rebounded back to their pre-pandemic levels.[91]

Considering the relatively low NPF despite the implementation of IFRS 9, the Omani Islamic banking sector's asset quality is expected to remain strong. It is anticipated that as economic conditions improve further, the NPF of the Islamic banks, despite being low, will reduce further, especially given that the policy responses of the CBO have provided significant support for the households amid adequate provisions frontloaded by the banks. The results of the stress test conducted by the CBO indicate that even during adverse scenarios, and a resulting increase in NPFs, the required regulatory capital of the banks in the country will still be higher than the threshold.

Although commencing from a low base, the NPF of Saudi Arabia's Islamic banking sector has been fluctuating since 3Q'20 to reach 1.5% as at end-4Q'21. The relatively lower NPF was due to the Islamic banks' retail focus and increased provisioning. The forbearance measures have also been very effective at keeping the NPF within a manageable range. Based on sectoral distribution, the construction sector and the wholesale and retail trade-

[90] The computation of the NPF is based on Islamic banking operations and relates to assets that are booked within Bahrain. As such, the NPF of overseas subsidiaries and branches of Bahrain Islamic banks is not considered.

[91] International Monetary Fund (2021), Regional Economic Outlook Update. Middle East and Central Asia. https://www.imf.org/en/News/Articles/2021/04/27/na042821-4-questions-about-debt-and-financing-risks-from-covid-19-in-mena

sector accounted for 22% and 23% of the Saudi Islamic banks' NPF, respectively. Other sectors, in order of proportion of NPF, are the manufacturing sector at 20% and the household sector at 16%. These sectors are highly linked to the pandemic-induced prevailing economic conditions, which have been improving on the back of economic reopening and recovery, increasing oil revenue and the activities relating to "Vision 2030".

The NPF of the UAE's Islamic banking sector deteriorated throughout the period under review, albeit at a declining rate, to reach an NPF of 7.1% in 4Q'21. Provisioning also declined during the period. Perhaps the positive effect of the economic reopening and rising global oil prices is yet to reflect on the key sectors accounting for the largest chunk of the NPF. For instance, the UAE Islamic banking sector's exposure to the real estate sector was weakened by oversupply and by a fall in demand due to challenging economic conditions, lockdowns and the increasing shift to virtual workspaces at the outbreak of the pandemic. Nonetheless, the asset quality outlook is expected to improve due to front-loaded provisions for NPF which, despite remaining flat y-o-y, also provided adequate coverage for the credit risk. Moreover, it is expected that the impact of economic recovery activities, including the waiver of lockdowns, the resumption of economic activity, and other prudential measures put in place in the country under the TESS programme, would yield a positive effect moving forward.

Brunei's Islamic banking sector's NPF declined throughout the period under review. Specifically, the NPF declined up to 4Q'21 to end at 4.1% (4Q'20: 4.8%). Although the largest share of financing is to the household sector, the NPF remained lower. Based on the provision for NPF, which recorded continuous improvement for most of the period, the asset quality outlook seems favourable. The downstream sector has also witnessed gradual improvements and Brunei has reopened its economy since Q2'20. Both factors, in addition to the monetary policy measures put in place by the Brunei Darussalam Central Bank (BDCB), are important to the favourable outlook for the asset quality of the country's Islamic banks.

The asset quality of the Indonesian Islamic banking sector remained stable due to the regulators' relaxation of the policy on bank financing restructuring and repayment deferral. Specifically, the NPF increased up to 2Q'21 before declining up to 4Q'21 to end the period at 2.6%, which is less than its pre-pandemic level. Based on sectoral composition, 22% of the NPF of Indonesia's Islamic banking is to the real estate sector. Other sectors with relatively high NPFs are construction, manufacturing, and wholesale and retail trade. These sectors have been directly affected by the COVID-19–induced economic contraction. The increased loan provisioning puts the Islamic banking sector in a better position to weather the storm in the event of asset deterioration once the regulatory forbearances are suspended. Moreover, the partially relaxed financing classification that allows banks in the country not to immediately reclassify restructured financing as substandard has seen the NPF ratios continue to decline during the period.

The asset quality outlook, very much like that of the entire banking system in Indonesia, depends on how quickly the economic situation and (by extension) credit conditions improve. The soundness of the current asset quality position of the Islamic banking sector, which as at 4Q'21 remained within desirable policy levels, will also be tested by the extent of non-provisioned losses in the sector when policy relaxation is ended in March 2022.

The asset quality of the Islamic banking sector in Malaysia remains healthy. Although commencing from a low base of 1.4% in 4Q'20, Malaysia's NPF ratio fluctuated and declined marginally to 1.3% as at end-4Q'21. The resurgence of the pandemic in Q3'21, which necessitated reintroduction of various restriction measures, affected both businesses and households. Nonetheless, provisions by Islamic banks increased over the period due to (among other factors) the approximately 40% overlay by banks in excess of the provisions based on the expected credit losses (ECL) model. This was necessary against future credit losses to ensure continued resilience against a potential rise in impairments given the increasing uncertainty surrounding the recovery phase of the pandemic amid a resurgence when repayment assistances measures are gradually being suspended. The targeted repayment assistance measures extended to both households and SMEs to manage cash-flow issues have been very effective in ensuring that the impairments from the household sector to which the Islamic banks have 65% exposure do not increase post the automatic blanket moratorium.

The BNM takes note that credit risk is still an issue, as the proportion of Stage 2[92] household financing for the entire banking industry increased by 2.4 pp to 9.7% between 2H'20 and 2H'21. However, the Islamic banks, like their conventional counterparts, will be faced with the challenge of incorporating forward-looking information into the measurement of ECL given factors such as uncertainty, relief measures and general economic recovery, and the absence of the requisite recent repayment data needed for assessment.

Notwithstanding the expected challenging situation, Malaysia's Islamic banks remain resilient against credit risks. The vaccine campaign in Malaysia has been very helpful in relaxing restrictions and improving the business environment, with positive implications for quickening business recovery and repayment capabilities. Moreover, the fact that the banks have front-loaded and continue to adjust their provisioning and have enhanced their credit monitoring practices and staging classifications, etc. implies that adequate measures are being put in place to mitigate any potential elevated credit risks during the recovery phase of the pandemic.

The average NPF ratio for Bangladeshi Islamic banking declined slightly throughout the review period to end 4Q'21 at 3.9%. The largest share of the NPFs was accounted for by the wholesale and retail trade sector, which accounted for 42%. This was followed by the manufacturing sector, with 34%. The slight improvement in asset quality can be linked to the policy measures by the Bangladeshi Bank, especially those relating to the moratorium facility provided to borrowers on financing, and increased provisioning during the period. The BB had already noted an increase in required provisioning – a provision maintenance ratio of 91% in the banking sector. Notwithstanding the effectiveness of the various supporting measures put in place by the BB to reduce the impact of the pandemic on borrowers, there is a possibility of hidden vulnerability, as poor assets are expected to start manifesting as forbearance measures are gradually lifted.

The Islamic banking sector in Pakistan recorded improved asset quality in 2021. The NPF decreased over the period under review to end 4Q'21 at 2.7%. Provisioning also increased during the period. The sectoral NPF also reflected sectoral financing, as the manufacturing sector accounted for the largest share of the NPF at 66%. Other sectors with a lower but notable share of the NPF are the household sector (19%), and wholesale and retail trade (4%). The SBP granted permission as well as regulatory relaxation to the banks to consider the deferment, rescheduling or restructuring of financing upon request by borrowers.[93] For the principal financing amount, restructuring was allowed until March 2021 and this and other measures have proven effective in sustaining the favourable asset quality outlook of the Islamic banks in Pakistan.

Palestinian Islamic banks registered deteriorating asset quality performance during the period under review. The NPF of the sector deteriorated to 3.3% in 4Q'21. The provisions for NPF have also been on a steady decline during the period under review. The various support measures introduced by the Palestine Monetary Authority, such as allowing borrowers the possibility of postponing the payment of their obligations with multiple options (e.g. overdraft, restructuring, rescheduling, a temporary *tawarruq* ceiling for Islamic banks), have (at least in the interim) helped to keep asset quality deterioration at a manageable level.

The NIB sector in Nigeria recorded asset quality improvement to reach 5.2% in 4Q'21. This NPF was, however, higher than the 5.0% threshold set by the CBN. This was due to the Central Bank of Nigeria regulatory forbearances, which allowed banks to temporarily restructure or reschedule financing to those businesses and households that were most affected by the COVID-19 pandemic. Against a declining provisioning over the four quarters under review, the NPF of the NIBs requires monitoring.

The participation banks in Turkey registered improved asset quality performance throughout the period under review. The sector recorded a reduction in NPF to reach 2.9% as at end-4Q'21, while provisioning increased from 79.5% to 85.0% during the same period. The improved performance in NPFs of the Turkish participation banks-

92 For an explanation of the various stages of recognising ECL, see: https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-in-depth-expected-credit-losses.pdf

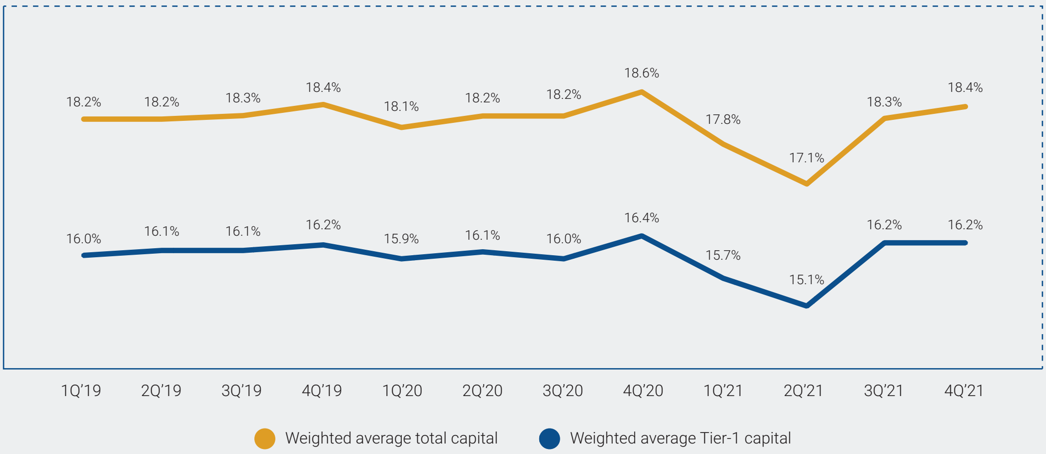
93 State-Bank (sbp.org.pk)

could be explained by the decision of the Banking Regulation and Supervision Agency (BRSA) to extend the period of Stage 2 and NPL classification flexibility that was in effect until 3Q'21, along with debt restructuring and instalment deferral practices. Moreover, the CBRT's gradual tightening of monetary policy and the reduction in the maturity of consumer loans since 3Q'20 helped to reduce financing growth and, by extension, the NPFs. Even when these measures were being gradually suspended in 3Q'21,[94] increased provisioning, a strong increase in credit volume and the rapid recovery in economic activity are expected to provide the requisite boost to keep the NPF within manageable limits.[95]

2.1.6 Capital Adequacy

The capital structure of the Islamic banking industry remained stable and strong in the current reporting period. The average total and average Tier-1 capital adequacy ratios (CARs) of the global Islamic banking industry as at end-4Q'21 were 18.2% and 16.2%, respectively (see Chart 2.1.6.1).

Chart 2.1.6.1 Global Islamic Banking Average Capital Adequacy Ratios (1Q'19–4Q'21)



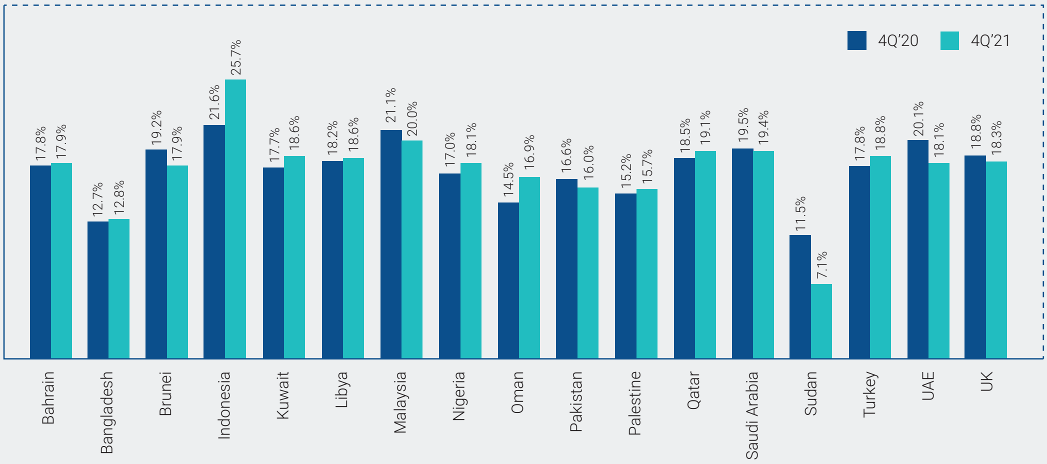
Source: PSIFIs.

The Islamic banking industry across many jurisdictions entered the pandemic-induced crises with stable CARs and Tier-1 capital to risk-weighted assets (RWA) ratios that were also well above the IFSB's and respective jurisdictions' regulatory thresholds. There are a couple of countries, however, where both of these regulatory capital ratios show worryingly low levels on average, implying almost certainly that some Islamic banks in those jurisdictions have significantly lower figures. Perhaps some of these Islamic banks may be hovering on the brink of failure, with possible knock-on effects to other banks. The various policy measures put in place across jurisdictions have also helped to ensure that the regulatory capital ratios do not decline below the regulatory minimum on account of the outbreak of the COVID-19 pandemic. Country-by-country representations of the CAR and Tier-1 capital ratios are shown in Charts 2.1.6.2 and 2.1.6.3, respectively.

[94] For instance, the suspension of the 90-day overdue period for loans to be classified as NPLs (now 180 days) and of the 30-day overdue period for loans to be classified as loans under close monitoring (now 90 days).

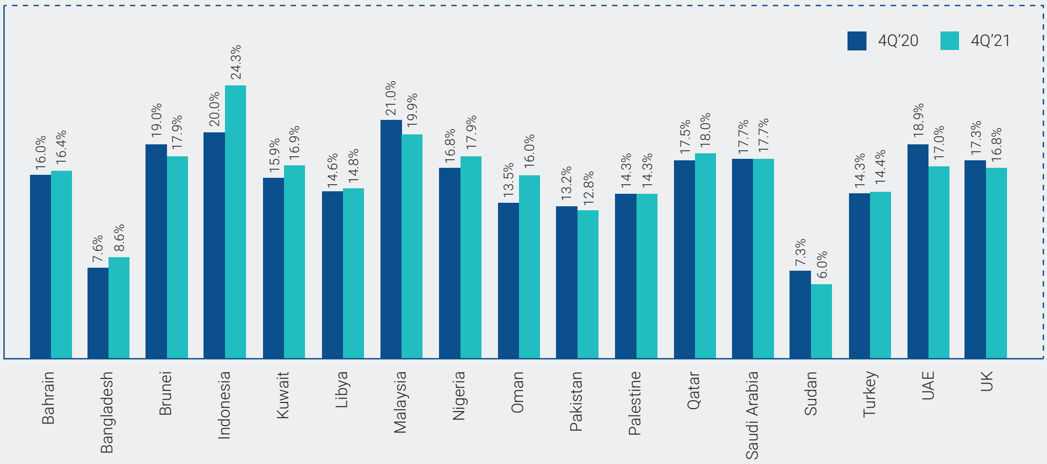
[95] In March 2020, the BRSA increased the payment deferral period for NPFs from 90 days to 180 days until 31 December 2020. The period for the delayed payment of Stage 2 loans was also increased, from 30 days to 90 days.

Chart 2.1.6.2 Islamic Banking Average Total Capital Adequacy Ratio for Stand-Alone Islamic Banks by Country (4Q'20–4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

Chart 2.1.6.3 Islamic Banking Average Tier-1 Capital Adequacy Ratio for Stand-Alone Islamic Banks by Country (4Q'20–4Q'21)



Source: IFSB Secretariat workings based on PSIFIs.

The GCC countries' Islamic banking industries remained well capitalised, with regulatory capital ratios well above the thresholds set by the Basel Committee on Banking Supervision (BCBS) and the IFSB, as well as the regulatory minimum set by the respective RSAs.[96] Reasons for the improved performance vary across the countries in the region. For instance, in Oman, the increase in CAR was derived from the internal generation of capital from retained earnings due to an increase of Islamic banks' income during 2021. In Saudi Arabia, this was mainly a result of the growth in risk-weighted assets (RWAs) that outpaced the growth in total capital. An analysis of capital components indicates that the Saudi Islamic banking sector continues to maintain an excellent quality of capital, as common equity Tier-1 (CET1) capital accounts for 91.1% of the regulatory capital. The sector is expected to register a further capital growth, as a leading Islamic bank in Saudi Arabia, Al Rajhi Bank, has received approval from the CMA of Saudi Arabia to raise capital of USD 11 billion to enhance its operational efficiency, growth and capacity to support the kingdom's "Vision 2030".

[96] For instance, while the Central Bank of Bahrain set 12.5% and 10.5% for both the CAR and Tier-1 Capital to RWA ratios, the Central Bank of Kuwait has lowered the CAR requirements to 10.5% from 13% by allowing banks to utilise their capital conservation buffers. Risk weights for SMEs were also lowered, from 75% to 25%. The minimum requirement prescribed by the Central Bank of Oman was 13.5%, which was reduced to 12.25% in March 2020 to counter the economic effect of the COVID-19 pandemic in Oman.

In the SEA region, Brunei's Islamic banking sector has shown a declining trend of the regulatory capital ratios during the period under review. Notwithstanding the decline, the regulatory capital of the Islamic banking sector is well above the regulatory minimum of 10.0% set by the Brunei Darussalam Central Bank. The Islamic banking sector in Indonesia continues to report CARs well above the regulatory minimum requirement. This was due to the build-up in regulatory capital as profitability increased. This performance has indicated the capacity of Islamic banking in Indonesia to withstand balance sheet shocks and unexpected losses, especially from COVID-19. Similarly, the Malaysian Islamic banking sector continued to report stable and consistent capital above the regulatory minimum. The improvement in earnings from operations has enabled banks to preserve healthy capital buffers. Moreover, Bank Negara Malaysia has raised lending limits and reiterated that capital and liquidity buffers can be drawn down by banks.

In the MESA region, despite registering a slow growth, the regulatory capital of the Islamic banks across the countries remains higher than their respective regulatory thresholds[97] as at end-4Q'21. The slow growth could be attributed to reduced retained earnings due to rising NPFs and the need to keep higher loss provisions. More specifically, in Pakistan, expansion in advances contributed to an increase in credit RWAs, while Islamic banks' regulatory capital increased at a relative lower pace of 9.1%. An analysis of capital components indicates that Islamic banks in Palestine continue to maintain an excellent quality of capital, with a Tier-1 capital account for 91.2% of the regulatory capital and 14.3% of RWAs.

The improving trend in CAR for the NIB sector in Nigeria continued in 4Q'21 to end the quarter at 18.1%. The CAR for the NIB sector was well above the 10% threshold set by the CBN and the 15.5% registered by the entire banking system as at end-Q3'21. In contrast, the Sudanese Islamic banking sector registered a decline in CAR due to an increase in RWAs, which was more than offset by the increase in total qualifying capital of the banks. Though the Sudanese banks are yet to begin compliance with Basel III, they are nonetheless undercapitalised. Their capital buffers are deemed to be fragile, given upward pressure on RWAs due to devaluation of the Sudanese Pound as well as limited economic growth prospects amid political instability.

The participation banking sector in Turkey recorded a decline in regulatory capital indicators during the period under review. At end-4Q'21, the CAR and Tier-1 capital to RWA ratios were 18.8% and 14.4%, respectively. Notwithstanding, the regulatory CAR was above both the regulatory threshold of 8.0% and the targeted threshold of 12.0% set by the BRSA. The decline in CAR was due to the growth in RWAs by 31.4% compared to the end of 3Q'20 amid the increase in financing by 16.7% during the same period. The growth in income slowed to 9.1%, showing there was a lower support from income to build up the capital base compared to the faster growth in financing.

[97] In Bangladesh, the minimum requirement is set at 10.0% with at least 6.0% as Tier-1 capital ratio. In Pakistan, the regulatory benchmark is 11.5%, while in Palestine it is 13%, including a capital conservative buffer of 2.5%.

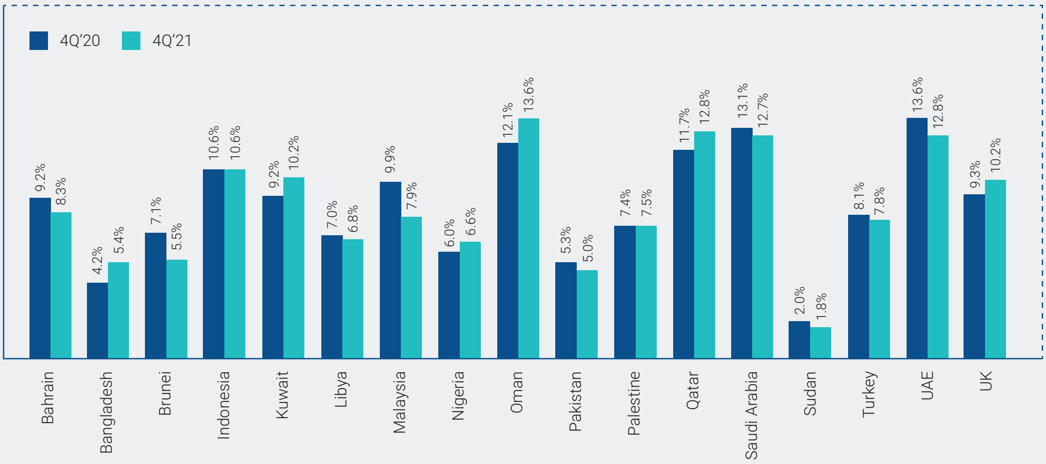
2.1.7 Leverage

The leverage ratio[98] is a measure that acts as a supplement to risk-based capital requirements in order to help restrict the build-up of leverage and to prevent damage to the financial system and the economy as a result of any deleveraging process. As per the BCBS and IFSB standards, the leverage ratio is applicable at the level of 3%. The regulatory leverage ratio was reported by 15 PSIFI-participating jurisdictions, all of which (apart from Sudan) have exceeded the 3% requirement (see Chart 2.1.7.1). The leverage ratio of the Sudanese Islamic banks dropped to 1.8% at the end of 4Q'21 compared to 2.0% at the end of 4Q'20, due mainly to the steep depreciation of the Sudanese Pound.

Generally speaking, Islamic banks are less prone to engaging in highly leveraged products, because *Sharī`ah* requires in principle that all financing be linked to transactions in the real economy – that is, production and trade transactions and activities. Similarly, there are restrictions on debt trading and engaging in products involving undue and excessive speculation (*gharar*). At the same time, risk-sharing means of raising funds are encouraged. The combination of these measures seriously limits the leverage effects in Islamic finance, although it does not completely eradicate this phenomenon.

Only to a limited extent do Islamic banks use return-paying deposits to leverage their capital. Although they may use unremunerated current accounts for this purpose, with few exceptions such current accounts do not constitute the bulk of an Islamic bank's funding. Unrestricted PSIAs have historically been one of the major sources of funds for Islamic banks. Similarly, Islamic banks do not become involved in transactions involving gharar or other leveraged transactions, such as collateralised debt obligations or resecuritisations. Nonetheless, there are a few practices and transactions that may involve Islamic banks in leveraged transactions. Some offer a commodity *murabahah* transaction (CMT) for liquidity financing to their customers as well as for raising deposits. Reverse CMT-based deposits are a form of leverage, which, together with CMT-based term financing, has the potential to create unlimited debt in the system. Based on the factors highlighted above, the IFSB considers it prudent that RSAs that are yet to implement the leverage ratio requirements in their jurisdictions are highly encouraged to do so.

Chart 2.1.7.1 Islamic Banking Leverage Ratio by Country (4Q'20–4Q'21)



Source: PSIFIs.

[98] Leverage ratio = Tier-1 capital / total exposure.

2.2 Assessment of the Islamic Capital Market's Resilience and Stability

The global financial system was fairly resilient in 2021, with favourable external financial conditions, due largely to continuing policy support. However, the extraordinary policy measures have also created global concern that they may create unintended risks for financial stability, such as a rise in excessive risk taking and stretched valuations as well as elevation of financial vulnerabilities across countries. The possible repricing of risk and an abrupt tightening of financial conditions could exacerbate the existing financial vulnerabilities and affect confidence in and the stability of the capital markets, particularly in emerging markets.

The move towards policy normalisation after COVID-19, especially by advanced economies, could tighten financial conditions for emerging and developing markets and result in large portfolio outflows, presenting challenges in fulfilling their financing needs. Alongside this risk, emerging markets may also be exposed to rollover risk, if domestic inflation and global long-term interest rates continue to increase. Many corporates also emerged from the pandemic highly indebted, which may present the risk of increasing defaults or the need for restructuring as policy support is retracted in 2022.

Alongside these developments, the impact of the evolving geopolitical risks can present implications for the stability of the financial markets as a whole and for the Islamic capital markets, especially if downside risks materialise. In particular, the war in Ukraine and the sanctions on Russia with the resulting impact on global commodity prices can present challenges for the markets, including an overall impact on growth, on equity prices, and on oil and gas prices (although the latter may be positive for some Islamic finance jurisdictions). The policy impact is less clear. Global interest rates may continue to rise to curb inflation, but policymakers may also hold off a little longer until the impacts are seen.

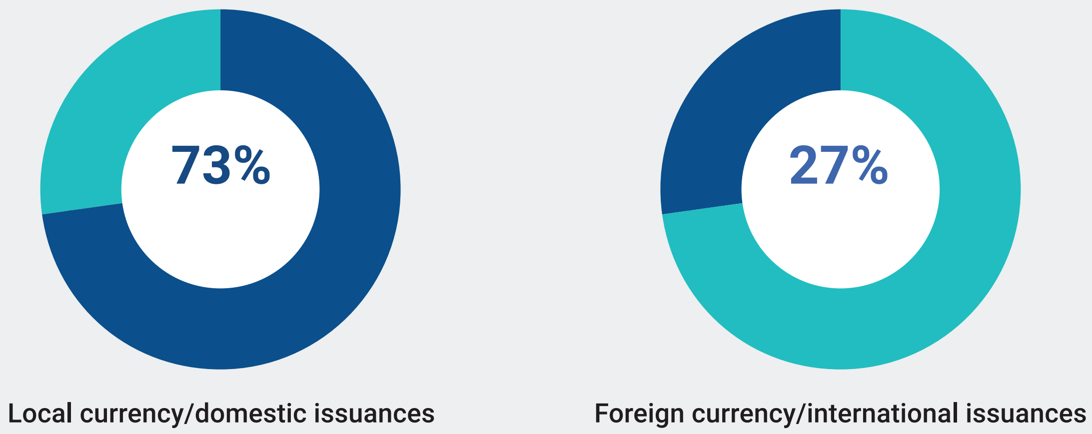
The following sections assess the resilience in 2021 of Islamic capital market segments, including *sukūk*, Islamic funds and equity markets, and the possible implications and considerations going forward.

2.2.1 *Ṣukūk*

Supported by a continuation of accommodative policies, the *ṣukūk* market remained resilient in 2021, with major issuers remaining active and total *ṣukūk* outstanding reaching a new historical high. Foreign currency-denominated *ṣukūk* issuance remained largely consistent with the previous year (2020: local currency 70%; foreign currency 30%), supported in part by the large size of issuances, but also indicating sustained global market confidence in the *ṣukūk* market, despite a prolonged pandemic that slowed down the easing of restrictions globally (see Chart 2.2.1.1). Foreign currency issuances were from Saudi Arabia, Turkey, Indonesia, UAE, Qatar, Bahrain, Kuwait, Oman and Maldives.

Corporate issuers accounted for 64% of total foreign-denominated *ṣukūk*, although 95% were from financial sector issuers, with only 5% coming from non-financial sector corporates. While an increase in foreign currency debt presents the need to keep in view the debt-servicing levels of respective issuers, 59% of the foreign currency issuances in 2021 were from jurisdictions whose currencies are pegged to the USD, presenting limited foreign exchange risk. Additionally, just over half of foreign currency issuances in 2021 were investment-grade issuances. High-yield *ṣukūk* accounted for 20% of issuances, which included primarily corporate issuers and two sovereign issuers – Maldives and Oman.

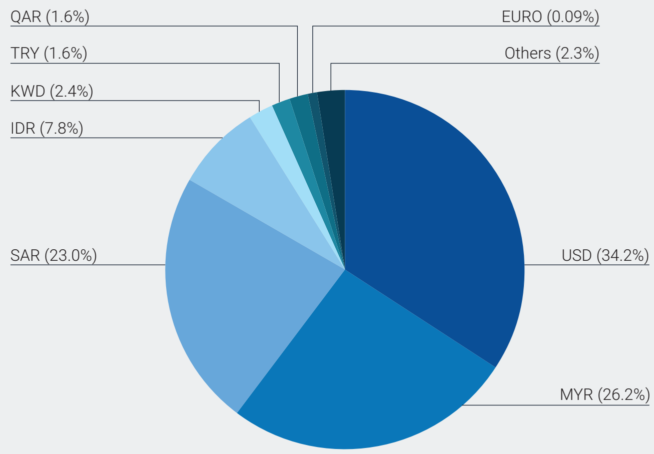
Chart 2.2.1.1 *Sukūk* Issuances by Market (2021)



Source: IFSB estimates based on data from Refinitiv.

The US dollar was the largest currency of issuance in 2021, owing to the large size of foreign currency issuances in that currency. Malaysia, with a well-established and strong domestic *ṣukūk* market, contributed to a significant volume of local currency issuances, followed by Saudi Arabia, which has also continued to issue a significant volume of local currency–denominated *ṣukūk* via the National Debt Management Centre's unlimited SAR-denominated *ṣukūk* programme. Indonesia also saw both corporate and sovereign issuances denominated in Indonesian Rupiah, which comprised around 78% of all *ṣukūk* from Indonesia during the year (see Chart 2.2.1.2).

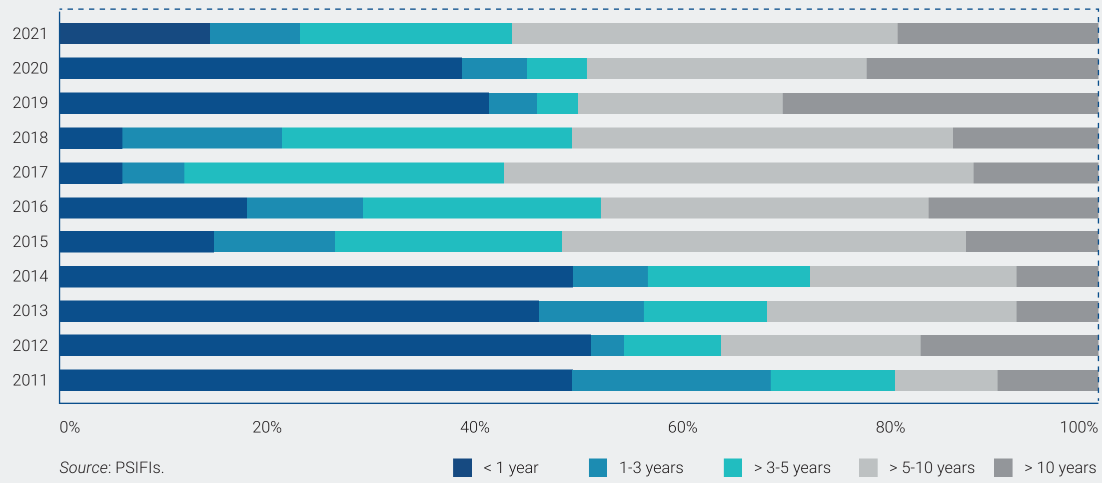
Chart 2.2.1.2 *Ṣukūk* Issuances by Currency (2021)



Source: IFSB estimates based on data from Refinitiv.

The development of strong local currency *ṣukūk* and bond markets is a good indicator of the ability to maintain financial stability by reducing currency mismatches, particularly for jurisdictions where the currency is not pegged to the USD. Heavy dependence on foreign currency debt can have stability implications by making countries more vulnerable to large currency depreciation. A wider local base of institutional investors for domestic issuances, such as that resulting from the pension system and Islamic capital market development in general, can further contribute to the deepening of domestic *ṣukūk* markets and therefore their stability. However, *ṣukūk* markets across all jurisdictions generally remain illiquid and the domestic investor base is often narrow, with large investors adopting buy-and-hold strategies that limit liquidity as well as effective price discovery.

Chart 2.2.1.3 Maturity Trend of All New Issuances (2011–21)



Source: PSIFIs.

In terms of the maturity trend of *ṣukūk* issuances, the volume of short-term *ṣukūk* issuances (with a tenor of less than 1 year) dropped compared to the previous year, while medium-term *ṣukūk* (with tenors of between 3–5 years and 5–10 years) increased. The trend indicated a reduction in *ṣukūk* issuance for liquidity purposes, particularly due to liquidity facilities being provided by central banks that were adequate to ease market constraints resulting from the pandemic.

Additionally, an increase in the level of liquidity in GCC banks as a result of the rise in oil prices further reduced a need for short-term liquidity management *ṣukūk* issuances. The issuance of short-term *ṣukūk* was largely contributed by the IILM, Malaysia, Kuwait, Turkey and Bahrain. Indonesia, Bangladesh, Brunei and Gambia also issued short-term *ṣukūk* in 2021.

Table 2.2.1.1 Demand Comparison for Selected *Ṣukūk* Issued in 2021

Sukūk Name	Issue Size (USD million)	Issuer Type	Tenure (Years)	Rating	Oversubscription (Times)
SA Global *Ṣukūk* Ltd 6/24; 06/26; 6/31	6,000	Corporate	3-10	A (Fitch)	20.0
Malaysia Airports Holdings Bhd 2/26; 12/28; 12/31	192	Corporate	5-10	AAA (RAM)	9.0
Malaysia Wakala *Ṣukūk* Bhd 4/31; 4/51	1,300	Sovereign	10	A3 (Moody's)	6.4
Warba Tier-1 *Ṣukūk* Ltd Perp	250	Corporate	Perpetual	Unrated	4.3
SME Development Bank Malaysia Bhd 7/26	118	Corporate	5	AAA (MARC)	3.6
Indonesia Green *Ṣukūk* 6/26; 6/31; 6/51	3,000	Sovereign	5-30	BBB (Fitch)	3.4
Ahli United AT1 *Ṣukūk* Ltd Perp	600	Corporate	Perpetual	BB+ (Fitch)	3.0
EI *Ṣukūk* Company Ltd 11/2	500	Corporate	5	A+ (Fitch)	2.4
Islamic Development Bank (IsDB) 10/26[99]	1,700	Multilateral	5	AAA (Moody's) AAA (S&P) AAA (Fitch)	1.7

Source: Various sources.

[99] The IsDB *Sukūk* 10/26 oversubscription of USD 1.7 billion was based on original issuance size of USD 1.5 billion.

Of the total number of *ṣukūk* issued in 2021, 56.6% were offered with a maturity of more than five years. This rate indicated that *ṣukūk* remained favoured by long-term investors seeking to diversify their portfolio in *Sharī`ah*-compliant instruments. While *ṣukūk* issuance with maturities of 10 years or more experienced a slight contraction in 2021 compared to the previous year, longer-term issuances generally remained significant. The relatively favourable financing conditions that continued into 2021 encouraged *ṣukūk* issuers (both public and private) to lock in long-term financing across the rating spectrum. In terms of rollover risk, around USD 56.85 billion *ṣukūk* will mature within the next five years, which may induce refinancing risks for some issuing countries if global economic conditions worsen and may emerge as a challenge to financial stability.

A robust demand for *ṣukūk* was indicated by the number of *ṣukūk* issuances that were oversubscribed in 2021 (see Table 2.2.1.1). The continuing high demand for *ṣukūk* indicated investor confidence in and a strong appetite for *ṣukūk* despite continuing market uncertainty. Issuers with sound creditworthiness proved to be able to retain investors' interest and to secure external funding, with exceptional rates of oversubscription for issuances such as Saudi Aramco's debut USD *ṣukūk*, which drew an oversubscription of 20x. Several Islamic financial institutions also issued Basel III-compliant Additional Tier-1 *ṣukūk* in 2021 and the market responded positively as indicated by the oversubscription rates observed. Strong interest was also demonstrated by investors towards sustainability-related *ṣukūk*. This was reflected by successful issuances of sustainability-related *ṣukūk* from both sovereign and private issuers. Moving forward, this trend is likely to continue, considering a strong commitment by global leaders and industry players towards sustainability and climate-related initiatives as well as an increasing appetite of investors for ethical and sustainable investments.

In addition to robust investor appetites for *ṣukūk*, the share of investment-grade *ṣukūk* in total *ṣukūk* outstanding has increased (see section 1.3), while the negative outlooks for *ṣukūk* issuers are decreasing.[101] However, there is still a concern that issuers with unfavourable credit quality or underlying vulnerabilities may find it more difficult to sustain their operations once governments' accommodative policy support is withdrawn as the world moves towards policy normalisation. Hence, regulators should carefully examine their responses and measures during the recovery stage to avoid creating unnecessary financial distress, particularly where vulnerabilities have been built up, including high corporate debt. The Financial Stability Board (FSB) report on COVID-19 support measures in April 2021 identified debt overhang as a significant risk that could arise from prolonged policy support measures. Debt overhang of corporates can slow down economic recovery of jurisdictions and pose risks to financial stability in a number of ways, including underinvestment by viable corporates due to excessive indebtedness, misallocation of resources by financing unviable corporates, and lower productivity. There might also be a risk of widespread defaults and insolvencies, giving rise to financial stability risks.

In terms of policy approaches to addressing debt overhang issues, the FSB highlighted in a Discussion Paper[102] issued in 2022 examples of approaches to debt overhang of non-financial corporates applied by a number of jurisdictions. The challenges posed by debt overhang issues in a post-COVID-19 environment and possible policy approaches have also been discussed in several papers published by other international organisations, including the Organisation for Economic Co-operation and Development (OECD),[103] IMF,[104] World Bank,[105] G30[106] and European Systemic Risk Board (ESRB).[107]

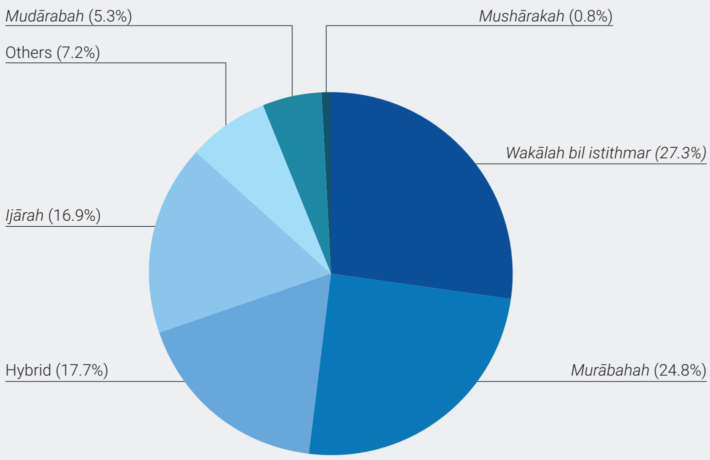
100 Excluding perpetual *ṣukūk*.
101 Fitch Ratings.
102 FSB (2022), *Approaches to Debt Overhang Issues of Non-financial Corporates.*
103 OECD (2021), *Insolvency and Debt Overhang Following the COVID-19 Outbreak: Assessment of Risks and Policy Responses.*
104 IMF (2021), *Insolvency Prospects among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options.*
105 World Bank (2021), *The Calm before the Storm: Early Evidence on Business Insolvency Filings after the Onset of COVID-19.*
106 G30 (2020), *Reviving and Restructuring the Corporate Sector Post-Covid: Designing Public Policy Interventions.*
107 ESRB (2021), *Prevention and Management of a Large Number of Corporate Insolvencies.*

A number of *ṣukūk* restructurings and *ṣukūk* defaults were announced in 2021, including PT Garuda Indonesia's default on its USD 500 million *ṣukūk* after it failed to meet its obligations post-restructuring in the prior year, as well as Serba Dinamik Holdings Berhad, which defaulted on its USD 222.22 million *ṣukūk*. Another *ṣukūk* issuer from Malaysia, MEX II Sdn Bhd which is a privately owned Malaysian highway concessionaire, was also declared as defaulted after investors rejected its proposal for restructuring and deferment of *ṣukūk* payments due on 31 December 2021. Earlier, in October 2021, its group company, MEX I Capital Bhd, also requested to restructure its *mushārakah ṣukūk*, which was approved.

The higher-than-normal number of defaults and restructurings in 2021 present some concern that even more defaults will materialise as the favourable conditions over the past two years created by pandemic-related policy measures are reversed. It is also noteworthy that many *ṣukūk*-issuing jurisdictions are still lacking in terms of providing effective legal enforcement mechanisms to deal with cases of *ṣukūk* default. The lack of clarity and certainty for *ṣukūk* restructuring and resolution is just one obstacle the IFSI needs to address in order to develop the *ṣukūk* market and establish investors' confidence.

In recent years, greater diversity in the use of *Sharī`ah*-compliant contract types and a more balanced distribution between different contract types has been observed. In 2021, *wakalah*-based contracts constituted the largest share of *ṣukūk* issued, followed by *murābahah*-based, hybrid and *ijārah*-based *ṣukūk*. The increase in *wakalah*-based issuances was contributed to by issuances from the IsDB and Dubai Islamic Bank, as well as by sovereign issuances from Malaysia and Indonesia. Malaysia also contributed to a large proportion of *murābahah* issuances. While the utilisation of *mudarabah* contracts has grown more recently due to the increase in issuances of AT1 *ṣukūk* by Islamic banks, the overall use of profit-sharing contracts in general is still low compared to fixed-return contracts, which are more desirable to the market, especially during times of turbulence and increased uncertainty.

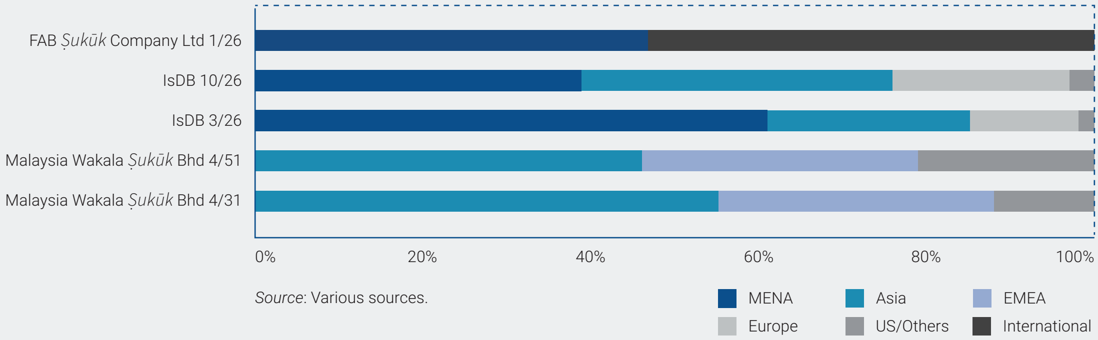
Chart 2.2.1.4 *Ṣukūk* Issuances by Structure (2021)



Source: IFSB estimates based on data from Refinitiv.

The geographic distribution of *ṣukūk* issuances in 2021 continued to be well balanced across regions, with strong interest from both regional and international markets. While issuances attracted strong domestic and regional subscription rates, as well as significant allocation to other core Islamic finance regions, there was also notable interest from investors in non-Islamic jurisdictions, such as Europe/US and other markets, including for sustainability-related *ṣukūk*.

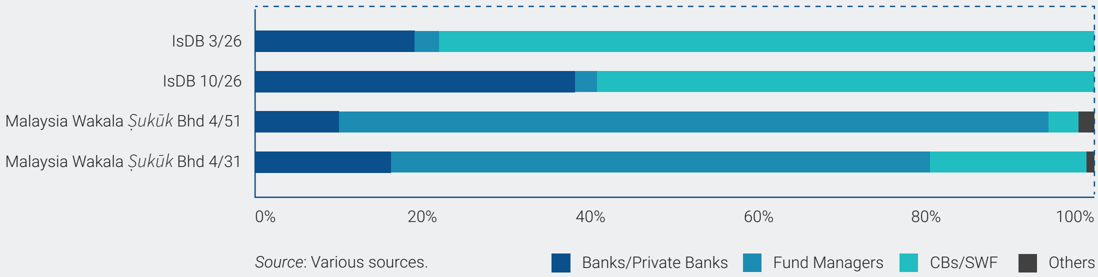
Chart 2.2.1.5 Geographical Distribution of Selected *Ṣukūk* Papers Issued in 2021[108]



Source: Various sources.

While there are data gaps in terms of investor distribution in the *ṣukūk* market, based on the limited data available, fund managers showed substantial interest in long-term *ṣukūk* issuances, including sustainability-related issuances. Central banks, as well as banks, showed a strong preference for investment-grade USD issuances, consistent with the past trend.

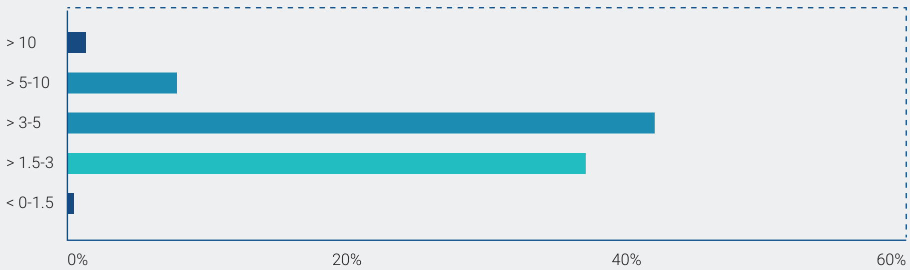
Chart 2.2.1.6 Investors' Breakdown of Selected *Ṣukūk* Papers Issued in 2021



Source: Various sources.

During the 2011–21 period, the yields for the majority of *ṣukūk* outstanding (79%) were between 1.5% and 5% (see Chart 2.2.1.7). However, compared to the previous year, the trend has shifted to lower yields in 2021 (whereas the majority of *ṣukūk* outstanding were concentrated in the 3–5% yield bucket in 2020). This shift in trend could be due to several possible reasons, including increasing investor confidence in *ṣukūk* markets and the increasing flow of funds into the *ṣukūk* market, which is pushing down yields. Another contributing reason may have been the improvements in credit ratings for *ṣukūk* issuers in 2021.

Chart 2.2.1.7 Outstanding Volume of *Ṣukūk* by Yield Bucket (%) (2011–21)



Source: IFSB estimates based on data from Refinitiv.

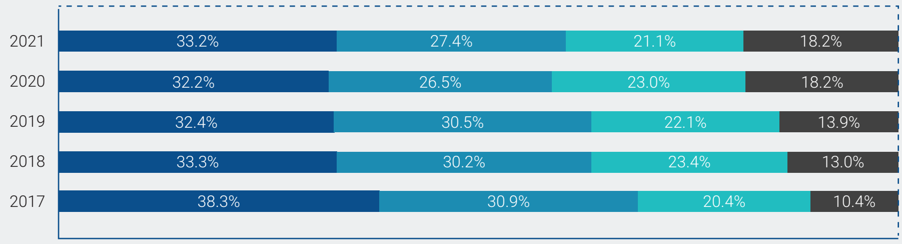
[108] EMEA (Europe, Middle East and Africa).

2.2.2 Islamic Funds

The Islamic funds market remained resilient despite the prolonged pandemic and ongoing uncertainty in 2021. The performance of Islamic funds is largely dependent on the performance of the assets they manage (including the performance of the *Sharī`ah*-compliant equities and *ṣukūk* that the funds invest in). Thus, the overall growth and resilience trends seen across the *ṣukūk* and equity markets in 2021 have also been reflected in the Islamic funds market. Financial stability issues related to Islamic funds are also comparatively more limited compared to their conventional counterparts, due to the absence of riskier fund categories, including hedge funds and stable net asset value money market funds, as well as the overall smaller size of the funds segment.

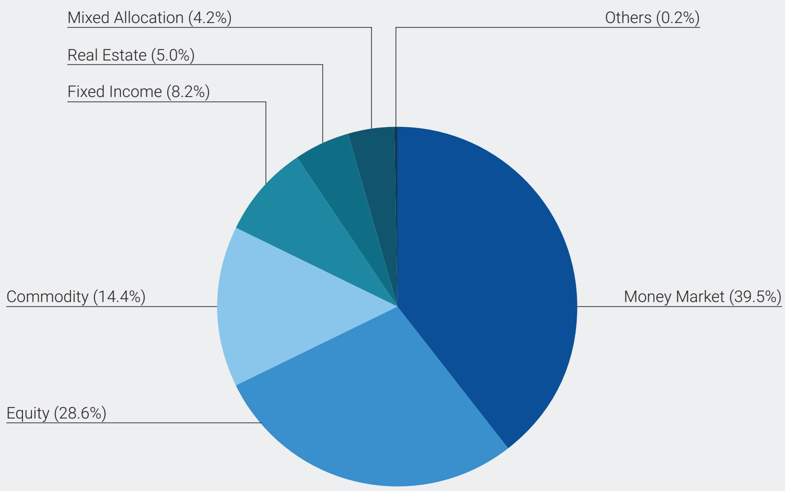
The asset size composition of Islamic funds did not demonstrate any significant change compared to 2020 (Chart 2.2.2.1). The issue of scale of funds continues to remain a challenge for the Islamic funds segment.

Chart 2.2.2.1 Number of Islamic Funds by Asset Size (USD million) (2017–21)



Source: IFSB estimates based on data from Refinitiv.

Chart 2.2.2.2 Islamic Fund Assets by Asset Class (2021)



Source: IFSB estimates based on data from Refinitiv.

Consistent with the previous trend, Islamic funds are mainly concentrated across money market, equity asset and commodity classes, followed by relatively smaller shares distributed across fixed income, real estate, mixed allocation and other funds (see Chart 2.2.2.2).[109] Although the trend towards diversification across Islamic fund asset classes has continued, it has not yet significantly altered the overall asset class mix of Islamic funds.

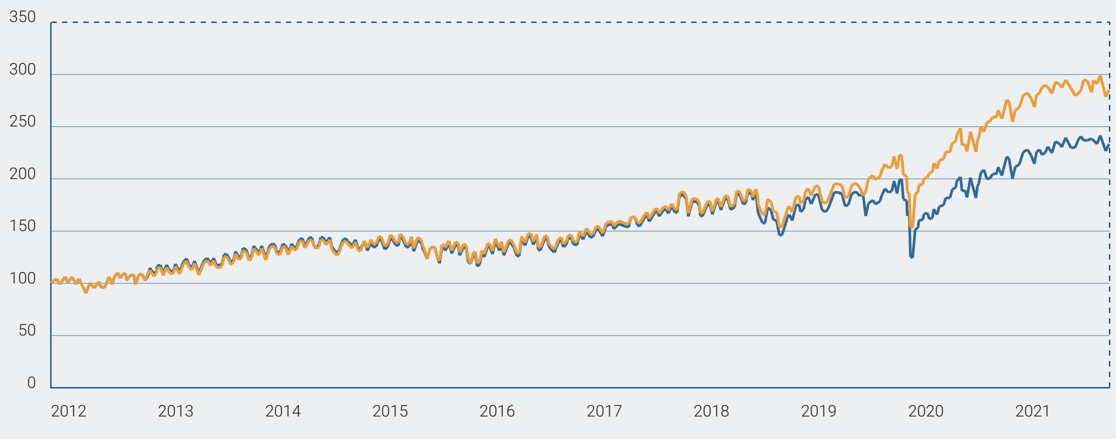
[109] Noting the limitation in data availability, as the databases used may not capture all funds.

From a financial stability perspective, effective liquidity management of money market funds (MMFs) (which constitute the largest share of Islamic funds) and other open-ended funds remains the most important concern, particularly in the case of exogenous shocks. Liquidity mismatches could be a potential source of vulnerability, particularly given the higher share of MMFs. MMFs can be susceptible to sudden and disruptive redemptions and may face challenges under stressed conditions, particularly if there are large outflows. Thus, ensuring that there are effective policy options to address such potential vulnerabilities in MMFs remains important to ensure financial stability. While the segment has remained largely resilient during the pandemic, strengthening liquidity management is important to ensure that the sector is not vulnerable in the event of large-scale outflows.

2.2.3 Islamic Equity Markets

Equity markets maintained a remarkable buoyancy, bolstered by continuing accommodative financial conditions despite ongoing uncertainties. While equity markets saw an overall climb during the year, markets saw declines during September in response to concerns about inflationary pressures, supply chain bottlenecks and fears over the bankruptcy of the Chinese property developer Evergrande, which resulted in broad sell-offs in global markets. However, markets rebounded quickly, reflecting a continued strong risk appetite.

Chart 2.2.3.1 Returns of Equity Indices



Source: Refinitiv.

Nonetheless, equity markets continue to present concerns of stretched valuations and susceptibility to market corrections. Possible market corrections could be triggered by a slower-than-expected economic recovery or an adjustment in market expectations regarding the prospective policy path to normalisation. The first quarter of 2022 was characterised by sell-offs in equity markets due to expectations of a US interest rate hike and worry over rising inflation, with a further sell-off resulting from the Russian invasion of Ukraine. However, the market remained generally more stable than expected in the wake of the Russia–Ukraine war, although it continues to be vulnerable to a correction.

While Islamic equity indices continued to outperform their conventional equivalents, emerging market indices underperformed compared to developed market indices in 2021, with China accounting for the bulk of the underperformance. In terms of the recovery of equity markets since the initial crash at the start of the pandemic in 2020, while emerging markets fared better in terms of the size of the initial crash compared to developed markets, both developed and emerging markets indices rebounded from the crash largely in parallel in 2020. However, in 2021, the performances of emerging and developed market Islamic indices diverged, with a weaker performance in emerging market indices across the year (Chart 2.2.3.2), although there was significant variability across regions (Chart 2.2.3.5). The underperformance of emerging markets in 2021 stemmed from lower vaccination rates in emerging markets, as well as from a downturn in the Asia-Pacific region, contributed to largely by negative returns in China. On the other hand, Islamic indices in the European region showed positive returns, while the GCC market performed exceptionally well due to the rise in oil prices (Chart 2.2.3.3).

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Chart 2.2.3.2

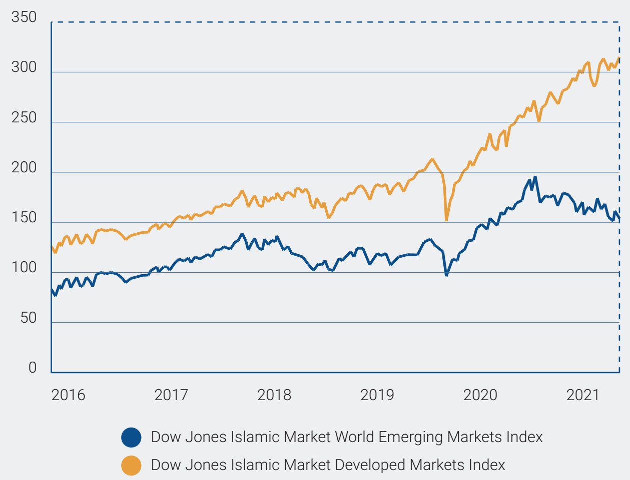


Chart 2.2.3.4

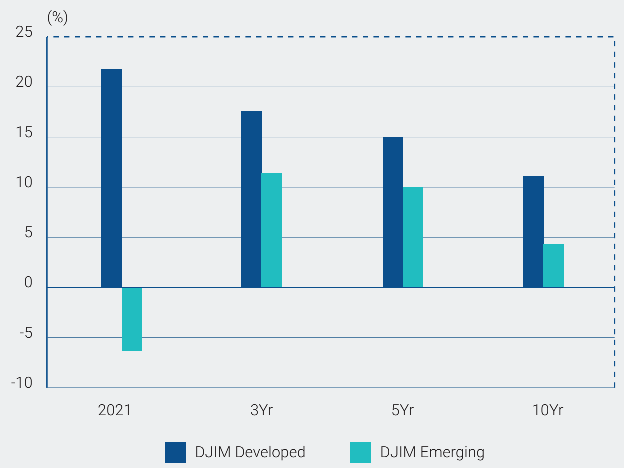


Chart 2.2.3.3

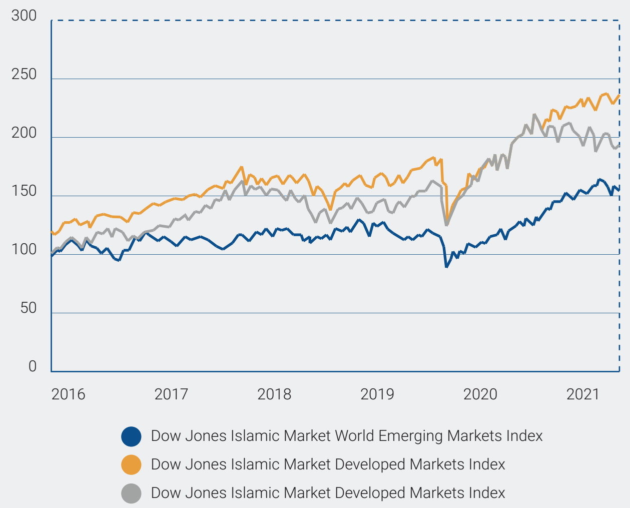
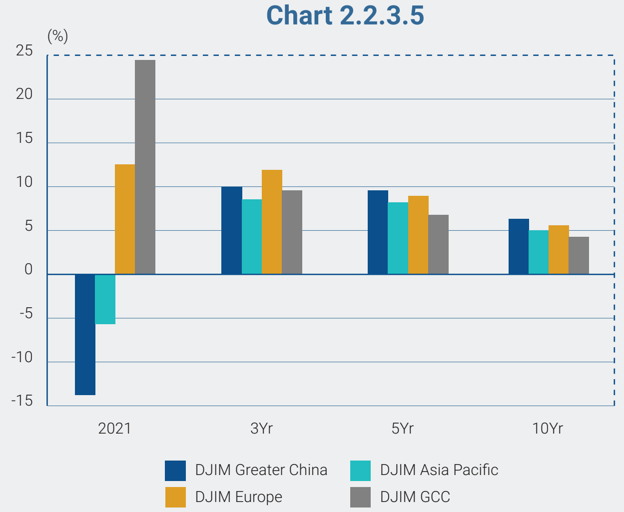


Chart 2.2.3.5



Source: Refinitiv.

2.2.4 Islamic Capital Market Stability Outlook 2022

Looking forward, the stability outlook for the ICM will largely be shaped by the pace of economic recovery in Islamic finance jurisdictions and the materialisation of downside risks. Thus far, policy measures and recovering economic conditions have ensured resilience in the ICM and eased immediate risks to financial stability. However, adverse geopolitical developments and other downside risks also have the potential to slow down recovery and exacerbate existing vulnerabilities.

As post-pandemic recovery begins, corporate fragility remains high in sectors that were more heavily impacted by pandemic restrictions. Thus, more vulnerable and highly leveraged firms could be challenged by the scaling-back of policy support, and debt sustainability concerns may emerge in the medium term given debt accumulation during the pandemic. However, short-term risks due to the pandemic have lessened considerably compared to the previous year as a result of improved economic conditions, the easing of pandemic restrictions and a decline in near-term vulnerabilities for sovereigns and corporates, although there is heterogeneity at the country and regional levels. In particular, the recovery in emerging markets, including most of the major Islamic finance jurisdictions, is likely to be varied. Growing vulnerabilities in major emerging market economies, such as the strains experienced in China, may add to the risks to recovery in some regions. Geopolitical risks that may cause further surges in oil prices can impact ICM growth and slow recovery in some regions while being a positive factor in others.

While government action was instrumental in avoiding deeper pandemic-related impacts on economies thus far, there are also concerns that they may have added to medium-term sovereign debt challenges in some jurisdictions, particularly for the more highly indebted countries. The build-up of medium-term vulnerabilities should be an area of attention, particularly where there has been an increase in debt levels in the corporate and public sectors due to the pandemic. These vulnerabilities could unravel in a disorderly manner if markets experience shocks such as an abrupt change in market expectations regarding the pace of policy normalisation, or a premature withdrawal of government support to non-financial sectors, or the impact of the current geopolitical instability on markets. The potential for these vulnerabilities to materialise simultaneously and to amplify each other can further increase the medium-term risks to financial stability.

Policymakers have also recognised this shift towards medium-term risks and are moving from providing short-term support towards addressing financial stability vulnerabilities that are further ahead. While fiscal, supervisory and monetary policies largely remained supportive in 2021 and early 2022, avoiding strong adverse real-financial feedback loops, policy direction is starting to shift from containing the economic impact of the pandemic and ensuring the near-term recovery, to managing the medium-term risks to financial stability.

As discussed earlier, there is also a growing divergence between emerging and developed economies. Emerging market equities started to underperform global equities over the course of 2021. Adverse developments in emerging markets can potentially lead to spillovers across other markets through a decline in global demand. Some emerging markets also play a key role in global supply chains, and disruptions may also further fuel inflationary pressures.

The sharp increase in energy commodity prices has also contributed to rising global inflationary pressures, which poses wider risks to the recovery and to markets. The second half of 2021 saw sharp increases in energy commodity prices due to insufficient supply in combination with low reserves. The sanctions on Russia in 2022 have resulted in a further surge in prices, which can affect industries that rely heavily on these commodities, as well as having a negative impact on growth and weighing on market confidence. Corporate defaults may also be triggered in the event of unhedged exposures.

While there has been a widespread rise in inflation rates around the world due to the aforementioned factors, a more persistent high inflation scenario could translate into an untimely tightening of financial conditions and slow down economic recovery. Additionally, the buoyant financial asset price developments in recent years raise concerns about overvaluation and vulnerabilities from increasing mispricing in some financial and tangible assets that might result in market corrections, which can also affect Islamic markets.

On the whole, while global risks present potential downside scenarios, the Islamic capital market is expected to remain relatively resilient under adverse conditions given the fundamental *Sharī`ah* principles it follows, which reduces its exposure to speculative and riskier segments of the financial market. The continued growth potential of the ICM is also supported by high investor appetite, refinancing needs and funding diversification strategies, as well as by Islamic finance development agendas in some jurisdictions. However, as discussed above, the outlook is affected by high uncertainty due to geopolitical factors and other downside risks, as well as climate change-related risks that pose several challenges. Climate-related risks remain difficult to assess and measure; they may involve a longer time horizon and are unpredictable as to when they will materialise. In addition, political and security issues also further fuel the vulnerability, uncertainty, complexity and ambiguity of the current condition.

Furthermore, these emerging challenges could also bring new opportunities for acceleration in *ṣukūk* issuance, particularly coming from sovereign entities, multilateral organisations or development agencies, as well as private companies. Aiming at transitioning towards a more sustainable Islamic finance industry, the aforementioned institutions will require significant funding for which the *ṣukūk* market can be an attractive alternative.

2.3 *Takāful*: Assessment of Resilience

This section outlines the assessment of resilience of the *takāful* sector in 2020 based on two key performance metrics – profitability and underwriting performance – commonly used for the insurance sector. Countries considered are those where the *takāful* sector has achieved a notable presence.[110] Assessment of resilience of the *takāful* sector is based on *takāful* operators' (TOs') underwriting performance measured by the extent that the underwriting and other operating expenses are curtailed to a lower level than the difference between premium contributions and claims payments. Poor claims management could lead to a rise in loss payments, besides the possible external factors such as the prevailing economic condition, market competition, political interest or catastrophes.[111]

The assessments are presented in country-level aggregates for profitability and underwriting performance metrics based on 2020 year-end data, and in comparison, with average data of the previous three years (2017–19).[112] In addition, the discussion of underwriting performance metrics follows business segments (i.e. general and family business), in order to reflect their peculiarity. However, the same cannot be applied to profitability and earnings performance indicators. This is due to different operating structures across countries (i.e. composite, general and family), and the difficulties encountered in data segmentation of some items in the financial statements such as expenses and assets in takāful undertakings (TUs) with composite business.

Generally, TOs have the overarching goal of growing top-line revenue (contributions) and bolstering bottom-line profitability, the outcomes mostly influenced largely by the macroeconomic environment and other market dynamics. Some of these are within the scope of the operators (i.e. pricing of risk, underwriting discipline and risk management framework), whereas others (e.g. a low investment return environment, catastrophe-related losses and political instability) are not within the industry's control. The capacity of the takāful sector to build the resilience needed to overcome these challenges will determine its viability over the long term.

2.3.1 Profitability/Earnings Performance

The traditional profitability/earning metrics (e.g. return on assets and return on equity) used to assess overall returns and profitability of a conventional insurer over a given period can equally be applied to the *takāful* market for a similar purpose.[113] Therefore, it may be necessary to aggregate the two income statements of a TU (policyholder and shareholder funds) and eliminate any balances between them so as to avoid double-counting.

Generally, the *takāful* sector in a majority of the markets represented in Chart 2.3.1.1 reported positive ROA in 2020, with the exception of Bahrain (–0.02%) and Kuwait (–14.7%). According to the trend shown in the chart, ROA was better than expected in a number of the markets in 2020 compared to the average of the previous three years (2017–19). Lower volume of claims in motor, medical, and property and casualty (P&C) lines as a result of pandemic-related containment measures, offsetting losses from event and travel cancellation, and trade credit business contributed to the improvement in the ROA and the overall profitability of the sector.

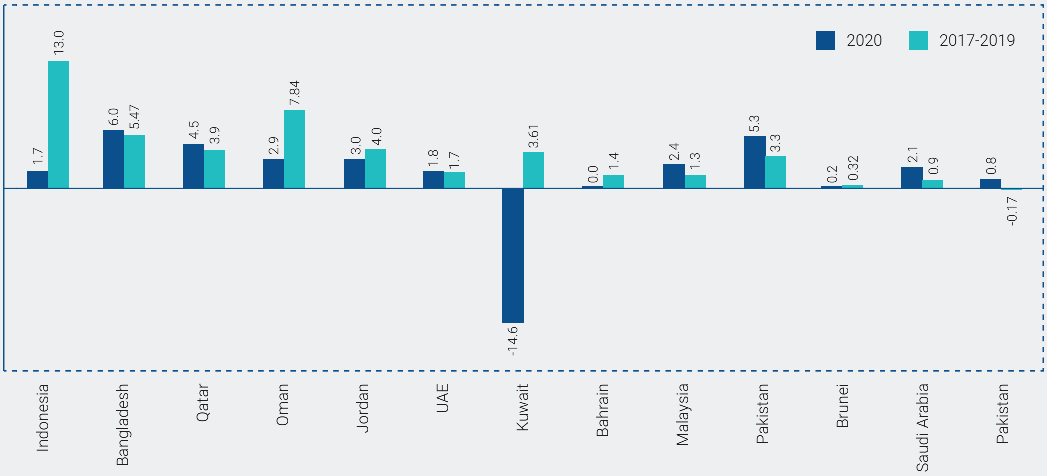
[110] Specifically, these include the GCC countries (Saudi Arabia, UAE, Kuwait, Bahrain, Qatar and Oman), Middle East and South Asian countries (Iran, Jordan, Pakistan and Bangladesh), and South-East Asian countries (Malaysia, Brunei and Indonesia).

[111] A rise in claims payments does not necessarily lead to a rise in the loss ratio, especially, for example, in some circumstances where a rise in earned contributions after re*takāful*/reinsurance commission could even result in a lower loss ratio.

[112] The assessment metrics do not include capital adequacy because the metrics vary dramatically across the markets. Also, the data are not readily available. Liquidity metrics are excluded because liquidity is much less important in takaful compared to the banking sector.

[113] Unlike a conventional insurer, a typical *takāful* undertaking's income statement has two separate sections (policyholder and shareholder funds).

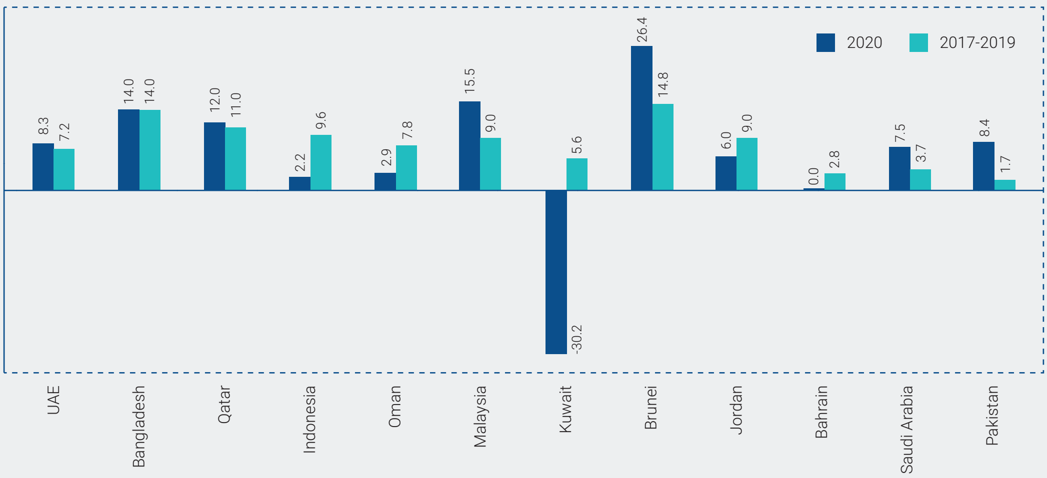
Chart 2.3.1.1 Return on Assets (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

Bangladesh and Brunei achieved the highest ROA above 5%, and relatively positive growth return was attained in the following countries: Qatar (4.5%), Malaysia (2.4%), Saudi Arabia (2.1%) and Pakistan (0.80%). During the same period, ROA in countries such as Jordan, Indonesia, Iran and Oman declined, compared to the average of the past three years (2017–19), although it remained positive.

Chart 2.3.1.2 Return on Equity (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

The ROE trailed a trend similar to ROA in 2020 across the markets, although with a relatively wider margin ranging from a low of –30.23% to a high of 15.5% (Chart 2.3.1.2). Brunei achieved the highest ROE (26%) in 2020. During the same period, a marked improvement in ROE was shown in Malaysia (15.5%), Bangladesh (13.95%), Qatar (12.03%), Pakistan (8.36%) and Saudi Arabia (7.52%). The UAE (8.25%), Oman (6.05%), Jordan (6%), Iran (5.8%) and Indonesia (2.27%) maintained a positive ROE, but with a slight decline.

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[114] Note that this does not apply to all countries.

The improvement in earnings in Saudi Arabia in 2020 was a huge turnaround compared to the same period in 2019, when overall profitability shrank by 11.7%. Similarly, the growth in operating profits in the UAE despite an increase in the market-wide loss ratio in 2020 can be attributed to the improved investment markets combined with low claim frequencies due to pandemic-related lockdowns. Confronted with similar circumstances, TOs in Oman managed to achieve positive returns, but net profit shrank by 15.8% to USD 11.5 million.

The general *takāful* business in Pakistan generated an underwriting profit of USD 162,000 (PKR 26 million) in 2020, on the back of considerable gains in net contribution revenue. During the same period, the surplus reserve in the policyholders' funds rose by 4.8% due to a significant increase in net realised gains on investments, which covered the increases in net *takāful* benefits and other expenses. The *takāful* sector in a number of countries, including Malaysia, Jordan and Qatar, benefited from a lower volume of claims in motor and from a modest exposure to pandemic-related claims, leading to a strong improvement in operating performance in 2020.

On the other hand, TOs in Kuwait reported that profits plunged by 890.4%, recording a net loss of USD 20.6 million. These unexpected and severe technical losses were attributed to lower business activity, high competition and a sharp decline in asset prices.

In the family *takāful* segment, the overall impact on profitability depends on the extent of an operator's exposure to mortality or longevity risk.[115] Additionally, the investment-linked family products suffered decreased investment returns, which mainly occurred over the first half of 2020 (sometimes reaching negative returns); they recovered partially over the second half of the year, albeit less acutely, due to diminishing profit margins.

2.3.2 Underwriting Performance and Risk

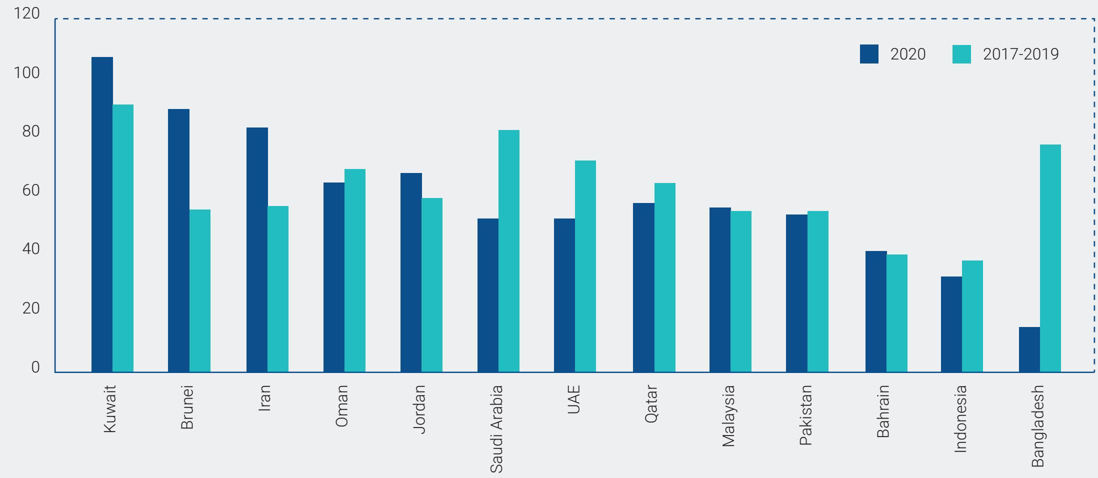
Sound underwriting performance is mostly determined by a TO's product pricing decision, risk selection and claims management. It is a key element in determining a TU's profitability and income generation, especially during a low investment yield environment. The pandemic has forced many TOs to review their strategies and focus on products that guarantee optimum underwriting performance. Usually, *takāful* products, by their nature, tend to lean towards the retail segment, which was significantly affected by the pandemic. However, these products tend to be exposed to lower claims severity as their customers are mainly individuals or SMEs that purchase personal and retail risk coverage, as opposed to large commercial and possibly long-tail risks. Similar to conventional insurers, the indicators used to assess underwriting performance and risks of a typical TU or market are the loss ratio, the expense ratio and the combined ratio.

Loss Ratio

The loss ratio measures the actual impact of incurred losses on participants' risk funds (PRF). Under the *wakālah* and *mudārabah takāful* models, the PRF is segregated from the operator's fund. An operator's goal is to achieve a loss ratio below 100% to prevent the need for *qard* (although any gap could be partly bridged by investment earnings on PRF assets). Therefore, the sufficiency of the PRF to cover the actual losses incurred as measured by the loss ratio is an indication of underwriting performance. Mostly, variabilities in this metric are caused by both externalities, such as economic factors (i.e. market competition, price/underwriting cycles), and catastrophic losses (e.g. natural disasters), including emerging risks such as cyber risk and climate-related risk, among others. Depending on the rates and underwriting pricing, the ratio may increase (decrease) without any significant changes in the actual loss experience.

115 This is particularly relevant to pure-protection products.

Chart 2.3.2.1 Loss Ratio: General *Takāful* (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

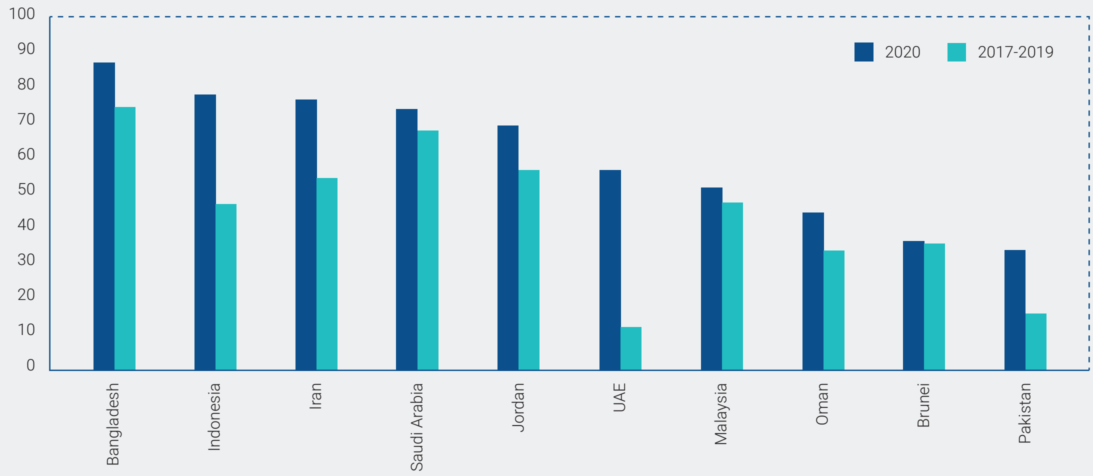
Chart 2.3.2.1 illustrates the loss ratio of general *takāful* businesses in 13 markets in 2020, in comparison to the average of the previous three years (2017–19). The *wakālah takāful* sector in Kuwait recorded the highest loss ratio (106.3%), mainly attributed to a large payout for family and household medical expenditures. In addition, the motor line has been a contentious and loss-making line in Kuwait over the past years due to pressure on the rate as a result of competition. This pressure is forcing the operators to underwrite business without proper terms and conditions and risk consideration of the driver. For example, the rate at which motor third-party liability policies are underwritten in Kuwait was very low, most likely the lowest in the GCC.

Markets with a high loss ratio in 2020 (as shown in Chart 2.3.2.1) include Bangladesh (90%), Brunei (88.8%), Iran (79%), Pakistan (78.7%) and Jordan (67%). Moreover, these markets experienced deterioration in their loss ratio when compared to the average of the previous three years, reflecting the market situation in the year under consideration – in particular, the decline in the number of *takāful* subscribers and the slow rate of collection of receivables in the face of increased claims pay-outs (i.e. pandemic-related medical bills). For instance, the net claims from the general *takāful* segment in Pakistan increased by 8.3% y-o-y to USD 32.5 million (PKR 5.2 billion) in 2020 on the back of increased health claims. As a result, the claims ratio increased significantly, from 63.7% in 2019 to 78.7% in 2020.

Conversely, the loss ratio in Saudi Arabia, UAE, Malaysia, Qatar, Oman, Jordan and Indonesia declined in 2020 compared to the average of the previous three years, due to a drop in new car sales by about 16% in Saudi Arabia and 35% in the UAE and other GCC markets, leading to reduced insured values.[116] To further highlight, the average loss ratio for the *takāful* sector in Oman decreased by 14.3% y-o-y to 57.2% in 2020 (2019: 68.9%). In absolute amounts, the total claims paid for *takāful* business fell to OMR 33.78 million in 2020, compared to OMR 39.41 million in 2019. As mentioned earlier, the improvement in underwriting performance in these markets was ascribed to a lower volume of claims in motor and medical lines during the period, which more than offset the decline in contributions due to low sales. However, the improvement in underwriting performance may not continue for long and may not necessarily be an indication of future profitability. This is due to the ongoing recovery and increase in economic activity that has seen road traffic return to pre-pandemic levels, a situation which could increase the loss ratios for the motor books in the future.

[116] S&P (2021), *GCC Takaful Market Report*.

Chart 2.3.2.2 Benefits/Claims Ratio: Family *Takāful* (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

Chart 2.3.2.2 shows benefits/claims ratios in the family segment for 10 countries. Half of these countries reported a loss ratio of above 70% in 2020. Bangladesh tops the chart with a loss ratio of 90%, followed by Indonesia (80.43%), Iran (79%), Saudi Arabia (75.9%) and Jordan (71%), with all ratios higher than the previous three years' average (2017–19). This is attributed to a surge in claims related to COVID-19 and to a rise in the surrender rate due to deterioration of customers' disposable income during the pandemic. For instance, in Indonesia, the amount of COVID-19–related claims paid in the family segment in 2020 was larger than that paid by life insurance peers, which is attributed to the increased uptake of family and health *takāful* products compared to conventional products.[117]

On the other hand, the data available from TOs in Jordan indicates a decrease in total payouts of 16.1%, to USD 579.8 million (JOD 411.1 million), in 2020, despite a 7.7% rise in contributions from the family segment in 2020 as a result of a surge in personal and retail credit financing by banks during the peak of the pandemic. Meanwhile, the net claims of the family *takāful* segment in Pakistan rose by USD 12.91 million (PKR 2 billion) to USD 62.58 million (PKR 10 billion) in 2020 due to an increase in net claims for window TOs that brought the claims ratio for the year to 35.0% (2019: 30.0%). Although a rise in the claims/benefits ratio in Pakistan undermined the underwriting performance for 2020, it is seen as a positive development by the supervisory authority, as it will enhance *takāful* participants' confidence in the sector and facilitate greater participation and thus a higher penetration rate.

Expense Ratio

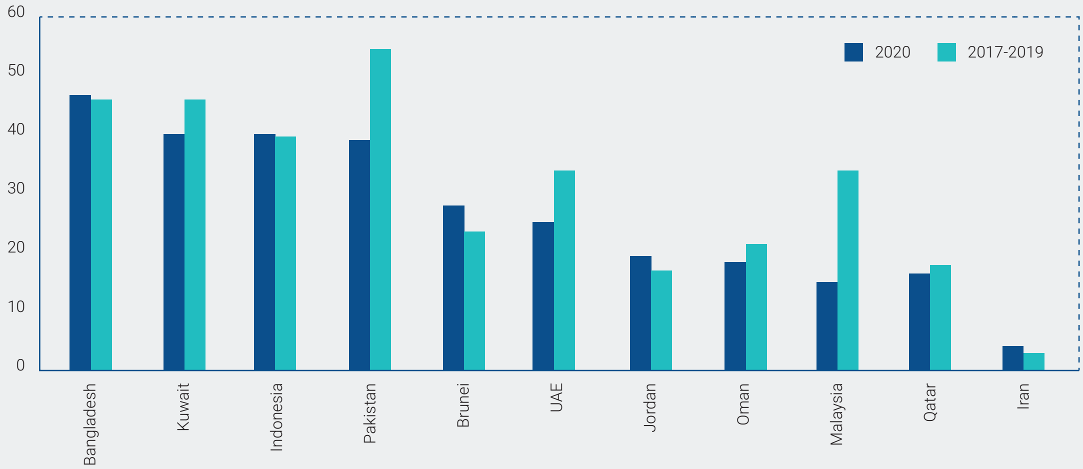
The expense ratio measures the marketing and administrative expenses incurred relative to contributions written. Gross contributions may be more appropriate as the denominator (rather than earned contributions), as the expenses are incurred prior to and throughout the coverage period. However, different supervisors use different approaches (including both gross and net premiums written or earned). A high expense ratio may be due to a rise in market competition (e.g. high commissions and brokerage fees) or to inflation in the territory of operation.[118] Similar to the case of the loss ratio, rates or underwriting pricing is a key determinant. More than half of the markets assessed recorded an upsurge in the expense ratio compared to the average of the previous three-year period, due to a drop in business (especially in motor, as a result of COVID) against the fixed overhead expenses.

Charts 2.3.2.3 and 2.3.2.4 illustrate the expense ratio for general and family *takāful* businesses, respectively. For general *takāful* business, countries with an expense ratio of 40% and above of gross contributions are Kuwait, Bangladesh, Indonesia and Pakistan. In contrast, the ratio was below 30% in the following markets: Iran (21.3%), Jordan (20%) and Malaysia (14.7%), indicating improved efficiency relative to the ratio of the previous years.

117 OJK Indonesia, *Annual Report 2020*.

118 If the expense ratio is comparatively higher than those of benchmarked TOs and conventional insurers, the operator needs to examine the probable causes, including (but not limited to) TO fees and agency commission rates.

Chart 2.3.2.3 Expense Ratio: General *Takāful* (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

Chart 2.3.2.4 Expense Ratio: Family *Takāful* (%) (2017–19 and 2020)

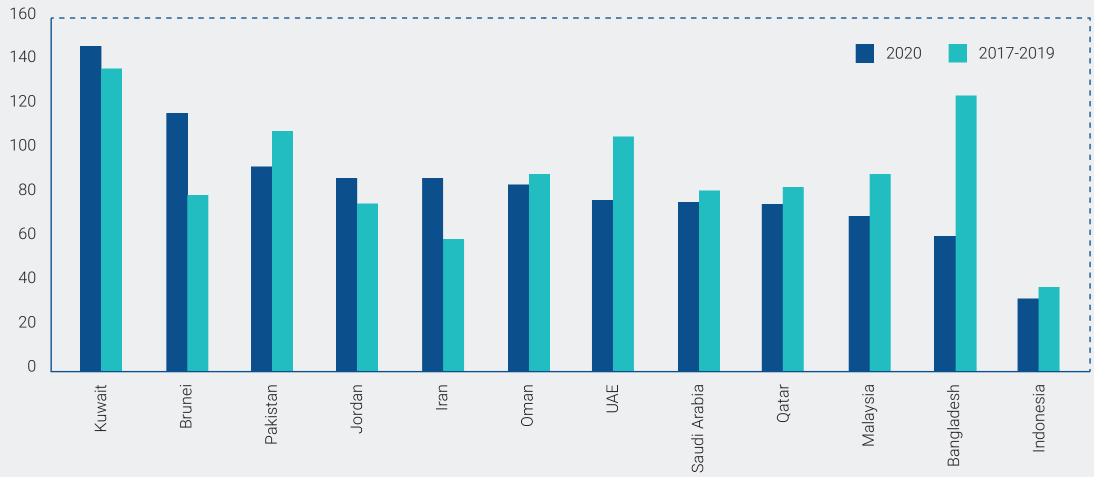
Source: IFSB Secretariat workings.

Family *takāful* business in Bangladesh and Pakistan registered the highest expense ratio – 34.0% and 33.8%, respectively (Chart 2.3.2.4). In addition, these markets experienced a surge in the ratio compared to the previous periods. Markets with a similar experience are Kuwait, Oman and Iran. However, the expense ratio in the UAE, Malaysia, Brunei and Indonesia showed a decreasing trend, which might be explained by a broad range of cost-saving measures to reduce overhead expenses in marketing and consulting services during the period. For instance, the adoption of a digital model during the peak period of the pandemic allowed operators to directly reach out to their customers in a way that increased sales and reduced underwriting costs, since agents' commission is one of the biggest contributors to the increase in underwriting costs.

Combined Ratio

The combined ratio measures the sufficiency of contributions revenue to cover the underwriting operations of a *takāful* fund. A ratio less (greater) than 100% means profits (losses) in the fund during the period. It is most often used in general business, although a similar measure may be adapted to monitor the sufficiency of contribution revenue in the family business. Generally, a combined ratio exceeding 100% over two or more years can probably provoke a long-term stability concern. The overall combined ratio nonetheless reflects TOs' choices regarding marketing, client segmentation, risk selection, pricing and claims administration. As observed in some of these markets, earnings from other sources, such as commission income from *retakāful*/reinsurers and investment income, offset a rise in the combined ratio in 2020.

Chart 2.3.2.3 Expense Ratio: General *Takāful* (%) (2017–19 and 2020)

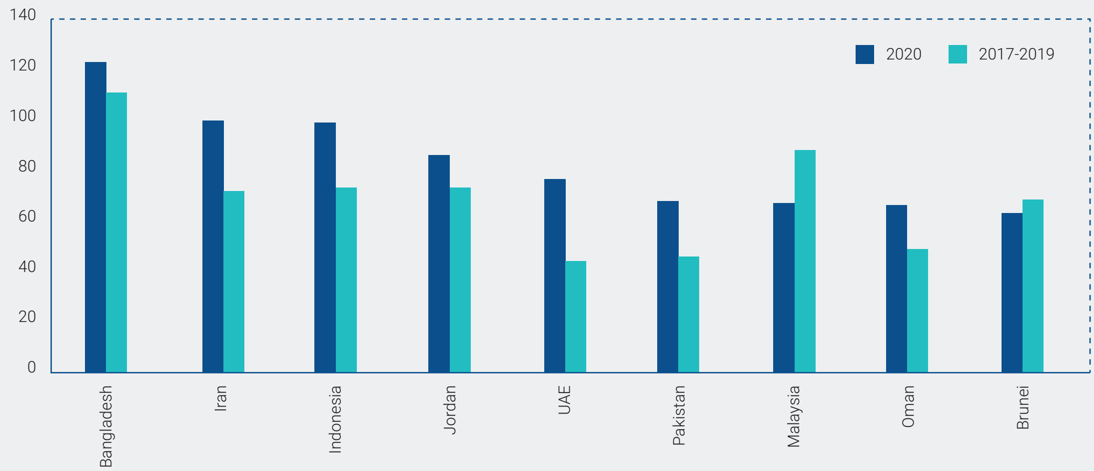


Source: IFSB Secretariat workings.

Charts 2.3.2.5 and 2.3.2.6 show the combined ratio in 2020, and an average of the past three years (2017–19) for both general and family business in the selected markets. Countries with the highest ratios are Kuwait (182%), Bangladesh (136%) and Brunei (116.7%). The ratio shows a significant surge compared to the average of 2017–19, reflecting a combination of high compensation paid for life and medical insurance and the difficulty of collecting insurance premiums from customers. Additionally, the difficulty of obtaining *retakāful* services in some of these markets, especially for medical products, and the slow collection of receivables for new policies and policies in force, are issues undermining the cash flow, liquidity and capital position – and, consequently, the underwriting performance – of some TOs in these markets.

On the other hand, the combined ratio showed a declining trend in 2020, relative to the average of the past three years, in Saudi Arabia, the UAE, Qatar, Oman and Pakistan. Much of this stems from changes in the loss ratio, which, to a large extent, was a manifestation of events such as government support for pandemic-related medical treatment, and a lower incidence of accidents as a result of lockdown measures to curb the spread of the COVID-19 pandemic.

Chart 2.3.2.6 Combined Ratio: Family *Takāful* (%) (2017–19 and 2020)



Source: IFSB Secretariat workings.

As seen in Chart 2.3.2.6, the combined ratio in the family segment showed a rising trend in the majority of the markets compared to the three-year average, with the exception of Malaysia and Brunei where a marked improvement in the combined ratio was registered in 2020, compared to the preceding period. The relative improvement shown in the few markets suggests dynamic underwriting controls and improved underwriting margin during the period under review, whereas the rising trend in the combined ratio as indicated in the majority of the markets demonstrates a weaker underwriting performance.

Measures Taken to Improve Profitability and Curb Risks that May Impact on Financial Performance of the *Takāful* Sector

COVID-19 posed considerable threats to the *takāful* sector's efficiency and stability in 2020. However, so far, the *takāful* industry has shown flexibility and resilience in facing the pandemic. Supervisory authorities responsible for the *takāful* sector across countries implemented several measures to manage the multiple risks that may have resulted from a pandemic-induced economic slowdown, with the aim of ensuring the sector remained viable. At the individual level, TOs may have experienced a dip in automobile, and travel and medical policies due to the fall in the purchases of new vehicles, travelling and other events induced by COVID-19 travel restrictions and economic slowdown.

Consequently, TOs have implemented a variety of measures, including granting fee/contribution waivers and extending grace periods, in order to mitigate surrenders, retain *takāful* participants and help those in financial difficulty. Measures taken to strengthen liquidity buffers include increasing cash buffers, extending terms of repo transactions, raising short-term funds through issuing additional debt instruments (*ṣukūk*), and postponing share buy-backs and dividend distributions.

During the period under review, the *takāful* sector's profitability was impacted positively by cost savings outcomes from business transformation to new ways of working, such as extended remote working, and reduced overhead expenses in marketing and consulting services. However, profitability was also negatively impacted by increases in other expenses, such as information technology. Given that principles underpinning the *takāful* model are much oriented towards retail lines, it is expected that the sector will continue to benefit from the widening of compulsory retail covers, such as for motor and medical, and the growing demand for health covers post-pandemic.

On the liability side, a key observation of the impact in a number of markets relates to fewer motor claims as a result of movement restrictions, and pandemic-related claims included in the exclusion list (i.e. not being covered under the existing policies). To a varying extent, this has led to improvements in underwriting performance, depending on the mix of business lines in the general segment. However, the *takāful* sector in some countries – for instance, Bangladesh, Iran, Indonesia and Jordan – witnessed high compensation paid for family and medical covers. On the other hand, the difficulty of collecting contributions from customers, in addition to measures such as contributions deferrals and higher claims payment, led to impairment of liquidity positions in some lines of business. Nonetheless, the overall impact on liabilities was assessed to be limited, due to the offsetting effect of lower claims in other business lines.

In addition, contributions (premiums) were affected through lower new business volumes. Slow collection of receivables could also become an increasing issue for some operators, depending on their portfolio and customers mix. It is anticipated that contributions collections will remain slow, especially in general business, as private businesses and governments delay their payments in an attempt to manage cash flows. A potential rise in premium contributions receivables was one of the major risks, leading to increasing receivables and potential write-offs, further stressing liquidity, earnings and capital, and, consequently, credit conditions for some TOs, and this may persist in the near term.

On the assets side, the challenge for TOs was to find assets with a sufficient yield to maintain asset–liability matching without taking on a significantly higher level of risk. Consequently, many TOs implemented various investment portfolio measures over the second half of 2020, following financial markets recovery after a sharp drop in the wake of the COVID-19 outbreak. In search of higher-yielding assets because of the low return on cash deposits, some operators shifted their assets mix to increase their exposure to equities or other high-risk assets, which resulted in strong investment performance. Other operators reported asset de-risking – for example, deploying capital on high-quality assets, decreasing credit risk exposures and reducing equity exposures to volatile segments. As a result, some operators were able to reverse some of the unrealised investment losses that had accumulated earlier in the year, which might have constituted a sizeable proportion of shareholder equity.[119]

Looking ahead, positive impacts on profitability are expected from economic recovery with the easing of lockdown measures. Nonetheless, a high degree of uncertainty about profitability still exists due to a variety of factors, including the risk of higher claims in certain lines of business (such as motor and medical), and fixed distribution costs relative to lower expected new business volumes. Supervisors in many countries have called on operators to increase their loss reserves as part of efforts to enable them to cope better with potential risks amid increasing financial market uncertainty.

Some supervisors have enhanced requirements on internal control procedures for *takāful* operators regarding investments so as to assess and monitor the market risks to which an operator is exposed. In many jurisdictions, regulations are already in place that require TOs to have a robust risk management framework that enables them to identify, measure and mitigate the emerging risks and stay operationally resilient. Other supervisory requirements include: public disclosure of solvency reports; a statement of investment orientations (such as in the investment plan and performance objectives); limits on volatility and sensitivity of financial instruments; minimum required diversification of investments; and the *retakāful*/reinsurance strategy (describing how *retakāful*/reinsurance policies must consider diversification and the financial rating of *retakāful*/reinsurance operators).

Furthermore, some supervisors have shown that TOs intensified credit risk monitoring during the pandemic (e.g. to a monthly basis), based on the credit risk standard model in their solvency regimes. Others intend to improve the design of the credit risk standard model and monitoring frameworks in order to manage a *takāful* undertaking's credit risk, such as having concentration limits in place on the asset, sectoral, geographic, currency, maturity and counterparty levels.

Capitalisation of the *takāful* sector is expected to be strengthened as risk-based capital regulations are introduced across countries, albeit in the short term as this poses some implementation and operational hurdles, including added costs for TOs for M&A in order to achieve the scale required to absorb these costs. The expectation is that growth will remain strong for the sector as a whole in the coming period, as both supervisors and *takāful* operators intensify efforts towards exploiting opportunities created by the other key risks (i.e. natural catastrophes, climate change and technology disruptions) that would have impacted on the balance sheet and the underwriting performance of *takāful* undertakings in the coming years.

[119] IFSB WP-22: *Assessing the Effectiveness of the COVID-19 Policy Responses in the Takāful Industry,* January 2022.

3.0 TRANSITIONING FROM LIBOR TO RISK-FREE RATES IN SELECTED JURISDICTIONS OFFERING IIFS

The London Interbank Offered Rate (LIBOR) measured the interest rates that large banks offered when lending to each other on an unsecured basis in the London short-term money market. It represented the average of submissions from a panel of banks and published by ICE Benchmark Administration (IBA), which was regulated by the Financial Conduct Authority (FCA). LIBOR was used in the financial world, having been the reference rate that underpinned more than USD 400 trillion of financial contracts, derivatives, bonds, loans and other exposures worldwide. LIBOR was calculated for five currencies (USD, GBP, EUR, CHF and JPY) and for seven tenors in respect of each currency (Overnight/Spot Next, One Week, One Month, Two Months, Three Months, Six Months and 12 Months). This resulted in the publication of 35 individual rates (one for each currency and tenor combination) on every applicable London business day. The most commonly quoted rate was the three-month USD rate, usually referred to as the current LIBOR rate. The rate was calculated using the Waterfall Methodology, a standardised, transaction-based, data-driven, layered method. It utilised eligible transaction data, where available (Level 1), transaction-derived data from historical transactions otherwise (Level 2), if neither was available, then expert judgement was used (Level 3).

LIBOR was calculated as of 11.00 every London business day and is normally published by ICE Benchmark Administration Limited (IBA) at 11.55 London time. It was a trimmed arithmetic mean that excluded the highest and lowest quartiles of submissions. Trimmed mean is a method of averaging, that eliminates a small, specified percentage of the largest and smallest values before calculating the mean. Each panel bank's submission carried an equal weight, subject to the trimming. LIBOR was often referenced in derivative, bond and loan documentation, and in a range of consumer lending instruments such as mortgages, lease and student loans. The IBA constituted a designated panel of global banks for each currency and tenor pair. For example, 16 major banks, including Bank of America, Barclays, Citibank, Deutsche Bank, JPMorgan Chase, and UBS constituted the panel for USD LIBOR. Only those banks that had a significant role in the London market were considered eligible for membership on the ICE LIBOR panel, and the selection process was held annually. Although LIBOR was accepted globally, there were other similar regional interest rates that were popularly followed across the globe. For instance, in Europe, the European Interbank Offered Rate (EURIBOR), in Japan, the Tokyo Interbank Offered Rate (TIBOR), in China, the Shanghai Interbank Offered Rate (SHIBOR), in Malaysia, the Kuala Lumpur Interbank Offered Rate, and Emirates Interbank Offered Rate (EIBOR) in the UAE.

In fact, LIBOR has been used for several decades as a global benchmark for interest rates, underpinning derivatives, loans/financings, bonds and other financial products. Nevertheless, it had several weaknesses, which became more apparent with the Global Financial Crisis of 2007–8. A review set up by the British government[120] identified a number of issues, including that: (i) it was subjective in nature that a shortage of transaction data meant that submissions were largely based upon expert judgement rather than actual transactions; (ii) both banks and the individuals within them had incentives to manipulate the rates, and there had in fact been significant manipulation over a period of years; and (iii) there were major weaknesses in governance, which at that time lay with the British Bankers Association. This led to a set of immediate reforms in governance, regulation and calculation, but also to international efforts coordinated by the Financial Stability Board (FSB) to reform benchmark rates.[121]

[120] *The Wheatley Review of LIBOR: Final Report* (publishing.service.gov.uk).
[121] FSB, *LIBOR and Other Benchmarks* (fsb.org).

The FSB and other standard setters set the objective of transitioning away from LIBOR to more robust benchmarks, and a large amount of detailed work was undertaken. In early 2020, the market turmoil during the COVID-19 pandemic added impetus to the transition. The limited number of market transactions underpinning LIBOR decreased even further, meaning that these rates were almost entirely based on expert judgement.[122]

The FSB[123] has identified that continued reliance of global financial markets on LIBOR poses clear risks to global financial stability. In October 2020, it published a global transition map away from LIBOR.[124] On 5 March 2021, IBA and the FCA formally confirmed the dates when panel bank submissions for all LIBOR settings will cease, after which representative LIBOR rates will no longer be available. The majority of LIBOR panels ceased at the end of 2021, with a number of key USD settings continuing until end-June 2023[125] to support the rundown of legacy contracts only. The extended dates for the USD LIBOR tenors may enable legacy USD LIBOR contracts to mature before LIBOR experiences disruptions, because the transition of these contracts to alternative reference rates will be challenging.[126]

The FSB encouraged authorities to set globally consistent expectations and milestones that firms will rapidly cease the new use of LIBOR, regardless of where those trades are booked or in which currency they are denominated. Market participants are to cease new use of LIBOR in all currencies as soon as practicable,[127] respecting national working group timelines and supervisory guidance where applicable, and in any case not later than by the end of 2021.[128] Continued reliance of global financial markets on LIBOR benchmarks, particularly the most widely used USD LIBOR settings, might pose risks to financial stability, market integrity and investor protection, litigation and reputational risks.[129]

Regulators have been urging market participants to replace interbank offered rates (IBOR) with recommended risk-free rates (RFRs), which tend to be backward-looking overnight reference rates compared to LIBOR which is forward-looking.[130] In contrast, the issue of backward-looking rates is becoming uncommon with the introduction of CME Term SOFR rates.

The CME Term SOFR Reference Rates benchmark is a daily set of forward-looking rates, calculated and published for 1-month, 3-month, 6-month and 12-month tenors. Each CME Term SOFR Reference Rates tenor will start on (and include) the second US Government Securities business day following the publication day and span the corresponding tenor (e.g. 1-month, 3-month, 6-month, 12-month) in accordance with Modified Following day-count conventions.[131] The CME Term SOFR Reference Rates calculation method enables determination of a possible path of overnight rates that is consistent with the observable averages implied by SOFR-based derivative contracts. Intuitively, averages over standard tenors can be directly created once the path of overnight rates is determined.

The publication of CME Term SOFR Reference Rates will occur on the next business day following the business day during which futures data sampling takes place. Term SOFR Reference Rates are computed based on a reference period that begins two business days (T+2) after the publication date settlement. Table 3.1 list the key RFRs that will replace the LIBOR in different countries.

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122 See Bank of England (2020), *Interim Financial Stability Report*, May. https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf

123 FSB (2021a), "Transition Away from LIBOR Requires Significant Commitment and Sustained Effort from Both Financial and Non-Financial Institutions across Many LIBOR and Non-LIBOR Jurisdictions". https://www.fsb.org/2021/06/global-transition-roadmap-for-libor-2/

124 FSB, *Global Transition Roadmap for LIBOR* (fsb.org).

125 See FCA (2021), "FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks", 5 March. https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf

126 See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2020), "Statement on LIBOR Transition", 30 November. https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf

127 IOSCO (2021), The Board of International Organization of Securities Commissions, *Statement on Benchmarks Transition*.

128 FSB (2021b), *Progress Report to the G20 on LIBOR Transition and Remaining Issues*. https://www.fsb.org/2021/07/fsb-urges-action-to-complete-the-transition-away-from-libor-by-end2021/#:~:text=In%20June%202021%2C%20the%20FSB,is%20chaired%20by%20Randal%20K

129 See IOSCO (2021), The Board of International Organization of Securities Commissions, *Statement on Benchmarks Transition*.

130 AAOFI (2021), Research on Alternative Reference Rate, Benchmark Rate for Islamic Finance in Post-LIBOR Scenario.

131 CME (2022), "CME Term SOFR Reference Rates Benchmark Methodology", CME Group Benchmark Administration Limited. Available at https://www.cmegroup.com/market-data/files/cme-term-sofr-reference-rates-benchmark-methodology.pdf

Table 3.1 Alternative Reference Rates

Currency	Current	Alternate Reference Rate	Transaction Type	Administrator
USD	USD LIBOR	Secured Overnight Financing Rate (SOFR)	Secured	Federal Reserve Bank of NY
GBP	GBP LIBOR	Sterling Overnight Index Average (SONIA)	Unsecured	Bank of England (BoE)
EUR	EURIBOR	European Short Term Euro Rate (ESTER)	Unsecured	European Central Bank (ECB)
YEN	JPY LIBOR	Tokyo Overnight Average Rate (TONAR)	Unsecured	Bank of Japan (BoJ)
CHF	CHF LIBOR	Swiss Average Rate Overnight (SARON)	Secured	SIX Swiss Exchange

When using LIBOR, the rate is fixed at the start of the relevant interest period, and therefore the borrower knows what the interest amount will be for that period. With RFRs, however, the rate is measured on each day over the interest period, and therefore the total interest payable will only be known at the end of the interest period. Compared to LIBOR, which is forward-looking, RFRs are backward-looking overnight rates. This means that, if applied to a calculation period, they can only be determined at the end of that period. This potentially creates an element of *gharar* in the pricing of Islamic contracts. In contrast, RFRs are considered to be more robust as they are based upon a larger volume of observable transactions.

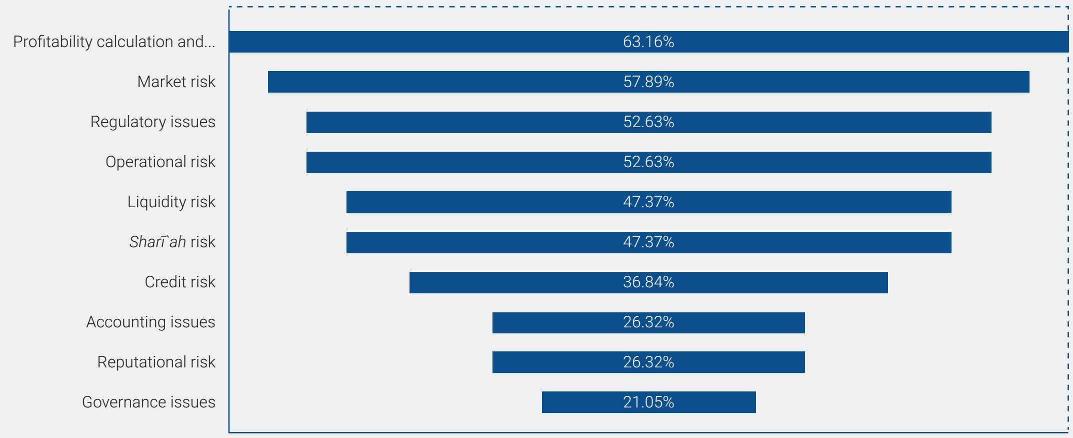
RSAs in jurisdictions offering Islamic financial services are also concerned about the transitioning from LIBOR to RFRs, and its impact on the resilience and stability of the Islamic finance sector. In December 2019, the Islamic Development Bank formed a task force to study and recommend Islamic financial return indicators. The Auditing Organization for Islamic Financial Institutions (AAOIFI) formed, in conjunction with other international Islamic finance organisations such as the IFSB, a working group to, among other things, understand the issues that Islamic financial institutions may face when transitioning from the LIBOR, with the aim of developing a comprehensive framework for RFR implementation. The working group aimed to assess the potential models that could be adopted when calculating a *Sharī`ah*-compliant benchmark. Discussions are still in progress before testing the models and proposing a comprehensive governance guideline. Furthermore, RSAs are also conducting studies on this LIBOR transition and collaborating with international standard-setting bodies to ensure transparency and consistency when adopting alternative rates.

Based on the aforementioned insights, this chapter reports a survey of 24 RSAs that are members of the IFSB from 21 countries in Asia, Africa and the Middle East to gather detailed inputs from RSAs and monetary authorities in jurisdictions offering Islamic financial services. The survey covers four main areas, namely: (i) identifying the risks that may arise due to the transitioning from LIBOR to alternative RFR; (ii) determining the planned actions and measures taken (to be taken) to mitigate these potential transitioning risks; (iii) proposing alternative rate(s) under consideration as part of transitional arrangements on the abolishment of LIBOR; and (iv) explaining the various suggested models that might be considered when developing Islamic benchmark rates, based on the review of the literature.

Potential Risks Identified in the LIBOR Transition

As shown in Figure 3.1, RSAs indicated their relative degree of concern arising from the transitioning from LIBOR to RFR. Notably, profitability calculation and market risk are two main issues identified as portending potential risks in the transition. The lowest-ranked risks are reputation risk and governance risk.

Figure 3.1 Potential Risks Related to the Transition from LIBOR to RFRs



In terms of profitability calculation and pricing, respondents indicated that financial institutions may not be fully ready for RFRs calculation due to compatibility issues between the various financial systems.[132] Considering that LIBOR is used in cross-border transactions, complications might appear when using RFRs on cross-border derivatives transactions due to differences in the methodologies of RFRs across different currencies. RSAs, hence, need time to understand the mechanics involved in RFR and its application. As such, in the interim, valuation of risk may be arbitrary and high.[133] Respondents mentioned that the transition from LIBOR to alternative RFRs may increase product price and volatility due to non-consideration of credit risk in RFRs' pricing strategies.

Although the rate of profit can be known at the end of the particular product period,[134] possible changes in pricing and profitability calculation will occur due to the abolishment of LIBOR. In the same context, the transition process will oblige international banks to renegotiate the existing contractual agreements with clients. Thus, banks need to have contingencies to mitigate the risk and monitor the situation proactively as the alternative benchmark develops in the global markets. Interestingly, the issue of valuation risk arising from the difference between LIBOR and RFRs will no longer arise given the imposition of spread adjustment on RFRs as a fallback rate.[135] Furthermore, large-scale changes in the value of banks' financial assets and liabilities are less likely to occur as the replacement in a financial contract of one benchmark rate by another is expected to generally be done on an economically equivalent basis.[136]

In terms of market risk, it is noticed that the transition process will have comparatively less interruption for IIFS, as their current exposures are not significant compared to those of their conventional counterparts. In terms of credit risk, the abolishment of LIBOR will have an impact on how financing rates are calculated. In this regard, banks will need to identify LIBOR-impacted models and develop, validate and implement model revisions. Operational and regulatory risks could crystallise if there is a lack of market consensus (conventions) for the development of RFR-based instruments and contracts. Other issues such as non-readiness of the IT system as well as the lack of an adequate administrator might also trigger operational and regulatory risks. The transition from LIBOR to RFRs may therefore also trigger *Sharīʿah* risk related to uncertainty. Reputational risk may also occur if retail financial institutions fail to successfully implement LIBOR's conversion to RFRs.

132 As stated by the Central Bank of Bahrain and the State Bank of Pakistan.
133 As stated by the Central Bank of Nigeria.
134 As stated by Bangladesh Bank.
135 The Working Group on Sterling Risk-Free Reference Rates (2020), "Credit Adjustment Spread Methods for Active Transition of GBP LIBOR Referencing Loans", available at: https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/credit-adjustment-spread-methods-for-active-transition-of-gbp-libor-referencing-loans.pdf
136 According to the latest updates by the Accounting Experts Group (AEG) of the Basel Committee on Banking Supervision.

Actions Taken by RSAs to Mitigate Potential LIBOR: Transitioning Risks

In order to mitigate the potential transitioning issues, some RSAs have taken various measures:

a) **Central Bank of Oman**: Banks were advised to stop entering into new LIBOR-based financial contracts. Moreover, they were advised to formulate a plan to ensure transition from LIBOR to alternative reference rates and to undertake comprehensive review of all direct and indirect LIBOR exposures and identify the steps to be taken to address the risks arising from such exposures, including adaptation of alternative reference rates.

b) **Saudi Central Bank** (SAMA) established an industry-led working group in early 2020 to discuss banks' preparations for and challenges to LIBOR migration. Banks are also required to provide periodic update reports, containing both qualitative and quantitative information regarding their migration progress.

c) **Bangladesh Bank** (Bangladesh) has issued a circular to allow alternative reference rates such as globally recognised reference and benchmark rates that are adjustable by Bangladesh Bank based on market conditions.

d) **Palestine Monetary Authority** assessed the impact of LIBOR abolishment on financial stability. Banks in the country have been advised to intensify their efforts to follow up on relevant regional and international developments relating to the issue and to mitigate their exposure.

e) **Central Bank of Nigeria** identifited that the market is shifting to the secure overnight financing rate as a benchmark for setting rates and key derivatives to deal with challenges of the LIBOR. As such, several RFR mechanics are assessed, given that transition to an alternative RFR may also increase the product price's volatility due to non-consideration of credit risk of the RFR pricing mechanism.

f) **Central Bank of Jordan** revealed that a working group has been formed to move from the LIBOR to alternative reference rates, and to identify the risks related to the transition from the LIBOR for the Jordanian banking sector. In addition, the working group will follow up the decisions and directions of the global regulators regarding the transition, by the end of 2021, to alternative reference rates.

g) **Central Bank of Kuwait** instructed banks not to issue new LIBOR-linked contracts beyond the related cessation dates and to amend those maturing beyond the LIBOR cessation dates.

h) **Bank of Mauritius** left the LIBOR transition to all banks to decide on the alternative rate to be applied.

i) **Central Bank of Bahrain** has instructed financial institutions to conduct a gap assessment and prepare an action plan, form internal committees to govern the LIBOR transition process, and assess the impact of the LIBOR transition on their customers, contracts, accounting and other systems.

j) **Bank Negara Malaysia** has taken early proactive measures to ensure the industry transitions smoothly, including setting signposts with an explicit timeline, regular engagements with banks and large corporates, and conducting regular monitoring.

Alternative Rate(s) in Some Regulatory and Supervisory Authorities (RSAs)

The survey found that some RSAs have been proactive and considered some domestic reference rates that are in line with IOSCO's Principles for Financial Benchmarks as a replacement for LIBOR, as highlighted below:

a) **Saudi Central Bank** enhanced the methodology of SAIBOR to better reflect the actual cost of transactions in the markets, taking into account both international best practice and Saudi Arabian wholesale funding for banks.

b) **Palestine Monetary Authority** has tended to use overnight interest rates in the financial markets, or any alternative tool that enhances the ability of the central bank to direct interest rates in the market.

c) **Central Bank of Jordan** indicated that SOFR, SONIA, €STR and TONAR can be considered as alternative rates to LIBOR.

d) **Central Bank of Bahrain** indicated use of the International Islamic Financial Market's (IIFM's) standard structuring solutions for a new benchmark RFR for *murābahah* and *ijārah* transactions.

e) **Bank Indonesia** stated that Islamic finance requires a close link between the real sector and financial markets, and that the benchmark rate needs to refer to real sector activities.

f) **Bank of Korea** has already selected the overnight repo rate of government bonds and monetary stabilisation bonds as its new RFR.

g) **Central Bank of the Republic of Turkey** adopted the Turkish Lira Overnight Reference Rate (TLREF) for its short-term reference rate in any financial transaction.[137]

h) **Bank Negara Malaysia's** (BNM's) *Shari`ah* Advisory Council resolved that the use of globally accepted RFRs as a replacement for LIBOR is permitted, including compounding methodology in determining the term rate and methods to mitigate gharar (uncertainty) in using average an RFR or a backward-looking term rate.[138] For the domestic market, BNM has introduced and administers the Malaysia Overnight Rate (MYOR) starting from 21 September 2021 and the Malaysia Islamic Overnight Rate (MYOR-i) starting from 25 March 2022, which are based on unsecured overnight ringgit interbank transactions.

i) The BNM has a foreign currency alternative reference rate (ARR) and a Ringgit ARR. The former is permissible with proper determination/disclosure of ceiling price and formula to derive a periodic payment to mitigate uncertainty arising from the backward-looking methodology. The latter introduces a new *Sharī`ah*-compliant ARR (MYOR-i), which allows reference to be made to the domestic conventional term rate on a needs basis, pending the availability of a reliable Islamic term rate.

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137 Bursa Istanbul (2019), *TLREF Turkish Lira Overnight Reference Rate Rules.* https://www.borsaistanbul.com/en/sayfa/2351/tlref
138 BNM SAC, https://www.bnm.gov.my/-/sac-bnm-210th-meeting

Alternative Reference Rates for Islamic Finance

The first option is to encourage the adoption of the globally accepted ARRs, such as SOFR (Secured Overnight Financing Rate) and SONIA (Sterling Overnight Index Average) on the premise that Islamic finance structures and contracts are valid, since they are *Sharī`ah*-compliant. In the same context, when *ijārah* and *murābahah* contracts are employed, there will be no strict *Sharī`ah* requirement to use a distinct Islamic benchmark for such transactions to remain halal. However, from the perspective of *Sharī`ah* compliance practice, some of the RFRs are backward-looking, and this implies that actual payoff commitments in the commodity *murābahah* or *ijārah* will not be determinable ex-ante. Nevertheless, if the underlying benchmark is identified and agreed upon and becomes a norm in the industry, then it can be made admissible on the presumption that it is not excessive gharar (uncertainty) and is based on *urf* (customary usage) and where the underlying transaction is *Sharī`ah*-compliant. Alternatively, a fixed profit rate adjusted ex-post with reconciliation and rebate can be used.

Table 3.2 Pros and Cons of Using Term ARRs

Potential Strengths	Possible Challenges
Term RFRs are robust, stable and less volatile.	Different time period of publishing.[139]
Term RFRs are based on voluminous underlying transactions.	Some ARRs are secured and some are unsecured, causing problems in cross-currency transactions.
Greater acceptance in markets where interbank activity involves other than full-fledged Islamic financial institutions (IFIs).	If the forward-looking rate is not given, the issue of *gharar* in pricing can occur.

The second option is called a bottom-up approach, which is developing an instrument to generate real activity to establish the price. The government can set up a trading corporation to trade commodities and set prices to reflect the target profit rate which can become a benchmark for issuing Islamic securities (i.e Treasury *ṣukūk ijārah* bills) and affect the other rates of return in Islamic short-term financing instruments. Alternatively, the accounting price of capital and weighted average profit rate in commodity trading can be considered.

Table 3.3 Pros and Cons of Using the Bottom-Up Approach

Potential Strengths	Possible Challenges
Pricing is based on real economic activity.	Such real economy-based pricing does not have a zero floor and can be more volatile.
Instrument can be used for monetary functions for the central bank.	There is no term premium, meaning that it needs to be added separately.
Instrument can resolve liquidity management issues of IFIs.	Big transaction volumes cannot be supported if there is an insufficient number of *ṣukūk ijārah* bills.

[139] Banks located in different geographical locations operate in different time zones. Their rates will be published at different times, which might be an issue for Islamic financial institutions needing to adopt the appropriate rate in any given financial transaction.

The main focus of option 2 is that the transactions and contracts are based on the real economy in substantial and distinctive ways. This will require a paradigm shift in mindset. Nevertheless, choosing distinctive real-economy-based transactions and pricing is expected to reduce displaced commercial risk, which arises due to a perceived similarity in cash flows and pricing of Islamic finance contracts vis-à-vis conventional interest-based finance contracts. Nonetheless, this instrument can be used domestically in the national currency and the investment must not be open to foreign investors. This is because if the national infrastructure is used as a subject matter in these Treasury *ṣukūk ijārah* bills, any default might result in the transfer of significant national wealth if the Treasury *ṣukūk ijārah* bills are not denominated in national currency and are open to foreign investors.

The third option is a rental index in medium- to long-term fixed assets financing to be used in *ijārah* and diminishing *mushārakah* contracts for car and home financing. The rental index can be based on inputs such as: (i) useful life of vehicle in kilometres; (ii) tenure of financing; and (iii) per kilometre fare in Uber/Grab based on car type or on per-kilometre saving in travelling distance. This can also be followed by selling of assets at their residual value on the basis of market price.

Table 3.4 Pros and Cons of Rental Indices

Potential Strengths	Possible Challenges
Asset-specific pricing benchmark reflects relevant risks.	Rental indices may have more fluctuations, be less widely available for suburban/rural regions and expose the banks to asset price risk.
With a rise in asset pricing, the bank has the potential to profit from asset price appreciation.	There is no term premium. It will have to be added separately.
Avoids reference to interest-based benchmarks.	With escalating asset pricing, currency depreciation, inflation and other factors, asset prices and rents may go up and affect the consumers' cost, causing commercial displacement risk.

Real-Economy-Based Price, Production and Return Measures

Besides the three pricing options identified above, there are some real-economy-based prices, production and return measures. First is a seasonally adjusted output price index to measure the core inflation (non-food, non-energy) after appropriate smoothing by using a moving average. In the case where costs remain unchanged in a short period of time, an increase in output price will positively affect profitability. Second, for consumer and corporate finance, the Consumer Price Index (CPI) or Wholesale Price Index (WPI) and commodity price indices in commodity-based trade finance contracts can also be used.

Table 3.5 Pros and Cons of the Output Price Index

Potential Strengths	Possible Challenges
Frequency of data availability is weekly, and is instantaneous for commodities as compared to other real-economy measures.	For banks, credit or deferred price is more relevant than spot price. Term premium will need to be added separately.
Banks can potentially gain from asset price appreciation and can pre-emptively invest in commodities in jurisdictions where it is allowed. Seasonal adjustment can make price fluctuations smoother.	There are numerous output price indices, with differences in weights, composition of basket of commodities, base year, frequency of publishing and calculations.
Avoids reference to interest-based benchmarks.	Banks are exposed to asset price risk and supply-side factors of the real economy.

Third is the stock price index's variation to capture the historical and futuristic return on assets. By taking into account past, present and future information, stock price represents a substantive measure of performance. In an efficient market, the stock price index is supposed to capture both private and public information. Given that the stock price index is available on an instantaneous basis through daily and tick-by-tick data, it represents a useful measure for evaluating the performance of enterprises.

Fourth, a portfolio-based index could be a better measure for risk diversification to ensure stability and the adequate representation of different players. For instance, a sovereign index can be constructed comprising stocks of only the selected government-owned enterprises. Since financial institutions mostly enter in non-equity-based transactions, such as sale, lease and investment agency, an asset price index constituting *ṣukūk* issued by government-owned enterprises can be used. In this alternative measure, data can be made available at short frequencies. But, having a sufficient number of government-owned *ṣukūk* in diverse sectors might be an issue. Furthermore, there may not be enough *ṣukūk* for each term.

Table 3.6 Pros and Cons of the Asset Price Index

Potential Strengths	Possible Challenges
Frequency of data availability is instantaneous, as compared to other real-economy measures.	For banks, credit or deferred price is more relevant than spot price. Term premium will need to be added separately.
Price fluctuations usually reflect historic and futuristic expectations and are triggered by fundamentals in a relatively efficient market.	Forward-looking target price calculations based on a dividend discount model, or a variety of methods, cannot give unique answers. Calculations are based on several assumptions and one of the required inputs is the discount rate itself.
Asset price indices are not referenced to interest-based benchmarks.	In the short term, prices are driven by noise trading, volumes,herding and other anomalies. Thus, banks become exposed to these risks with much less variety of hedging instruments in the Islamic finance space.

Economic Growth Rate: Nominal and Real

Fifth, the nominal growth of GDP can be a plausible measure as the benchmark rate in the money market. This means that indexing the instrument based on a nominal GDP growth rate will be appropriate because it is related to production. In the same context, the utilisation of gross regional product can be an even more stable average return in regional economies. However, since the nominal GDP growth takes into account inflation, which is considered a cost-push, the use of real GDP growth plus moving average core inflation growth is an option to be pursued.

Table 3.7 Pros and Cons of Output Growth Indices

Potential Strengths	Possible Challenges
If nominal GDP growth rate is used, it includes the effect of inflation and makes the rate more robust. Even if output growth is low or negative, inflation is not and the overall rate (real GDP growth + core inflation) will remain positive.	Output growth is not a function of time. Term premium will need to be added separately.
If nominal GDP growth rate is used, a multiple or spread can be added to mitigate commercial displacement risk and make the return market competitive.	Frequency of data availability is quarterly at best, or monthly for some sectoral indices such as the industrial production index.
Avoids reference to interest-based benchmarks and reflects pure economic activities in a comprehensive way, covering the output of all sectors plus prices.	Cost of capital based on this measure can be high. Also, production is a function of demand. Demand-side stagnation, intensified competition, or unfavourable policies or regulations can also affect production.

Sixth, the profit rate paid by the government in government contracts and projects can also be explored as a potential benchmark. For instance, the government procures commodities from the agriculture sector. In such commodity operations, the profit rate can be imputed from the transactions. Likewise, governments offer a profit rate to independent power producers and other suppliers. In such transactions, as a monopsony and regulator, the government can influence price and, hence, the profit rate. Such profit rates are strictly and directly based on real-economy-based transactions. However, a term or maturity premium will have to be added, since financial institutions are basically interested in the time value of economic transactions, which are intertemporal.

There are certain projects where it is possible to launch *musharaka ṣukūk* and enable profit sharing on a pure pass-on basis, such as railways (yielding fare revenue), airlines (yielding fare revenue), energy production and distribution (yielding sales revenue) and roads (yielding toll taxes), for instance. To cover the possibility of negative net profits, profit calculation can be done at the gross or operating profit level. Again, tier-based profit sharing, along with cost sharing in specific heads only, will ensure that the eventual ex-post return on investment is close to the target rate. Cost sharing in specific heads will ensure profit calculation at a relatively gross level to further ensure that the profit sharing goes to the second tier whereby the financier has obtained the target return.

Table 3.8 Pros and Cons of Implied Profit Rates

Potential Strengths	Possible Challenges
If profit sharing is tier-based, then a target profit rate implied from the profit rate on commercial contracts can be used as a threshold to yield a relatively closer ex-post return that is nearly equal to the target profit rate.	Projects vary in risk, maturity and scale. Unlike output growth rates, profit rates on individual contracts, in particular, can have a long range from negative to positive.
There are certain projects where the implied profit rate is known to be positive through the contracted prices, such as in energy and construction projects. Such implied profit rates can be used to derive a target profit rate.	Ex-post profit rates on short-term and long-term projects are not based on a maturity premium. Therefore, for a term premium, separate adjustments may be required.
Avoids reference to interest-based benchmarks and reflects profits on actual commercial transactions.	Implied profit rates from commercial contracts may not be universally and transparently available to all market players.

Policy Recommendations

As the development of Islamic benchmark rates is still ongoing, relevant recommendations are provided for Islamic financial institutions (IFIs) to make the transition seamless. They are as follows: (1) Tough legacy contracts must be dealt with to minimise IFIs' exposure to financial risks. (2) IFIs must ensure that a fall-back[140] mechanism to an alternative benchmark rate is included in the contract to minimise any value transfer. (3) The technological infrastructure needs to be updated when integrating the newly adopted alternative reference rates, for transparency and security purposes. (4) A comprehensive governance framework is needed to identify, measure, monitor and control financial and non-financial risks of transition, establishing processes and oversight routines for ongoing management. (5) Islamic banks and regulators need to continue collaborating with *Sharī`ah* scholars to come up with solutions about various *Sharī`ah* issues.

Furthermore, the substantial interaction between Islamic and conventional institutions cannot be mitigated while IIFS represent a part of the global economic and financial sector. Intuitively, issues related to regulatory arbitrage are most likely to emerge. In this regard, much focus is needed on how to mitigate the regulatory arbitrage in a dual banking system so as to ensure the stability and resilience of the Islamic banking industry.

[140] "Fall-back" refers to the legal provisions in a contract that apply if the underlying reference rate in the product (LIBOR) is discontinued or unavailable.

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Box Article 4:

Central Bank Digital Currency (CBDC) Initiatives in Turkey

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TÜRKİYE CUMHURİYET MERKEZ BANKASI

Introduction

Money is an invention of humanity that is utilised in all aspects of human life. More and more, a digitalized way of living has an inevitable consequence for money to manifest itself in digital form.

The technological progress around digitalisation and the emergence of numerous implementations/trials in the form of private digital currencies have accelerated efforts of central banks to create their digital form of cash, so called Central Bank Digital Currencies (CBDC).

Almost all central banks around the globe are working on CBDC projects. They are researching, developing, testing, piloting and collaborating on this strategic technology to create digital rails that can put money into digital circulation.

This article provides an overview of the latest developments in digital payments in Turkey, including Digital Turkish Lira project of the Turkish Central Bank.

Payment Ecosystem and Covid Impact on Digitalisation of the Economy

Central banks have been providing rails for both wholesale and retail payments through the banking system. Digitalisation of the payment industry has been evolving rapidly and changing the way we pay – not only wholesale payments among financial institutions but also retail payments between individuals and businesses.

Proper utilisation of the innovative technologies in payments can help many countries to leapfrog ahead in digitalisation of their financial services and increase their financial inclusion. For central banks and financial system regulators, keeping track of the developments in digitalisation, and keeping regulatory frameworks up to date accordingly, is not only an institutional mandate but also a social-requirement to realise the potential benefits of digitalisation for all layers of society.

The recent global pandemic brought fundamental challenges in the production, distribution and consumption of goods and services. These challenges further accelerated the digitalisation of economic activity, including the development and utilisation of Instant Payment Systems (IPS) and CBDCs.

Digital Payments and Central Bank of the Republic of Turkey (CBRT)

Demand for safer, efficient and seamless 24/7 instant electronic payments has surged, and central banks have resumed their roles as innovators in these rapidly emerging technologies. The CBRT responded by launching its "FAST" instant payment system, developed in-house at the central bank, which started its operations in January 2021.

FAST has swiftly become part of daily life. Sixteen million customers have used it to transfer money electronically within seconds, without limits at certain times of the day or on certain days of the week. Furthermore, they have been enabled to utilise their national ID number, phone number or email address instead of bank account numbers to receive money.

A dedicated department, the Financial Innovation Department (FID), was established in order to consolidate the bank's digitalisation efforts and to conduct research and development (R&D) to create digital Turkish Lira (DTL). The FID has been enhancing its capacity with engineers, data scientists, experts in machine learning, finance and digital technologies in order to design the architectural framework for a digital Turkish Lira.

A roadmap for technological requirements, economic policy implications and legal aspects has been prepared. This roadmap includes the creation of a platform for cooperation and co-creation with-technology partners and stakeholders in the financial sector to guarantee the successful launch of DTL. This will enable the CBRT to assume the role of being the backbone of the digital economy by putting money into full-fledged digital circulation after thorough investigative processes, experiments and pilot testing.

The "Digital Turkish Lira Collaboration Platform" was established for this purpose. Major technology providers and technology research institutions have joined with the CBRT for the purpose of creating the technological infrastructure that can deliver throughput, security and the legal requirements of digital Turkish Lira.

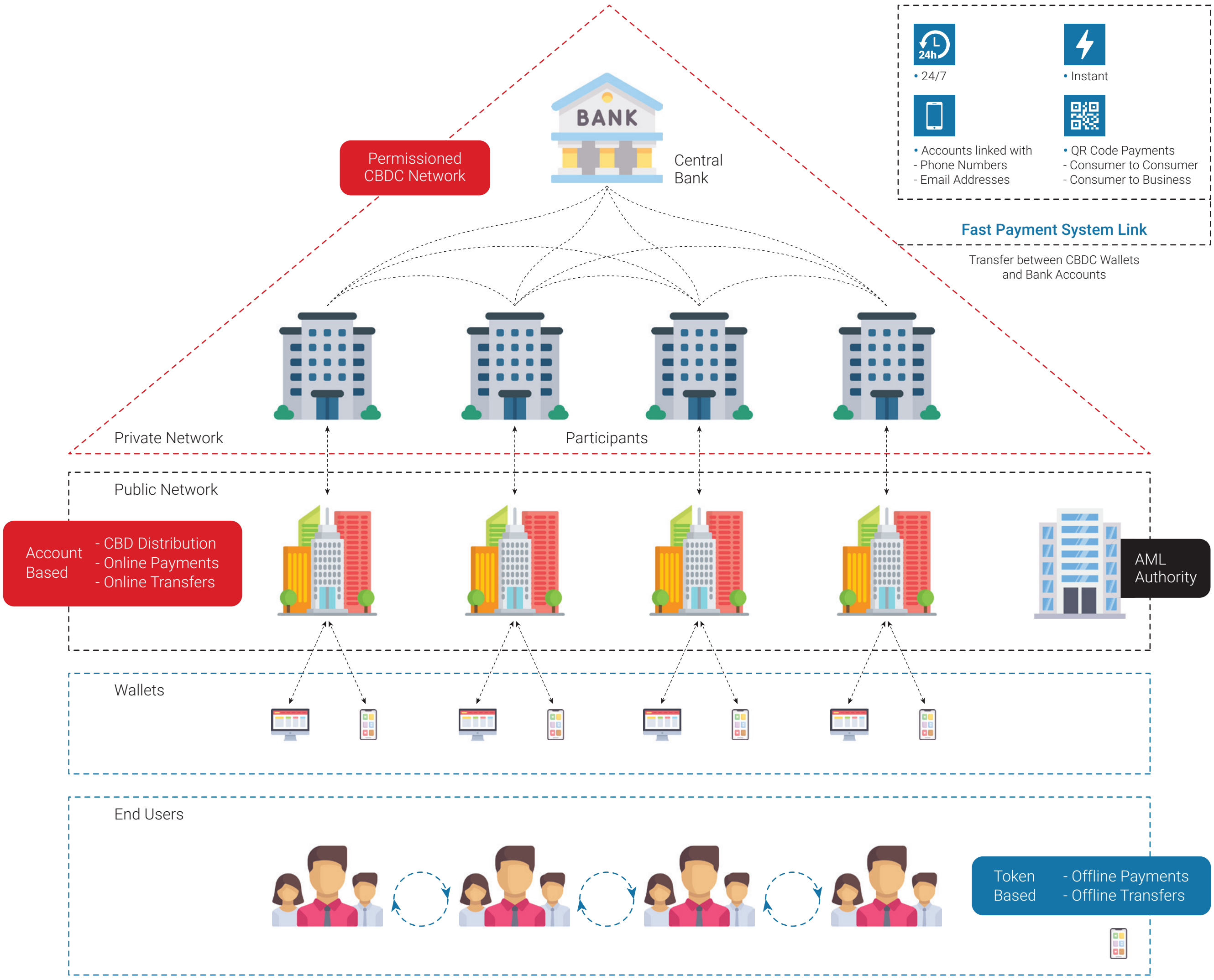

Figure 1: Digital Turkish Lira Network

Through collaboration, this platform is conducting the first phase of the pilot study to develop a prototype "Digital Turkish Lira Network" (Figure 1) and to run limited closed-circuit pilot tests. Based on the results of those tests, the CBRT will unveil advanced phases of the pilot study that will reflect a broader participation by extending the platform to include financial intuitions and other relevant bodies.

It is important to note that the CBRT has not yet reached a final decision regarding the issuance of a digital Turkish Lira. The outputs of the ongoing research will shed light on the feasibility and potential benefits of introducing digital Turkish Lira to complement the existing payments infrastructure. The capacity, scalability, interoperability and resilience of different technological alternatives are being investigated in order to decide whether the existing technologies can meet the economic, legal and financial requirements of the digital Turkish lira.

CBDC Initiatives and Cross-Border Payments

Faster, cheaper, more transparent and more inclusive payments are important for achieving efficient global trade, realising investment potential and ensuring fair distribution of wealth among nations. Cross-border integration of instant payment systems is an important development in that direction and has already started. CBDCs have the further potential benefit of providing additional layers of privacy and security while meeting legal requirements and connecting payments with digital ID infrastructure.

In this regard, the BUNA payment platform of the Arab Monetary Fund (AMF) and the BIS initiatives such as Project Nexus and Project Dunbar are ongoing examples of how to cover key issues and challenges in achieving interoperability in IPS and CBDCs. These projects present a useful analytical framework for addressing issues around multilateral cross-border retail payments.

Conclusion

Governments, households and businesses demand safe, resilient, efficient and 24/7 instant payments with finality. It is important to stress that only sovereign money in the form of cash enables real-time payments with ultimate finality. Cash as banknotes and coins provides unconditional finality of debt or due payments. This is a societal function of money that no other alternative can fulfil as yet. However, cash would not function in a perfectly digital economy.

CBDCs are enhanced cash with digital capabilities. Offline payment capabilities, digital identity systems, integration with existing payment rails and enabling cross-border transfers are challenges for realising the full potential of CBDCs for digital life.

4.0 GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

4.1 Global Developments and Impacts on the IFSI

This section of the chapter summarises actions by global standard setters in 2021 and early 2022 that are relevant to the IFSI and to the standard-setting work of the IFSB. The IFSB, being the complementary global standard setter for the Islamic financial services industry, monitors closely the work streams of global standard setters, which are naturally an important influence on the direction of its own work. The summaries given here, which are based on public-domain information, do not attempt to be comprehensive surveys of the work of other bodies, but rather to draw out possible implications for the IFSB's future standards work. More details of all these actions are available through the websites of the relevant bodies.[141]

Although there have been a small number of very important developments, the flow of key documents from the main standard setters has abated somewhat in 2021. This partly reflects the preoccupation of national and international authorities with the COVID-19 pandemic, but also the gradual completion of the post-GFC work programmes. Standard setters are therefore reducing their focus on creating new standards in favour of placing a greater focus on implementation, although there are exceptions to this pattern – for example, in sustainability and in some areas of technology. In addition, many of the early lessons of the pandemic have been in relation to operational risk and resilience, including the impacts of outsourcing, and much of the work done in these areas applies as much to IFIs as it does to their conventional counterparts.

4.1.1 International Sustainability Standards Board

Issues of sustainability and sustainable development are important to the Islamic finance industry, even more than to the conventional finance community, because of the ethical principles that provide the foundation and rationale for Islamic finance.

The IFSI Stability Report 2021 noted the proposals by the trustees of the IFRS Foundation for a new Sustainability Standards Board and the significant support they had already received from governments and international organisations. These developments culminated in the announcement on 3 November 2021 that the IFRS Foundation would indeed be setting up an International Sustainability Standards Board (ISSB), alongside but independent of the International Accounting Standards Board, to develop a global baseline of high-quality sustainability disclosure standards. It also announced the consolidation into the ISSB of two existing initiatives, and subsequently announced a chair and vice-chair of the new body.

In parallel with the organisational developments, the Foundation had been working on prototype climate and general disclosure requirements. These were published for consultation to help the ISSB to produce its first standards more quickly that would otherwise have been the case. In fact, the ISSB published its formal draft standards in both these areas in March 2022; both were welcomed by IOSCO, in particular.

The IFSB has included limited climate/sustainability-related disclosures in some of its standards, based on those recommended by the Task Force on Climate-Related Financial Disclosures, and is currently working on a guidance note on sustainability in Islamic capital markets. That work will now be able to proceed on the assumption that there will be at least some conventional disclosure standards commanding wide support, though initially not focused on the financial sector in particular. New standards from the ISSB will also be taken into account in any future revision of the IFSB's disclosure standards.

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[141] See: International Sustainability Standards Board; Financial Stability Board (fsb.org); The Basel Committee – overview (bis.org); OICV-IOSCO – Iosco.org; International Association of Insurance Supervisors (iaisweb.org) and FATF-GAFI.ORG – Financial Action Task Force (FATF).

4.1.2 Financial Stability Board (FSB)

Lessons Learnt from the COVID-19 Pandemic

Last year's IFSI Stability Report discussed some of the initiatives taken by various bodies, and the FSB in particular, to analyse the lessons of the pandemic. In October 2021, the FSB produced its final report, drawing on work by the other global standard setters and external inputs. Although this is badged as a final report, it recognises that there will still be lessons to be learnt as the pandemic draws to an end and the global economy recovers. These lessons will no doubt feed into other FSB and standard-setter workstreams and, indeed, a significant aspect of the Final Report is its contribution to identifying areas for future work.

The report takes a generally positive view of the way the international financial system coped with the pandemic, aided by post-GFC regulatory reforms and strong policy measures. However, it draws attention once more to the non-bank financial intermediation (NBFI) sector, whose role in financial intermediation is growing and which is considered to have some vulnerabilities, particularly in the area of liquidity. This is discussed in more detail below. The pandemic has also raised issues around operational resilience, including cyber resilience; these issues, though important, will generally impact Islamic institutions similarly to conventional ones. In addition, it has accelerated digitalisation in financial services, some key issues of which are also discussed below.

The FSB also notes that there will be further macroeconomic issues to be discussed in the recovery from the pandemic, including the unwinding of policy measures and the impact of the debt overhang in the non-financial corporate sector partly resulting from the support measures implemented in response to COVID-19.

The FSB and other global standard setters have a concerted programme to address concerns arising from the growing role of NBFI in intermediation, and its increased interconnectedness with the banking sector. An overall progress report from the FSB was published in October 2021 and summarises the main workstreams. A particular issue is liquidity and its behaviour under stressed conditions.

Much of the key work published in 2021 was concerned with collective investment schemes (CIS). A particular issue was how to enhance money market fund (MMF) resilience, given that many of the instruments in which MMFs invest trade in relatively illiquid markets; this would be true also of Islamic MMFs. A report published by the FSB also in October 2021 puts forward a policy toolkit for dealing with liquidity issues in MMFs. Some of the measures evaluated – for example, swing pricing when redemptions are high – would need careful examination from a *Sharī`ah* viewpoint if it were proposed to apply them to Islamic MMFs. Islamic MMFs are important not only from an investor protection point of view but also because of their use by Islamic banks to manage liquidity given the limited options in some Islamic money markets.

Meanwhile, IOSCO published a report on the behaviour of exchange-traded funds under stress and is conducting a joint analysis with the FSB on liquidity management tools for open-ended funds more generally; this is expected to result in a report during 2022. Given the Islamic specificities – for example, the *Sharī`ah* restrictions on some liquidity management approaches – it is possible that there may be a future case for IFSB work in this area.

Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements

In October 2021, the FSB published what was nominally an update on progress in implementation of the high-level recommendations it made a year earlier, but which in fact covered a broader set of developments in the regulation of crypto-assets. The report notes that the current generation of stablecoins are used primarily as a bridge between fiat currencies and crypto-assets traded for speculative purposes, rather than being used in traditional payments on any significant scale. However, the Committee on Payments and Market Infrastructures and IOSCO have consulted on proposed guidance on how the Principles for Financial Market Infrastructures might apply to stablecoins if used within systemically significant payment systems. In June 2021, the Basel Committee on Banking Supervision (BCBS) made proposals as to the prudential treatment that should apply to banks' exposures to crypto-assets of different kinds, taking a rather conservative view of the risks involved, but at the time of writing it has not published a definitive standard. The Financial Action Task Force (FATF) has also updated its guidance on the anti-money laundering/combating the financing of terrorism treatment of virtual assets.

Subsequently, the FSB has also produced an update on the financial stability risks from crypto-assets, which at present remain limited though with the potential for escalation. It has indicated that it is beginning work with other standard setters on regulatory and supervisory issues in relation to unbacked crypto-assets.

At present, there is no consensus among *Sharī`ah* scholars on which, if any, crypto-assets are permissible. However, should a consensus emerge, there is clear potential for the IFSB to undertake work in this area.

4.1.3 International Organization of Securities Commissions

Much of the work published by IOSCO in 2021 and early 2022 has been analytical or has suggested possible approaches by regulators (regulatory toolkits) rather than definitive standards. This partly reflects that some potentially important market developments remain in their early stages. Examples of publications of this kind include those on digitalisation of retail marketing and distribution, including the use of social media, and lessons learnt from the use of global supervisory colleges.

Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management

This report, published in November 2021, sets out five recommendations for securities regulators and policymakers to improve sustainability-related practices, policies, procedures and disclosures in asset management. These are couched in very general terms, and of course relate to only one part of the capital markets, but they will nevertheless be relevant to the IFSB guidance note on sustainability in Islamic capital markets referred to above.

4.1.4 International Association of Insurance Supervisors

Roadmap for 2022–3

In January 2022, the International Association of Insurance Supervisors (IAIS) published its 2022–23 Roadmap – effectively, its work programme for those two years. It regards as its key projects the Insurance Capital Standard (ICS), currently in its five-year monitoring period, and the Holistic Framework for assessing systemic risk in the insurance industry. While there will be limited new work on the ICS itself, there will be revisions to two key core principles, on valuation and capital adequacy. These are not expected to be finally adopted until 2024, but they may have significant implications for the *takāful* industry and the associated IFSB standards. The IAIS is due to report to the FSB in 2022 on the first two years of operation of the Holistic Framework. However, given the limited systemic significance globally of the *takāful* industry, this is unlikely to have important implications for it.

4.1.5 Financial Action Task Force

Unintended Consequences of the FATF Standards

In February 2021, the FATF established a project team to analyse and understand better the unintended consequences resulting from the FATF standards and their implementation. This project examines the unintended consequences related to four broad themes: (a) de-risking; (b) financial exclusion; (c) undue targeting of non-profit organisations; and (d) curtailment of human rights. A high-level synopsis of the team's work was published in October 2021 to facilitate discussion with stakeholders during the next phase of the work, which will look at potential mitigating options.

Although there are limited, if any, Islamic finance specificities in the areas covered by the FATF standards, because of their locations and, sometimes, their role in collecting charitable contributions such as zakat, some Islamic financial institutions believe they have suffered unfairly from de-risking in particular. This work will therefore be of particular interest to the IFSI, though it appears unlikely to have any direct impact on the work of the IFSB.

4.2 IFSB Standards, Research and PSIFIs Activities

4.2.1 Update on Standards under Development

The IFSB, as an international standard-setting body with the mandate to ensure soundness and stability of the IFSI, currently has nine standards, technical notes and guidance notes under development that seek to achieve the objectives of promoting a more prudent, transparent and resilient IFSI.

Islamic Banking Workstream

Resolution and Recovery Plan (RRP) for IIFS

The technical note aims to help the relevant RSAs and related authorities to establish an effective recovery and resolution framework and appropriate tools for effective implementation of recovery and resolution for IIFS in a manner fully compliant with *Sharī`ah* principles. This will include setting out the required measures to carry out effective recovery and resolution planning for IIFS, as part of their proactive measures to prepare for any potential stressed situation; supporting and enabling effective resolvability assessments essential for bespoke resolution regimes for the IIFS; and requiring *Sharī`ah* governance in relation to resolution and recovery planning for IIFS.

Technical Note on *Sharī`ah*-Compliant Liquidity Management Tools

The technical note aims to provide harmonised and standardised liquidity management instruments that will meet *Sharī`ah* rules and principles and which RSAs can transpose into national regulations for the purpose of managing liquidity issues of their IIFS. It is also intended to provide technical guidance on the modus operandi of the specific *Sharī`ah*-compliant liquidity management tools, highlight risks associated with these instruments, and assess their implications in relation to liquidity risk management and regulatory capital requirements for IIFS.

Guiding Principles on Corporate Governance for IIFS

The standard aims to revise the existing standard, IFSB-3 which was issued in December 2006, to incorporate recent substantial developments in other corporate governance global standards to provide an updated and comprehensive framework for corporate governance for Islamic banks. In particular, the revised standard will take into account the updated versions of the G20/OECD *Principles of Corporate Governance* and the BCBS *Corporate Governance Principles* for Banks issued in 2015.

Technical Note on Macroprudential Tools in Islamic Banking

The development of this new technical note aims to provide guidance on adjustments to existing macroprudential tools that may be needed to reflect the specificities of Islamic banking contracts. It will address implementation challenges in stress testing and other methods used to identify vulnerabilities in the Islamic banking sector. Several recommendations are also included to enhance the governance arrangements to ensure that the specificities of Islamic banking are catered for when decisions to apply these tools are made. As most regulators already have established policies and ranges of tools, an approach focusing only on the specific challenges in the implementation of these instruments to the Islamic banking sector will be used in developing the technical note.

Islamic Capital Markets Workstream

Guidance Note on Deepening the Islamic Capital Markets

The guidance note seeks to promote financial stability through deep and liquid Islamic financial systems with diverse instruments that will help enhance countries' resilience to shocks, and in turn, also support the resilience of other parts of the Islamic financial services industry by providing a wider range of investments with better price discovery. The guidance note identifies the current gaps and challenges in the development of Islamic capital markets and outlines the necessary preconditions for the development and deepening of Islamic capital markets. It provides 13 recommendations addressing the issues and gaps that were identified by members. The recommendations are designed to provide a list of best practices and potential areas for consideration in line with domestic regulatory frameworks and policy approaches for Islamic finance development.

Guidance Note on Sustainability-Related Issues and Disclosures in the Islamic Capital Markets (ICMs)

The guidance note aims to look at sustainability and climate-related issues that relate specifically to the IFSB's mandate of ensuring stability and resilience in the IFSI. In particular, given that ICM instruments are structured differently from conventional financial instruments as well as the additional layers of governance involved in Islamic finance, the guidance note will aim to identify how principles related to sustainability apply to the peculiarities of the ICM and provide guidance on these issues for Islamic capital market regulators.

Takāful Workstream

Core Principles for Islamic Finance Regulation: *Takāful*

The Core Principles *takāful* standard aims to provide an international benchmark to promote a sound regulatory and supervisory system for the *takāful* sector. A fair, safe and stable *takāful* sector will benefit and protect the interests of participants, beneficiaries and claimants, as well as contribute to the stability of the Islamic financial system. A hierarchical structure of principles, standards and guidance material, consistent with that of the IAIS Core Principles, is currently under development which, like other IFSB Core Principles, covers the full range of regulatory issues.

Revised Standard on Solvency Requirements for *Takāful*

The revised solvency standard for *takāful* undertakings, replacing the existing IFSB-11, is intended to foster confidence among the general public – in particular, *takāful* participants – in the financial stability of the *takāful* sector. It aims to increase the likelihood that a *takāful* undertaking would be able to meet all its contractual obligations and commitments; to act as an early warning system for regulatory intervention and immediate corrective action; and to provide a buffer so that even if the *takāful* participants are to suffer a loss in the event of failure of a *takāful* undertaking, the impact can be limited or reduced, especially the systemic effects. The standard will take account of developments in conventional standards since IFSB-11 was issued in 2010, especially the IAIS Insurance Capital Standard and the finalisation of the European Solvency II regime.

Conduct of Business for *Takāful* Undertakings

This standard recognises the link between conduct of business and prudential risks, and the significant difference between conduct-of-business issues in *takāful* and those in conventional insurance. It therefore aims to provide comprehensive supervisory guidance to the RSAs within the conduct-of-business environment and to articulate the link between prudential and conduct-of-business risks to strengthen the prudential supervisory framework and practices.

Cross-Sectoral Workstream

Revised Guiding Principles on the *Sharī`ah* Governance Framework for IIFS

The IFSB and the AAOIFI have partnered to jointly provide a revised set of guiding principles on the key components of a sound and effective *Sharī`ah* governance system for IIFS. The aim of the standard is to provide a revised set of guiding principles and rules on the key components of a sound and effective *Sharī`ah* governance framework for IIFS. It sets out 14 principles that seek to improve the quality of *Sharī`ah* governance by providing comprehensive guidance on minimum and best practices for various elements of *Sharī`ah* governance; to help RSAs and IIFS fulfil their responsibilities towards the various stakeholders regarding *Sharī`ah* compliance and governance; and to provide greater harmonisation of *Sharī`ah* governance structures and practices across jurisdictions. The standard will replace IFSB-10, issued in December 2009.

4.2.2 Synopsis of IFSB Research Projects

The IFSB has issued five working papers since the publication of the Stability Report 2021. IFSB working papers are research-based publications intended to lay the groundwork for future standards development and implementation. The papers can be downloaded from the IFSB website.

WP-17: EFFECTIVENESS OF MACROPRUDENTIAL TOOLS FOR ISLAMIC BANKING

WP-17 applies a quantitative method to assess the effectiveness of a set of macroprudential tools on household credit growth in banking environments with both Islamic banks and conventional banks. A qualitative method based on survey findings and case studies of two countries – namely, Saudi Arabia and Indonesia – was also used to examine the country-specific contexts relating to implementation of the macroprudential policy framework. The analysis suggests that Islamic banks also respond appropriately to the implementation of macroprudential policy tools. This demonstrates the importance of macroprudential tools for managing potential risks associated with the high financing exposure of Islamic banks. Thus, a relatively high financing exposure of Islamic banks to household credit (the real sector), which could probably make them vulnerable to macroeconomic dynamics, can be effectively controlled.

WP-20: THE ROLE OF SOCIAL IMPACT *ṢUKŪK* IN THE RECOVERY PHASE OF THE COVID-19 PANDEMIC

WP-20 addresses the role of social *ṣukūk* in the recovery phase of the COVID-19 pandemic. Notwithstanding the pandemic has done a considerable amount of economic, social and emotional damage to the global economy and people the world over, the Islamic financial system's resilience, sustainability and contribution during the recovery from GFC of 2008 suggests it will play a crucial role in the recovery from recent events as well. To achieve this, Islamic financial services have a bundle of social financial services at their disposal – in particular, social *ṣukūk*. The present working paper, based on extant literature and notable examples of the use of social impact *ṣukūk* in mitigating the impact of COVID-19, analyses the potential role of social impact *ṣukūk* in the recovery phase from the perspective of both investors and issuers. The findings of the study indicate that this role may be a critical one.

WP-21: ASSESSING THE EFFECTIVENESS OF COVID-19 POLICY RESPONSES IN THE ISLAMIC CAPITAL MARKET

WP-21 focuses on developments in the Islamic capital market during the COVID-19 pandemic. Adopting a conceptual approach, the paper specifically assesses the performance of the key segments in the ICM. It also considers the experience and measures adopted by the key multilateral and international organisations, as well as the policy responses adopted across IFSB member jurisdictions, with an emphasis on their relative effectiveness. The paper provides an overview of the ICM post-COVID-19 pandemic and the opportunities the pandemic offers to the industry during the recovery phase.

WP-22: ASSESSING THE EFFECTIVENESS OF COVID-19 POLICY RESPONSES IN THE TAKĀFUL INDUSTRY

WP-22 focuses on developments in the *takāful* segment of the IFSI during the COVID-19 pandemic, up to August 2021. Based on responses obtained from *takāful* companies, insurance companies and RSAs across IFSB member jurisdictions, the paper specifically assesses the performance of *takāful* companies. It also considers the COVID-19 experience and the measures adopted by both operators and regulators across IFSB member jurisdictions, with an emphasis on their relative effectiveness. The paper provides an overview of the *takāful* industry post-COVID-19 and of the opportunities the pandemic offers to the industry during the recovery phase. It also provides views of key industry leaders and experts regarding issues highlighted in the survey and offers insights that may be taken into account by policymakers and regulators to support and encourage *takāful*'s sustainability and growth.

WP-23: ASSESSING THE EFFECTIVENESS OF COVID-19 POLICY RESPONSES IN THE ISLAMIC BANKING INDUSTRY

WP-23 empirically assesses the effectiveness of COVID-19 policy responses in the Islamic banking industry across IFSB member jurisdictions. Specifically, the paper aims to determine if the various monetary, financial and fiscal policy support measures used have resulted in the intended outcome of ensuring that Islamic banks remain resilient and complement the functioning of the economy by providing financing to the real economy during the ongoing pandemic. Moreover, the paper investigates whether Islamic banks have used the flexibility provided for in the IFSB standards and guidelines to adapt to the peculiarities of the COVID-19 pandemic shock, and whether there are potential Islamic banking sources of procyclicality arising especially from the macrofinancial policy measures. The analyses are based on data extracted from the IFSB Prudential and Structural Islamic Finance Indicators from Q1'19 to Q4'20 for 17 jurisdictions. Other data sources include various COVID-19 policy response indexes, IFSB surveys issued during the pandemic, and publications by the IFSB and other standard-setting bodies. Specifications of a number of panel regression analysis models are tested. Findings indicate that the various COVID-19 policy responses have been generally effective in ensuring that Islamic banks continue to perform their intermediation role of supporting the real economy during the pandemic. Finally, the paper identifies the financial stability implications of the findings and offers suggestions for scheduling the phasing out of policy support measures.

4.2.3 Final Review of the IsDB–IFSB Ten-Year Framework and Strategies Paper

The IFSI Ten-Year Framework and Strategies Report, covering the period 2008–18, was first issued in 2007, followed by a Mid-Term Review issued in May 2014. The Mid-Term Review discussed the proposed measures to address the gaps or challenges in meeting the objectives of the Ten-Year Framework, as well as the roles of the public and private sectors and other stakeholders in carrying out the key recommendations, taking into account the state of development of the IFSI in the respective jurisdictions.

The Mid-Term Review also proposed 16 recommendations, comprising 13 from the 2007 document and three new additions, which are further grouped into three themes, namely: "enablement", "performance" and "reach". Additionally, the Mid-Term Review publication identified a total of 20 key initiatives to support the implementation of recommendations. These initiatives are grouped along the three pillars of the framework: "enablement", "performance" and "reach". Importantly, the Mid-Term Review envisioned that the review of the industry-wide progress of the recommendations and key performance metrics would culminate in a final review, which essentially marks the completion of the period envisioned by the Ten-Year Framework; hence, the need to embark on this last phase of the Ten-Year Framework to complete the entire project.

The final review will examine the progress and current status of the priorities and initiatives recommended in the Mid-Term Review across the Islamic banking, Islamic capital markets, *takāful* and Islamic non-banking financial institutions segments. It will assess the effects on the respective Islamic finance segments of developments in the global financial system and propose key recommendations and implementation initiatives for the future direction of the IFSI as a global financial ecosystem.

The project, which is expected to culminate in a final report that will be jointly published by both the IsDB and IFSB, is presently being carried out by a working group comprising staff of both organisations and external consultants. A review committee from the IFSB Technical Committee has also been appointed to provide a technical review at various stages of the project.

4.2.4 Prudential and Structural Islamic Financial Indicators (PSIFIs) Database: A Repository of Global Islamic Finance Data

The PSIFIs database consists of a set of aggregate indicators of the financial health, soundness, size and growth of the IFSI in a country. The PSIFIs are designed to capture the specificities of IIFS, while also providing a set of standardised indicators that are broadly parallel to the framework for the financial soundness indicators (FSIs) developed by the IMF to help enable global comparability of Islamic finance statistics and similar conventional finance statistics. The database project was initiated in 2004 and was developed in phases, primarily with the aim of capturing information on the size, growth and structural features of the Islamic banking system. After completion of four successful phases, the PSIFIs project is now in Phase V under the Medium-Term Plan 2020–22 and has reached a sustainable stage in terms of regular reporting of Islamic banking data. The PSIFIs project currently compiles Islamic banking data from 26 jurisdictions – namely, Afghanistan, Bahrain, Bangladesh, Brunei Darussalam, Egypt, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Lebanon, Libya, Malaysia, Morocco, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Sudan, Turkey, the United Arab Emirates and the United Kingdom. Overall, the PSIFIs member countries collectively hold more than 95% of global Islamic banking assets and over 90% of the jurisdictions with a systemically important Islamic banking sector.

In Phase V, the IFSB initiated expansion of the PSIFIs database to also cover the *takāful* and ICM sectors. PSIFIs data on the *takāful* sector have been disseminated annually since 2020. Similar to the CAMELS analytic framework used for organising prudential indicators for Islamic banking, *takāful* indicators use a CARMELS framework that has an additional measure for retakāful: Capital Adequacy, Asset Quality, *Retakāful* (Reinsurance), Management, Earnings, Liquidity, and Sensitivity to Market Risk. Reinsurance, which results in transfer of risk to a reinsurance/*retakāful* undertaking, is added because it is directly related to the soundness of the operation. Currently, nine RSAs from Bahrain, Brunei Darussalam, Indonesia, Jordan, Malaysia, Nigeria, Saudi Arabia, Turkey and the United Arab Emirates are participating in the compilation of *takāful* PSIFIs.

The inaugural dissemination of PSIFIs data for the ICM sector was completed in 2021 with subsequent disseminations planned to follow annually. The PSIFIs for the ICM sector cover three main areas: *ṣukūk*, *Sharīʿah*-compliant equities and Islamic funds. At present, seven jurisdictions – namely, Bahrain, Brunei Darussalam, Indonesia, Kenya, Malaysia, Qatar and Turkey – have joined the PSIFIs database for the ICM sector.

In Phase V, the IFSB also started collecting more granular-level data for the Islamic banking sector in the form of detailed financial statements (DFS) that cover the aggregated income statements, balance sheets and memoranda items for the Islamic banking sector. DFS data have been disseminated on a yearly basis since 2020. The DFS provides analysts with information that enables them to experiment with different variations of the indicators and to examine other linkages of the accounts with the general economy. The full structural information can also facilitate comparison to microdata from individual enterprise financial reports and from various commercial databases that present bank-by-bank reporting. The DFS parallels the IMF's collection of similar accounts covering full national banking systems (conventional and Islamic combined).

4.3 Facilitating the Implementation of IFSB Standards Initiatives

Since its establishment, the IFSB has conducted several types of activity that support the implementation of standards in member countries. These activities include: facilitating the implementation of IFSB standards (FIS) workshops, technical assistance (TA), policy advice (PA), an e-learning platform, an outreach programme, the translation of IFSB standards into additional languages, and provision on the IFSB website of frequently asked questions (FAQs) for standards, guidance notes and technical notes. Some of these activities are meant to educate and raise awareness of IFSB standards. Others provide direct support to member RSAs, since technical support is extended during the drafting of policies and regulations to ensure consistency with the IFSB's standards.

The Secretariat also conducts an annual implementation survey to assess the progress made in implementing the IFSB's published standards and to understand the major challenges and constraints faced in this regard. The feedback received from members helps in identifying strategies that can assist in accelerating and strengthening the process of implementing the IFSB's standards.

In addition to the above activities, the IFSB Secretariat introduced new initiatives in its Strategic Performance Plan 2018–2020 that aim to further enhance the implementation support provided to member RSAs. These newly introduced initiatives include the publishing of an Implementation Guidelines (IG) Report, development of the Impact and Consistency Assessment Programme, building a database of experts in IFSB standards through conducting the Training of Trainers Programme, and publishing FAQs on IFSB standards, guidance and technical notes. The following summary provides further information on the IFSB's implementation initiatives.

4.3.1 FIS Workshop, Technical Assistance and Policy Advice

In 2021, the Secretariat conducted 12 FIS workshops, two capacity-building workshops for market players, and three workshops for RSAs on different IFSB standards, covering the three sectors of Islamic banking, Islamic capital markets and *takāful*. The Secretariat also finalised TA and PA to member RSAs in 2021, delivered through a mix of virtual engagements and email communications.

4.3.2 Impact and Consistency Assessment Programme

The IFSB Secretariat has been working on the development of an impact and consistency assessment programme (ICAP) for IFSB standards in member countries. In this regard, an ICAP handbook and assessment templates have been finalised and approved by the task force and the IFSB's Technical Committee. The ICAP assessment is meant to provide a validated representation of the implementation status of particular member RSAs and to allow the identification of any regulatory gaps that might have a serious impact on the financial sector in member jurisdictions. It will also allow the IFSB to extend any support required to remedy gaps and to ensure effective implementation of standards.

The initiative has the following aims:

a. to promote the full and consistent adoption of IFSB standards by identifying provisions in the standards that are not reflected in domestic regulations and practice;
b. to assess the current and potential impact of any deficiencies for the objectives of the regulator;
c. to help member jurisdictions by providing technical assistance to undertake the reforms needed to improve the alignment of national regulations with IFSB standards;
d. to assess the impact of implementing IFSB standards on member countries; and
e. to ensure that Islamic financial institutions and markets in member jurisdictions are effectively regulated and supervised on an equitable basis with conventional financial institutions.

The introduction of ICAP as one of the main activities under implementation will have several benefits for both the IFSB and member RSAs. While it will help the IFSB to achieve a vital part of its core mandate, it will allow member RSAs participating in the ICAP programme to build a stable, resilient and high-integrity Islamic finance sector through complete and consistent implementation of IFSB standards. They will also be encouraged to create a fair and competitive environment where both Islamic and conventional financial institutions and markets are provided with a level playing field from a regulatory perspective.

Initially, the programme will focus on assessing implementation of the Islamic banking standards, and will be extended in due course to the ICM and takāful sectors. Two ICAP approaches will be available: (a) facilitated ICAP, and (b) self-assessment ICAP. A facilitated ICAP involves external parties such as an ICAP team, while a self-assessment ICAP will be controlled internally by the RSA without any involvement by the IFSB.

The main outcome of the ICAP will be a final assessment report highlighting identified gaps or deviations in the domestic regulations and providing recommendations on bridging the gaps. Based on the ICAP findings and results, RSAs will be provided with feedback from the IFSB Secretariat on how to address the gaps and undertake the reforms needed to improve the alignment of national regulations with IFSB standards in the assessed RSA. RSAs will also receive any necessary support from the Secretariat to achieve complete and effective implementation of standards.

4.3.3 Training of Trainers Programme

The Training of Trainers (ToT) Programme is an initiative under the Implementation Framework that aims to mobilise subject matter experts (SMEs) in IFSB standards who can be engaged in the IFSB's activities, such as FIS workshops, TAs and PAs. They are expected to train colleagues within their own RSA and to act as resident consultants on standards implementation. Invitation letters have been sent to all member RSAs, inviting them to nominate qualified staff to be part of the programme. The Secretariat conducted an extensive technical training for the nominated applicants in 2021, which covered the three sectors of Islamic banking, Islamic capital markets and *takāful*. Participants were invited to attend the programme based on their specialties and area of expertise. The participants went through an assessment and will be given a certificate verifying their attendance at the first ToT programme. The programme will be held annually, and at the end participants will be certified as experts to facilitate workshops on IFSB standards.

4.3.4 Implementation Guidelines

Another initiative under the Implementation Framework is the Implementation Guidelines (IG) project. The objective of the IG is to show different countries' experiences in implementing standards and prerequisites for effective implementation, creating an easy pass for member RSAs who want to improve their implementation rates by leveraging on the experience of other member RSAs with high implementation rates.

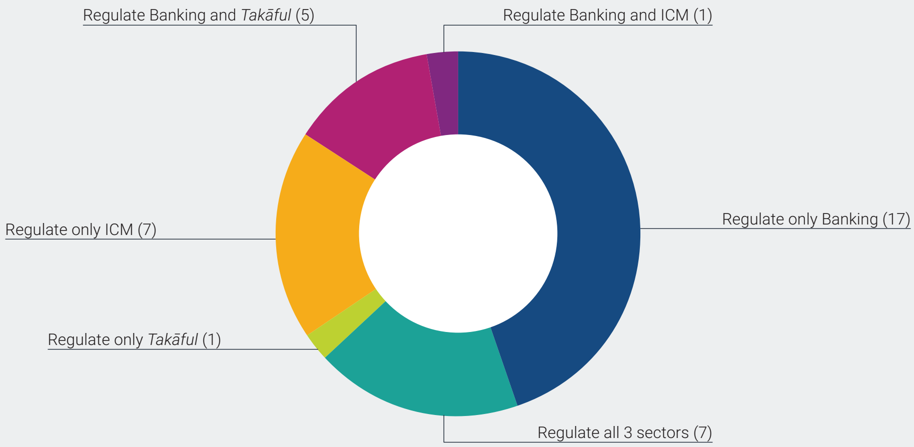
In 2021, the Secretariat published the first edition of the Implementation Guidelines project with participation of the Central Bank of Bahrain, the Central Bank of Jordan, the Central Bank of Oman and the Agency of the Republic of Kazakhstan for Regulation and Development of the Financial Market. The Secretariat has also commenced the second IG project for 2021. The second edition of the Implementation Guidelines report will be published with the support of the State Bank of Pakistan, Otoritas Jasa Keuangan (Financial Services Authority of Indonesia), the Central Bank of Nigeria and the Central Bank of Sudan.

4.3.5 Highlights of the IFSB Standards Implementation Survey 2021

The IFSB Standards Implementation Survey is an annual survey exercise, undertaken by the IFSB, covering IFSB RSA members. Specifically, the survey helps in assessing the progress made in implementing the IFSB's published standards by member RSAs, understanding the major challenges and constraints faced by member RSAs in implementing the standards, and identifying the right strategies that can assist in accelerating and strengthening the process of implementing IFSB standards. As in previous years, the survey relies on self-reporting; no verification of the responses is undertaken, nor is any assessment made of the completeness of implementation.

The IFSB Secretariat has conducted its 2021 Implementation Survey which covers the three Islamic finance sectors. A total of 38 RSA members participated in the 2021 survey, which was conducted between 26 January and 15 March 2021. Thirty responses were received on the Islamic banking sector, 13 were received with regards to the *takāful* sector and another 15 were received on the ICM sector. A more detailed composition of the respondents and their sectors of responsibility is illustrated in Chart 4.3.5.1.

Chart 4.3.5.1 Regulatory Sectors of the Responded RSAs

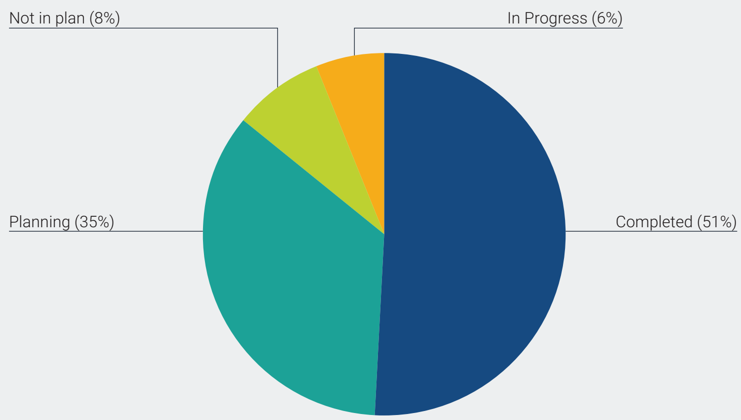


The response rate is still very low compared to the previous year. The consistency of responders is another challenge for the Secretariat in generating accurate data. The Secretariat is developing a new approach to engage with members that are yet to respond and will revise the data accordingly.

The respondents indicated that 51% of all key[142] IFSB standards (covering all three sectors) have "Complete" status, meaning they have completely implemented those standards. This was followed by "Planning" status at 35% and "In Progress" status at 6%.

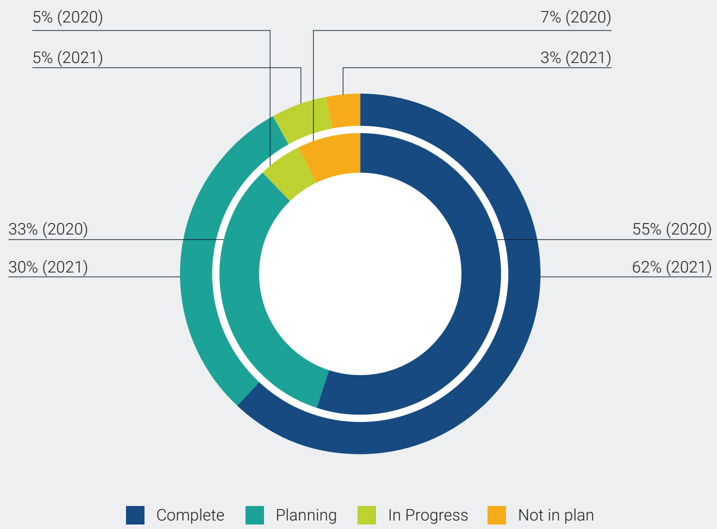
[142] Among the key banking standards are: Risk management (IFSB-1), Corporate governance (IFSB-3), Disclosures to promote transparency and market discipline (IFSB-4, IFSB-22), Capital adequacy (IFSB-2, IFSB-7, IFSB-15), Supervisory review process (IFSB-5, IFSB-16), Shariah governance (IFSB-10), Code of conduct (IFSB-9), Liquidity risk management (IFSB-12, GN-6), Core principles (IFSB-17), and Stress testing (IFSB-13). Key takaful standards are: Guiding principles (IFSB-8), Solvency requirements (IFSB-11), Risk managements (IFSB-14), *Retakaful* (IFSB-18), Shariah governance (IFSB-10), and Code of conduct (IFSB-9). Key ICM standards are: ICIS guiding principles (IFSB-6), Disclosure requirements (IFSB-19), and Core ICM principles (IFSB-21).

Chart 4.3.5.2 Overall Implementation of IFSB Standards (2021)



Due to the low rate of response from RSAs, the IFSB made a comparison among the consistent members that submitted their survey results in 2020 and 2021 to analyse the changes in the implementation rate. Of the 38 respondents in 2021, 18 also participated in the 2020 survey. Looking at the consistent members, there has been an increase of 7% in "Complete" status, and a decrease of 3% and 4% in "Planning" and "Not in Plan" status, respectively.

Chart 4.3.5.3 All IFSB Standards: Consistent Members (2020 and 2021)



The Implementation Survey report also provides snapshots on the implementation rate for each sector. For the Islamic banking sector, 47% of the standards have been implemented completely by the RSAs that participated in the survey. However, it is observed that there is no significant change in implementation status among the consistent members in 2020 and 2021 across all types of completion status. The consistent members include 15 RSAs that participated in both surveys.

Chart 4.3.5.4 Overall Implementation of Islamic Banking Standards (2021)

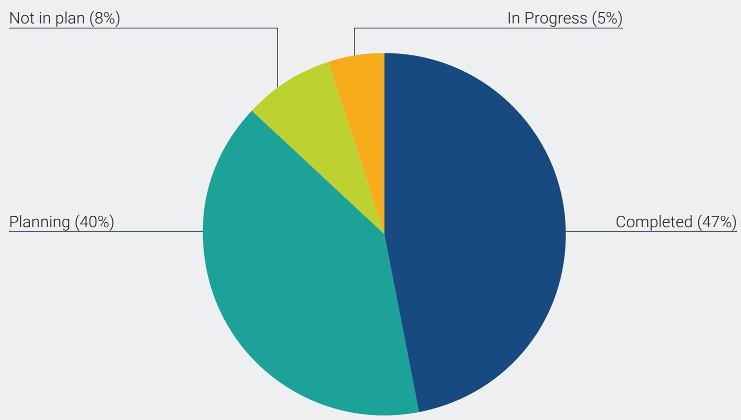
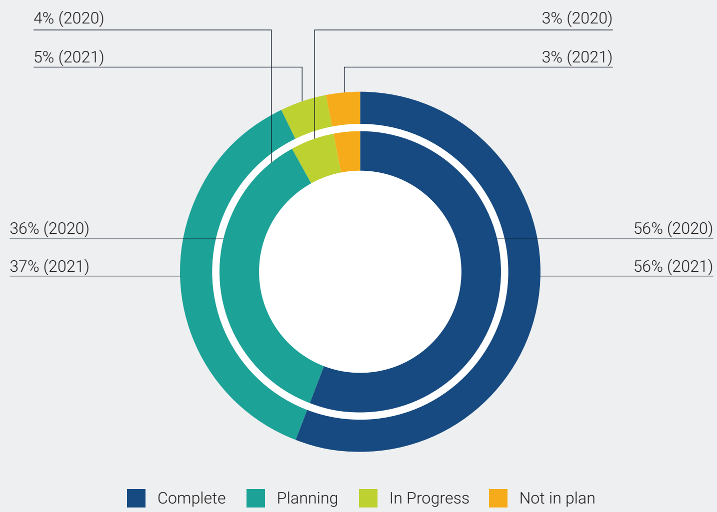


Chart 4.3.5.5 Islamic Banking Standards: Consistent Members (2020 and 2021)



In terms of Implementation rate for the *takāful* sector, the *takāful* standards have experienced a remarkable increase from a 55% completion rate in 2020 to 80% in 2021. This can be explained by a new set of respondents that participated in the 2021 implementation survey and has achieved high implementation rates. While considering the consistent members only, the growth is still significant at 25%.

Chart 4.3.5.6 Overall Implementation of *Takāful* Standards (2021)

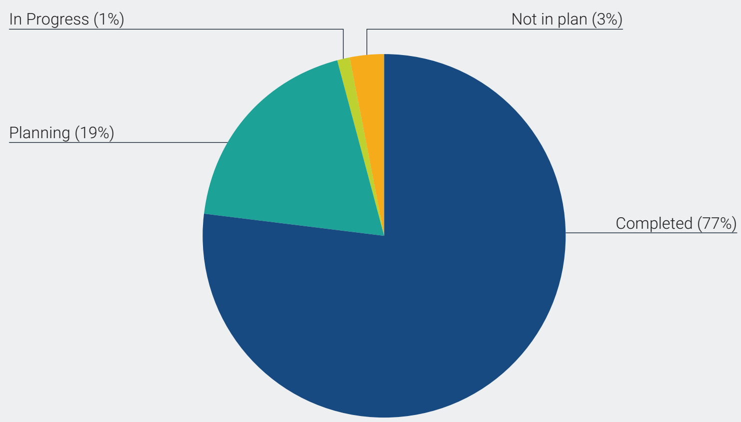
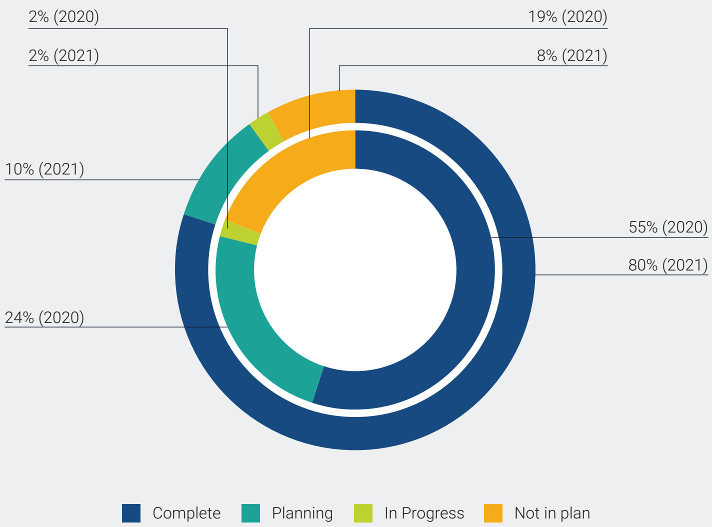
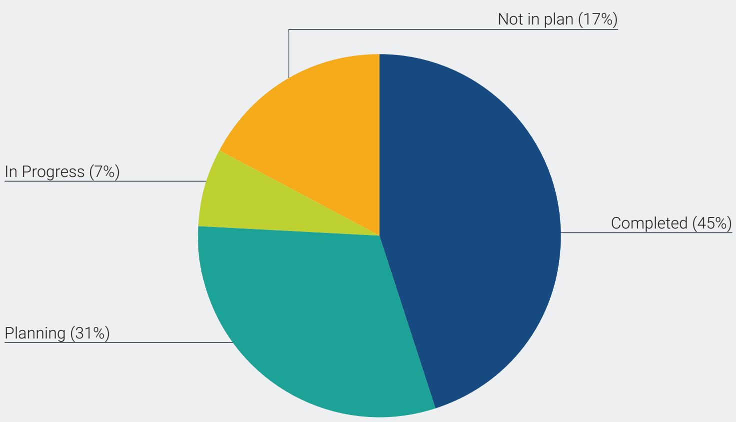


Chart 4.3.5.7 *Takāful* Standards: Consistent Members (2020 and 2021)



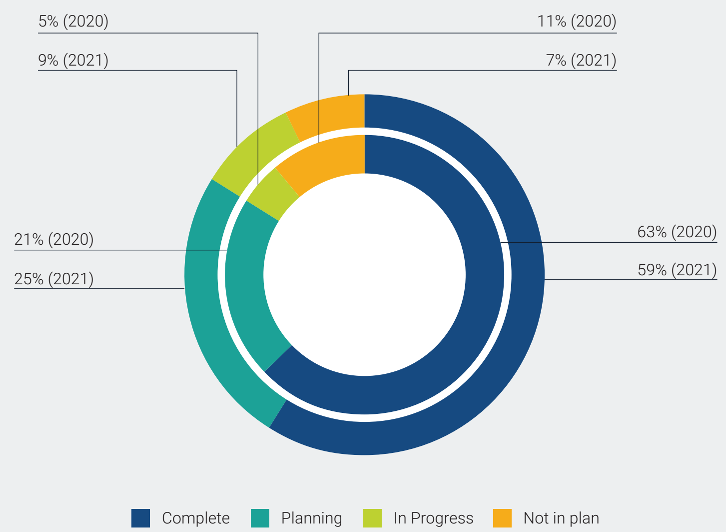
In contrast, the ICM implementation rate has shown a drop from 63% in 2020 to 59% in 2021 among consistent members only. There is a decrease of 4% in the "Complete" implementation rate status due to the different responses of the same jurisdiction.[143] "Not in plan" decreased by 4%, while both "Planning" and "In progress" increased by 4%.

Chart 4.3.5.8 Overall Implementation of Islamic Capital Markets Standards (2021)



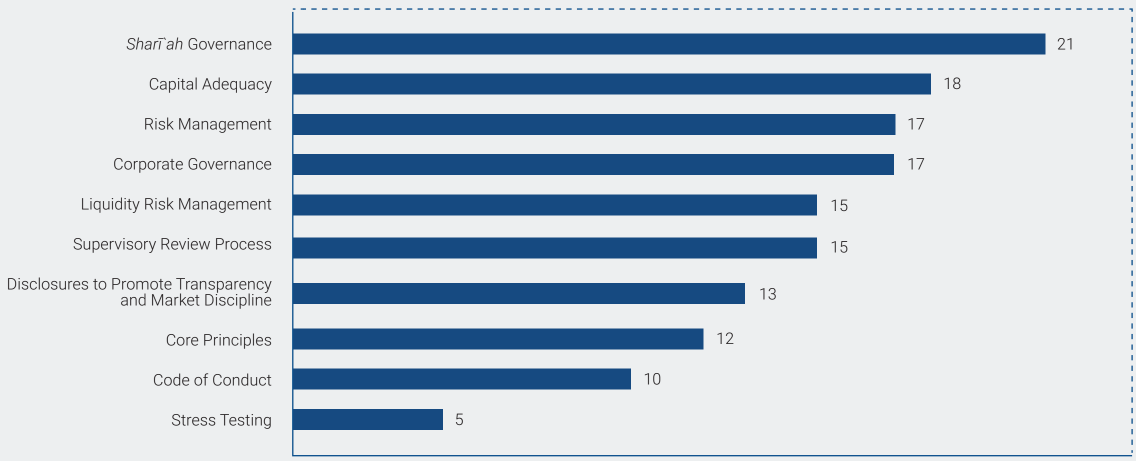
[143] The Secretariat received contradicting responses from a few jurisdictions that identified standards at the "Complete" status in 2020 but changed their responses in 2021 to "Planning" or "In progress" for the relevant standards. This is one reason why the Secretariat is working on changing the survey methodology.

Chart 4.3.5.9 Islamic Capital Markets Standards: Consistent Members (2020 and 2021)



Based on the survey findings, the most implemented standards for the Islamic banking sector are those on *Sharīʿah* governance, capital adequacy, corporate governance and risk management. The *Sharīʿah* governance standard was implemented by 21 out of 30 Islamic banking regulators that participated in the survey, which represents a 70% implementation rate. This was followed by the capital adequacy standard at 60%, and by the corporate governance and risk management standards, both with 57% implementation rates.

Chart 4.3.5.10 Number of Implemented Islamic Banking Standards by Key Areas by RSA (2021)

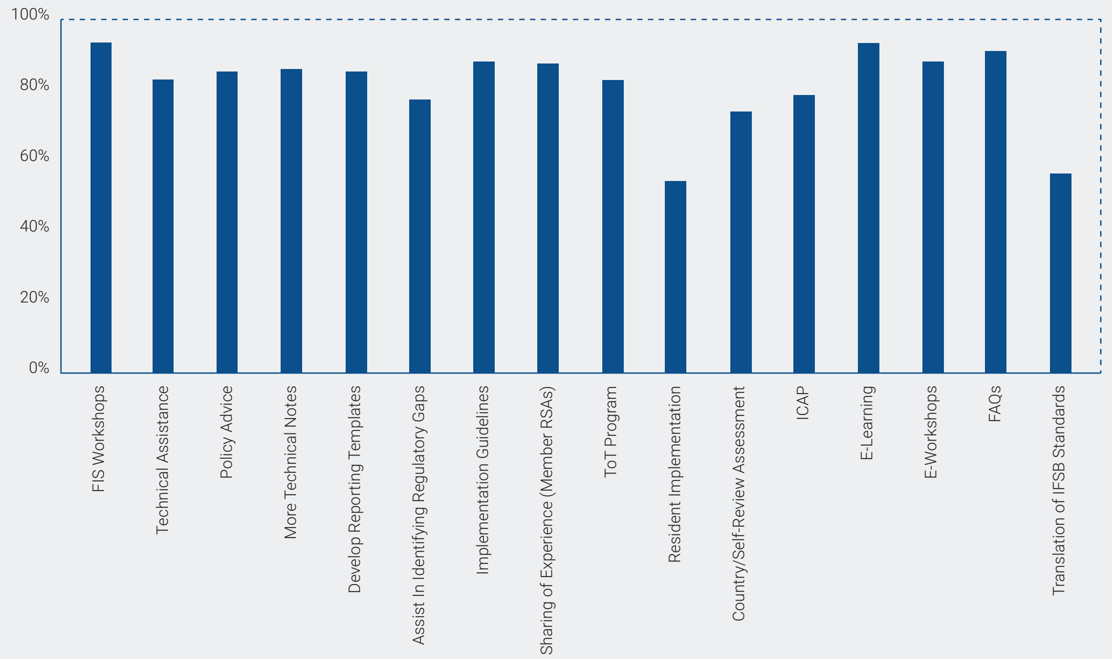


The survey also looked at the challenges faced by RSAs in the implementation of IFSB standards. The top three challenges identified by the respondents include: the lack of knowledge of Islamic finance by RSA's staff (59%); the identification of gaps between the existing regulatory framework and IFSB standards (56%); and the length of time required to implement the standards (54%).

For the purpose of supporting the RSAs in overcoming the challenges of implementing IFSB standards, the survey also focuses on respondents' views of the potential significance of the implementation tools that the IFSB might deploy to assist its members. The most desired forms of support from the IFSB identified by member RSAs were: facilitating the implementation of IFSB standards through workshops and e-learning (95% of the respondents found this very significant), and publishing FAQs (92% found this significant). These were followed by-

Implementation Guidelines, sharing of experience and e-workshops, with an 89% significance rate. The Secretariat compared the results among 17 consistent respondents from the previous survey, which showed an increased request for FIS workshops (from 89% to 95%) and for FAQs (from 79% to 92%). Other tools, such as Implementation Guidelines, sharing of experience and e-workshops, were also more in demand, along with technical assistance and reporting templates (up from 79% to 86%). There was a significant increase in ICAP (from 68% to 80%) and in the ToT programme (from 63% to 84%). The demand for e-learning remained unchanged among consistent respondents (95%).

Chart 4.3.5.11 Significance of Implementation Tools



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LIST OF ABBREVIATIONS	
AAOIFI	Auditing Organization for Islamic Financial Institutions
ACAPS	Morocco *takāful* sector supervisory authority
AFN	Afghanistan Afghani
APIF	Awqaf Properties Investment Fund
ASEAN	Association of Southeast Asian Nations
AuM	Assets under management
BCBS	Basel Committee on Banking Supervision
BNM	Bank Negara Malaysia
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CBDC	Central bank digital currency
CBN	Central Bank of Nigeria
CGA	Tunisian Insurance Authority
CIS	Collective investment scheme
CIS	Commonwealth of Independent States
CPIFR	Core Principles for Islamic Finance Regulation
CTI	Cost-to-income
DFS	Detailed financial statements
ECL	Expected credit losses
ESG	Environmental, social and governance
ETF	Islamic exchange-traded fund
FAO	Food and Agriculture Organization
FATF	Financial Action Task Force
FCA	UK Financial Conduct Authority
FDR	Financing-to-deposits ratio
FRA	Financial Regulatory Authority
FSB	Financial Stability Board
FWA	Fujairah Welfare Association
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GFC	Global Financial Crisis
GMPFC	Global Muslim Philanthropy Fund for Children
HQLA	High-quality liquid assets
IAIS	International Association of Insurance Supervisors
IB	Islamic bank
IBA	ICE Benchmark Administration
IBI	Islamic banking industry

IBOR	Interbank offered rates
ICM	Islamic capital market
ICS	Insurance Capital Standard
IsDB	Islamic Development Bank
IsDBI	Islamic Development Bank Institute
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IOSCA	International Organization of Securities Commissions
IPS	Instant payment system
ISF	Islamic social financing
JCPOA	Joint Comprehensive Plan of Action
LASLR	Liquid assets to short-term liabilities ratio
LCR	Liquidity coverage ratio
LIBOR	London Interbank Offered Rate
M&A	Mergers and acquisitions
MENA	Middle East and North Africa
MESA	Middle East and South Asia
MFI	Islamic microfinance institution
MFI	Mutual funds industry
MTPL	Mandatory third-party auto policy
NIB	Non-interest banking
NPF	Non-performing financing
NPL	Non-performing loans
NPM	Net profit margin
NSFR	Net stable funding ratio
NZF	National *Zakāh* Foundation
OECD	Organization for Economic Cooperation and Development
OJK	Otoritas Jasa Keuangan
OPEC	Organization of the Petroleum Exporting Countries
PSIA	Profit-sharing investment accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
R&D	Research and development
RFTs	Risk-free rates
ROA	Return on assets

ROE	Return on equity
RPSIA	Restricted profit-sharing investment account
RRP	Resolution and recovery plan
RSA	Regulatory and supervisory authority
RWA	Risk-weighted assets
SAMA	Saudi Arabia Monetary Authority
SBU	*Sharīʿah* business unit
SDG	Sustainable Development Goal
SEA	South-East Asia
SEDDK	Insurance sectors supervisory authority in Turkey
SEO	Securities and Exchange Organization
SME	Small and medium enterprise
S&P 500	Standard and Poor's 500
SRI	Socially responsible investment
TO	*Takāful* operator
TOR	Terms of reference
TOT	Training of Trainers
TU	*Takāful* undertaking
UAE	United Arab Emirates
VBI	Value-based intermediation

GLOSSARY

Commodity *Murābahah* or Tawarruq	A *murābahah* transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred *murābahah*, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
Diminishing *Mushārakah*	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or at the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Fiqh	Knowledge of the legal rulings pertaining to conduct, which has been derived from specific evidence.
Ijārah	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. The *ijārah* contract is binding on both contracting parties.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah*-compliant, with separate funds. It could also provide *takāful* or *retakāful* services.
Istisnā`	The sale of a specified asset, with an obligation on the part of the seller to manufacture/construct it using his own materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or instalments.
Mudārabah	A partnership contract between the capital provider (*rabb al-māl*) and an entrepreneur (*muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
Murābahah	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the *mushārakah* contract, while losses are shared in proportion to each partner's share of capital.
Mushārakah (Sharikat al-'Aqd)	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the *mushārakah* contract, while losses are shared in proportion to each partner's share of capital.
Retakāful	An arrangement whereby a *takāful* undertaking cedes a portion of its risks on the basis of treaty or facultative *retakāful* as a representative of participants under a *takāful* contract, whereby it would contribute a portion of the contribution as *tabarru'* into a common fund to cover against specified loss or damage.
Sharī`ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (*ijmā'*), analogy (*qiyās*) and other approved sources of the *Sharī`ah*.
Sharī`ah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its *Sharī`ah* compliance and governance system.
Sharī`ah non-compliance risk	An operational risk resulting from non-compliance of the institution with the rules and principles of *Sharī`ah* in its products and services.

Ṣukūk	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is *Sharī`ah*-compliant.
Tabarru'	The amount of contribution that the *takāful/retakāful* participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.
Sadaqah	Sadaqah also describes a voluntary charitable act towards others, whether through generosity, love, compassion or faith.
Takāful	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
Tawarruq	A *murābahah* transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred *murābahah*, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
Urf	Urf is an Arabic Islamic term referring to the custom, or 'knowledge', of a given society.
Wadī`ah	A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.
Wakālah	An agency contract where the customer (principal) appoints an institution as agent (*wakīl*) to carry out the business on his behalf. The contract can be for a fee or without a fee.
Waqf	A *waqf* (also known as hubous [حبوس] or mortmain property) is an inalienable charitable endowment under Islamic law.
Zakāh	An obligatory financial contribution disbursed to specified recipients that is prescribed by the *Sharī'ah* on those who possess wealth reaching a minimum amount that is maintained in their possession for one lunar year.

MEMBERSHIP BENEFITS

ISLAMIC FINANCIAL SERVICES BOARD

NO	MEMBERSHIP BENEFITS	MEMBERS		
		FULL	ASSOCIATE	OBSERVER
1	Be part of a prestigious international organisation with the broadest representation in the IFSI, from 57 countries	✓	✓	✓
2	Attend the IFSB General Assembly	✓	✓	✓
3	Vote at the IFSB General Assembly	✓		
4	Attend the IFSB Council Meeting	✓*		
5	Be a member of the Executive Committee	✓		
6	Be a member of the Technical Committee	✓		
7	Submit nomination for the IFSB Secretary-General	✓		
8	Participate (by invitation) in Working Groups, Task Force and Closed-door discussions for the development of the IFSB prudential standards	✓	✓	✓**
9	Ability to comment on the IFSB exposure drafts	✓	✓	✓
10	Request for Policy Advice	✓	✓	
11	Receive Technical Assistance	✓	✓	
12	Participate in the IFSB workshops (national & regional) and public hearings on exposure drafts at no charge	✓	✓	✓
13	Participate in the IFSB e-Workshops via webinar	✓	✓	✓
14	Participate in the IFSB Capacity Building Program	✓	✓	✓
15	Participate in IFSB Train of Trainer (ToT) Programme	✓	✓	
16	Support for IFSI Country Analysis and Self-Assessment	✓	✓	
17	Complimentary access to IFSB Standards E-Learning	✓	✓	✓
18	Participate in the IFSB events on a complimentary/priority basis and/or at special members' rate	✓	✓	✓
19	Collaborate for events, research and publications	✓	✓	✓
20	Receive complimentary copies of IFSB publications	✓	✓	✓
21	Access to materials of IFSB events and meetings and other web-based services at the Members' Zone of the IFSB website	✓	✓	✓
22	Speaking and networking with other members from 57 countries	✓	✓	✓
23	Host of IFSB Summit (bi-annual land mark event)	✓	✓**	
24	Hosting IFSB Working Group and Task Force Meetings	✓	✓	
25	Participate in IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) Programme	✓	✓	✓***

** Full Members who are not Council members may attend by invitation.*
*** For regulatory and supervisory authorities and international inter-governmental organisations only.*
**** For regulatory and supervisory authorities only*

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