ISLAMIC FINANCE
PROSPECTS AND CHALLENGES

In just four decades, Islamic finance has grown from a niche banking system to be regarded as one of the fastest growing segments of the global financial industry, with total global financial assets estimated to be around USD2tln. The past five years have been most significant, recording 17.3% Compounded Annual Growth Rate spurred by improved industry infrastructure, a more comprehensive industry, broader investor and issuer base and consequently, with more cross-border transactions. Adding further to its global status, Islamic Finance has attracted the attention of advanced economies to tap into this growing market; testament to its universal appeal and propositions.

MALAYSIA
WORLD'S ISLAMIC FINANCE MARKETPLACE

28 August 2015

Islamic Finance: Prospects and Challenges

From its beginnings as a nascent sector in the 1970s, mainly focused on Shariah-compliant banking systems, the present Islamic financial system has evolved to offer a comprehensive financial system of its own: ranging from banking, capital market to takaful sectors.

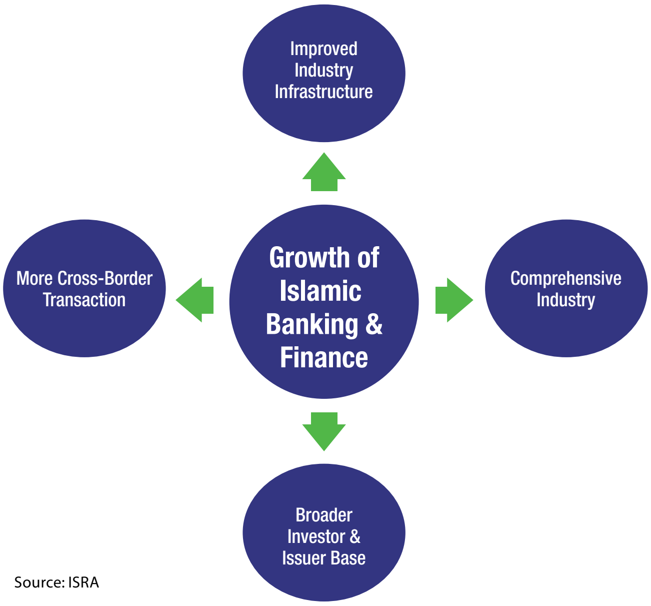
In just four decades, Islamic financial system has witnessed considerable developments and is now regarded as one of the fastest growing segments of the global financial system[1]. To date, total global financial assets of the Islamic financial industry is estimated to be around USD2tln and expected to reach USD5tln in the next five years.[2] The Islamic financial industry has experienced robust expansion in the past five years, recording a 17.3% Compounded Annual Growth Rate (CAGR) between 2009 and 2014.[3] Beyond these significant numbers, it is notable to share that the rapid growth of Islamic finance between 2009 and 2015 (post crisis period) has been characterized by an improved industry infrastructure, a more comprehensive industry, a broader investor and issuer base along with more cross-border transactions. Of significance, the global Islamic financial industry is progressively evolving to be an important component supporting the economic and financial linkages. Of importance, the growth of the Islamic financial industry has attracted the attention of non-key Islamic finance jurisdictions to tap into this growing market. The interest of non-key Islamic finance jurisdictions in Islamic finance is part of its testament on its universal appeal and propositions, especially to tap wider investor and consumer base.

Prospects in Non-Key Islamic Finance Jurisdictions

Apart from key Islamic finance jurisdictions such as Malaysia and the GCC, the industry is also gaining stronger foothold in other regions such as Africa in the likes of Senegal, Kenya, South Africa and Nigeria. Besides the African region, other parts of Asia such as Bangladesh and Indonesia are likewise showing bright prospects. Advanced economies such as the US, Europe and Singapore have similarly witnessed increased activities in Islamic finance in recent years.

1 ISRA
2 ISRA estimates
3 IFSB Stability Report, 2015

Characteristics of the Rapid Growth of Islamic Finance



Source: ISRA

In the Asian region, Bangladesh, being the third-largest Muslim country[4], has a long history in the development of Islamic finance. It started with the introduction of Islamic Bank Bangladesh Limited (IBBL) in 1983 and continued to develop to seven stand-alone Islamic banks and 16 conventional banks with Islamic banking branches in 2014.[5] The market share of Islamic banks in Bangladesh is sizeable, accounting for 18.9% of total deposit and 21.1% of total financing.[6] In addition, Bangladesh has managed to record solid growth for the takaful industry. There are currently eight takaful operators in Bangladesh, comprising five family takaful and three general takaful, recording market share of 26% of total premium in life insurance and that of 4.6% of premium in non-life business insurance.[7]

Indonesia on the other hand is home to the world's largest Muslim population, a nation home to 12.7% of the world's Muslims.[8] The number of high net worth individuals (HNWIs) in Indonesia increased significantly over the years. The economic conditions have been favourable in the past decade and is expected to grow at 5.3 in 2015.[9] On the supply side, there are a number of Islamic financial institutions in the Indonesian Market. Currently, Islamic banks in Indonesia comprise of 12 full-fledged Islamic commercial banks, 22 Shariah business units of conventional banks/Subsidiary of conventional banks, and 163 Islamic rural banks.[10] The assets of Islamic banks in Indonesia has grown from IDR100tln (approx. USD8bln) to IDR279tln (approx. USD22.3bln), or at a compound annual growth rate (CAGR) of 29.2% between 2010 and 2014.[11] In addition to that, there are 45 Islamic insurance institutions, offering both general and family takaful products, which are expected to grow up to 20% in 2015.[12] Futhermore, there are 316 Shariah-compliant stocks have been classified and listed under Shariah Listed Securities, comprising approximately 60% of the total stocks in Indonesia.[13] Furthermore, there are 61 Shariah-compliant mutual funds as per September 2014 and 23 government sukuk and 35 corporate sukuk as per February 2015.[14] In the National Budget 2015, the Indonesian government allocated IDR6.94tln for infrastructure project via government sukuk issuance.[15]

4 Wikipedia
5 IFSB, 2014
6 Annual Report, Bangladesh Bank, 2013
7 IFSB, 2014
8 Wikipedia
9 Survey Ekonomi OECD Indonesia, 2015
10 Bank Indonesia
11 www.indonesia-investments.com
12 www.medanbisnisdaily.com
13 Indonesia Stock Exchange, 2015
14 Indonesia Stock Exchange, 2015
15 Various sources

Moving to the African region, Islamic finance has made notable progress, spurred by demand from both Muslim and non-Muslim populations. For example, Nigeria now has one full-fledged Islamic bank, which serves a Muslim-dominated population of 173.6mln, thereby suggesting potential for more Islamic banks to set up. Meanwhile, both Kenya and South Africa have also welcomed Islamic banks. To date, several African nations have recently tapped the global sukuk market for sovereign funding. Amongst the sovereign issuers, Senegal has issued sub-Saharan Africa sovereign sukuk, clearing the path for the continent's biggest economies to follow with debut sukuk.[16] Nigeria on the other hand has sukuk as part of its strategic framework through 2017. This is facilitated with the amendments in the regulations by the Securities and Exchange Commission of Nigeria (SECN), to allow Nigerian companies to issue sukuk, in a bid to attract Shariah-compliant funds. For example, a state in Nigeria named Osun has recently sold USD61 mln of sukuk in Y2013, being the first state in the country to sell sukuk. Elsewhere, the government of South Africa issued their debut sukuk in 3Q2014. The USD500 mln ijarah sukuk, which was oversubscribed by more than four times [17], had attracted funding from both Middle Eastern and Asian investors.[18] It is also the first sukuk in Africa to be issued in US dollars.

Of importance, the growing potential of Islamic finance in Africa has attracted the attention of International Islamic banking players. For example, in 2014, Dubai Islamic Bank has announced their plans to open an Islamic bank in Nairobi, Kenya, citing the demand potential and regulatory support as key factors.[19] Meanwhile, as at 1H2014, Africa accounts for more than 2% of global Islamic banking assets and 0.5% of sukuk outstanding (2014).[20]

The development and prospects of Islamic finance in the African continent was supported by a number of catalysts, mainly governmental support via the introduction of the "Law Governing the Operation of Islamic Bank" by the central bank of Nigeria in 2009. These laws were likely to support Shariah-compliant financing for Nigeria's large Muslim population, which accounts for about 50% of the 170 mln Nigerian population. In addition, the emergence of a new middle class and steady economic growth for the last few years is expected to drive stronger demand for Shariah-compliant financial services.[21]

Meanwhile, the bright prospects that Islamic finance offers has also attracted the attention of advanced economies such as Europe and Singapore.

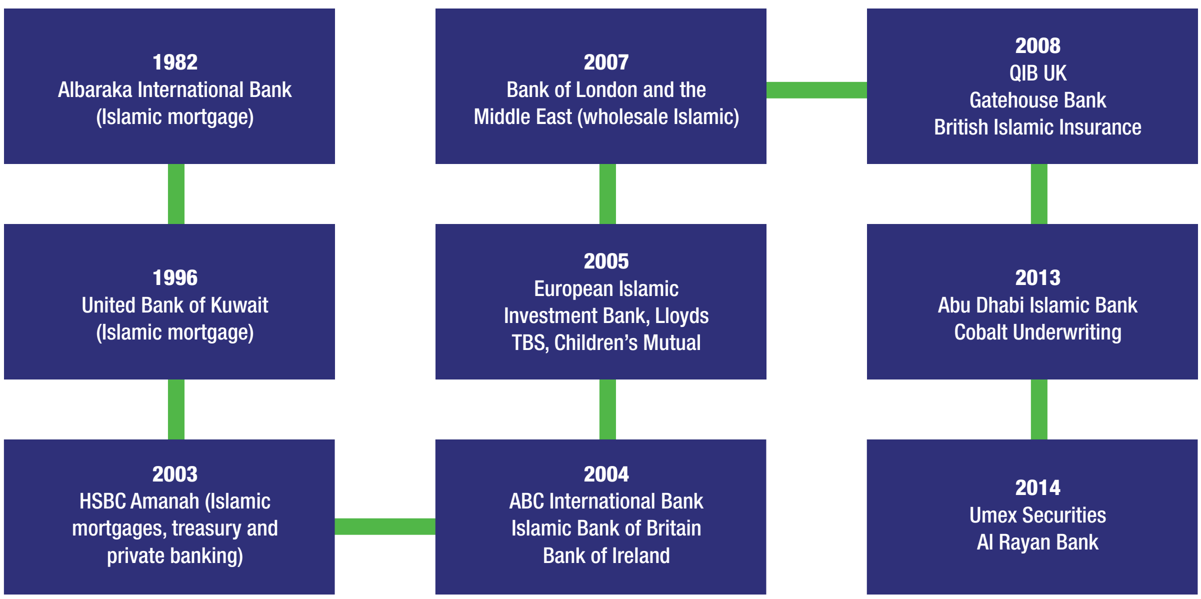
In Europe, interest in Islamic finance has been reignited following sovereign sukuk issuances by the UK. The 5-year British sovereign sukuk, the world's first sovereign Islamic paper from a non-OIC country, was distributed to investors, raising USD339.5mln for the government and providing investors a profit rate of 2.036%.[22] The order book recorded an oversubscription of nearly 10 times the issuance size.[23] Moving to Luxembourg, after the Parliament of Luxembourg has passed a bill that authorised the government to issue a sukuk using tangible real estate assets, Luxembourg issued a USD253mln (EUR200mln) 5-year sukuk in October 2014, becoming the only second EUR sovereign sukuk issuance in the global Islamic capital markets.[24] The sukuk was twice oversubscribed.[25] The Islamic financial sector in Europe, although small in size, has potentials to gain traction given the fast expanding bilateral ties between European countries and Islamic financial hubs in key Islamic finance jurisdictions such as the GCC and Malaysia. Overall, the outlook for Islamic finance in Europe remains positive, mainly due to the following factors.

9 "Senegal Sukuk Shows Way for South Africa, Nigeria to Debut", Bloomberg News (June 2014)
17 www.luxembourgforfinance.com
18 IFIS
19 "Dubai Islamic Bank Eyes Expansion into African Markets", Ventures (March 2014)
20 ISRA estimates
21 Shabana and Mahbubi. "Nigeria: Present state and future development", IFN (2013)
22 IFIS
23 IFIS
24 IFIS
25 IFIS

Factors Driving Islamic Finance Growth in Europe

Source: ISRA

Timeline of the Establishment of Islamic Finance Institutions in the UK



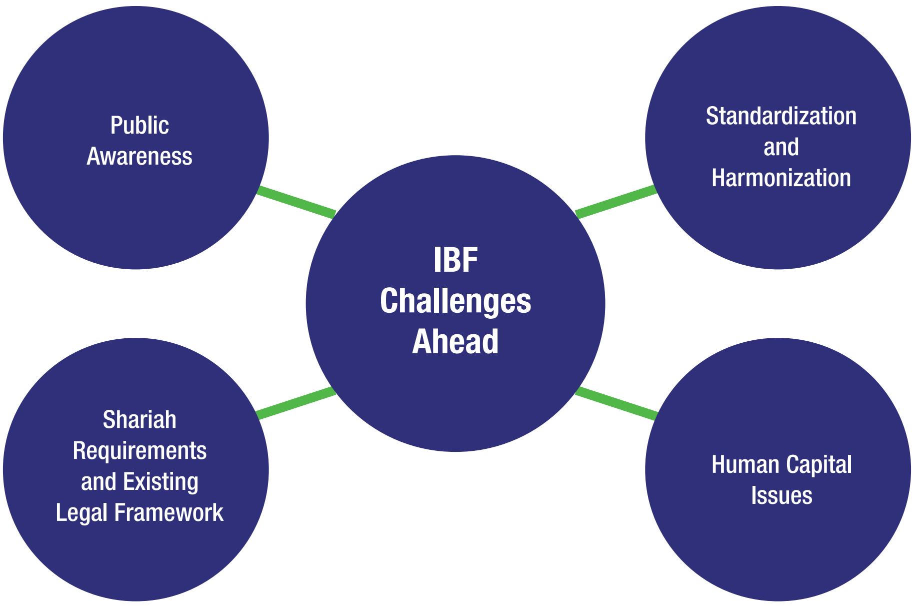
Source: UKTI, ISRA

Moving to Singapore, it has attracted sukuk roadshows by major issuers such as Emaar Malls Group, Damac Real Estate and Turkiye Finans.[26] In total, the country has approximately 15 banks offering Shariah-compliant banking options.[27] Presently there are approximately USD4.37 bln worth of Islamic assets under management in Singapore, with over a third of those held by the 15 banks offering Shariah-compliant banking options. In addition, there are also multiple sukuk issuances in Singapore. To date a total of 31 sukuk has been issued in Singapore.[28] Some of the recent issuances include USD300 mln sukuk wakalah issued in the early 2014 by the Export-Import Bank of Malaysia and USD118 mln sukuk murabahah issued in July 2014 by the Golden Assets International Finance.[29] In 2012, the Axiata Group has also priced a USD158.06 mln (CNY 1bln) sukuk wakalah, which at that time was the largest yuan-denominated sukuk issued.[30]

Challenges Ahead

Despite the promising development of Islamic banking and finance, nonetheless the industry is facing considerable challenges, in particular:

Challenges Ahead for Islamic Banking and Finance



Source: Various Sources

[26] "Singapore: Opportunities for Islamic Finance," IFN (September 2014)
[27] "Singapore: Opportunities for Islamic Finance," IFN (September 2014)
[28] "Singapore: Opportunities for Islamic Finance," IFN (September 2014)
[29] "Singapore: Opportunities for Islamic Finance," IFN (September 2014)
[30] "Singapore: Opportunities for Islamic Finance," IFN (September 2014)

1. Human Capital Issues

Highly dedicated and qualified human resources undoubtedly play a vital role for the development and success of any organization. In this regard, the Islamic financial industry requires a specific set of competencies and skills, such as Shariah understanding and market insight. The research carried out by the Capital Market Regulators Forum found that 82% of the countries which responded experienced scarcity of talent in the Islamic financial services areas such as Shariah and Takaful. The studies also revealed that another 60% of Islamic finance professionals require further training and skills development. The shortage of talents in Islamic finance poses a significant impact on the industry as it will affect the growth of Islamic finance.[31] At the expert level, there is a significant shortage of qualified Shariah scholars equipped with necessary knowledge and expertise in the field of Islamic finance.

2. Standardization and Harmonization

Given the nature of Islamic law which accommodates for different interpretations, Islamic finance is subject to different interpretations which lead to different practice and use of concepts across jurisdiction. This may impede the growth and internationalization of Islamic finance since certain products may not be accepted in some jurisdictions but not in the other. Therefore, there is a call for harmonization, standardization and mutual recognition of Shariah views so that legal uncertainty and the degree of Shariah non-compliance risk may be mitigated.

3. Shariah Requirements and Existing Legal Framework

Islamic finance is established based on Shariah principles thus the existing legal and regulatory framework should take into consideration the value propositions promulgated by Shariah. However, in practice, there are some challenges to harmonize the Shariah principles and the existing regulatory framework. For instance, the legal definition of banking and financial services in certain jurisdictions does not recognize Islamic financial transactions due to their unique nature and characteristics, leading to potential conflict and adverse legal effect.[32] For that reason, Bank Negara Malaysia has established Law Harmonization Committee in 2010 mainly to create a conducive atmosphere for legal system that facilitates and supports the development of Islamic financial industry.

4. Public Awareness

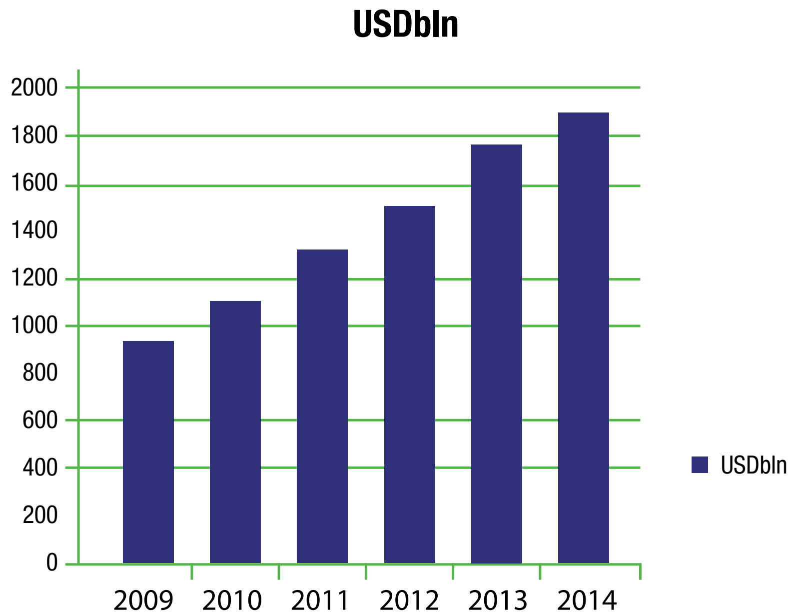
The low penetration rate of Islamic financial industry in certain jurisdictions is mainly due to lack of public awareness and perception toward Islamic financial products and services. The research conducted by Bursa Malaysia in 2009 for example revealed that the main obstacles in developing Islamic stock market in Malaysia are the lack of awareness of potential investors. Meanwhile, a survey carried out by PWC (2014) revealed that lack of awareness is the key factor for the low penetration level of Islamic banking in the GCC. The survey found that just over half of respondents believe that they are familiar with Islamic banking, while 64% of non-Muslim respondents cited lack of awareness as the main reason of not subscribing for Islamic financial products and services.[33]

[31] http://www.faa.org.my
[32] Akram Laldin, Legal, Regulatory and Enabling Framework, 2014
[33] PWC, What Customer Want: Customer Insight to Inform Growth Strategies of Islamic Banks in the Middle East. 2014

Conclusion

Notwithstanding the challenges that lie ahead, given the value proposition of Islamic finance, the industry will likely to expand further globally.

Growth Trends of Global Islamic Finance Assets



Source: Central Banks, Annual Reports, Bloomberg, IFIS, Zawya, ISRA

This is reiterated with the rapid development of Islamic banking and finance in various other parts of the word, especially in the non-key Islamic finance jurisdictions. This further proves the practicality of Islamic finance as solutions. Thus far, the industry has recorded double-digit growth rates in various segments, and has also further expanded its financing activities to non-key Islamic finance jurisdictions (as highlighted above). More importantly, the recent expansion of the industry in last 5 have further stamped the transformation of Islamic banking and finance into a more competitive and resilient industry. Moving forward, the industry's assets are expected to expand further to USD3.4tln by end-2018[34], further creating room for the Shariah-compliant financial system to evolve as an increasingly significant part of the global financial system.

[34] ISRA estimates