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**ISLAMIC FINANCIAL
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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

VISION

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

MISSION

Development of a dynamic, comprehensive and innovative Islamic financial services industry, which closely supports real economic activities and is well integrated within the international financial system

EXECUTIVE SUMMARY

This document, which will be revised and updated periodically by its initiators, aims at providing a general framework that national authorities may find beneficial for designing Islamic financial services industry (IFSI) development initiatives and including these in their national financial sector development policies. The document also aims at offering a comprehensive basis for promoting international policy dialogue among stakeholders and fostering the orderly development of an efficient, sound, resilient and sustainable IFSI in the rapidly changing global market, technological and regulatory environments.

The fundamental precondition for development of a robust financial services industry is the existence of conditions that are conducive to the operations of free, fair and transparent markets. On the other hand the critical issues of poverty alleviation and improvements in important socio-economic aspects of life such as health and education, reduction in child mortality, providing safe and secure future for youth etc., are on the top of the public policy agendas of our societies. A sound, vibrant and market-driven financial services industry can play a vital role in addressing the human development challenges by efficiently and equitably channeling financial resources towards production, trade and creating employment and business opportunities.

Islamic law protects private property, safeguards the free, fair and transparent operation of market forces and offers other significant guidance in the domain of economic, financial and commercial activities. Ensuring the compliance of financial services with these guidelines is necessary for the services to be relevant for use by Muslims and hence broadening the public's access to financial services. The IFSI caters to this special need of society. Simultaneously, it is also possible to capture demand beyond the Muslim population through the provision of innovative and high-quality Islamic financial services (IFS). Therefore, by adding another alternative in an array of choices of financial services, IFS can foster healthy competition. Promotion of the IFSI is also part of the efforts being made to gradually replace informal markets with organized and regulated ones and to enhance the overall development of the financial sector.

The contemporary IFSI has just passed through its 30th anniversary year. During those years, it has come a long way in providing a range of financial services in a variety of segments, including banking, non-bank financial services, insurance and capital markets. Given its inherent features, the IFSI has the potential to concurrently achieve the goals of sustainable economic development and just social progress, supported by sound and stable financial institutions and markets. However, the IFSI also faces significant challenges as a result of having its own special risk characteristics and unique governance requirements, on the one hand, and operating in a tax, legal and regulatory environment originally designed for conventional financial services, on the other hand.

Nonetheless, the IFSI is growing rapidly in national, regional and international financial markets and is increasingly gaining systemic significance. In order to set a dynamic and sustainable future path for the industry, the strategic focus of the IFSI needs to be included in national financial sector development policies while promoting systematic and collaborative efforts among interested countries.

Orderly development of the IFSI as an instrument of comprehensive human development is one of the three strategic objectives of the Islamic Development Bank (IsDB) Group. To achieve this objective the IsDB Group's Strategic Framework document entrusts the Islamic Research and Training Institute (IRTI) the responsibility for establishing suitable partnerships and networking programs. The Islamic Financial Services Board (IFSB) has been mandated by its members to provide guidance on effective supervision and regulation to ensure the soundness and stability of the global IFSI. Hence, the IsDB/IRTI and the IFSB have undertaken the joint initiative to draft this framework document as a "ten-year roadmap" for an orderly development of IFSI.

The aims and objectives of the framework are to:

- i) provide, for national authorities of IsDB and IFSB members as well as other interested countries, a platform for sharing experiences and a general blueprint for considering the formulation of national - and eventually regional-master plans as part of the promotion of the IFSI in their respective jurisdictions so that economic development can be achieved side by side with justice, social progress and financial stability;
- ii) identify the challenges facing the IFSI and suggest initiatives, ways and means through which the IFSI could interact with the conventional financial system and compete with it on equal terms;
- iii) enhance the role of the IFSI in redirecting financial resources towards real investment and the creation of employment opportunities;
- iv) provide a platform for policy dialogue among national, regional and international financial architecture institutions and industry players; and
- v) help and encourage the free, fair and transparent operation of markets and the IFSI's profitability, growth, sustainability and competitiveness, and its successful integration into the rapidly changing international financial systems.

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

Finally, the recommendations covering the broad strategies and initiatives to be undertaken for the development of the various components of the IFSI - banks, non-banking and microfinance institutions, capital markets, and insurance and re-insurance (*takāful* and *re-takāful*) services and the required support financial infrastructure, are summarized as follows:

1. Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector.
2. Enhance the capitalization, efficiency and resilience of Institutions offering Islamic financial services (IIFS) to ensure that they are on a par with international standards and best practices.
3. Enhance the access by all population segments to financial services.
4. Ensure Sharī'ah compliance and the effectiveness of corporate governance.
5. Develop the required pool of specialized, competent and high-caliber, human capital and ensure utilization of state-of-the-art technology.
6. Promote the development of standardized products through research and innovation.
7. Comply with the international prudential, accounting and auditing standards applicable to the IFSI.
8. Develop appropriate legal, regulatory and supervisory frameworks that could effectively cater for the specificities of the IFSI and ensure tax neutrality between IIFS and their conventional counterparts.
9. Develop a comprehensive and efficient infrastructure for the IFSI for inter-bank liquidity management as well as for Islamic capital markets.
10. Promote public awareness of Islamic financial services.
11. Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions.
12. Foster collaboration among countries that offer Islamic financial services.
13. Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial systems.

Implementation and follow-up efforts of the framework will be carried out by a joint standing committee in consultation with the industry players and other stakeholders.

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As a first step, a number of leading specialists and practitioners were requested to prepare technical papers on various themes. These were presented in a technical workshop jointly organized by the IsDB/IRTI and the IFSB, held from 31 May to 1 June 2005 in Dubai and hosted by the Dubai Financial Services Authority. Subsequently, the IsDB/IRTI and the IFSB jointly organized a Policy Dialogue Seminar on the same theme on 22 June 2005 in Putrajaya, Malaysia, which was facilitated by Bank Negara Malaysia. A Drafting Committee was consequently formed, which held three meetings and finalized a draft document. The draft document was distributed by the IFSB to solicit feedback from its members and other interested parties. It was also discussed in the Islamic Bankers' Forum held on 28 May 2006 in Kuwait, jointly organized by the IsDB/IRTI, the IFSB and the General Council for Islamic Banks and Financial Institutions (CIBAFI). At its final meeting held on 17 August 2006 in Kuala Lumpur, Malaysia the Drafting Committee reviewed all the comments and the feedback received, and reached a consensus on the revised document. The technical work of the Drafting Committee was anchored by Dr. Tariqullah Khan, IRTI/IsDB.

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GLOSSARY OF ARABIC TERMS

<i>Awqāf</i>	Plural of <i>Waqf</i> . For meaning, see below.
<i>Fatāwā</i>	Plural of <i>Fatwā</i> . Religious pronouncements by <i>Fuqahā'</i> .
<i>Fiqh</i>	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, <i>Fiqh</i> covers all aspects of life, be it religious, political, social, commercial or economic. The whole corpus of <i>Fiqh</i> is based primarily on interpretations of the Qur'ān and the <i>Sunnah</i> and secondarily on <i>ijma'</i> (consensus) and <i>ijtihad</i> (individual judgment). While the Qur'ān and the <i>Sunnah</i> are immutable, <i>Fiqh</i> pronouncements may change due to changing circumstances.
<i>Fiqhī</i>	Relating to <i>Fiqh</i> (see above).
<i>Gharar</i>	Literally, deception, danger, risk and uncertainty. Technically, it means exposing oneself to excessive or unnecessary risks and danger in a business transaction as a result of uncertainty about terms of the deal, such as the price, quality or quantity of the counter-value, the date of delivery or the ability of the buyer or the seller to fulfill his commitment.
<i>Ijārah</i>	Leasing. Sale of the usufruct of an asset. The lessor retains the ownership of the asset, together with all the rights and responsibilities that go with ownership.
<i>Istiṣnā'</i>	Refers to a contract whereby a manufacturer (or contractor) agrees to produce (or construct) and deliver, at a given price on a given date in the future, a well-described good (or building) according to specifications. As against <i>salam</i> , in <i>istiṣnā'</i> the price need not be paid in advance. It may be paid in installments, similar to progress payment as agreed by the parties, or partly up front, with the balance being paid later.
<i>Muḍārabah</i>	A contract of partnership between capital and work – that is, between two parties one or more capital owners or financiers (called the <i>rabb al-māl</i>) and an entrepreneur or investment manager (called the <i>muḍārib</i>). Profit is distributed between the two parties in accordance with a pre-determined ratio, agreed at the time of the contract. Financial loss is borne only by the financiers. The entrepreneur's loss lies in not getting any reward for his services.
<i>Murābahah</i>	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risks associated with the goods in possession until they are delivered to the buyer. <i>Murābahah</i> is also referred to as <i>bay' mu'ajjal</i> .

<i>Mushārah</i>	A contract of partnership somewhat similar to a <i>muḍārah</i> contract, but partners who provide the capital may participate in the management (although management may be left to one of the partners) and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
<i>Qarḍ</i> or <i>Qarḍ Al-Ḥasan</i>	Financing extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
<i>Ribā</i>	Literally, increase or addition or growth. Technically, it refers to the "premium" that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of <i>fuqahā'</i> to be equivalent to <i>ribā</i> .
<i>Ṣadaqah</i>	An act of charity.
<i>Salam</i>	The short form of <i>bay' al salam</i> .
<i>Sharī'ah</i>	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'ān and the <i>sunnah</i> , which embodies all aspects of the Islamic faith, including beliefs and practices.
<i>Ṣukūk</i>	Plural of ' <i>Sakk</i> ', which refers to a financial paper showing entitlement of the holder to the amount of money shown on it. The English word "cheque" has been derived from it. Technically, <i>Sukūk</i> are financial instruments entitling their holders to some financial claims.
<i>Takāful</i>	An equivalent to the contemporary insurance contract whereby a group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to any one of the group, the loss is met from the collected funds.
<i>Wakālah</i>	An agency contract in which one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
<i>Waqf</i>	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the <i>waqf</i> .
<i>Zakāh</i>	The amount payable by a Muslim on his net worth as part of his religious obligations, mainly for the benefit of the poor and the needy. Paying <i>zakāh</i> is an obligatory duty for every adult Muslim whose wealth exceeds a certain threshold.

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABS	Asset-backed securitization
ADB	Asian Development Bank
ARCIFI	Arbitration and Reconciliation Centre for Islamic Financial Institutions
BCBS	Basel Committee for Banking Supervision
BCPs	Basel Core Principles
CIBAFI	(General) Council for Islamic Banks and Financial Institutions
DJIMI	Dow Jones Islamic Market Index
FATF	Financial Action Task Force
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
GCC	Gulf Cooperation Council
IAH	Investment account holders
IAIS	International Association of Insurance Supervisors
ICM	Islamic Capital Market
ICR	Insolvency and creditor rights
IsDB	Islamic Development Bank
IFAI	Islamic financial architecture and infrastructure
IFS	Islamic financial services
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFM	International Islamic Financial Market
IIFS	Institutions offering Islamic financial services
IIIs	Islamic international infrastructure institutions
IIRA	International Islamic Rating Agency
IMF	International Monetary Fund
INBMFIs	Islamic non-bank and microfinance institutions

IOSCO	International Organization of Securities Commissions
IRTI	Islamic Research and Training Institute
JFFC	Joint Forum on Financial Conglomerates
LLR	Lender of last resort
LMC	Liquidity Management Centre
MBS	Mortgage-backed securitization
NAV	Net asset value
NBMFIs	Non-bank and microfinance institutions
OECD	Organization for Economic Co-operation and Development
OIC	Organization of Islamic Conference
REITs	Real Estate Investment Trusts
SCM	Securities Commission of Malaysia
SGC	Sharī'ah governance system
SRI	Socially responsible investing
TFC	Term finance certificates
WTO	World Trade Organization

1. INTRODUCTION

The critical and persistent issues of poverty reduction and improvements in important aspects of human welfare such as health and education, reducing child mortality, youth insecurity and restlessness, and so on, face every society today whether at the local, national, regional or international level. The financial intermediation system must play a vital role in alleviating these perennial human development problems and in achieving economic development by efficiently channeling financial resources towards productive opportunities, hence enhancing production, investment and trade activities.

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

1.1 THE NEED FOR A SOCIALLY INCLUSIVE FINANCIAL SYSTEM

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

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

Within a large segment of Muslim societies and communities, the compliance of financial services with Shari'ah rules and principles is a primary concern for the users of these services. As such, efforts to enhance the access of Muslim communities and societies to financial services will hinge upon, among other factors, the compatibility of these services with their religious principles. In other words, successful financial sector development in countries with such communities requires the promotion of Islamic financial services within appropriate regulatory frameworks. Such strategies will enable a much larger proportion of the population

all over the world to participate actively and effectively in the process of economic development.

While catering to such specific needs of society, Sharī‘ah-compliant financial services could appeal to other segments of the population so long as the quality of these services is at least comparable with other alternatives. Being an option among many others, the Islamic financial services industry (IFSI) could therefore enhance competition in the financial sector. In a nutshell, the services provided by the IFSI are compatible with the principle of “social inclusiveness”, which is a basic requirement for ensuring just and equitable social progress. Furthermore, such an inclusive financial sector development strategy with good service quality can be expected to successfully replace informal markets with formal and regulated ones.

1.2 EVOLUTION OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY: A SUMMARY

In the historical context, charging a return on loans and an additional amount or penalty in case of a delay in their repayments (*ribā*) is prohibited in the Holy Scriptures of several major religions, including Islam. In addition, these religions provide ethical proscriptions that have a significant bearing on economic and commercial activities and financial transactions. As a practical manifestation of these proscriptions, the contemporary IFSI has been in operation for over three decades. The landmark events in the industry’s evolution are summarized here chronologically.

- | | |
|-----------|---|
| 1890s | Barclays Bank opened its Cairo branch to process the financial transactions related to the construction of the Suez Canal. This is understood to be the first commercial bank established in the Muslim world. As soon as the bank’s branch was opened, Islamic scholars initiated the critique of bank interest as the prohibited <i>ribā</i> . |
| 1900–1930 | The critique also spreads to other Arab regions, and to the Indian sub-continent. In this debate, a majority of scholars subscribed to the position that interest in all its forms constitutes the prohibited <i>ribā</i> . |
| 1930–1950 | Islamic economists also initiated the first critique of interest from the Islamic economic perspective and attempted to outline Sharī‘ah-compliant alternatives in the form of partnership. |
| 1950s | Islamic scholars and economists started to offer theoretical models of banking and finance as a substitute for interest-based banking. By 1953, Islamic economists offered the first description of an interest-free bank based on two-tier <i>muḍārabah</i> (both collection of funds and extension of financing on a <i>muḍārabah</i> basis). Later, they showed that financial intermediation can also be organized on a <i>wakālah</i> basis. |

- 1960s Applications and practices in finance based on Islamic principles began in Egypt and Malaysia. The landmark events include the rise and fall of Mitghamr (Egypt) Saving Associations during the 1961–1964 period and the establishment of Malaysia’s Tabung Haji in 1962. Tabung Haji has since flourished and has become the oldest Islamic financial institution in modern times. Operational mechanisms for institutions offering Islamic financial services (IIFS) began to be proposed and a number of books on Islamic banking based on profit-and-loss-sharing/bearing and leasing were published.
- 1970s Islamic banks emerged with the establishment in 1975 of the Dubai Islamic Bank and the Islamic Development Bank (IsDB). Also in 1975, *fiqhi* objections to conventional insurance became pronounced, laying the ground for an alternative structure. Financial *murābahah* was developed as the core mechanism for the investment of Islamic banks’ funds. Academic activities were launched with the first International Conference on Islamic Economics, held in Makkah in 1976. The first specialized research institution – the Centre for Research in Islamic Economics – was established by the King Abdul Aziz University in Jeddah in 1978. The first *takāful* company was established in 1979.
- 1980s More Islamic banks and academic institutions emerged in several countries. Pakistan, Iran and Sudan announced their intention to transform their overall financial systems so as to be in compliance with Sharī‘ah rules and principles. The governors of central banks and monetary authorities of Organization of Islamic Conference (OIC) member countries, in their Fourth Meeting held in Khartoum on 7–8 March 1981, called jointly for the first time for strengthened regulation and supervision of IIFS. The Islamic Research and Training Institute (IRTI) was established by the IsDB in 1981. In 1980, Pakistan passed legislation to establish *muḍārabah* companies. Other countries such as Malaysia and Bahrain initiated Islamic banking within the framework of the existing system. The International Monetary Fund (IMF) published Working Papers and articles on Islamic banking, while PhD research and other publications on Islamic banking were on the increase in the West. The OIC *Fiqh* Academy and other *Fiqh* boards of IIFS engaged in discussions and the review of financial transactions. Islamic mutual funds and other non-banking financial institutions emerged towards the middle of the 1980s.
- 1990s Public policy interest in the Islamic financial system grew in several

countries. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established and its first standards were issued. The development of Islamic banking products intensified. Interest in Islamic finance increased in Western academic circles, and the Harvard Islamic Finance Forum was established. Large international conventional banks started operating Islamic windows. The Dow Jones and Financial Times Islamic indexes were launched. Systemic concerns and regulation, supervision and risk management issues gathered momentum. Several countries introduced legislation to facilitate Islamic banking and its regulation and supervision. Commercial event organizers discovered Islamic banking and finance activities as a source of lucrative business.

2000–2006 Sovereign and corporate *shukūk* as alternatives to conventional bonds emerged and are increasing rapidly in volume. Bahrain issued Financial Trust Laws.

International Islamic financial infrastructure institutions such as the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), (General) Council for Islamic Banks and Financial Institutions (CIBAFI), and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI), as well as other commercial support institutions such as the International Islamic Rating Agency (IIRA) and the Liquidity Management Centre (LMC), were established. The systemic importance of Islamic banks and financial institutions has been recognized in several jurisdictions.

The governments of United Kingdom and Singapore extended tax neutrality to Islamic financial services.

1.3 THE PRESENT STATE OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The above summary indicates that during the past three decades, considerable progress has been made in almost all significant aspects of a comprehensive IFSI. The various segments of the industry and the related intellectual capital, institutions and policy initiatives have developed rapidly and attained a degree of maturity and international recognition.

1.3.1 Composition of the industry

Currently in the early leg of the fourth decade of their practical existence, the IFSI and its institutional infrastructure now consist of the following:

- i) Islamic banks – that is, deposit-taking and financing institutions, including full-fledged Islamic banks, Islamic subsidiaries and “windows”¹ of conventional banks such as onshore and offshore commercial and investment banks;
- ii) Islamic non-bank financial institutions, including Islamic leasing and factoring companies, finance companies, *ijārah* and *muḍārabah* companies, Islamic housing cooperatives, Islamic microfinance institutions, credit sale subsidiaries of trading companies and other similar institutions, and private equity/venture capital, as well as institutions managing *haj* funds, *awqāf*, *zakāh* and *ṣadaqah*;
- iii) Islamic insurance and re-insurance or *takāful* and *re-takāful*, operators;
- iv) Islamic capital markets and their players, such as brokerage houses, investment banks, etc., as well as fund management institutions including Islamic asset management companies (such as mutual funds/unit trusts, hedge funds, etc.); and
- v) Islamic financial architecture and infrastructure, including:
 - payment-settlement systems and infrastructures;
 - financial markets and products, including market microstructures (Sharī‘ah screening and product identification systems), trading and clearance systems, and e-business infrastructure;
 - support facility providers, legal institutions and framework, safety net, liquidity support providers;
 - regulators and supervisors, including licensing authorities;
 - governance infrastructure, including Sharī‘ah governance institutions;
 - standard setters for financial supervision and infrastructure, including financial reporting, accounting and auditing, capital adequacy and solvency, risk management, transparency and disclosure, and corporate governance;
 - rating and external credit assessment institutions;
 - financial statistics and information providers;

¹ An Islamic window is generally defined as part of a conventional financial institution that undertakes Sharī‘ah-compliant deposit-taking, financing, investment and/or fund management activities. In principle, Islamic windows are potentially self-contained in their Sharī‘ah -compliant financial intermediation activities, and the funds mobilized are invested in Sharī‘ah -compliant assets. Thus, an Islamic window is a virtual branch without separate legal existence within the parent institution. Being a separate business unit that undertakes a complete range of financial intermediation activities, from sourcing of funds to extension of financing, an Islamic window shall be responsible to its fund providers in the same way as a full-fledged Islamic bank.

- knowledge management and human resource development institutions and programs; and
- research and development institutions and programs.

The interface between the Islamic and conventional financial services industries and their infrastructures and support institutions is significant. In a sound financial services industry, most of the above-mentioned entities and factors are expected to be efficient and supportive. However, in developing country jurisdictions that host the IFSI, there are serious gaps in the overall financial infrastructure, again shared by the industries for both Islamic and conventional financial services.

1.3.2 Size of the industry

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

- i) Concerning IIFS, CIBAFI is the only official source of information at present. According to information released by CIBAFI,² the IFSI includes 284 IIFS operating in 38 countries and managing US\$250 billion. However, this does not include Islamic window operations of conventional banks, which CIBAFI estimates to manage some US\$200 billion. Furthermore, the above information does not cover non-banking IIFS, *takāful* and *re-takāful* and capital market activities.
- ii) As regards Islamic capital markets:
 - Based on a comprehensive list provided by The Islamic Banker, London, it is estimated that there are more than 250 Sharī‘ah-compliant mutual funds, currently managing assets worth about US\$11 billion.
 - The Liquidity Management Centre of Bahrain lists 77 corporate and sovereign *sukūk* issues worth US\$17.97 billion.³
 - According to the available data, the outstanding Malaysian domestic market of Islamic debt certificates is estimated to be worth US\$17.1 billion, while that of Bahrain is estimated to be worth US\$2 billion.
 - A recent study conducted at the IRTI⁴ suggests that a sizeable proportion of existing companies listed in the stock markets of IsDB member countries are Sharī‘ah-compliant. Enhancement of Sharī‘ah screening technologies and market microstructures can further support

² CIBAFI Ten-Year Master Plan, released in June 2005.

³ Information downloaded on 1st October, 2006 from <http://www.lmc Bahrain.com>.

⁴ See Salman Syed Ali, *Islamic Capital Market Products: Development and Challenges* (IRTI, 2005).

this segment of the capital market. Applying the Dow Jones Islamic Market Index (DJIMI) criteria to local share markets of three IsDB member countries, this study suggested that the total annual market capitalization of counters meeting the DJIMI criteria in the three countries was US\$104 billion in 2004. Assuming that these three countries constitute 30% of the stock market capitalization in the IsDB universe, the annual stock market capitalization meeting the DJIMI criteria in the member countries may exceed US\$300 billion.

- iii) There is no established source of data for the *takāful* and *re-takāful* segment of the IFSI. The background papers prepared for this document showed that by the year 2005, some 78 *takāful* companies would be operating worldwide. These sources showed that by the end of 2000, the total gross premiums written by *takāful* operators were worth US\$530 million. The same sources estimated that the annualized average growth for 1995–2000 was 63%. Extrapolating this historical information, the present gross premiums written by *takāful* operators could be estimated to be worth US\$5 billion, providing insurance coverage to an estimated US\$20 billion of assets.
- iv) Non-banking financial institutions – in particular, non-bank real estate financing and housing mortgages – have also grown rapidly in the past five years. According to the Modaraba Association of Pakistan,⁵ the paid-up capital of the *muḍārabah* companies was estimated to be worth US\$145 million and their assets US\$300 million in 2004. Major providers of Islamic financial services in a number of countries are licensed as non-bank financial institutions. The estimated size of such services worldwide in 2005 was around US\$4 billion.

The above information needs to be considered as indicative only and not as an actual estimate of the industry's size. The information suggests that by the end of 2005, more than 300 institutions in over 65 jurisdictions were managing assets worth around US\$700 billion to US\$1 trillion in a Sharī'ah-compatible manner. A large part of the banking and *takāful* concentration is in Bahrain, Malaysia and Sudan. A significant portion of mutual funds is concentrated in the Saudi Arabian and Malaysian markets, apart from the more advanced international capital markets.

1.4 THE FUTURE OUTLOOK FOR THE ISLAMIC FINANCIAL SERVICES INDUSTRY

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

⁵ Information downloaded on 25th October 2005 from <http://www.modarabas.com>.

- i) The average annual growth rate of IFSI assets during the 1995–2004 period is estimated to have been 10–15%, according to various sources. Assuming that IFSI assets were worth US\$700 billion in 2005 and an annual growth of 15% until 2010, the IFSI could grow to US\$1.4 trillion by 2010 and to US\$2.8 trillion by 2015, as shown in Table 1.
- ii) The integration of the IFSI within the existing financial system, or even the transformation of the latter into a full-fledged Islamic financial system, will continue at different paces across jurisdictions – in particular, among IsDB member countries. By 2015, more than half of financial services provided are expected to become Shari‘ah-compliant in the Gulf Cooperation Council (GCC) region. Among South Asian member countries, this Shari‘ah-compliant proportion is expected to constitute 15–25% of the total financial services provided. However, in some other countries, the proportion may remain as low as 1–2% unless the population becomes more aware of the benefits of having Islamic financial services as an alternative. It is expected that in several Western jurisdictions, non-bank Islamic financial services, particularly mortgages, will continue to grow on condition that the relatively more sophisticated clients remain convinced of the credibility of the Islamic alternatives and the regulators pursue the principle of “social inclusion” as part of the goals of the financial sector.
- iii) Further growth of the Islamic banking industry is dependent on the establishment of new Islamic banks and the integration of the industry within the existing financial system.
- iv) Market-driven as well as mandatory industry consolidation, in particular through mergers and acquisitions, is expected to take place in view of the small capitalization of most Islamic banks.
- v) Islamic capital markets are expected to grow in line with the development and deepening of the financial markets generally, the increased issuance of new Shari‘ah-compliant stocks and *ṣukūk*, and the identification of additional existing stocks as Shari‘ah-compliant through screening processes. The *ṣukūk* markets are expected to receive a huge boost from the dynamism of real estate markets, sovereign needs to finance infrastructure projects, and corporate needs for stable income-generating financial instruments.
- vi) It is expected that awareness and understanding of Islamic finance by both the public and regulators will strengthen the demand for and supply of Islamic financial services.
- vii) The growth outlook for *takāful* services is robust in view of the population growth rate and increasing acceptance of *takāful* by the public, given its practical successes.
- viii) Other non-bank financial services are also expected to receive support from the regulatory authorities in view of the need to make financial

services accessible to a wider segment of the population. Institutions dealing with microfinance, venture capital, housing finance and social development are expected to benefit from regulatory response to the perennial developmental issues challenges.

- ix) Nevertheless, the sustainability of the IFSI's growth depends on public confidence, which in turn depends on Shari'ah compliance the credibility of the services offered by the IFSI worldwide.
- x) Given its ethical orientation and potential performance, the IFSI may not remain a niche industry only for Muslims; it is highly capable of attracting customers of other faiths, a phenomenon currently observed in some countries.
- xi) In view of the growing size of the industry, and in response to the rapidly changing regulatory requirements and operating environment brought about by globalization and heightened competition, IIFS are expected to increase their investments in research and development, accelerating product development for resource mobilization, and liquidity and risk management.
- xii) Integration of the IFSI into the international financial system will largely depend on the credibility of the work done by the IFSB, AAOIFI and other standard-setting organizations, as well as on the response of the industry to the rapidly changing regulatory, technological and market environments. Furthermore, harmonization of Shari'ah interpretations and the healthy interaction of Shari'ah with other legal regimes such as the common and civil law will play an extremely important role in this regard.

Table 1: Size of the IFSI

(A): Estimated Size of IFSI Segments (2005)		(B): Projected Size of IFSI		
		Years	Annual growth rate: 10%	Annual Growth rate: 15%
	Billions\$		Billions\$	Billions\$
Islamic banks (assets) ¹	250.0	2005 (Base: assumed)	700	700
Islamic banking windows (assets) ¹	200.0	2006	770	805
Modaraba Companies. Pakistan (assets) ²	0.3	2007	847	926
		2008	932	1065
Other non-banking FI (assets) ³	4.0	2009	1025	1224
Şukūk (outstanding) ⁴	18.0	2010	1127	1408
		2011	1240	1619
Malaysian Domestic Islamic Bonds	17.0	2012	1364	1862
Islamic Funds (total size) ⁵	11.0	2013	1501	2141
Shari‘ah-Compatible Stocks ⁶	300.0	2014	1651	2463
Takāful (gross premium written) ⁷	5.0	2015	1816	2832

Sources:

1. General Council of Islamic Banks and Financial Institutions: Islamic Finance Directory (2005).
2. Modaraba Association of Pakistan (2004) (<http://www.modarabas.com/>).
3. Based on estimates for UK, US and Singaporean Islamic real estates and mortgages.
4. Liquidity Management Centre (<http://www.lmcbahrain.com/>). These figures also include the Malaysian global and Bahraini domestic issues.
5. Islamic Banker London (January, 2006) provides a list of known Shari‘ah-compliant mutual funds with a total amount of US\$8 billion under management. This amount represents about 40% of the funds in the list. The other funds in the list are estimated to be value at US\$3 billion.
6. Estimates based on IRTI Occasional Paper (2005), “Islamic Capital Market Products: Development and Challenges”.
7. Estimates are based on background papers written for this document.

1.5 THE TEN-YEAR FRAMEWORK

As evidenced from the preceding paragraphs the systemic significance of the IFSI is rapidly gaining ground at the national, regional and international levels. With this

in mind, Bahrain and Malaysia have put in place elaborate Islamic financial infrastructures. A growing number of countries are implementing legal reforms to support the industry's development. Malaysia and Indonesia have already formulated and adopted long-term national master plans to strengthen the industry.

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

Promotion of the IFSI, as well as its markets and institutions, is one of the three strategic objectives of the Islamic Development Bank Group. The Group's "Strategic Framework" document entrusts to IRTI the responsibility for achieving the strategic objective by designing appropriate programs. The IFSB has also been entrusted with the task of enhancing the soundness and stability of the IFSI.

As such, the IsDB and the IFSB have undertaken the joint initiative to draft this document as a "Ten-Year Framework for Development of Islamic Financial Services Industry". The document attempts to provide guidance to national authorities on preparing their own master plans and a platform for promoting dialogues aimed at fostering the development of an efficient, competitive, sound and sustainable IFSI in a globalized environment.

The aims and objectives of the Framework, which will be revised and updated periodically, are to:

- i) provide a general framework for IsDB and IFSB members and other interested countries to share their experiences and consider the formulation of national and regional master plans to promote the IFSI in their respective jurisdictions so that economic development can be achieved side by side with justice, social progress and financial stability;
- ii) identify the challenges of the IFSI and suggest initiatives, ways and means through which the IFSI could interact with the conventional financial system and compete with it on equal terms;
- iii) enhance the role of the IFSI in redirecting financial resources towards real investments and the creation of employment opportunities;
- iv) provide a platform for policy dialogues among national, regional and international financial and architectural institutions and industry stakeholders; and
- v) help and encourage free, fair and transparent operation of markets, the IFSI's profitability, growth, sustainability and competitiveness, and its

successful integration into the rapidly changing international financial systems.

The Ten-Year Framework has to encompass the most significant segments of the IFSI in a comprehensive manner. The planned Framework also requires a focus on considerations that are unique to the IFSI. Hence, this document addresses the subject from the perspective of four main components of the industry, as well as the architecture and infrastructure arrangements that support the industry's effective functioning.

Box 1

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

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

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

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

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

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

2. THE ISLAMIC FINANCIAL SERVICES INDUSTRY: A STRATEGIC LANDSCAPE

The areas covered by the Ten-Year Framework include:

- i) Islamic banks, including full-fledged Islamic banks, Islamic subsidiaries, and “windows” of conventional banks such as onshore and offshore commercial and investment banks;
- ii) Islamic non-bank financial institutions, including leasing and factoring companies, *ijārah* and *muḍārabah* companies, Islamic finance companies, Islamic housing cooperatives, Islamic microfinance institutions, private equity/venture capital, credit sale subsidiaries of trading companies and other similar institutions, as well as institutions managing *haj* funds, *awqāf*, *zakāh*, *ṣadaqah* and inheritance;
- iii) Islamic insurance, or *takāful*, operators;
- iv) Islamic capital markets and their players, as well as fund management institutions; and
- v) Islamic financial architecture and infrastructure.

This section of the Ten-Year Framework identifies the most important challenges faced by the different segments of the IFSI.

2.1 ISLAMIC BANKING

Initiation of modern Islamic finance dates back to 1962 with the establishment of Tabung Haji in Malaysia. However, present-day Islamic banking had its debut in 1975, when the Islamic Development Bank (a multilateral development financing institution) and the Dubai Islamic Bank (the first commercial bank) were established and mandated to operate in adherence to Sharī‘ah rules and principles. Since then, Islamic banking has made significant progress worldwide, particularly in South-East and South Asia, the GCC region and the Middle East and South Asia.

2.1.1 Transformation processes

A variety of approaches have been adopted in different jurisdictions to authorize Islamic financial services. Among these are two somewhat distinct approaches:

- i) a policy framework approach that requires legal reforms and distinct licensing initiatives; and
- ii) a market-driven financial engineering approach that encourages the development of Sharī‘ah-compliant products and services within the existing legal and licensing regimes.

In the GCC region and in South Asia, which are home to more than 50% of the total Islamic banking industry, as well as in other countries, based on a policy framework approach, the most dominant and dynamic strategy has been to allow a

dual banking system, whereby Islamic banking co-exists alongside conventional banking. In this framework, Islamic banking services are offered through three types of governance structures:

- i) full-fledged Islamic banks, either newly licensed or converted from conventional banks: Major progress is being achieved in a number of jurisdictions in transforming conventional institutions into Sharī‘ah-compliant institutions;
- ii) Islamic banking windows of conventional banks;
- iii) Islamic banking subsidiaries of conventional banks, either newly established or converted from existing Islamic windows. For Islamic banking windows and subsidiaries, the overriding regulatory concern has been the prevention of any mixing of Sharī‘ah-compliant and non-compliant income that could create confidence issues, leading to fund withdrawals. Hence, such windows and subsidiaries have to comply with firewall requirements, including separate capital for the two types of banking services in some countries.

On the other hand, Iran and Sudan, where the public sector has a large share in the banking system, have adopted the strategy of complete conversion of their banking systems into totally Sharī‘ah-compliant ones, leaving no place for conventional banking. Pakistan was initially in this group of countries but later adopted the dual banking strategy. However, in the near future, conventional banking will also be permitted in the semi-autonomous Southern Sudan.

With respect to the financial engineering approach, an increasing number of conventional financial institutions worldwide are confident that in the medium term, if allowed by regulators, most banks will be able to offer Sharī‘ah-compliant services alongside their conventional banking activities. The regulatory response has been positive. In an increasing number of jurisdictions, the regulatory authorities have approved contracts such as *murābaḥah* and *ijārah*, which banks in their jurisdictions may use to offer financing to their clients. However, such an offering of asset-side products falls short of the definition for a “full Islamic window” operation, which also mobilizes funds in a Sharī‘ah-compliant manner.

There are therefore two different forms of the financial engineering approach. One form of the approach does not allow full Islamic window operations as described above. Instead, it encourages Sharī‘ah-compliant investment opportunities to be offered in the form of mutual funds. The other form of this approach permits full Islamic window operations as well as full-fledged IIFS, provided they are able to comply with existing banking regulations, although tax rules may be amended to avoid the double taxation of Sharī‘ah-compliant financing transactions based on *murābaḥah* or *ijārah* contracts. However, in either case, Sharī‘ah compliance is considered to be a matter of market discipline rather than a regulatory issue. At most, supervisory authorities will be concerned with the issue of whether the institution or Islamic window has in place an appropriate internal

Shari'ah compliance system. In contrast, in the policy approach, Shari'ah compliance is usually considered to be a regulatory issue.

2.1.2 Factors supporting the growth of Islamic banking

Islamic banking is viewed as one of the fastest growing segments of the IFSI. It has experienced double-digit growth, spurred by the licensing of new banks, largely in local markets, the establishment of Islamic windows and subsidiaries by major international banks, and partial or full conversion of conventional banks into Islamic banks. Apart from the rising demand for Islamic banking services as a result of increased awareness and population growth, a number of other factors work jointly in boosting the growth of Islamic banking. These factors are listed below.

A) Ease of implementation

The risk characteristics of assets and liabilities of Islamic banks are different from those of conventional banks. Nevertheless, Islamic banking is not technically difficult to implement.

- i) On the liabilities or funding side, owned funds, demand deposits and reserves of Islamic banks have similar risk characteristics to their conventional counterparts. However, unlike conventional banks, Islamic banks do not have tier-2 capital in the form of subordinated loans. Therefore, the only major difference between Islamic and conventional banking on the funding side rests on the unique nature of profit-sharing investment accounts. On the other hand, fee-based services (mostly based on a *wakalah* contract) occupy a more dominant position in Islamic investment banking. Such fee-based services also constitute a large part of conventional banking services and are also well known to regulators.
- ii) On the assets side, Shari'ah-compliant financing services can take the form of (a) asset-based financing involving either sale or purchase with deferred delivery and a profit margin or leasing, or (b) financing on an equity basis through several types of partnership contracts. In most cases, banks are familiar with these kinds of contracts, although they may need to be adequately adapted to comply with Shari'ah rules and principles. Activities of Islamic banks also make them similar to universal banks operating in some European countries. However, Shari'ah does not permit Islamic banks to take equity stakes in businesses that are not Shari'ah-compliant. This is a limitation faced by Islamic banks vis-à-vis conventional universal banks. Nevertheless, stock screening and identification technologies should help to mitigate this limitation by providing readily updated information on Shari'ah-compliant businesses.
- iii) On the international scene, banking is a universally known concept. Any form of banking, so long as it is conducted within the parameters of the

laws and regulations of a jurisdiction for providing services to the public in the best interests of the society, is expected to be welcomed all over the world. Hence, the number of national jurisdictions that issue Islamic banking licences is steadily growing. However, the requirement of the banking law that deposits be “capital certain” is a problem encountered in some jurisdictions. This problem may be circumvented by an IIFS not calling itself a bank, or by mobilizing funds in the form of mutual funds rather than investment accounts.

B) Strengths of Islamic banking

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

- i) Weak internal control and other corporate governance systems are important causes of financial instability and the failure of institutions. Due to its emphasis on ethical premises and rigorous self-regulation in terms of Shari‘ah supervision, the Islamic finance paradigm is expected to strengthen internal control systems in financial institutions, hence promoting their soundness and sustainability.
- ii) Ethical considerations are also expected to reallocate financial resources to more socially responsible areas, contributing to greater social well-being.
- iii) Recurring financial crises cause a large and unforeseen divergence in balance sheet and market values of assets, loss of wealth, destruction of employment opportunities and an increase in social insecurity. Such crises can be caused by the failure of corporate governance structures, excessively large short-term capital flows of speculative nature and high leverage. Islamic finance is based on “real” assets, as compared to financial assets, and equity-type profit-sharing facilities. By promoting risk-sharing through asset-based equity-type facilities on the assets side and profit-sharing investment accounts on the funding side, Islamic finance could in principle contribute to a better balance between debt and equity, thereby fostering stability. However (as noted in the subsection 2.1.4E, below), in practice, the use of equity-type financing facilities is limited due to risks linked to considerations of asymmetric information and adverse selection.
- iv) Islamic financial services insofar as they are based on “real” assets also impose limitations on the ways in which cash may be used. The nature of asset and project financing is such that financial institutions must have a good knowledge of their clients and the uses to which their funds are put. This process also includes the monitoring of Shari‘ah-compliance by an

IIFS's Sharī'ah board or committee constituting a degree of self-regulation.⁶

- v) Providing banking services in conformity with Sharī'ah rules and principles could help to enhance the accessibility of a significant section of the population to financial services, and should therefore have positive implications for social justice, economic development and peace. Such a reform will also promote the development of formal and regulated financial markets.
- vi) Islamic finance also puts relatively more emphasis on the feasibility of projects and real economic activities, as compared to focusing primarily on the creditworthiness of clients. This is also expected to contribute to enhancing the efficiency of resource allocation.

2.1.3 The environment

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

A) Technology

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

- i) During the past two decades, there has been an unprecedented development in the mathematical and quantitative treatment of financial variables with critical implications for banks. An important impact of this development has been on decomposing risk through financial engineering and product development, which have made risk management a serious scientific process. These innovations have led to significant cost reductions for most financial institutions. However, at the same time, additional uncertainties, have been created, which could have serious consequences for the development of Islamic banking.
- ii) Other impacts of the technological breakthrough have been on reducing the boundaries of legal jurisdictions, of transaction costs and of information asymmetries as a result of the development of market microstructures and the increased speed of transactions. Efficient e-business and electronic delivery systems help to reduce costs dramatically and enhance the quality of services.

⁶ Please refer to the *IIFSB Guiding Principles on Corporate Governance for IIFS (excluding Islamic insurance (Takāful) Institutions and Islamic Mutual Funds)* for further elaboration.

- iii) Technology creates new business risks and hence new opportunities. The spectrum and quality of services offered vary across financial institutions, depending on their utilization of state-of-the-art technology. Inevitably, however, the effects of technology on operational and business risks can be very severe for some financial institutions, while others that are quick to adapt and able to transform uncertainties into opportunities will thrive.

B) Markets

By altering the competitiveness of market players, technology also alters the market environment. The “emergence” period of Islamic banking over the past three decades also witnessed financial liberalization, globalization and the resultant recurring financial instabilities in conventional markets. These market conditions have forced firms to invest in research and to develop new technologies in order to cater to the growing demand for greater product mix by increasingly discerning consumers. In turn, technology has led to a sharp increase in the number of financial conglomerates in recent years. These entities sustain competitiveness by crossing traditional boundaries and achieving economies of scale. As a result, a drastic transformation is taking place in the financial services industry in the form of:

- i) cross-segment mergers, acquisitions and takeovers between banks and securities firms and between banks and insurance companies;
- ii) acquisition of fund management companies by banks and insurance companies;
- iii) expansion of financial institutions into new areas through internal growth, such as insurance companies setting up banks and vice versa, insurance companies selling various investment products, and banks setting up securities and fund management operations; and
- iv) involvement of non-financial firms in the financial services business through the extension of credit and financial services to their customers.

These worldwide transformations in the financial services industry have very important implications for the development of Islamic banking. Since most Islamic banks are rather small, pressures for economies of scale impose a need for important strategic initiatives such as mergers and acquisitions within the Islamic banking industry.

C) Laws and regulation

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

- i) The philosophy of Islamic banking and finance could be considered closer

to what is known as universal banking. A cursory look at the balance sheet of Islamic banks shows that there is no clear distinction between “banking book” and “trading book” activities. In their normal banking book activities, Islamic banks hold non-financial assets, while conventional banks only do so as part of their trading book activities. This nature of Islamic banks could have hindered their development in the past because, until recently, in many jurisdictions, activities of commercial banks, investment banks, insurance companies and mutual funds were traditionally considered to be distinct from one another. On the grounds of the perceived need to protect the soundness of each segment and its positive role in enhancing the stability of the financial system, inter-segment activities have traditionally been prohibited in many jurisdictions.

However, to the benefit of the philosophy of Islamic banking, this type of strict segregation of financial services seems to be a thing of the past, particularly since the repealing of the Glass-Steagall Act in 2000 in the United States. However, banks and securities firms have traditionally undertaken cross-segment activities in most European countries. In some countries, banks and insurance companies have more interactive business linkages; in some other countries, insurance companies and securities firms enter each other’s business domain more frequently. This, trend however, requires adequate firewalls between different business segments to protect against consequent problems relating to investor protection and capital adequacy requirements.

- ii) In response to the market developments highlighted above, at the national level various supervisory and regulatory authorities for different business segments have been merged into a single authority, along the lines of the Financial Services Authority (FSA) in the United Kingdom and its counterparts in other countries. Some other countries, such as the United States, have taken initiatives to identify a lead regulatory authority to coordinate the activities of other regulators and enhance cooperation among them. In view of the nature of Islamic banking, in particular, such developments appear to be highly relevant to providing a suitable supervisory framework for Islamic banks.
- iii) At the international level, the Joint Forum on Financial Conglomerates (JFFC) attempts to coordinate cross-segment supervision of global financial services – that is, supervisory coordination between activities of the Basel Committee for Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The Financial Stability Forum has been established with the objective of enhancing financial stability. From these experiences, important lessons could again be drawn for the IFSI and its infrastructure institutions.

- iv) The coverage of consolidated supervision has been extended to the full range of activities of financial conglomerates. With such consolidated supervision, which establishes effective safety nets with controls on capital leverage, non-prudential connected businesses and capital arbitrage while enhancing market discipline by appropriate disclosure requirements, the cross-segment activities of universal banks are expected to promote economies of scale and greater efficiency of financial institutions and markets. Again, important lessons could be drawn in developing Islamic banking, which is close in significant ways to the universal banking concept.
- v) Basel II aims at encouraging better risk management by offering capital incentives as well as by its flexible and comprehensive coverage of all significant exposures, securitizations and operational risks. It also puts emphasis on empowering supervisors, as well as enhancing disclosures, transparency and market discipline. An emphasis on the role of supervisors and their relationship with external auditors could indicate that more resources will be allocated by national authorities to banking supervision. Basel II may be relevant in different ways for various jurisdictions and institutions. However, it has already increased consciousness among banks concerning the importance of risk management. As with adaptation to the technological environment, adaptation to the new regulatory environment creates both uncertainties and opportunities. Without prompt and adequate responses to these changes, the competitiveness of some banks could be in serious jeopardy.

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

2.1.4 Challenges facing Islamic banking

Islamic banking has come a long way over the past three decades. However, it also faces a number of challenges that need to be addressed in order to provide a sound footing for its future path.

A) Human resource requirements for Shari'ah compliance

Users of Islamic financial services assign primary importance to Shari'ah compliance of the services they use. It is understandable that Shari'ah non-compliance entails a serious operational risk and can result in withdrawal of funds from and instability of an Islamic bank, irrespective of its initial financial

soundness. Shari'ah compliance is hence a serious matter for an Islamic bank, in addition to its compliance with other regulatory requirements.

Therefore, the most basic and unique building block of the Islamic banking industry is its Shari'ah governance system (SGS) at both the national and international levels. The SGS monitors the Shari'ah compatibility of banking services and products, as well as banks' trading activities. It plays a critical role in ensuring the voluntary compliance of the IIFS with the Shari'ah rules and principles. Hence, it helps to safeguard the reputation of institutions and fosters clients' confidence. Owing to this systemic significance of the SGS, licensing authorities have an important need to ensure that a credible SGS is in place in institutions seeking Islamic banking licences, as well as in those already offering Islamic banking services. The human resource requirements of SGS cover the following:

- i) Self-regulatory systems, processes and oversight procedures put in place by individual financial institutions for the formulation of Shari'ah-compliant contracts and products, financial engineering and risk management instruments, analysis of complex trading systems and transactions, and other banking transactions.
- ii) The licensing authorities would need to put in place human resources commensurate at least with the requirements to confirm the SGS credentials of banks licensed to conduct Islamic banking.

Therefore, the specific human resource requirements of the SGS include the need both for Shari'ah experts to have an adequate knowledge of banking and finance, and for bankers, finance specialists and regulators to have an adequate knowledge of the applicable Shari'ah rules and principles.

The institutional, technical and human resource requirements of the SGS are unique. Without a proper SGS in place, even if the demand for Islamic banking services increases, the supply of such services cannot be expanded before ensuring the adequacy of the SGS. If the SGS is not of the highest standard, the credibility, competitiveness and stability of the Islamic banking industry will be at stake. Hence, the most important unique challenge of the IFSI is the development of institutional, technical and human resources to meet its needs for Shari'ah governance.

B) Appropriate legal framework and tax neutrality

An appropriate legal, institutional and tax framework is a basic requirement for establishing sound financial institutions and markets. Like the common law and civil law systems, Islamic jurisprudence offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking, property and company laws appropriate for the enforcement of Islamic banking and financial contracts do not exist in many countries. In most countries, Islamic asset-based financing contracts are treated as

purchase and re-sales of the assets and hence are taxed twice. However, in some countries such as the UK and Singapore, the double stamp duty on some Islamic modes of finance has been abolished, so as to provide tax neutrality. The treatment of *sukūk* as an asset class differs across jurisdictions. While common law jurisdictions tend to put *sukūk* in the same class as conventional bonds - that is, as debt equity or pure debt - others treat them as equity, in the same class as shares, given the underlying ownership rights attached.

Conventional banking laws also narrow the scope of activities of Islamic banking within conventional limits. In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra effort and costs. Therefore, banking, property and company laws in several countries require a suitable modification to provide a level playing field for Islamic banks. Furthermore, international acceptance of Islamic financial contracts requires them to be Sharī‘ah-compatible as well as enforceable under the main legal regimes such as the common law and civil law systems.

C) Enabling supervisory framework

Prudential regulation and effective supervision may enhance the efficiency of financial institutions. It may also promote the development of markets by protecting the rights of users of financial services, especially depositors. It ensures a level playing field and equal competitive opportunities to market participants through the application of best practices, and offers support to financial institutions in times of need. Given its relative infancy and the special nature of its liabilities and assets, Islamic banking needs credible and more supportive supervision and regulation that accommodates its specificities. Not to reinvent the wheel, the approach of adapting existing regulatory and supervisory frameworks while taking into account the specificities of Islamic finance will also help to accelerate the integration of the IFSI into the global financial system. However, except in a few countries, such a supportive regulatory environment still does not exist for Islamic banks.

The supervision of Islamic banking needs strengthening in a number of areas, including the enhancement of:

- i) transparency and disclosures;
- ii) risk management;
- iii) corporate governance; and
- iv) internal control systems.

In addition, to ensure equal opportunities, a number of Sharī‘ah-compliant support facilities need to be provided to Islamic banks, including:

- i) liquidity support, such as lender of last resort (LLR) facilities;

- ii) neutrality regarding capital requirements to be accorded to assets of Islamic banks as compared to those of conventional banks;
- iii) a Sharī'ah-compliant return on bank reserves held at central banks;
- iv) appropriate treatment of investment accounts for mandatory reserves and capital requirements;
- v) investment opportunities in sovereign issues;
- vi) proper understanding of Islamic banking services and their equal treatment vis-à-vis conventional products;
- vii) a clearer understanding of the Sharī'ah governance structures and efforts to facilitate them further;
- viii) extension of safety net systems such as Sharī'ah-compliant deposit insurance;
- ix) ensuring that the legal system is supportive; and
- x) ensuring tax neutrality for Islamic financial contracts.

D) Unresolved fiqhi issues

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

- i) The treatment of default in deferred sale transactions is an important unresolved matter. A default, whether due to genuine circumstances of the client or to the client's unscrupulousness, will translate into a cost to the bank. Credit risk management, regulatory treatment of capital, and other important accounting issues concerning the assets depend on a clear treatment of such a default. However, in the absence of a uniform position, different banks may treat the matter differently.
- ii) There is no specific direct discussion in the *fiqh* literature on the nature of a partner's liability – whether limited or unlimited – with respect to third parties. This is understandable because the nature of liability gains prominence only when there is leverage. Such leverage was not possible within the framework of the classical modes of *muḍārabah* and *mushārahah*. However, in Islamic banking, funding of assets through demand deposits has given rise to leverage and made it possible to build assets in excess of the amount of the bank's equity and investment accounts. In such a situation, it is important for shareholders as well as investment account holders (IAH) to know the extent of their exposure to losses. Limited liability confines the investors' risks to the extent of their contribution to total equity or their investment (plus unpaid calls, in the case of shareholders). This has given rise to the unresolved corporate governance issue regarding protection of the rights of IAH versus

shareholders. In principle, for example, IAH should not be exposed to losses on assets financed by shareholders' funds or by demand deposits since income from such assets is attributable to shareholders although this may not always be made clear.

- iii) Sharī'ah scholars unanimously agree on the need for the lessor to bear a significant part of the risk attached to the asset in lease financing in order for the lease contract to be Sharī'ah-compliant. The kind of leasing that scholars have generally discussed in the classical *fiqh* literature, and on the permissibility of which there is no difference of opinion, is what is now called the operating lease. Nevertheless, there are differences of opinion among them on the permissibility of other types of lease contracts. For example, almost all Islamic banks use a form of capital lease (*ijārah muntahia bittamleek*) in which ownership is finally transferred to the lessee by fulfilling, or at least making an effort to fulfil, the Sharī'ah conditions. The residual value of the leased asset remains a problem. A number of banks have tried to overcome this problem by setting a small nominal value for the asset at the end of the lease or transferring it as a gift from the lessor to the lessee. This does not satisfy those who are opposed in principle to the capital lease because, according to them, it does not fulfil the Sharī'ah requirements. Unless these differences are resolved, it may not be possible to prepare a clear and comprehensive contractual framework for Sharī'ah-compliant leasing.
- iv) Receivables constitute a large portion of Islamic banks' asset portfolios. There are at least two opposing positions in practice with regard to selling such assets. Outside Malaysia, there is a general consensus among Sharī'ah scholars that the sale of debt assets is not allowed except at their face value. Hence, the assets of Islamic banks remain highly illiquid, forcing them to resort to very short-term financing while maintaining a high proportion of liquid assets. However, in Malaysia this prohibition is treated differently, and Islamic banks are able to manage their receivables more freely.
- v) Differing attitudes towards hedging techniques such as forwards, futures and options provide another example of a large divergence of opinions that does not benefit the industry.

E) Credibility and sustainability

As the *raison d'être* of Islamic banking is Sharī'ah compliance, the core constituent of Islamic banks' customers is always expected to remain very sensitive to this consideration. Such a preference among customers may be expected to introduce market discipline among banks in providing products and services of high Sharī'ah credibility. Since Islamic banking is an unprecedented experience, to maintain soundness and to remain competitive, Islamic banks have no other option but to

build on the experiences of conventional banks. This results in their practices having a considerable degree of resemblance to the services of conventional banks, which is quite the opposite of the vision of Sharī'ah scholars and perhaps of the aspirations of customers. Some aspects of this challenge are considered below.

Management of investment accounts

The most clearly unique feature of Islamic banking is the existence of investment accounts with a participatory aspect. These profit-sharing investment accounts are further classified as restricted investment accounts and unrestricted investment accounts. In their governance requirements, the management of restricted investment accounts is considered similar to the management of mutual funds, and hence they cannot be considered as sources of funds available to banks. However, holders of unrestricted investment accounts offer their banks the complete freedom to utilize their funds in Sharī'ah-compliant investment avenues. Hence, these accounts are an important source of funds for the banks. Islamic banks often mix these types of funds with their own funds and invest in profitable Sharī'ah-compliant investment opportunities. The profits are to be shared with the account holders on a pro rata basis. The challenge to Islamic banks in this area is to determine the rights and obligations of IAH vis-à-vis shareholders, especially when various types of Sharī'ah-compliant deposit accounts are offered, so as to ensure the required disclosures and transparency in the distribution of profits and the sharing of risks. Harmonization in the treatment and uses of investment accounts across jurisdictions should be one of the objectives to achieve.

Lack of participatory financing

There is an established belief that the essence of Islamic banking is participation in the risks and returns of investment projects and businesses by utilizing participatory Islamic financial contracts such as profit-and-loss-sharing *mushārah* and profit-sharing-and-loss-bearing *mudārah*. Hence, there is an expectation that Islamic banks should invest funds of IAH by extending finance on the basis of such contracts. Such participatory finance is not only valuable for promoting new businesses requiring capital, thus fostering entrepreneurship and private investment activities, but is also regarded as a genuine alternative to the conventional interest-based banking system. To strengthen the public's confidence in the IFSI and to ensure the industry's transparency, efficiency and stability, it is sometimes argued that IIFS need to promote risk-sharing and participatory financing on the assets side. However, in practice, IAH typically would not wish to incur the risks of capital impairment associated with that type of financing, especially in view of the problems of information asymmetry and adverse selection to which it is exposed. As such, Islamic banks need to find innovative ways of managing the capital impairment risk of assets engaged in participatory funding. In addition, there are pressures on Islamic banks to make their investment accounts behave like conventional deposits in terms of return profile. These pressures are two-fold – namely, from the marketplace and in some countries, from the banking

supervisor – for the unrestricted investment accounts to be a near-perfect Sharī‘ah-compliant substitute for conventional deposits as well as the incentive for an IIFS to use unrestricted investment accounts as a form of financial leverage, similar to the way conventional banks do with deposits. In these circumstances, there is no genuine partnership between IAH and the bank, due to the practice of smoothing of returns paid to IAH in line with market rates of return. Hence, striking a proper balance between protecting the interests of the unrestricted IAH and the aspirations of the common person poses another serious and unique challenge for Islamic banks.

Short-term financing

Since receivables of Islamic banks are non-tradable in nature, and liquidity support infrastructures are generally not available, Islamic banks need to be highly cautious about the maturity structure of their assets in order to remain solvent. Hence, most of the assets of Islamic banks are short-term in nature. However, this situation goes against the expectations of many Sharī‘ah scholars and some members of the public insofar as they aspire for Islamic banks to be different from conventional banks in financing long-term projects through a suitable balance between fixed-return, asset-based modes of financing such as *murābaḥah* and *ijārah* and profit-sharing modes such as *mushārakah* and *muḍārabah* facilities for entrepreneurs. It needs to be emphasized that providing various types of funds is the function of the financial system as a whole. Other segments of the industry, such as non-banking financial institutions and capital markets, may be well placed to take care of the various requirements of the economy for funds.

Redirection of international flow of funds

There are considerable investment opportunities in a number of the IsDB member countries, as well as in developing countries in general, and a large amount of financial resources is held by another group of the member countries. One of the most important and commonly held aspirations of the IFSI is to facilitate an efficient intermediation between these investment opportunities and financial resources. Although Islamic banks have so far mobilized large financial resources, due to unfavourable legal and infrastructure conditions, these resources have not been able to meet these expectations and have instead found their way into more developed financial markets in the form of commodity *murābaḥah* or investments in equities and private equity/venture capital. Hence, channeling surplus savings towards investment opportunities in developing countries and away from financial markets in developed countries is in fact a great challenge for Islamic banks to address, for their long-term credibility and, hence, sustainability.

F) Inter-bank liquidity placement and risk management

The competitiveness and soundness of financial institutions depend on the availability of efficient financial products. Islamic banks urgently need Sharī‘ah-compliant products to meet a number of pressing needs, including:

- i) short-term placement of funds and liquidity and asset-liability mismatch management;
- ii) financial risk management and hedging;
- iii) resource mobilization at a competitive cost; and
- iv) balance sheet management through securitization.

Owing to their need to develop new products, Islamic banks need to invest more in their research and development activities as compared to the conventional banks. However, such investments are hardly sufficient in individual Islamic banks.

Development of a well-functioning Islamic money market is crucial, as it can serve as the transmission channel for the conduct of monetary policy and provide the intersection between central banks and the financial system while also providing an avenue for liquidity management and more efficient use of excess funds of IIFS. Apart from monetary operations in a Shari'ah-compliant manner, active, deep and liquid Islamic money markets, both primary and secondary, could lead to the development of effective Shari'ah-compliant LLR facilities or other alternatives.

At present, the dearth of short-term Islamic financial instruments is a critical issue. By replicating the success of asset-based securitization transactions in the capital market, the IFSI should be able to structure more innovative tradable and liquid short-term Islamic financial instruments for the purpose of monetary operations of central banks/monetary authorities and liquidity management of IIFS. Nonetheless, there is a limit to the availability of Shari'ah-compliant underlying assets for the purpose of securitization.

2.2 ISLAMIC NON-BANK AND MICROFINANCE INSTITUTIONS

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

Broadly speaking, the NBMFIs cover all financial institutions, other than commercial and investment banks, and include specialized sectoral financiers, general and sector-specific finance companies, leasing and factoring companies, cooperatives, building societies and credit unions, microfinance institutions, private equity/venture capital, and financial services consultancy and advisory providers. It may be noted that insurance and capital markets are discussed separately in this document.

2.2.1 The present state

In contemporary times, the Islamic NBMFIs (INBMFIs) have played a pioneering role in introducing the practices of Islamic finance. In 1962, Tabung Haji Malaysia started its operations. During the 1961–1964 period, Islamic saving associations were introduced in Mitghamr, Egypt. The Nasser Social Bank Egypt was established in 1971. These landmark experiences are examples of INBMFIs.

Being nascent, the Islamic financial system lacks a comprehensive set of operational institutions and instruments compared to its conventional counterpart. Until recently, the IFSI has been largely dominated by banks. While banks play an important role by providing liquidity and access to a safe and efficient payment-settlement system for depositors, there is a need to expand the type of institutions offering a wide range of products and services that serve the various needs of society. The case for having a stronger NBMFI segment in the Islamic financial system is compelling.

In recent times, a number of INBMFIs have been established side by side with Islamic banks in different countries. While some of these institutions have counterparts in the conventional financial system, other NBMFIs have unique Islamic features. The INBMFIs that have counterparts in the conventional financial system include different types of finance companies, cooperatives, credit unions, and leasing and factoring companies. Examples of unique INBMFIs with no counterpart in the conventional financial system are Tabung Haji (Malaysia) type of institutions, Modaraba Companies (Pakistan), Qard Hassan Funds (Iran), Al-Rahnu (Malaysia), Waqf Foundations (Turkey and Indonesia) and other similar institutions.

2.2.2 Potential of INBMFIs

A number of factors make the INBMFIs potentially beneficial for the development of sound, efficient and accessible Islamic financial sectors. These factors are:

- i) Historically, the NBMFI segment's share of total financial sector activities has grown along with financial development as banking loses its relative significance. Because of the special status of investment accounts, licensing requirements for Islamic banks are very strict. Against this background, the geographic coverage of the INBMFIs is much wider due to the highly specialized nature of services and, hence, the relatively easier licensing requirements. As such, INBMFIs constitute true backup institutions for the IFSI, with the potential of becoming the vehicle for spreading Islamic finance to most jurisdictions. Putting the next ten years into perspective, it may be envisaged that the assets of the INBMFI segment will make up around 8–10% of the total IFSI assets.
- ii) When compared to the conversion of conventional banks into Islamic banks, or even to the development of Islamic banks, the conversion of

conventional NBMFIs into INBMFIs, and their subsequent development, is relatively easy. Moreover, due to the differences in the licensing and regulatory requirements, as well as the asset–liability structures, of the institutions, the development as well as transformation of INBMFIs is expected to take a different form and to be relatively less challenging as compared to the Islamic banking industry. Transformation of conventional NBMFIs involves, among others, elimination of the undesirable elements (such as *ribā* and *gharar*) from their transactions. In this process, the functions performed by the INBMFIs are similar to those of their conventional counterparts, although the operations would be within the bounds prescribed by the Shari‘ah. This method of creating IIFS would keep the same institutional format but would change the juristic basis used. Depending on the specific cases, this can be done at different levels of difficulty – sometimes by minor adjustments, while in other cases with extensive modifications.

- iii) Adaptability is expected to be relatively easier for transactions that do not have prohibited elements. For example, venture capital providers would easily qualify as Islamic institutions. Conventional leasing companies, mortgage finance institutions, finance companies, saving associations, microfinance institutions, etc., converted into IIFS are examples of cases where the institutional structure of the conventional NBMFIs is retained, but the contracts used are adapted to be compatible with Shari‘ah.
- iv) The establishment of unique INBMFIs replicating, for example, Tabung Haji, Modarabah Companies, Qard Hassan Funds, Awqaf Foundations and pawning institutions is also expected to be easier if encouraged by the public sector. These institutions have unique features serving different purposes in the economy. Development of social-oriented financial institutions – for example, by pooling obligatory charities (*zakāh*) and voluntary charities (*ṣadaqah* and interest-free loans) in an Islamic financial system – will fall in this category.
- v) INBMFIs allow functional specialization of financial services. In their diversity, these functions range from providing risk capital to offering social services. Islamic banks are often called for to cater to these specific needs. However, banks are neither suitable to offer venture capital-type financing, nor can they offer social services. The INBMFI framework allows the establishment of institutions catering to such diverse needs of the society. Socio-economic justice and equitable distribution of income are among the paramount goals of an Islamic economy, and these goals must be reflected in an Islamic financial system. There are various institutions and structures Islam has installed through which income and wealth can be redistributed to fulfil the basic needs for all in society. Among others, *zakāh*, *awqāf* and *qard ḥassan* have played an important role in the past in increasing the welfare of society and mitigating poverty.

These charitable acts have wide economic implications. The social objectives of the Islamic financial system can be fulfilled if these important traditional Islamic institutions are integrated into the contemporary financial sector. Although, in the conventional sense, such institutions are not a part of the financial sector, it cannot be ignored that they have a large potential for economic development, being part of the Islamic financial sector.

2.2.3 Challenges facing INBMFIs

At present the INBMFIs face a number of critical challenges as listed in the following:

- i) Despite the potential noted above, the INBMFI segment faces a serious threat emanating from the image built as a result of a number of previous mishaps caused by pyramid schemes in various countries. In these schemes, the name of Islamic finance was misused and innocent small investors lost their savings. There is a possibility of such incidents occurring again in some countries, while in other countries, these incidents might have made regulators over-cautious, leading to over-regulation. Both circumstances are detrimental to the development of the INBMFIs.
- ii) The legal framework is indeed again the single most important determinant of a sound INBMFI segment. There is a need for legislation for both the regulators and the regulated. The laws should clearly specify the activities that various INBMFIs can undertake. These laws should be complemented by supporting laws that assign regulatory powers to relevant authorities to supervise and regulate the INBMFIs. In jurisdictions where commercial banks are highly regulated and the related statutory laws and regulations are difficult to change, INBMFIs, due to their very specific functions and clear risk profile, can be established within the existing laws with relative ease. However, as INBMFIs are expected to play an important role in an Islamic financial system, there is a need for legislation to give backing to these institutions.
- iii) It is necessary to have a prudent regulatory and policy framework for a broad-based and efficient INBMFI segment. This regulatory framework should, however, have the right balance. It should neither be too restrictive nor too lax. While the former would hamper the growth of the INBMFI segment, a deficient regulatory regime would lead to instability in the segment and impede its long-term growth potential. Some regulatory overview may also be needed, not only to instill confidence and protect the stakeholders, but also to ensure the healthy growth of the industry. Furthermore, tax neutrality can play an important role in the growth of INBMFIs.
- iv) Most IsDB and IFSB member countries have inherited either the civil or common law regimes. Neither of these inherited bodies of law contains

specific legal provisions of the kind needed to support the unique features of Islamic financial contracts. Under such circumstances, there may be two ways in which IIFS can operate. The first is to enact new laws or adjust existing ones to accommodate the specificities of Islamic finance. Apart from Islamic banking laws enacted so far in several countries, there are other specific laws that have led to the establishment of INBMFIs. The enactment of the Modarabah Companies and Modarabah Floatation and Control Ordinance 1980, which outlines the rules, regulations and guidelines for Modarabah Companies operating in Pakistan, is an example. The second way to provide Islamic financial services in countries where specific laws related to Islamic financial activities do not exist would be to identify the institutions that can operate within the framework of the existing laws and regulations. In many jurisdictions where Islamic banks cannot operate due to legal and regulatory restrictions, there may be room for NBMFIs to engage in Islamic finance. As laws relating to NBMFIs are less stringent than those relating to banking, NBMFIs can provide Islamic financial services under existing laws and regulations. For example, finance companies, leasing and factoring companies, cooperatives, credit unions, etc., can offer Islamic products and services in countries that have no specific laws and regulations related to Islamic financial services.

- v) The development of modern financial institutions requires high-quality human capital with the appropriate financial skills. The segment can grow only if there are skilled lawyers, accountants Shari'ah specialists, financial experts and analysts who can comprehend the basic principles and manage the various aspects of operations of INBMFIs. Specifically, there is a need for skilled professionals who understand the risks inherent in various Islamic financial instruments and the ways of mitigating them.
- vi) Islamic finance is a relatively new concept, and the exchange of ideas and cooperation between institutions across borders can help the growth of the industry. Allowing the establishment of foreign IIFS from countries where the IFSI is more developed can be instrumental for the growth of the INBMFI segment in jurisdictions where it is relatively underdeveloped. Foreign INBMFIs can bring with them not only capital but also the Islamic finance expertise that the host country may lack. Furthermore, more foreign IIFS will make the industry more competitive and increase the efficiency and quality of services provided.
- vii) The challenges faced by the Modarabah Companies in Pakistan highlight the difficulties in accessing sources of appropriate funds due to the lack of Islamic financial products and capital market support for such products.

2.3 ISLAMIC INSURANCE (*TAKĀFUL*) AND REINSURANCE (*RE-TAKĀFUL*) SERVICES

As a Shari‘ah-compatible risk intermediation industry, *takāful* offers highly valuable services to individuals, families, businesses and the economy. Without *takāful* coverage, Islamic banks and asset management institutions are exposed to potentially insurable risks that add to operational costs and impair competitiveness. Likewise, without a micro-*takāful* coverage, the microfinance recipient’s family will remain exposed to additional hardship in the event of his or her death.

2.3.1 Present state of *takāful*

The world’s first *takāful* operator, the Islamic Insurance Company, was established in Sudan in 1979. At present, more than approximately 80 companies are operating in various jurisdictions offering life and general insurance services in compliance with the Shari‘ah. There is no established source of data for the *takāful* segment of the IFSI. The background papers prepared for this document showed that by 2005, some 78 *takāful* companies would be operating worldwide. These sources showed that by the end of 2000, the total gross premiums written by *takāful* operators were worth US\$530 million. The same sources estimated that the annualized average growth for 1995–2000 was 63%. Extrapolating this historical information, the present gross premiums written by *takāful* operators could be estimated to be worth US\$5 billion, providing insurance coverage to an estimated US\$20 billion of assets.

Takāful operators are largely concentrated in Malaysia, Sudan and Bahrain, where separate regulatory frameworks for *takāful* have been introduced, which helps to spur the growth of *takāful* services in these countries.

In any developed financial services environment, conventional insurance, be it general or life protection and savings, is an integral part of the financial sector. On the one hand, there is a large demand for such services in the IsDB member countries. On the other hand, conventional insurance is widely believed to be against the injunctions of the Shari‘ah. *Takāful* is not only a product that provides financial security (for example, for the insured’s family in the event of his or her death), but such products can also enhance solidarity under the cherished Islamic principle of cooperation and mutual help. Hence, the worldwide potential market for *takāful* and *re-takāful* is large.

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

Microfinance programs are on the rise all over the developing countries. These programs require micro-*takāful* support in order to function efficiently.

The synergy between conventional life insurance and the asset management industries is well known. It is no different for the *takāful* and Islamic asset management industries. The development of *takāful* – especially life (family) *takāful* – will greatly enhance the ability of Islamic fund managers to significantly increase assets under management as well as the number of clients in a fund. Similarly, the development of *takāful* services will also strengthen Islamic banking by providing risk coverage to their clients and reducing the banks' exposure to risks, in particular when the permissibility of derivatives instruments in Islamic finance is still largely debatable. The potential of *takāful* as an alternative to hedging or risk management mechanisms makes it more important.

2.3.2 Challenges facing *takāful* and *re-takāful* services

The *takāful* industry confronts a number of critical challenges that need to be addressed without delay. These are:

- i) The development of human resources that have competencies in both Shari'ah and actuarial sciences.
- ii) The single most important challenge faced by the *takāful* segment is the non-existence of a supportive legal and regulatory framework. In countries other than Bahrain, Malaysia and Sudan, *takāful* is regulated within the regulatory framework of conventional insurance services. Furthermore, the existing legal framework usually treats *takāful* like conventional insurance. As a result, *takāful* services providers face difficulty in competing with conventional insurance providers. Therefore, globally, no significant development of *takāful* has taken place outside the areas that have a predominantly Muslim community. For jurisdictions with a distinctive regulatory and legal framework, updating *takāful*-related laws could pose a challenge.

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

in a way that contradicts good corporate governance within the *takāful* segment is a very real threat going into the future.

- iii) The non-existence of uniform terminologies and the degree of unresolved *Fiqhi* issues is much more serious in the *takāful* segment than in any other segment of the IFSI. There are no Sharī‘ah guidelines on even very basic issues. The *fiqhi* views differ widely, often challenging even the basic concept of *takāful*. Moreover, the lack of a uniform corporate governance standard and Sharī‘ah audit guidelines that the industry can follow leaves the industry open to criticism when *takāful* operators themselves fail or fail to protect their policyholders.
- iv) For *takāful* to succeed, it is essential that the segment provides services that are clear and transparent. Long-term contracts in life *takāful* need to deal with transactions over the lifetime of a contract, which can be as long as 40 years. Such facilities can only be assured where the level of technology implemented by the operator can provide the participant with assurances that his or her long-term interests are protected. Technology has driven conventional insurance development and there is no reason for it not to drive *takāful* development forward. Many of the markets still to be developed by *takāful* operators are not technology-driven environments. The speed of technological development in the *takāful* segment must be matched by such developments in the general marketplace.
- v) Long-dated sovereign and corporate Islamic financial products, in which funds collected by *takāful* companies can be invested, are in short supply. The success of *takāful* depends on the availability of financial assets that can match the long-term nature of the risks of *takāful* contracts.
- vi) The non-existence of highly rated re-*takāful* companies causes concern both inside and outside of the *takāful* segment. Even with Sharī‘ah dispensation in supporting the use of conventional reinsurance, reliance upon the latter means that the *takāful* segment is, in practice, a hybrid of Islamic and conventional institutions. Re-*takāful* facilities themselves depend on a sufficient pool of underlying *takāful* business, as well as on the availability of acceptable assets for investment.
- vii) Awareness campaigns and marketing of *takāful* and re-*takāful* services and products are still lacking.
- viii) The *takāful* and re-*takāful* segment is open to criticism and credibility challenge if the roots of the *takāful* concept as being mutual risk protection under Sharī‘ah rules and principles are not recognized. For example, the very essence of *takāful* is mutual risk protection between members on a cooperative basis, under Sharī‘ah-compliant principles. The adoption of a savings element for individual participants is laudable but, as in conventional insurance, such funds are not mutual or cooperative but

belong exclusively to the member making the contribution. Therefore, these investment products are offered with little or no *takāful* coverage. Furthermore, to move away from the very essence of *takāful* is to lean too far towards a conventional insurance model, mimicking the tax advantages of products that are significantly more in the nature of investment and tax avoidance vehicles than they are protection or *takāful* products.

2.4 ISLAMIC CAPITAL MARKETS

Capital markets including both primary and secondary segments provide the financial sector with three vital functions: pricing of assets and risk management, liquidity management, and specialized services in resource mobilization and allocation. Development of a well-functioning capital market is therefore critical for a sound and efficient IFSI. The key pre-requisites of well-functioning capital markets are: (i) supporting legal, regulatory, accounting and tax framework (ii) established standards and (iii) market depth and liquidity. In a young industry, such as the IFSI, it is to be expected that capital markets will be underdeveloped, with weak standards and sub-scale markets, and lacking the necessary depth and liquidity.

Intervention by public and semi-public institutions such as relevant government ministries and securities commissions has historically been an important factor in the development of capital markets. This is due to two principal factors: (i) the need for a favourable legal, tax and regulatory framework; and (ii) the dynamics of “network externalities”. The public sector (including central banks, securities commissions, etc.) therefore has responsibility not only for regulating financial intermediaries involved in Islamic finance, including contractual savings institutions (such as mutual funds/unit trusts, pension funds, hedge funds, etc.) and market makers (such as securities dealers, investment banks, stockbrokers, etc.), but also for enabling them through initiatives that promote the development of an Islamic capital market. It is this perspective on the responsibility of public institutions in any country concerned by the development of the IFSI that forms the basis of the Ten-Year Framework.

2.4.1 Present state of Islamic capital markets

The need for vibrant and efficient capital markets in the area of Islamic finance cannot be over-emphasized. The IFSI can claim to offer a full-fledged financial system only when its capital markets have the depth and liquidity typically found in well-developed conventional markets. Since the IFSI itself is a new industry, it is not surprising that the capital markets segment is underdeveloped. However, the Islamic capital market is emerging gradually, as is noticeable from a number of significant developments.

- i) Shari‘ah-compliant stocks: The availability of Shari‘ah-compliant stocks is most basic consideration in the development of Islamic stock

markets. This need of the market has led to the development of the Shari'ah screening of stocks based on quantitative measures such as debt-to-asset, liquidity-to-asset and receivables-to-asset ratios as well as on fundamental subjective criteria such as Shari'ah compliance of the business line. Major Islamic stock indexes now include: the Dow Jones Islamic Market Indexes, the FTSE Global Islamic Index Series, Global's GCC Islamic Index, the Kuala Lumpur Shari'ah Index and the Jakarta Islamic Index. The technology is expected to be gradually in common usage in major markets. As a result, real-time data on the indexes will enhance the market microstructures for the Islamic capital market.

- ii) The market capitalization of the Global DJIMI as of 31 March 2005 was estimated to be US\$10.65 trillion, and the Shari'ah-compliant universe comprised 1942 stocks. Since the Global DJIMI takes up only those stocks in which an international investor can invest and repatriate the proceeds, it excludes many local stocks. The Islamic capital market is not so global; it is rather segmented. By applying the DJIMI criteria to local markets of four IsDB member countries, a recent study conducted at IRTI found that 6.4%, 12%, 42% and 60% of stocks, respectively, in the four countries met the DJIMI criteria. The total annual market capitalization of the stock meeting the DJIMI criteria in three countries was calculated to be US\$104 billion. This constitutes about 42% of total market capitalization in the three countries, indicating that Shari'ah-compliant stocks constitute a significant part of the stock markets in the countries concerned. This size is expected to grow through a wider application of the screening technology, as well as through formalization of product identification marks.
- iii) Islamic alternatives to debt: The most prominent development in this regard has been the introduction of corporate and sovereign *ṣukūk* or trust certificates as well as pooled securitization as substitutes for conventional bonds. Recently, hybrid *ṣukūk* such as convertibles and exchangeables have also been issued. Table 2 lists Islamic capital market products in some IsDB member countries. Although there are significant differences across countries, broadly speaking, the products listed in table can be considered as the currently available Islamic capital markets instruments. Table 3 presents the principal instruments available in the conventional capital markets and their Shari'ah-compliant alternatives and highlights the gaps in the case of the Islamic alternatives.
- iv) Legal framework and tax neutrality: In terms of the development of appropriate legal and tax framework, two significant developments are noteworthy. The first is the tax neutrality accorded to Islamic financial contracts in UK and Singapore - in particular, the coverage of *ṣukūk* in the later case. The second significant development is the enactment of

Financial Trust Laws in Bahrain. A few other countries have also introduced securitization laws. These are expected to be highly supportive of the development of the *ṣukūk* market, as *ṣukūk* are trust certificates and there are no trust laws in most countries.

Table 2: Types of capital market products available (in various markets)

Bahrain	Malaysia	Pakistan	Sudan	Saudi Arabia
Ordinary stocks	Ordinary shares	Ordinary stocks	Ordinary stocks	Ordinary stocks
Preferred stocks	Preferred shares/warrants Futures Index futures contracts (if underlying asset is Shari'ah approved)	Preferred stocks/warrants <i>Muḍārabahs</i> (or <i>muḍārabah ṣukūk</i>) Single stock futures		
Bonds	Bonds	Bonds and term finance certificates (TFC)		
<i>Ijārah ṣukūk</i>	<i>Ijārah ṣukūk</i>	<i>Ijārah ṣukūk</i> (issued but not available in local market) Partnership <i>ṣukūk</i> (participation term certificates)		<i>Ijārah ṣukūk</i>
<i>Salam/Istiṣnā</i> ^c -based <i>ṣukūk</i>	<i>Salam/Istiṣnā</i> ^c -based <i>ṣukūk</i>		<i>Salam/Istiṣnā</i> ^c -based <i>ṣukūk</i> Special government investment certificates Central bank <i>Mushārah</i> certificates, government <i>Musharākah</i> certificates	
Mutual funds (Islamic/conventional)	Unit trusts (Islamic/conventional) Discounting products <i>Murābaḥah</i> bonds (securitized debt), generally based on the Bai' Bithaman Ajil principle	Mutual funds (Islamic/conventional)		Mutual funds (Islamic/conventional)
Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities for asset-backed securities	Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	

Table 3: Capital market products

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

* This column reflects the current practices in the IFSI, which are not necessarily endorsed by this document.

2.4.2 Challenges and key areas for product and market development

The Islamic capital markets are facing a number of challenges. Some areas for product development and policy intervention to redress these challenges are identified below:

A) *Leveraging the infrastructure and liquidity of conventional capital markets*

The industry's practice has been to develop close substitutes for conventional capital market instruments (commercial paper, bonds, derivatives or asset-backed securitizations, or ABS) and utilize conventional pricing benchmarks (LIBOR, swap rates, etc.). As long as the resulting instruments satisfy core Sharī'ah requirements (which typically eliminates elements of *ribā* or *gharar*), this strategy is driven by two key considerations. First, conventional instruments have been developed to perform in an effective fashion, one or more legitimate functions of financial markets, which Sharī'ah-compliant instruments will also need to fulfill. Second, an emerging, subscale and fragmented Islamic capital market cannot afford not to leverage on the existing liquidity and infrastructure provided by the conventional market. Creating near substitutes for conventional instruments allows the Sharī'ah-compliant market to "borrow" the liquidity of conventional markets and to utilize with adjustments the same infrastructure (payment-settlement systems, accounting and auditing systems, rating procedures, etc.). However, after more than three decades, it is high time for the IFSI to move away from this substitution approach and to channel all efforts towards creating pristine Islamic capital market products and services, characterized by unique Islamic value propositions.

B) *Ṣukūk, the backbone for the Islamic bond market*

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

The *ṣukūk* market provides a functional equivalent to the conventional government and corporate bond market. The Islamic ABS market provides a functional equivalent to the conventional mortgage-backed securitization (MBS) and ABS markets. Although at an embryonic stage of development, the latter has great potential to develop in the form of residential and commercial MBS. The reason is that real estate is the most appropriate asset type to back the development of the Islamic capital market, since it typically constitutes a very large portion of the national balance sheet in general, and that of IIFS in particular (as the latter typically avoid non-negotiable long-dated debts and many equities).

C) The Islamic mutual funds/unit trusts

Despite the impressive achievements thus far, there is room for further growth. To be competitive globally and able to tap the vast opportunities available worldwide, the IFSI needs to find ways to strengthen the Islamic mutual fund industry.

The mechanism for the scanning or evaluation of listed companies to identify Shari'ah-compliant shares is an effective tool for attracting investors seeking Shari'ah-compliant products to the equity market. Yet, this is currently available only in a limited number of jurisdictions. Shari'ah screening mechanisms, whether initiated by the government or the private sector, are not available in many other jurisdictions. This automatically excludes those in search of Shari'ah-compliant investments from the stock market and, indirectly, hampers the development of the Islamic fund management industry. In fact, the concept of screening of listed companies to determine Shari'ah compliance within a given set of standards is neither new nor uniquely Islamic. The same approach is used by those managing funds based on the Socially Responsible Investing (SRI) principle. Regardless of who is initiating this effort, the most important consideration is that the disclosure of screening criteria should be transparent to enable investors to review the Shari'ah-compliant status of shares.

The initiative undertaken by certain jurisdictions such as Malaysia to facilitate the growth of Islamic Real Estate Investment Trusts (REITs) through the issuance of Islamic REITs Guidelines by the Securities Commission may be considered by other IsDB and IFSB member countries as a background given the demand for Shari'ah-compliant investment in real estate funds.

D) Development of markets for risk management instruments

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

E) Credit assessment of IIFS and Islamic issues

All issued Islamic securities – in particular, obligation-type securities or bonds – are encouraged to secure a credit rating from a recognized rating agency, domestic or international, so as to refute claims that IIFS and Islamic securities lack transparency and monitoring mechanisms for performance tracking, and lack sophistication in terms of customers, systems, underlying assets, etc., for securitization transactions.

As such, it is recommended that a jurisdiction with a sizeable domestic IFSI either direct initiatives towards the establishment of a full-fledged Islamic rating agency or encourage existing conventional rating agencies to set up a dedicated department for Islamic rating assessment.

F) International vs. domestic Islamic capital markets

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

2.5 ISLAMIC FINANCIAL ARCHITECTURE AND INFRASTRUCTURE

In this document, architecture refers to the internationally credible best practice standards of corporate governance, transparency, disclosures, risk management, capital adequacy and regulation and supervision. "Financial infrastructure" refers to the institutional arrangements that ensure the development and implementation of standards such as legal, tax and regulatory frameworks as well as knowledge and technology and the related preconditions. Therefore, the composite phrase "Islamic financial architecture and infrastructure" (IFAI) refers to the best practice standards and the legal and institutional arrangements required for a sound and well-functioning IFSI. IFAI covers both national and international components.

2.5.1 National Islamic financial architecture and infrastructures

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

- i) legal infrastructure underpinning laws and contracts concerning property rights, insolvency and creditor rights regime as well as financial safety nets;
- ii) transparency, information and governance infrastructure, including monetary and financial policy transparency and neutrality, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements such as credit ratings, and credit reporting systems; and
- iii) systemic liquidity infrastructure, including monetary and exchange operations, payment and securities settlement systems, and microstructure of money, exchange and securities markets.

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

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

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

Significant weaknesses in the legal, governance and systemic liquidity infrastructure are impeding the spread of product innovations in Islamic finance and preventing effective supervision and risk management. The still underdeveloped state of the securities markets and insurance industry in many countries – in part, reflecting the infrastructure weaknesses – is affecting greater use of equity-based and asset-backed facilities in IIFS. Weaknesses in insolvency and creditor rights regimes and in contract enforcement, the limited adoption of AAOIFI accounting standards for Islamic institutions, and the weaknesses in the

content and scope disclosures, all affect further development of investment account management and impede an equity culture necessary to support a greater use of equity-based facilities in IIFS. Significant weaknesses in the systemic liquidity infrastructure have raised liquidity risks for Islamic banks and prevented the effective use of monetary operations with Sharī'ah-compatible money market instruments as a means to manage market liquidity and set a benchmark rate of return. The recent developments in Islamic asset securitization, however, have opened up opportunities to strengthen systemic liquidity arrangements (by fostering national money markets for suitably designed securitized assets) and for greater use of markets for securitized assets as a tool of risk management.

2.5.2 International Islamic financial infrastructure institutions

At the international level, the IFAI includes the following:

- i) International infrastructure institutions are those that collectively facilitate monetary and financial policy-making at the national level, and promote national development, financial stability and international financial integration, by helping to develop standards, guidelines and best practices, coordinating national policies, and organizing international financial and technical support. This includes many of the international and regional development banks, which also cover Islamic finance in the context of their surveillance, technical and financial assistance, and policy development work. In particular, the IsDB plays a special role in the architectural hierarchy.
- ii) A number of initiatives have been taken in recent years, both nationally and internationally, to strengthen the Islamic financial architecture. Some IsDB member countries such as Malaysia and Indonesia have adopted comprehensive medium-term strategies to foster IIFS and Islamic financial markets, as part of broader financial sector reforms. In addition, the IsDB, in coordination with other institutions, has played a catalytic role in establishing Islamic international infrastructure institutions (IIIs) comprising:
 - the Islamic Research and Training Institute (IRTI, established by the IsDB in 1981);
 - the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, set up in 1991);*
 - the International Islamic Financial Market (IIFM, set up in 2002);*
 - the (General) Council for Islamic Banks and Financial Institutions (CIBAFI, set up in 2001);
 - the Islamic Financial Services Board (IFSB, set up in 2002),* established by several central banks and monetary authorities, working together with the IsDB, IMF and AAOIFI; and

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

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

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

- i) All major IIIs are engaged in promoting and building public awareness of Islamic finance issues, through conferences, seminars, workshops and roundtables. While this is quite appropriate, additional coordination is warranted to steer each institution to focus on its core objectives.
- ii) AAOIFI has played a pioneering role in designing key accounting, auditing and reporting standards for IIFS; it has complemented these with Shari'ah standards for contracts and governance, and has built awareness of major risk and prudential issues in Islamic finance. However, the pace of adoption of standards is slow. Also, considerable challenges remain to upgrade the standards and develop new ones in order to support the rapid innovations in the industry, and to align the accounting and auditing standards more closely with the evolving regulatory standards.
- iii) In order to foster a suitable climate for development of the required infrastructure, an effective coordination arrangement for the Shari'ah standard-setting and endorsement processes for both cross-border instruments and national markets needs to be evolved.
- iv) The scope of the objectives of the IFSB is broad. This broad scope is appropriate owing to the cross-sectoral features of IIFS and the role of Islamic capital and money markets in providing effective risk mitigation arrangements. This is also consistent with the move towards integrated supervision in many countries, due to increasing conglomeration and globalization in the industry. This broad scope, however, has certain organizational and operational implications, such as a need to broaden the

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

representation in the governance and operations of IFSB by including all sectoral supervisors (not limited mainly to banking supervision). Indeed, the Council of the IFSB has amended the IFSB Articles of Agreement in March 2006 to enable admission of securities and insurance supervisory authorities as Full Members of the IFSB.

- v) The IIIs need to coordinate with each other in specific areas, in order to take into account different perspectives in setting supervisory and prudential norms without duplication of effort. Furthermore, the IIIs need to develop a strategic alliance with BCBS, IOSCO, IAIS, IASB and other such standard-setting institutions.
- vi) In the absence of national/regional strategies to design and implement Islamic money and capital markets nationally (regionally), at present there is not sufficient depth or volume to support a cross-border market for money market/capital market instruments. Thus, the mission of IIFM to develop secondary markets globally is appropriate, but may be premature, unless supported by appropriate national or regional strategies.
- vii) In parallel with this, the IIFM could usefully form an association of Islamic capital market players. The intention would be to focus on: (a) designing product guidelines; (b) developing a code of conduct of market practices; (c) standardization of contracts in cooperation with private sector institutions and other IIIs; and (d) developing other Islamic capital market-related infrastructure components.
- viii) A lack of adequate insolvency and creditor rights (ICR) regimes at the national level is a more pressing issue than cross-border dispute resolution. The new ARCIFI could, in coordination with other IIIs, also contribute to the broader objective of facilitating robust ICR regimes at the national or regional level in addition to its primarily commercial functions – dispute resolution services for members.
- ix) CIBAFI's core promotional and representational roles, and its renewed efforts to contribute to training and human resource development, are valuable; some of its research and policy development work that relates to standards setting or harmonization of practices – for example, the Model Islamic Banking Law – would require further coordination with other IIIs.
- x) The current objectives and associated work programs of Islamic infrastructure institutions, when compared with the comparable infrastructure for conventional finance, reveal some gaps that remain to be addressed through future cooperation and a resetting of objectives and instruments.
 - Technical assistance to countries in designing and implementing national-level Master Plans to develop Islamic finance as part of broader financial sector reforms. This will provide a strategic focus on the

industry, facilitate private sector planning, and help to implement standards suited to Islamic finance.

- Developing standards, guidelines, good practices and technical information on laws on Islamic banking, insurance and capital markets; on legal, accounting and operational aspects of asset securitization; and on adaptations of existing laws and contracts to facilitate enforcement of Islamic contracts in various legal environments.
- Guidance on adapting capital market laws and regulations, insurance laws and regulations, and Financial Action Task Force (FATF) AML/CFT recommendations to the specific context of Islamic finance.
- Research and analysis on access indicators for Islamic financial services, and design policies to enhance access, including Islamic rural and microfinance institutions.
- Developing guidance and good practices on developing credit reporting systems and credit rating agencies to support IIFS.
- Developing a work program to design Islamic hedging instruments.
- Guidelines on the issuance and management of Islamic sovereign debt and guidance on developing markets in such instruments.
- Arrangements for monitoring and coordination of the work programs of IIIs, and setting priorities for their work in order to support emerging national priorities.

2.5.3 Responding to the rapidly changing environment

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

- i) the impact of globalization;
- ii) technological changes, with growing application of information technology for the delivery of services and management of risks;
- iii) changes in the regulatory environment, with increased emphasis on risk-focused supervisory approaches and market discipline; and
- iv) rapid growth in IIFS and Islamic financial markets in response to market demand, government strategies to promote the industry in some countries, and product innovations based on securitization of Islamic finance contracts.

These factors have highlighted the unique mix of risks and special operating characteristics of Islamic finance, and the need for these to be taken into account in the risk management by IIFS, in official supervision, and in formulating development strategies for Islamic finance. The unique operational features of Islamic finance derive from the contractual design of instruments based on

Shari‘ah rules and principles, and the overall legal, governance and liquidity infrastructure underpinning Islamic finance.

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

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

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

3. STRATEGIC OBJECTIVES AND INITIATIVES

In the light of the stated vision and mission, and in view of the preceding strategic landscaping of the IFSI, the medium-term focus of public policies should be on the following goals:

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

3.1 INSTITUTIONAL DEVELOPMENT

The following priority areas and initiatives are envisaged for the development of IIFS during the next ten years.

3.1.1 Priority areas

It is envisioned that, over the next ten years, the landscape of IIFS (banks, non-bank and microfinance institutions, *takāful* and *re-takāful* operators and capital market players) would have evolved as a full-fledged system of IIFS that operate effectively and efficiently in parallel with conventional financial institutions to achieve the priority goals:

- i) a critical mass of strong and highly capitalized IIFS offering a comprehensive range of Islamic financial products and services and enhanced access to financial services by all, particularly through *awqāf* and *zakāh*;
- ii) a sufficient number of well-trained, competent, high-calibre Islamic finance professionals and management teams with the required expertise;
- iii) an active inter-bank market with the necessary treasury operations and short-term Islamic financial instruments; and
- iv) well-informed individual and corporate consumers, knowledgeable about Islamic finance in general.

3.1.2 Initiatives

The prioritized initiatives for the development of IIFS (banks, non-bank financial institutions, *takāful* and *re-takāful* operators and capital market players) include the following.

A) Balancing diversification and functional specialization

The public's access to diverse types of competitive financial services is one of the basic requirements enabling them to participate in the process of economic

development. The nature of Islamic banking is similar to that of universal banking, whereby banks cross traditional boundaries in providing different types of financial services. In order to ensure systemic soundness, such banks must be strongly capitalized and of an appropriate economic size with suitable supervisory oversight. Most IIFS are, however, rather small in size. Yet, society's needs for finance are diverse. Commercial banks, investment banks, *takāful* and the various forms of Islamic NBMFIs perform diverse functions as required for mobilization of funds, asset management, risk intermediation, provision of risk capital and meeting the needs of social development. Islamic banks alone cannot be expected to undertake these diverse types of financial intermediation efficiently. Therefore, at this initial stage of the industry's development, and in the medium term, national policy interventions may have two-pronged approaches.

- i) To ensure wide-ranging access to financial services and to meet the needs of the economy for various types of funds, the domestic markets should encourage and promote functional specialization of the various segments of the industry as outlined in this document. This is expected to facilitate an extensive penetration of financial services without causing an unhealthy mixing of the various types of risks by relatively small and new institutions.
- ii) At the same time, the process of market-driven mergers and consolidation should be encouraged, so that strongly capitalized IIFS can emerge within the Framework period to safely offer a range of Islamic financial services as part of a single corporate group.

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

B) Human resources and Shari'ah governance systems

It is not possible to sustain the growth and credibility of the IIFS without focusing on the very special human resource requirements of the industry. The priority in the first instance is for the institutions themselves to make concerted efforts to build capacity and to develop the combined competencies of finance and Shari'ah. Various private and public initiatives are under way, such as the endowment fund established by Bank Negara Malaysia in 2005. Institutions such as the IsDB/IRTI, IFSB, regulators and the industry itself need to address the matter in a concerted manner. For instance, Islamic training institutes and universities may consider establishing strategic alliances aimed at creating more well rounded talents in Islamic finance.

C) Research and development

Research and development (R&D) is needed to cater to the product development requirements of the IIFS and their markets. Again, it is a primary responsibility of

the institutions themselves to allocate resources to undertake research, as well as financial engineering, to develop products that can enhance their resource mobilization, liquidity and risk management capabilities. Policy intervention, in the form of the lead institutions within the industry combining their resources to carry out the R&D task, is required for a more dynamic product innovation drive.

D) Financial soundness indicators

A reliable and consistent database of global Islamic financial services statistics is important for the purpose of monitoring the operational efficiency and soundness of financial institutions and markets. Such a database is required for research and development, as well as for supervisory surveillance. IRTI, IFSB and CIBAFI are currently undertaking efforts to fill the existing gaps and meet the different needs of the industry for statistical information. In particular, the IFSB has undertaken the initiative to design a global database of prudential and structural Islamic finance statistics, with a Technical Assistance grant from the IsDB and Asian Development Bank (ADB).

E) Standardization of contracts, harmonization of Shari'ah interpretation and settlement of unresolved issues

The industry also needs to address this subject in a concerted manner. Unless there is a reasonable level of understanding, agreement and clarity about the Islamic financial contracts, the industry will be perceived as having higher contractual as well as systemic risks. Unless key pending issues are resolved from within the IIFS, the integration of the IFSI into the competitive mainstream financial markets and system will not be possible. Medium-term policy intervention needs to focus on meeting this challenge, and on developing contract structures that are not only widely acceptable from within the industry but also are recognized by the civil and common law regimes.

F) Changing the perceptions about takāful

It would seem that *takāful* is still perceived by a considerable number of Shari'ah scholars and members of the public as something undesirable and incompatible with the Shari'ah. Yet, households, companies, governments and civil society institutions cannot function efficiently without having access to risk intermediation services. Therefore, the IFSI needs greater attention and concerted efforts among market players and regulators in order to favourably change perceptions about *takāful* and *re-takāful* in the medium term. *Takāful* should also be studied from the perspective of developing it as a viable alternative to conventional derivatives instruments for hedging purposes.

G) Ensuring access of the poor to Islamic financial services

Although the institutions of *zakāh*, *awqāf* and charitable lending are an integral part of the Islamic economy, the vital area of microfinance has remained one of the weakest practical areas of the IFSI. In order to alleviate the abject poverty existing

in a large number of IsDB member countries, priority should be given to developing Islamic microfinance institutions offering the composite services of saving, financing and *takāful*.

H) Equity support for the establishment of IIFS

As a multilateral initiative, the IsDB and IFSB member countries may consider establishing a multilateral organization with a mandate to provide equity support to set up new IIFS.

3.2 CAPITAL MARKET DEVELOPMENT

The following priority areas and initiatives are identified for promoting robust Islamic capital markets during the next ten years.

3.2.1 Priority areas

- i) Universal acceptable foreign and local-currency *ṣukūk* for sovereign and corporate issues across jurisdictions based on internationally recognized standards while offering genuine liquidity.
- ii) Primary and secondary markets for Islamic residential and commercial property finance with sound foundations that provide IIFS with effective liquidity and risk management opportunities and which form the basis for local-currency Islamic ABS markets that are based on a standard form of security and offer genuine liquidity.
- iii) The depth and breadth of standardized Sharī'ah-compliant financial instruments and securities and their markets.

3.2.2 Initiatives

A) Develop the legal, regulatory and institutional framework

- i) Adapt the legal and regulatory framework to ownership-based financing and securitization. For each country, this includes removing regulatory obstacles (including achieving tax neutrality). It also includes eliminating uncertainty regarding such matters as the enforceability of contract clauses and tax treatment. This objective will typically involve the cooperation of the central bank, securities commission, finance ministry and other public agencies in a jurisdiction.
- ii) Develop the basic enabling conditions for a primary and secondary Islamic mortgage market, including an institutional channel through which the government will support the emergence of a secondary market. The list of primary market-enabling conditions is well known (title and mortgage registration, foreclosure, credit information, removal of double stamp duties, etc.). Experience with the enabling conditions for the secondary market is still lacking, although development has been observed in certain jurisdictions (flow of ownership liabilities through the secondary market, “open-architecture” security structures that prevent market fragmentation

between conventional and Islamic markets, etc.). A publicly sponsored institution to develop the secondary market is critical and would involve market reliance on some form of implicit or explicit government guarantees, as implemented in Malaysia. To develop a secondary market, there is also a need for a set of market institutions to provide liquidity, trading and market-making services, an enabling regulatory environment, benchmarking, systemic liquidity arrangements, explicit guarantees, or public sponsorship to promote confidence in institutions offering secondary trading services.

B) Promote public sectors' participation in capital markets

- i) Government participation in the capital market through the regular issuance of sovereign Islamic bonds, in international or domestic currencies, depends on public financing requirements and is integrated with the national public debt management framework.
- ii) Allocation of a target share of publicly controlled portfolios to investment in Islamic capital markets. This includes publicly controlled or sponsored saving institutions and covers the local and international equity and fixed-income markets.
- iii) Strategic commitment of a small share of foreign-currency reserves to investment in high-quality and liquid Islamic fixed-income instruments if and when they become available. Such instruments are unlikely to provide the same degree of liquidity and rating as conventional instruments, but they can correspond to the least liquid foreign exchange reserve tranche. The strategic use of a share of reserves to support the development of the international Islamic market is within the mission of central banks who look to cooperate internationally to support the creation of a capital market that ultimately will enable their domestic financial institutions to better manage their balance sheets. A commitment from central banks would provide an extraordinary impetus for quality international issuers to participate in the Islamic capital market. Such a policy is facilitated by the currently favorable international environment, which has permitted the accumulation of significant foreign exchange reserves among emerging markets.

C) Promote international cooperation

Mechanisms for international cooperation to create a unified international Islamic capital market and to harmonize domestic Islamic capital markets across jurisdictions. Harmonization of the standards for international *ṣukūk* is critical to the creation of a unified market. It is facilitated by the relatively small number of investment banks involved. The rating agencies will also need to standardize their treatment of the manner in which ownership-related risks are managed in the *ṣukūk*. The proposed coordinated strategic allocation of reserves to the Islamic

capital market is an example of a cooperation mechanism that can be very effective. The cooperation can take the form of the “Universal *Şukūk*” or any other modality to be agreed by the participating institutions. It is only through the combined commitment of several central banks that participation by key international issuers can be “jump started”. A degree of harmonization can also be introduced in domestic equity screening, *şukūk* and Islamic ABS markets. There is a need for standards in this area, which will gain in effectiveness if they are derived on a “bottom up” (that is, based on actual transactions) rather than a “top down” basis.

D) Enhance market openness

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

3.3 INFRASTRUCTURE DEVELOPMENT

To support the envisioned development of the IFSI, the following priority areas and initiatives are identified for building the required Islamic financial infrastructure.

3.3.1 Priority areas

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

- i) a legal infrastructure underpinning laws, contracts, property rights, insolvency and creditor rights regime, as well as financial safety nets;
- ii) a transparency, information and governance infrastructure, including monetary and financial policy transparency and neutrality, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements such as credit ratings, and credit reporting systems; and

- iii) a systemic liquidity infrastructure, including monetary and exchange operations, payment and securities settlement systems, and microstructure of the money, exchange and securities markets.

The means to these ends include: organizing international technical and financial cooperation and information exchange; developing standards, codes of good practice and market conduct, informal self-regulation among IFSI players, and guidelines on monetary and financial policies; and developing strategic alliances with other multilateral institutions.

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

- i) increasing presence of non-bank financial institutions, including, in particular, *takāful* operators;
- ii) greater integration of IIFS and money and capital markets, in part reflecting the increasing use of asset securitization and other product innovations for balance sheet management; and a growing share of Islamic financial market instruments, with a sizeable presence of sovereign and money market issues and securitized mortgages;
- iii) product innovations and a risk management technology that permit a greater role for equity-based finance and more transparent profit-sharing investment account products of different risk-return-maturity combinations; and
- iv) increased availability of Shari‘ah-compliant derivative contracts.

The design of the financial architecture should promote a robust infrastructure at the national level, which is a pre-requisite for greater cross-border access to Islamic financial services and for greater global integration of both conventional and Islamic finance. Thus, international infrastructure institutions should have as a goal acceleration of the national-level institutional development through cooperation, information exchange, and developing standards and guidelines where needed.

The design should build on and ensure close coordination with the existing architecture for conventional finance. It should facilitate product innovations and risk management that could lead to a deeper integration with the rest of the financial system. It should also help to broaden access to the services of the industry by avoiding, where feasible, segmentation or isolation of the IFIS as a result of having separate products and services that are not comparable with or competitive against conventional finance. Moreover, it should not result in a heavy compliance burden that is disproportionate to the size and scale of IIFS, which are still small compared to their conventional counterparts. The developmental and

financial stability considerations would need to be carefully balanced in the design of the regulatory framework and the support institutions.

3.3.2 Initiatives

The needed initiatives have to be undertaken at both the national and multilateral levels.

A) National initiatives

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

- i) an extensive catalytic role played by the public sector in developing Sharī'ah governance systems within financial institutions and regulatory organizations through effective education and an appropriate institutional reform;
- ii) more explicit recognition of the position of Islamic finance in the financial sector laws and the supervisory regime, so that the unique operational features of Islamic finance can be recognized in the regulatory framework, and an enabling environment can be provided for product innovations and enhanced access, while safeguarding stability;
- iii) the establishment of preconditions for greater use of equity-based facilities and more active investment account management;
- iv) strengthening of corporate governance of IIFS and their disclosure regime;
- v) strengthening of the ICR regime, investor protection arrangements, and corporate governance of non-financial corporations;
- vi) the reduction of legal risks and the improvement of legal certainty;
- vii) strengthening of national institutional arrangements to harmonize Sharī'ah interpretations;
- viii) strengthening of the ICR regime and arbitration procedures;
- ix) facilitation of the effective enforcement of Islamic finance contracts in various legal environments;
- x) the establishment of a medium-term program to raise the level of compliance with BCPs, phasing in Basel II supplemented by the IFSB standards, and, in parallel, a program to strengthen Islamic banking supervision and regulation;
- xi) strengthening of the credit information system;
- xii) an upgrade of risk measurement and risk management systems in banks;

- xiii) the establishment of a program to compile and disseminate financial soundness indicators, as well as financial structure, access and development indicators for Islamic finance;
- xiv) the establishment of a detailed and well-sequenced program for further development of money and capital markets and the diversification of financial services (including insurance, pensions and various specialized financial services), with an emphasis on asset securitization. Some key elements of the program include:
 - giving high priority to developing Shari'ah-compatible instruments suitable for monetary operations, sovereign debt management and money market trading;
 - addressing legal, regulatory and supervisory, operational, accounting, auditing and tax issues in asset securitization; and
 - initiating a work program, in cooperation with Islamic infrastructure institutions, to design Shari'ah-compatible hedging instruments.

B) Multilateral initiatives

Strengthening the contribution of IIIs in supporting national Islamic financial infrastructure development policies requires further coordination and partnership among the institutions and with the IsDB and other multilateral institutions. There is thus a need for the following:

- i) Broadening the representation in the governance structure of IFSB to cope with the increasingly cross-sectoral aspects of IIFS operations.
- ii) The IFSB, IRTI and IIFM, working with the IMF and national authorities, to develop comprehensive guidance on the design of Shari'ah-compatible money market instruments, government borrowing instruments, and market-based monetary operations (and LLR support) using such instruments; related guidance on Islamic asset securitizations that are suitable for monetary and government borrowing operations; and the policy and operational requirements for fostering markets in these instruments.
- iii) Broadening of the representation in the governance structure of the AAOIFI to include a greater role for national accountancy bodies and regulators in designing national accounting and auditing standards, and initiating a program to upgrade current standards and develop new ones.
- iv) The IFSB, with a Technical Assistance grant from the IsDB and ADB, is finalizing the drafting of the Compilation Guide on Prudential and Structural Islamic Finance Indicators with a view to designing a global database of statistical information on the IFSI – in particular, prudential, structural and access indicators.

- v) The IsDB, in consultation with other multilateral institutions, to help set up and/or promote a policy development and technical assistance program in Islamic finance. This could involve:
 - (a) incorporation of financial sector work as part of the operational activities of IsDB, and offering its own policy development and Technical Assistance (TA) program, in coordination with the multilateral institutions; and
 - (b) mobilization and provision of external funding to support TA activities in Islamic finance by multilateral institutions.
- vi) Review of the current institutional structure at the international level for Sharī'ah endorsements/enhancements, and for the setting of Sharī'ah standards for Islamic finance contracts and streamlining the structure to achieve greater cohesion and to minimize the potential for duplication. The governance structure for Sharī'ah supervision and regulation, and internal audits at the national level, can also benefit from strengthened standards and guidelines, building on the AAOIFI's work.
- vii) Organization of periodic meetings alongside annual meetings of a Joint Forum consisting of the IsDB, IIIs, multilateral institutions and other stakeholders to coordinate a work program for IIIs, to monitor progress in implementing the work program, to identify gaps, and to set priorities for the work program.
- viii) Encouragement of the use of AAOIFI and IFSB standards in World Bank and IMF assessments and technical assistance.

4. RECOMMENDATIONS, IMPLEMENTATION AND FOLLOW-UP

4.1 RECOMMENDATIONS

These summary recommendations, which are subject to periodic revision and updating, cover the broad strategies and initiatives to be undertaken for developing the various components of the IFSI – namely, banks, non-banking financial institutions, inter-bank and capital markets, and insurance services (*takāful*) and to provide the required support financial infrastructure.

4.1.1 Institutional development

Recommendation 1

Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector.

Recommendation 2

Enhance the capitalization and efficiency of IIFS to ensure that they are adequately capitalized, well-performing and resilient, and on a par with international standards and best practices.

Recommendation 3

Enhance access by the large majority of the population to financial services.

Recommendation 4

Enhance Sharī'ah compliance, effectiveness of corporate governance and transparency.

Recommendation 5

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

Recommendation 6

Promote the development of standardized products through research and innovation.

Recommendation 7

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

4.1.2 Infrastructural development

Recommendation 8

Develop an appropriate legal, regulatory and supervisory framework as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality.

Recommendation 9

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

Recommendation 10

Promote public awareness of the range of Islamic financial services.

Recommendation 11

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

Recommendation 12

Foster collaboration among countries that offer Islamic financial services.

Recommendation 13

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

4.2 IMPLEMENTATION AND FOLLOW-UP

Implementation and follow-up of this Framework document should be carried out by a joint standing committee in consultation with the industry players and other stakeholders.