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ISLAMIC FINANCE IN ASIA: RECENT DEVELOPMENTS AND REGULATORY ISSUES

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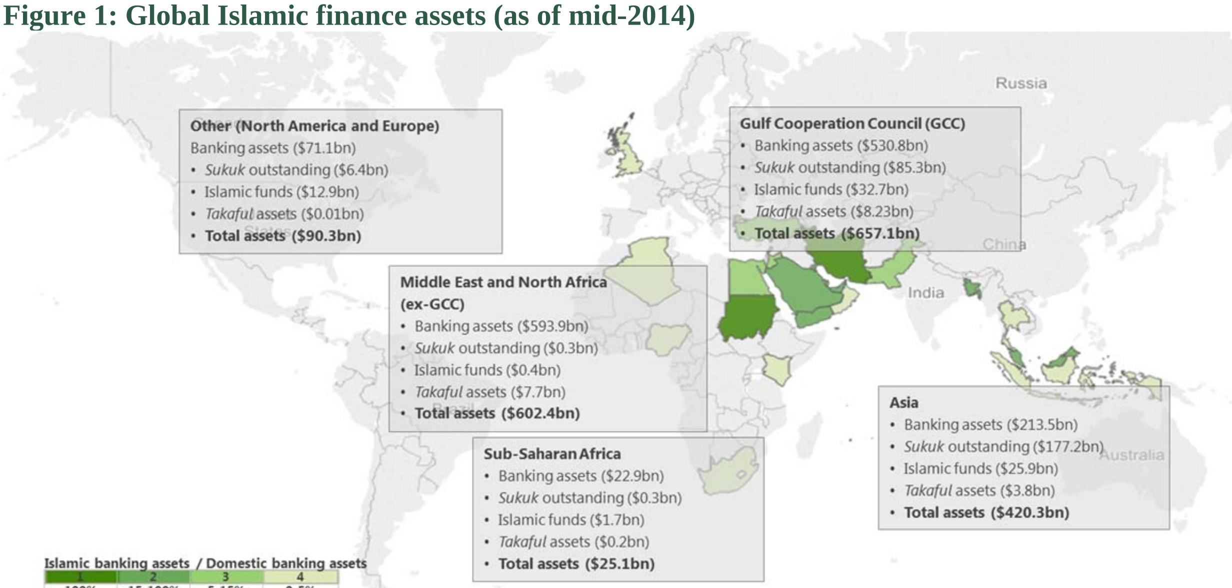
With nearly two-thirds of the world's Muslim population, Asia plays an important role in Islamic finance. The industry has experienced solid growth in the region in recent years due to robust demand for *Shariah*-compliant financial products as well as national governments' efforts to support the development of Islamic financial markets. This *Asia Focus* examines the size and growth of Islamic finance, reviews recent reports and studies on the industry, discusses key benefits and regulatory challenges, and summarizes recent developments in Asia.

Size and growth in recent years

Modern Islamic finance has existed for decades, but the industry's growth was especially strong over the past several years.[1] The global financial crisis seriously affected conventional banks, but only had a limited impact on Islamic banks. The Islamic world's booming oil wealth also increased demand for *Shariah*-compliant financial products. Global Islamic finance assets grew by an average of 17 percent annually between 2009 and 2013, due to both brisk investor demand and strong governmental support. As of mid-2014, total Islamic financial assets were US$ 1.9 trillion, according to the Islamic Financial Services Board (IFSB).[2] Of this amount, Islamic banking assets and outstanding *sukuk* (Islamic bonds) accounted for 79 percent and 16 percent, respectively.[3] Despite its rapid growth in recent years, Islamic finance still remains a niche market, representing less than 1 percent of global financial assets as of 2013.[4]

Figure 1: Global Islamic finance assets (as of mid-2014)



Sources: IFSB, KFH Research.

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Geographically, Islamic finance assets are mainly concentrated in a number of majority Muslim countries in the Middle East and Asia. The top three countries in terms of total Islamic banking assets are Iran, Saudi Arabia, and Malaysia. They collectively hold 60 percent of total global Islamic banking assets. According to the IFSB, by mid-2014, Islamic finance had reached systemic importance in nine countries.[5] These countries either have more than 5 percent of total global Islamic banking assets, or have an Islamic banking segment that accounts for 15 percent or more of total domestic banking assets.[6]

With nearly two-thirds of the world's Muslim population, Asia is the only region with a significant Islamic finance presence outside of the Middle East. Malaysia is the undisputed regional leader, accounting for more than 70 percent of Asia's Islamic finance assets. Other majority Muslim Asian countries, such as Brunei, Bangladesh, Indonesia, and Pakistan, also have witnessed strong growth of this segment in the past decade. Most recently, Islamic finance has become a rapidly growing niche in non-Muslim economies, including Hong Kong, Singapore, and Thailand, although the segment remains small relative to conventional financing.

While Asia lags behind the Middle East in terms of Islamic banking assets, the region plays a leading role in the global *sukuk* market, accounting for 64 percent of *sukuk* outstanding as of Q3 2014. In fact, Malaysia is the world's only active full-fledged secondary Islamic bond market. Moreover, Asia accounted for 31 percent of Islamic fund assets and 18 percent of Islamic insurance (*takaful*) assets as of mid-2014.

Potential benefits and risks

Islamic finance differs from conventional finance in that its core characteristics comply with *Shariah* in the provision of financial services, which entails banning interest, products with excessive uncertainty, gambling, short sales, and the financing of prohibited activities harmful to society.[7] Islamic finance requires that financial transactions be based upon real economic activities and that profit and losses be shared between all parties. *Box 1* summarizes the key aspects of Islamic banking products.

Potential benefits

Policymakers expect many benefits from the development of Islamic finance, especially financial inclusion. According to a study by World Bank economists, self-identified Muslims are less likely to have a formal financial account or to save at a formal financial institution when compared to non-Muslim individuals living in the same country.[8] Developing Islamic finance can help encourage savings among individuals who do not wish to open an account with non-*Shariah*-compliant banks for religious reasons. Multinational agencies, including the World Bank, the International Monetary Fund (IMF), and Asian Development Bank (ADB), have thus opined that Islamic finance has great potential to promote inclusive growth and alleviate poverty.[9] An ADB study published in 2015 provided anecdotal evidence that Islamic banking contributed to better access to financial services in Pakistan, Bangladesh, and Philippines.[10] However, cross-country empirical analyses have not yet been able to confirm that Islamic banking has promoted financial access after controlling for other factors.[11]

Box 1: A Primer on Islamic Banking

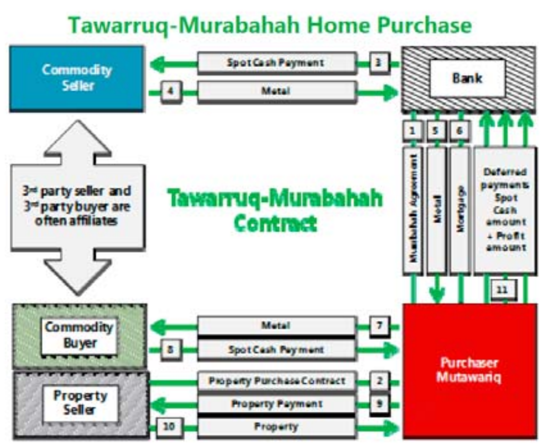
Islamic banking services adhere to *Shariah* principles, which bans interest, products with excessive uncertainty, gambling, short sales, as well as financing of prohibited activities considered harmful to society. Returns on investments should be based on real economic activities and/or underlying assets, and all parties to a transaction should share risks.

These principles have shaped Islamic banks' business model. As Kammer et al. pointed out in their 2015 report, "Islamic banks are funded by noninterest-bearing current accounts… as well as profit-sharing investment accounts (PSIA) where investors receive a return that is determined *ex post* by the profitability of the bank or the pool of assets financed by these accounts. Correspondingly, on the asset side, [Islamic] banks do not engage in lending, but in sales, lease, profit-and-loss-sharing financing, and fee-based services. The return to the banks on these transactions is based on the profitability of the underlying transactions. … Islamic banks are prohibited by nearly all jurisdictions from undertaking certain types of derivatives, such as foreign exchange forwards and futures."

In practice, Islamic banks often structure *Shariah*-compliant products so that their projected cash flows closely match those of conventional banking products. Examples include:

- Mortgage and consumer loans can be structured as sales with an agreed profit margin and deferred payments (*Murabahah*).
- Corporate loans can be structured as profit-and-loss-sharing (PLS) arrangements. For example, an Islamic bank provides capital and acts like a passive investor, while an entrepreneur provides labor and skills and manages the use of the capital (*Mudarabah*). The bank and the entrepreneur agree to share profits and losses, unless there is negligence, misconduct or breach of contract on the entrepreneur's part.
- In another profit-and-loss-sharing arrangement known as *Musharakah*, an Islamic bank and an investor both contribute capital to an enterprise. Both act like equity partners. Profits are shared according to agreements, and losses are divided in proportion to each partner's share of capital.
- When accepting noninterest bearing deposits, the bank acts like a service provider. The deposit is held in a trust. The depositor does not share profits or losses, but the deposit is guaranteed in full. This arrangement is known as *Wadiah*.
- When accepting interest bearing deposits, the depositor can appoint the bank as an agent to carry out business on their behalf. A voluntary third-party guarantee can be used to prevent potential investment losses. This type of arrangement, known as *Wakalah*, is gaining popularity in recent years.

Islamic banking products can be complex in structure. The figure to the right (adapted from Kammer et al.) illustrates one way to structure a mortgage-equivalent *Shariah*-compliant product. In this structure, the bank purchases a commodity (in this case metal), and sells the commodity to the home buyer on a deferred-payment basis. The home buyer then sells the commodity for cash, and uses the proceeds to purchase home.



Obviously, this arrangement involves a complex layer of transactions and additional third parties. Unsurprisingly, Islamic banks tend to have higher compliance, operational and legal costs than conventional banks. They also face the challenge of effectively manage operational, legal, and reputational risks. The extra layers of transactions often have tax consequences. To address this issue, many country governments have put in place measures that ensure tax neutrality between Islamic financial products and conventional financial products.

Notwithstanding these important differences in structure and operation, for an average bank customer, Islamic finance products and conventional finance products often provide similar financial outcomes. The gap between Islamic banking and conventional banking further shrinks as conventional banks can redraft their products as *Shariah*-compliant if needed. In addition, bank customers do not always base their investment decisions on religious considerations, meaning Islamic banks must remain competitive with conventional banks.

Sources: Kammer et al. (2015), "Islamic Finance: Opportunities, Challenges, and Policy Options," *IMF Staff Discussion Note* SDN/15/05, April 2015; IFSB.

Another often discussed advantage of Islamic finance is that it is inherently more stable than conventional finance. *Shariah* prohibits Islamic banks from investing in speculative, excessively risky, and toxic assets. Islamic banks generally fared better than conventional banks during the 2007-2009 global financial crisis largely because they were not allowed to hold subprime mortgages and collateralized debt obligations. Moreover, the asset-based nature of Islamic finance results in limited use of leverage. Again, empirical evidence on Islamic banks' resilience remains mixed. A 2010 study by IMF economists, for example, concluded that Islamic banks on average showed stronger resilience during the global financial crisis than conventional banks, but suffered larger losses after the crisis as financial market turmoil spread to the real economy.[12] When Dubai and Bahrain experienced real estate market slumps in 2008 and 2010, respectively, nonperforming loan ratios for local Islamic banks were well above banking sector averages.[13]

There have been few empirical studies on the performance and impact of *sukuk* and other Islamic finance segments, likely because they are a relatively new phenomenon that did not emerge until the early 2000s. However, institutional investors have great interest in *sukuk* since it has relatively low correlation with conventional asset classes (*Table 1*) and therefore provides diversification benefits. Notably, demand for *sukuk* from investors outside the Islamic world has been significant, largely because *sukuk* trade at a slight premium to comparable conventional fixed-income instruments.[14] In addition, investors view *sukuk* as one of the best ways to gain exposure to the fast-growing emerging markets of Southeast Asia, the Middle East, and North Africa. According to some estimates, non-Islamic investors can account for 40-60 percent of any individual *sukuk* offering.[15]

Table 1: Sukuk provides diversification benefit

Correlation with major asset classes, three-year return (10/1/2009-7/31/2015)

	Correlation with global *sukuk*
Global *sukuk*	1.00
Global bonds	0.56
Global equity	0.35
Global *Shariah* equity	0.65
Commodities	0.63

Note: Global *sukuk*, global bonds, global equities, global *Shariah* equity, and commodities are represented by the *Dow Jones Sukuk Index*, the *JP Morgan GBI index*, the *MSCI World Index*, the *MSCI AC World Islamic Index*, and the *Dow Jones UBS Global Commodity Index (Total Return)*, respectively.
Source: Author's calculation based on Bloomberg data.

Regulatory issues

The need to develop compatible legal and regulatory frameworks is the biggest challenge that Islamic finance faces. Countries like Iran and Sudan have an Islamic-only banking system. Elsewhere in the world, government authorities have adopted different approaches to laws and regulations pertaining to Islamic finance. Currently, Islamic banks have presence in over 70 countries. Most of these countries only have a few Islamic banking institutions operating within a predominantly conventional banking system. Authorities typically opt to rely on the existing regulatory framework and treat Islamic banks as special cases. In countries where Islamic finance has become mainstream, authorities often find it necessary to revise tax codes and accounting rules to level the playing fields between Islamic finance and conventional finance. Malaysia and Indonesia have adopted a dual system where the Islamic banking system operates parallel with the conventional system under different sets of laws and regulations. In particular, Malaysia's *Islamic Financial Services Act 2013* is considered the world's first omnibus legislation on Islamic finance.

Deposit insurance is an important regulatory issue. In Islamic finance, depending on the structure of a contract, the legal status of depositors can be as owners of their funds rather than creditors of the bank. This can lead to questions regarding the eligibility of Islamic bank depositors with respect to traditional deposit insurance. In the case of profit-sharing investment accounts, if a bank fails, the deposit insurance scheme can pay back the net value of investment accounts to investors without compromising *Shariah* compliance. Nonetheless, it may not be *Shariah* compliant for the deposit insurance scheme to pay principal and expected returns in full, since depositors are supposed to share the losses. One way to address this issue is to structure a *Shariah*-compliant deposit insurance scheme with a third-party guarantor. To date, only a handful of countries have specific Islamic deposit insurance schemes that cover such accounts.[16] Moreover, most countries do not have a *Shariah*-compliant lender-of-last-resort facility. Developing such facilities, together with *Shariah*-consistent resolution frameworks, will be essential should Islamic banks grow in systemic importance.

Another challenge for regulators and international agencies is to benchmark the performance of Islamic banks and to assess the stability of the segment. The IMF's Financial Sector Assessment Program (FSAP) and Article IV consultation documents in recent years typically do not include an in-depth assessment of the Islamic banking industry, even if the country may have significant Islamic banking presence. The IMF stated in the 2013 Financial Sector Stability Assessment for Malaysia that "the regulatory framework specific to Islamic banking was not formally assessed, as separate assessment standards for Islamic banking have not been developed." So far, risk surveillance efforts by international agencies have not taken into account unique characteristics of Islamic finance.

Islamic banking faces specific challenges associated with the implementation of Basel principles as well. For example, in order to be compliant with *Shariah*, Islamic banks cannot issue capital instruments such as preferred shares or subordinated debt securities. Therefore, they have limited options when it comes to additional Tier 1 capital and Tier 2 capital instruments. In addition, the lack of *Shariah*-compliant high-quality liquid assets (HQLA) makes it difficult for Islamic banks to satisfy the Basel III liquidity coverage ratio (LCR) requirement.

Two standard-setting bodies, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the IFSB, have made solid progress in recent years toward developing technical standards and guidance that are applicable to Islamic banking. Established in 1990, the AAOIFI has issued standards on accounting, auditing, governance, ethics, and *Shariah*. The IFSB was set up in 2002 to develop prudential standards in capital adequacy, risk management, corporate governance, and *Shariah* governance. Both institutions work closely with the Basel Committee and other international agencies in order to achieve consistency. Applications of these standards are voluntary and uneven across countries. Not all countries find it necessary to adopt a parallel system that governs Islamic financial institutions. According to the *IMF Survey on the Legal, Regulatory, and Supervisory Frameworks for Islamic Finance* conducted in 2011, only 8 out of the 29 countries surveyed apply AAOIFI accounting standards. The *2014 IFSB Standards Implementation Survey* found that 15 out of 28 surveyed countries applied one or more of the 16 IFSB standards.

<u>Risks</u>

Shariah compliance is arguably the most important risk specific to Islamic finance. Financial supervisors typically require financial institutions to obtain certifications that the Islamic finance products that they offer are *Shariah* compliant as claimed. Financial institutions, however, do not make *Shariah* judgments. In a centralized *Shariah* governance system, a national *Shariah* authority has the final say on all *Shariah* compliance related matters. Alternatively, countries may have a decentralized governance system, where each Islamic financial institution has its own *Shariah* board.[17]

The interpretations of *Shariah* compliance have variations across the Islamic world. In 2007, signs of disruptions emerged on the *sukuk* market after the AAOIFI issued a statement that put into question the *Shariah* compliance of the majority of *sukuk* instruments existing in the marketplace at that time. This case demonstrates how different interpretations among *Shariah* scholars can have substantial impacts on financial market and banking stability. Should investors lose confidence in *Shariah* compliance of a bank or financial product, this compliance issue could evolve into liquidity and solvency issues, and even become a systemic risk if the bank is sufficiently large and connected with the rest of the financial system.[18]

The *Shariah*-compliant feature of Islamic finance products can exacerbate consumer protection concerns. In practice, Islamic banks and Islamic finance products differ in the level of risk sharing. Inadequate disclosure or vague explanations of how a profit-sharing investment account is structured, for example, can lead investors to misunderstand the nature of their investments and to choose a product that may not best fit their risk preference. Furthermore, the complex structure of Islamic finance products calls for better consumer education and higher levels of financial literacy among investors.

The complex structure of Islamic finance products also results in extra layers of legal risk. In 2009, the near-default of a high-profile *sukuk* caused turmoil in the global Islamic bond market.[19] *Sukuk* holders found that contrary to their original understanding, they had no recourse to the underlying assets. Eventually, a bailout by the Abu Dhabi government prevented an outright default on the issue. Still, the incident highlighted the challenges in properly evaluating legal and credit risks associated with Islamic finance products with complex structures, especially in the event of default and resolution.

Compared with conventional banks, Islamic banks can have higher levels of credit, operational, and liquidity risks. In their 2014 study, Mejia et al. pointed out that receivables represent a high percentage of Islamic banks' assets.[20] Conventional banks have the option to sell receivables either at a discount or as part of a package to reduce credit risk. In contrast, Islamic banks can only hold them until maturity, because receivables are intangible and not considered to be real assets. In the event of a default by the counterparty, *Shariah* principles prohibit banks from charging accrued interest or imposing penalties. The relatively complex structure of Islamic banking products also implies higher inherent operational risks for banks due to documentation requirements and the need to store and manage real assets, which are often commodities.

Maturity mismatch is typically greater for Islamic banks, because most of them rely on short-term funding from retail customers. Moreover, Islamic banks have difficulty effectively managing liquidity risks, since they face restrictions on the use of conventional derivatives when hedging, and have limited access to conventional lender-of-last-resort facilities due to the absence of an Islamic equivalent of the repo rate and the lack of *Shariah*-compliant collaterals. To address these issues, national authorities have taken steps to encourage product innovation in the Islamic money market. As previously mentioned, *Shariah*-compliant lender-of-last-resort arrangements only exist in a small number of jurisdictions. Some other countries, including Indonesia and Pakistan, are researching different models to provide similar support for Islamic banks, although these efforts are still work-in-progress.

Recent development in Asia

Many Asian governments have identified Islamic finance as a way to promote inclusive growth and to fund infrastructure at home. In recognition of the challenges facing Islamic finance, governments have been proactive in developing new legal frameworks, financial regulations, and market infrastructure to better accommodate the segment. Still, the development of Islamic finance has been uneven across countries. While Malaysia is a success, Islamic banking has a long way to go in other countries, including Muslim-majority Asian countries such as Indonesia, Pakistan, and Bangladesh. This section discusses Islamic finance's development in Asian countries, with special focuses on Indonesia and Malaysia.

Indonesia

Indonesia is representative of broader challenges in the growth of Islamic finance. Developing the industry has been a policy priority of the Indonesian government's for more than a decade. The *Blue Print of Indonesian Islamic Banking Development* issued in 2004 included a number of initiatives that would be implemented from 2006 to 2015. These initiatives include increasing *Shariah* compliance, improving the quality and efficiency of Islamic banks, enhancing the stability of banking system, building human capital, and encouraging Islamic banks to provide credit to small and medium enterprises.[21] In December 2014, Indonesia's financial services authority, *Otoritas Jasa Keuangan* (OJK), published a five-year strategy for developing the Islamic finance industry. It laid out an extensive agenda that ranged from reducing fees on *Shariah*-compliant products to developing education and training program.

In addition to these high-level government initiatives, Indonesia is building a relatively sophisticated legal and regulatory framework tailored to Islamic finance's needs. The government hopes to tap Islamic wealth to fund the country's infrastructure and reduce reliance on external debt. Due to strong government support, Islamic banking assets grew by an annualized 30 percent between 2007 and 2013. However, Islamic banking only accounted for 4.5 percent of Indonesia's banking system assets as of end-2014, far from the authorities' goal of 15 percent.

The development of Islamic finance in Indonesia faces a number of obstacles. First, Indonesia's Islamic banks have a relatively small dedicated customer base. Although the country has the world's largest Muslim population, retail banking customers appear to base most economic decisions on non-religious considerations. *Shariah*-compliant windows of conventional banks tend to be more popular than Islamic banks. Similarly, government funds are mostly held in conventional banks. The growth of the nascent Islamic banking industry is constrained by limited source of funds. Secondly, the industry faces a persistent talent shortage. The number of qualified workers cannot keep up with the rapid growth of Islamic banking branches and assets. Third, the industry cannot always satisfy the market demand for innovative *Shariah*-compliant products. Beyond these reasons, low levels of financial literacy among the country's Muslim population are also a barrier to the growth of *Shariah*-compliant financial services.

Malaysia

Malaysia is often touted as Asia's poster child for Islamic finance. It is the largest Islamic banking center outside the Middle East with 9.6 percent of global Islamic banking assets as of mid-2014. Malaysia also dominates the global *sukuk* market, accounting for two-thirds of total *sukuk* issuances in 2014. Domestically, Islamic finance is a major source of growth for Malaysia's banking sector. According to Moody's, the country's Islamic banks grew their assets by 15 percent in 2014, three times faster than conventional banks. In 2014, *sukuk* issuance accounted for 53 percent of all bond issuance in Malaysia.

The Malaysian government has played an instrumental role in Islamic finance's fast expansion in the country. The government and central bank have taken steps to establish forward-looking market infrastructure, institutions, and regulatory frameworks. Early on, the *Islamic Banking Act* was enacted in 1984. In subsequent years, authorities established laws, regulations, and guidelines that govern the Islamic insurance market, *Shariah*-compliant equity market, and *sukuk* market. Malaysia is actively involved in the global Islamic finance rule-setting bodies. It is a founding member and host of the IFSB which plays an important role in setting accounting standards applicable to Islamic financial services and products.

Government support has been especially crucial for the country's *sukuk* market. The Malaysian government has issued Islamic bonds with different tenors ranging from three-month Treasury bills to thirty-year government financing *sukuk*. Consequently, Malaysia is one of the few countries that is capable of establishing benchmark curves for *sukuk* across different maturities.

Malaysia is also among the first countries to revise its tax regime to ensure tax neutrality for Islamic financial instruments. In addition, the Malaysian government provides substantial tax incentives to Islamic finance beyond tax neutrality. This includes tax exemption of Islamic banks and Islamic insurance companies, tax deduction on issuance costs of Islamic securities, and tax relief for Islamic REITs. Malaysia also has tax exemptions specifically for international Islamic banks, Islamic insurance companies, and Islamic funds.

Islamic finance in Malaysia has greatly benefited from robust product innovation. Financial institutions are able to provide a range of innovative products on the back of a well-developed Islamic capital market, including the world's first modern corporate *sukuk* in 1990, the first Islamic mortgage-backed securities in 2005, and the first covered *sukuk* in 2013. Most recently, Malaysia's securities regulator introduced a framework for socially responsible *sukuk* in September 2014. The country's sovereign wealth fund, *Khazanah Nasional*, reportedly is planning to issue Malaysia's first social-impact *sukuk*.

While other countries often suffer from a talent shortage in the Islamic financial services industry, the Malaysian government has taken a proactive approach to address this issue. Malaysia established the International Centre for Education in Islamic Finance (INCEIF) in 2006 and the International *Shariah* Research Academy for Islamic Finance in 2008. These institutions are now leaders in Islamic finance-related research, and have trained a large financial service workforce that is knowledgeable in *Shariah* compliance.

Rest of the region

Asia's two international financial hubs, Singapore and Hong Kong, have taken steps to leverage their respective strength in global financial services to foster the growth of Islamic finance. Islamic financial services became available in Singapore as early as 1998. During the past decade, Singapore has witnessed solid growth of Islamic asset management, Islamic funds, and Islamic insurance assets. The Monetary Authority of Singapore (MAS) set up a *sukuk* trust certificate program in 2009 and has since issued about S$599.4 million (US$464.7 million) of the securities,[22] all with one-year maturities. The MAS' approach is to accommodate Islamic finance within the existing single regulatory framework, and focus on leveling the playing field by ensuring tax neutrality.

The Hong Kong government first enumerated the development of Islamic financial market as a policy priority in October 2007. In July 2013, it published formal guidance on the exemption of profit and property taxes and the refund of stamp duty tax for *sukuk* in order to eliminate tax differences between *sukuk* and conventional bonds. In September 2014, the Hong Kong government issued US$1 billion in five-year sovereign *sukuk*, the largest AAA-rated sovereign *sukuk* issuance to date.[23] In May 2015, a second US$1 billion five-year sovereign *sukuk* issuance followed. Given Hong Kong's ample fiscal space, analysts view the issuance of sovereign *sukuk* as a strategic move to establish Hong Kong's status as one of the world's leading *sukuk* hubs. As the gateway to mainland China, Hong Kong financial institutions have great ambitions to explore overseas Islamic investors' interests in *Shariah*-compliant investments in mainland China.

Islamic finance is also gaining momentum in the rest of Asia. In 2006, Japan's Ministry of Finance established the Islamic Finance Research Group to conduct a study on the viability of introducing Islamic finance in Japan. In 2008, Japan revised the *Order for Enforcement of the Banking Act* to allow subsidiaries of Japanese banks to engage in Islamic banking services and to ensure tax neutrality. Islamic trade financing is of special interest to Japanese financial institutions. Some of Japan's largest banks, including MUFJ and Mizuho, now offer Islamic financial services through their subsidiaries in Gulf Cooperation Council (GCC) countries and Malaysia, leveraging their strength on syndicated loans and project financing.

Like Japan, China has significant international trade ties with both GCC countries and Southeast Asian economies. China's Muslim-majority Ningxia Province has taken a lead in pioneering Islamic finance with blessing from the authorities. Ningxia Province reportedly is planning a US$1.5 billion municipal *sukuk* issuance.

International organizations are actively promoting the development of Islamic finance in Asia. The ADB, the region's largest multilateral lending agency, entered into a memorandum of understanding in October 2012 with the IFSB, which emphasized the role that Islamic finance can play in improving financial inclusiveness and infrastructure in Asia. The two organizations pledged to strengthen their ability to support the policy, institutional and capacity requirements for a more resilient Islamic financial sector in the region. Most recently, the Islamic Development Bank entered discussions with Chinese officials to study the use of Islamic finance in the Asian Infrastructure Investment Bank (AIIB), which could spur the use of *sukuk* in AIIB member countries in the future.

Conclusion

Islamic finance has achieved rapid growth around the world in recent years. Asia is one of the hot spots in the development of Islamic finance, with Malaysia as one of the world's largest Islamic finance centers. The remarkable growth of Islamic finance can be partly attributed to solid demand for *Shariah*-compliant investment products. However, in Asia and elsewhere, government initiatives in building legal, regulatory, accounting, and tax frameworks that can accommodate Islamic finance have been instrumental to the growth of the segment. Compared to conventional financial services, Islamic finance has both benefits and unique risks. It poses special challenges for financial regulators on a wide range of issues including liquidity, Basel III compliance, deposit insurance, and consumer protection. Despite these challenges, the Islamic finance market is likely to continue to grow in Asia on the back of both investor demand and strong government supports.

Endnotes

[1] Established in 1975, Dubai Islamic Bank (DIB) is generally believed to be the first modern commercial Islamic bank in the world. Some scholars argue that "Islamic finance is as old as the religion itself with its principles primarily derived from the Quran," and can be traced back more than 1,400 years. In its modern form, Islamic banking started with pioneering experiments in the early 1960s in Egypt, when the Mit-Ghamr Islamic Saving Association provided *Shariah*-compliant returns to its Muslim investors.

[2] Islamic Financial Services Board (2013), *Islamic Financial Services Industry Stability Report*, 2013-2015.

[3] This report focuses on Islamic banking but also discusses *sukuk* (Islamic bonds). Islamic banking and *sukuk* together account for 95 percent of the global Islamic finance assets, while Islamic funds and *takaful* (Islamic insurance) assets account for 4 percent and 1 percent, respectively.

[4] For a comprehensive discussion, see Kammer, Alfred, Mohamed Norat, Marco Pinon, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and an IMF staff team (2015), "Islamic Finance: Opportunities, Challenges, and Policy Options," *IMF Staff Discussion Note* SDN/15/05, April 2015.

[5] These countries are: Iran, Sudan, Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

[6] The IFSB focuses on Islamic banking sector when defining "systemic importance," since 80 percent of Islamic finance assets are held within the banking sector.

[7] Kammer et al. (2015).

[8] Demirguc-Kunt, Asli, Leora Klapper, and Douglas Randall (2013), "Islamic Finance and Financial Inclusion: Measuring Use of and Demand for Formal Financial Services among Muslim Adults," *World Bank Policy Research Working Paper Series* 6642, October 2013.

[9] For example, on its Islamic finance portal (accessed on August 3, 2015), the IMF indicates that "Islamic banking… has the potential to foster greater financial intermediation and inclusion, especially among Muslim populations that may be underserved by conventional banks, and to facilitate lending in support for small- and medium-sized enterprises, while *Sukuk* can facilitate investment in public infrastructure projects."

[10] Asian Development Bank and Islamic Finance Services Board (2015), *Islamic Finance for Asia: Development, Prospects, and Inclusive Growth*, May 2015.

[11] Ben Naceur, Sami, Adolfo Barajas, and Alexander Massara (2015), "Can Islamic Banking Increase Financial Inclusion?" *IMF Working Paper* WP/15/31, February 2015.

[12] Hasan, Maher and Jemma Dridi (2010), "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study," *IMF Working Paper* WP/10/201, September 2010.

[13] Hassler, Olivier (2011), *Housing and Real Estate Finance in Middle East and North Africa Countries*, June 2011.

[14] Standard & Poor's Rating Services (2014), *Islamic Finance Outlook 2015*, September 2014.

[15] Franklin Templeton Investments (2014), *Sukuk: An Asset Class Goes Mainstream*, September 19, 2014.

[16] According to the International Association of Deposit Insurers, as of November 2014, Malaysia and Sudan were the only two countries that provide guarantees for Islamic deposits and investment accounts under an Islamic deposit insurance scheme. Some other countries, such as Indonesia and Turkey, provide a guarantee under the conventional system.

[17] Malaysia, Dubai, Oman, Pakistan and Nigeria have a national *Shariah* board, while most GCC countries have adopted a decentralized *Shariah* governance system. Although there does not exist a global *Shariah* authority, in the past the Islamic Development Bank called for the creation of a universal *Shariah* advisory board in order to improve uniformity for the Islamic finance industry.

[18] Mejia, Alejandro Lopez, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song (2014), "Regulation and Supervision of Islamic Banks," *IMF Working Paper* WP/14/219, December 2014.

[19] On November 25, 2009, Dubai World, an investment holding company fully owned by the Dubai government, announced that it was seeking to restructure US$26 billion in debts. This includes a US$4 billion *sukuk* issued by Nakheel (Dubai World's real estate subsidiary that famously developed the Palm Islands) that was scheduled to mature on December 14, 2009.

[20] Mejia, Alejandro Lopez, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song (2014), "Regulation and Supervision of Islamic Banks," *IMF Working Paper WP/14/219*, December 2014.

[21] Ismal, Rifki (2011), "Islamic Banking in Indonesia: Lessons Learned," prepared for the Annual Meeting on Trade and Development, United Nations of Conferences on Trade and Development, April 6th-8th, 2011, Geneva, Switzerland.

[22] The latest issuance statistics is as of March 31, 2015. SGD/USD exchange rates are average rates for fiscal years.

[23] The United Kingdom was the first nation to issue AAA-rated sovereign *sukuk*. The issuance in June 2015, with a total size of US$339.5 million, was oversubscribed by 11.5 times. In October 2015, Luxembourg also issued US$271.7 million in sovereign *sukuk*, which received AAA ratings from all three major rating agencies.

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