

IMF STAFF DISCUSSION NOTE

Islamic Finance: Opportunities, Challenges, and Policy Options

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCBS	Basel Committee on Banking Supervision
CAMELS	Capital Adequacy, Asset Quality, Management Quality, Earnings Efficiency, Liquidity, and Sensitivity
CIBAFI	General Council for Islamic Banks and Financial Institutions
CAR	Capital adequacy ratio
DIS	Deposit insurance scheme
FSAP	Financial Sector Assessment Program
FSI	Financial soundness indicators
GCC	Gulf Cooperation Council
GFSM	Government Finance Statistics Manual
HQLA	High-quality liquid assets
IADI	International Association of Deposit Insurers
IAH	Investment account holders
IB	Islamic banking
IsDB	Islamic Development Bank
IDIS	Islamic Deposit Insurance Scheme
IDWGIF	Interdepartmental Working Group for Islamic Finance
IFC	International Finance Corporation
IFI	Islamic financial institutions
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IPSASB	International Public Sector Accounting Standards Board
IRR	Investment risk reserve
IRTI	Islamic Research and Training Institute
LME	London Metal Exchange
LCR	Liquidity coverage ratio
MCMA	Master collateralized <i>murabahah</i> agreement
MENA	Middle East and North Africa
ML/FT	Money Laundering and Financing of Terrorism
NPL	Nonperforming loans

NSFR	Net Stable Funding Ratio
OIC	Organization of Islamic Cooperation
PER	Profit equalization reserve
PFM	Public financial management
PPP	Public-Private Partnership
PLS	Profit and loss sharing
PSIA	Profit-sharing investment accounts
RWA	Risk-weighted assets
SME	Small and medium-sized enterprises
SPV	Special-purpose vehicle
SSB	Shari'ah Supervisory Board

EXECUTIVE SUMMARY

Islamic finance has the potential for further contributions in at least three dimensions. First, it promises to foster greater financial inclusion, especially of large underserved Muslim populations. Second, its emphasis on asset-backed financing and risk-sharing feature means that it could provide support for small and medium-sized enterprises (SME), as well as investment in public infrastructure. Finally, its risk-sharing features and prohibition of speculation suggest that Islamic finance may, in principle, pose less systemic risk than conventional finance.

For this potential to be realized, however, and to allow this industry to develop in a safe and sound manner, a number of challenges will need to be addressed.

Islamic banking

Specific standards have been developed by specialized standard-setting bodies, but regulatory and supervisory frameworks in many jurisdictions do not yet cater to the unique risks of the industry. Partly as a consequence, the practice of Islamic banking (IB) has, in some jurisdictions, resulted in complex financial products and corporate structures. Moreover, cross-border operations have expanded without regulatory harmonization. These developments indicate a need for increased regulatory clarity and harmonization, closer cooperation between Islamic and conventional financial standard-setters, and further enhancement of tools for effective supervision.

An important regulatory challenge is to ensure that profit-sharing investment accounts (PSIA) at Islamic banks are treated in a manner that is consistent with financial stability. Many regulators treat these as deposits, which undermines their loss and liquidity absorbency feature. When regulators do allow for some loss-absorbency, they do not always pay sufficient attention to the implications for corporate governance and consumer protection. Regulation and supervision should ensure that PSIAs are not treated as pure deposits, while also ensuring better disclosure and enforcement of the investors' rights, including those related to payouts and reserves.

Regulators do not always have the capacity (or willingness) to ensure Shari'ah compliance, which undermines consistency of approaches within and across borders. Greater harmonization should be sought across and within countries, including through better implementation of existing standards for Shari'ah governance and possibly by establishing central boards at the national level.

Although Islamic banks appear well-capitalized, there will be challenges with the implementation of the Basel III Accord. For example, further clarification will be needed from national regulators regarding the instruments that are eligible for treatment as additional Tier 1 and Tier 2 capital. Also, the scarcity of Shari'ah-compliant high-quality liquid assets (HQLA) will make it difficult for Islamic banks to satisfy the Basel III liquidity coverage ratio (LCR) requirement. Therefore, it is important that national authorities use the leeway given by Basel standards to grant highly rated and tradable Sukuk HQLA status, and take steps to deepen local Sukuk and money markets.

Safety nets and resolution frameworks remain underdeveloped. Very few countries with IB have a full-fledged Islamic deposit insurance scheme with premiums invested in Shari'ah-compliant

assets. Moreover, only a small number of countries have developed a Shari'ah-compliant lender-of-last-resort facility. Developing such facilities, together with Shari'ah-consistent resolution frameworks, will be essential as Islamic banks grow in systemic importance.

Notwithstanding its potential, IB appears to have had a limited impact so far on access to finance. To help unlock this potential, it will be important to reduce the tax and regulatory impediments to Islamic bank financing, as well as to enhance the financial infrastructure.

Sukuk markets

Sukuk are seen as well-suited for infrastructure financing because of their risk-sharing property could also help fill financing gaps. The supply of Sukuk, however, falls short of demand and, except in a few jurisdictions, issuance takes place without a comprehensive strategy to develop the domestic market. National authorities should, therefore, focus on developing the necessary infrastructure, including promoting true securitization and enhanced clarity over investors' rights, and on stepping up regular sovereign issuance to provide a benchmark for the private sector. Increased sovereign issuance should be underpinned by sound public financial management.

Macroeconomic policies

Monetary policy formulation and implementation are challenging in the presence of Islamic finance because of the scarcity of Shari'ah-compliant monetary policy instruments and a lack of understanding of the monetary transmission mechanism. In addition to weakening the transmission channel for monetary policy, the scarcity of instruments also forces Islamic banks to hold higher unremunerated reserves, affecting their ability to compete with conventional banks. Therefore, it is important to further deepen Sukuk markets and develop Shari'ah-compliant monetary policy instruments.

Macroprudential policies will need to play a more important role because systemic risks can result from the mix of deposits and investments on the liability side, as well as the greater concentration of assets in cyclically sensitive sectors. Thus, efforts are required to develop cross-sectoral supervision, explore the use of macroprudential tools to contain concentration risks, close data gaps, and develop the capacity to assess systemic risks.

Islamic finance raises a number of taxation issues. These include tax incentives for debt over equity, the tax treatment of sales and additional layers of transactions in some instruments. Moreover, differences in the treatment of Islamic and conventional finance, if unchecked, can create cross-border spillovers and encourage international tax arbitrage. Tax systems should base treatment on economic substance and move away from distortionary transaction taxes toward more neutral profit-based taxes. International standards for accounting and auditing of Islamic finance should be further developed, and regional and global tax cooperation strengthened.

I. INTRODUCTION

Islamic finance has grown rapidly over the past decade, and its banking segment has become systemically important in a dozen countries in a wide range of regions. Islamic finance is projected to continue to expand in response to economic growth in countries with large and relatively unbanked Muslim populations. It is also fueled by the large savings accumulated by many oil-exporting countries that are seeking to invest in Shari'ah-compliant financial products.

The growing reach of Islamic finance promises a number of possible benefits. For example, it is often argued that Islamic finance is inherently less prone to crisis because its risk-sharing feature reduces leverage and encourages better risk management on the part of both financial institutions and their customers. It is also argued that Islamic finance is more stable than conventional finance, because: (i) Islamic finance involves prohibitions against speculation; (ii) financing is asset-based and thus fully collateralized; and (iii) it is founded on strong ethical precepts. Moreover, Islamic financial institutions (IFIs) are considered to be a good platform for increasing access to financial inclusion, including access to finance for SMEs, thereby supporting growth and economic development.

Nonetheless, Islamic finance faces a number of challenges. For example, despite the efforts of Islamic finance standard setters, in many countries the industry is governed by a regulatory and supervisory framework developed for conventional finance. Therefore, it does not fully take account of the special nature of Islamic finance (Al-Maraj 2014). The industry is still largely a nascent one, lacking economies of scale, and operating in an environment where legal and tax rules, financial infrastructure, and access to financial safety nets and central bank liquidity are either absent or, if available, do not appropriately take into account the special characteristics of Islamic finance (Askari, Iqbal, and Mirakhor 2010; Ernst and Young 2014; IFSB, IsDB, and IRTI 2010).

Reflecting the importance of Islamic finance for many of its members, the International Monetary Fund (IMF) has had a long-standing interest in its implications for macroeconomic and financial stability. Indeed, it played a key role in the establishment of the Islamic Financial Services Board (IFSB). The IMF has also taken into account the implications of Islamic finance, for those members where it has been relevant, in the context of its Article IV consultations and its Financial Sector Assessment Program (FSAP) assessments. It has also provided technical assistance and training to assist countries seeking to strengthen the regulation and supervision of their Islamic banks, and to develop domestic Sukuk markets.

The recent growth of Islamic finance has led to increased demand for the IMF to provide policy advice and capacity building in a broad range of areas. These demands for advice will likely increase as the industry grows and its systemic importance increases, notably in areas related to IB, Sukuk markets, and macroeconomic policies.

This staff discussion note represents an effort to take stock of the lessons learned in these areas, and identifies policy issues that bear further consideration. Section II briefly explains the nature of Islamic finance. Section III presents the rationale for undertaking this work. Section IV discusses Islamic bank regulation and supervision, and related issues of financial stability and

inclusion. The same issues are covered for Sukuk markets in Section V. Finally, Section VI discusses monetary, macroprudential, and tax policies.

II. WHAT IS ISLAMIC FINANCE?

Islamic finance refers to the provision of financial services in accordance with Islamic jurisprudence (Shari'ah).³ Shari'ah bans interest (*Riba*),⁴ products with excessive uncertainty (*Gharar*), gambling (*Maysir*), short sales, as well as financing of prohibited activities that it considers harmful to society. It also requires parties to honor principles of fair treatment and the sanctity of contracts. Transactions must be underpinned by real economic activities, and there must also be a sharing of risks in economic transactions.

Islamic finance products are contract-based and may be classified into three broad categories: (Hussain, Shahmoradi, and Turk 2015):

- Debt-like financing structured as sales, which could be sales with mark up and deferred payments (*Murabahah*) or purchases with deferred delivery of the products (*Salam* for basic products and *Istisna'* for manufactured products), and lease (*Ijārah*) with different options to buy. Pure lending is allowed only when benevolent (*Qard*, which is often used for current deposits);
- Profit-and-loss-sharing (PLS)-like financing with two modalities: (i) profit-sharing and loss-bearing (*Mudarabah*) whereby the financier (investor, bank) provides capital and the beneficiary provides labor and skills (profits are shared, but losses would be borne by the financier who does not have the right to interfere in the management of the financed operation, unless negligence, misconduct, or breach of contract can be proven); and (ii) pure profit-and-loss-sharing (*Musharakah*) where the two parties have equity-like financing of the project and would share profits and losses; and
- Services, such as safe-keeping contracts (*Wadi'ah*) as for current deposits, or agency contracts (*Wakalah*), which are also increasingly used for money market transactions.

Islamic finance now encompasses a wide range of services. Nonetheless, banking still dominates and represented about four-fifths of total Islamic finance assets in 2013 (IFSB 2014). The Sukuk market is also a fast-growing segment with assets equivalent to about 15 percent of the industry. Other services include leasing, equity markets, investment funds, insurance (*Takaful*), and microfinance.

IB differs from conventional banking in several dimensions.⁵ As a result of the prohibition on interest, Islamic banks are funded by noninterest-bearing current accounts (benevolent loans or

³ The industry is termed participation finance or noninterest-bearing finance in some jurisdictions.

⁴ That said, there is a minority of scholars who do not consider the interest-bearing instruments as prohibited, mainly on the grounds of necessity.

⁵ In most jurisdictions, conventional banks are allowed to provide Shari'ah-compliant services through Islamic windows, or through a fully segregated entity, such as a subsidiary.

safe-keeping contracts), 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.⁶ Correspondingly, on the asset side, 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. There are some differences on the treasury side: Islamic banks are prohibited by nearly all jurisdictions from undertaking certain types of derivatives, such as foreign exchange forwards and futures (see Table 1).

Table 1. Stylized Balance Sheet of Islamic and Conventional Banks

Balance Sheet of an Islamic Financial Institution 1/	Balance Sheet of a Conventional Financial Institution
Assets	Assets
Cash and cash equivalents	Cash and cash equivalents
Investment in securities	Investment in securities
Sales Receivables	Loans and advances
Investments in leased assets	Statutory deposits
Investments in real estate	
Equity/Profit-sharing financing	
Investment in Subsidiaries	Investment in Subsidiaries
Fixed assets	Fixed assets
Other assets	Other assets
Liabilities	Liabilities
Current Accounts	Current Accounts
Other Liabilities	Saving and Time Deposits
	Other Liabilities
Equity of PSIA	
PSIA (Unrestricted)	
Profit Equalization Reserve	
Investment Risk Reserve	
Owner's Equity	Owner's Equity
PSIA (Restricted) [Off-balance Sheet] [letters of credit/guarantees]	Off-balance Sheet [letters of credit/guarantees/derivatives]

Note: PSIA= profit-sharing investment account.

1/ Differences are in red.

Sukuk, the Islamic equivalent of bonds, are similar to asset-backed securities.⁷ Whereas a conventional bond is a promise to repay a loan, Sukuk constitutes partial ownership in receivables

⁶ PSIA could be unrestricted or restricted. They are unrestricted when account holders authorize the bank to invest their funds without any restriction. Restricted PSIA are often registered off balance sheet.

⁷ Formally, Sukuk are defined as "certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs, and services or (in the ownership of) the assets of particular projects or special investment activity" (AAOIFI 2008).

(*Sukuk al Murabahah*), a lease (*Ijārah*), a construction project (*Istisna'*), a deferred delivery of assets (*Salam*), a joint partnership (*Mudarabah* or *Musharakah*), or investment (*Istithmar*); the principal amount is typically not guaranteed and the return is linked to the performance of the underlying assets (Maziad and AlSaeed 2015). Sukuk can take the form of asset-backed securities, which involve true securitization of underlying assets, or they can be asset-based securities.⁸

In practice, Islamic finance often involves structuring transactions in a manner that closely mimics conventional finance insofar as a periodic rate of return is provided (Box 1). In certain types of Sukuk instruments, a predetermined rate of return is often paid to the investor; this rate is based on the expected return of the underlying assets that collateralize the Sukuk. In the case of debt-like financing by Islamic banks, interest is not charged; instead, debtors will provide predetermined and periodic payments to the bank, based on the expected profit that would accrue to the underlying asset (in the case of a capital investment), or on the rent that might be charged for the use of the underlying asset (in the case of a home or car loan). This leads to minimal differences in substance with conventional finance and, in some cases, requires a complex layering of transactions, involving third parties. These can create operational and other risks that may have to be managed carefully (Box 1), and (Beck, Demirgüç-Kunt, and Merrouche 2010; Čihák and Hesse 2008; Chong and Liu 2009; and Ali 2011).

III. WHY ISLAMIC FINANCE MATTERS

Islamic finance has grown rapidly in recent years, but remains concentrated in a few jurisdictions. Islamic finance assets grew at double-digit rates during the past decade, from about US\$200 billion in 2003 to an estimated US\$1.8 trillion at the end of 2013 (Ernst & Young 2014; IFSB 2014; and Oliver Wyman 2009). (See Figure 1). However, despite this growth, Islamic finance assets are still concentrated in the Gulf Cooperation Council (GCC) countries, Iran, and Malaysia, and represent less than 1 percent of global financial assets.

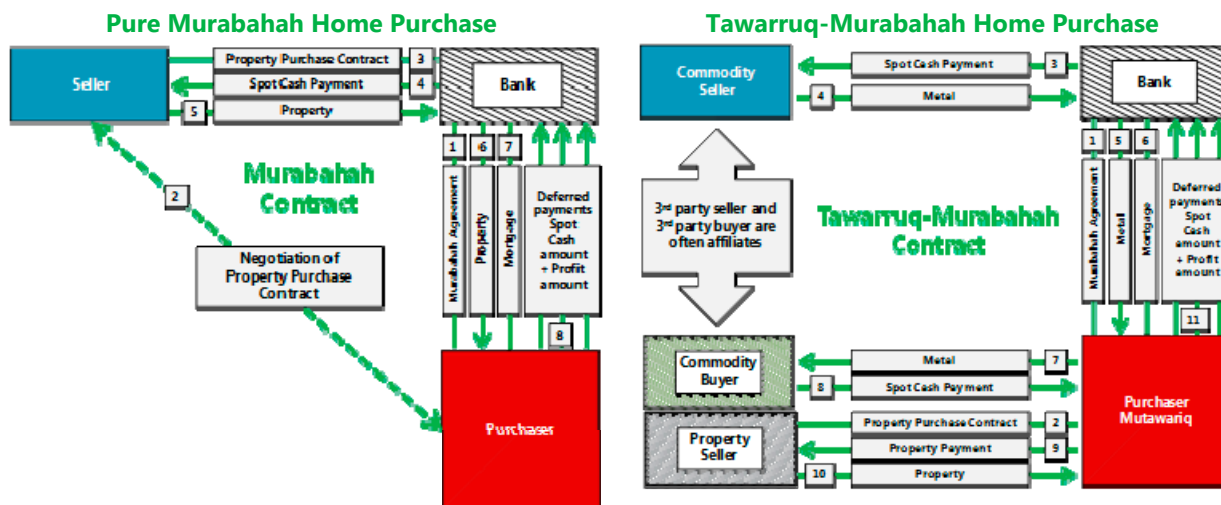
The growth of IB, in particular, outperformed conventional banking over the past decade. IB has thus increased its penetration in many countries, crossing the threshold of 15 percent as a share of banking system assets in 10 countries (Iran and Sudan with a full-fledged Islamic financial sector, Bangladesh, Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen) (IFSB 2014). IB represents about 1¼ percent of global banking assets. During the recent global financial crisis, Islamic banks were less exposed to the toxic assets that contaminated the conventional banking world, but suffered from second-round effects, notably through the real estate slump. Asset quality and capitalization are still better on average than for conventional banks,

⁸ Sukuk can take the form of an asset-backed investment, which involves granting the investor (Sukuk holder) a share of a tangible asset or business venture along with a corresponding share of the total risk (that is, a share commensurate with this ownership). In this structure, there is a true sale transaction, where the originator sells the underlying assets to a special-purpose vehicle (SPV) that holds these assets and issues the Sukuk backed by them. Asset-based Sukuk involve the issuer purchasing the underlying assets and then investing, trading, or leasing them on behalf of the investors (Sukuk holders), using the funds raised through the issued certificates (Sukuk).

while profitability remains lower (although the industry averages mask wide variation across different jurisdictions, IFSB 2014).

Box 1. Complexity of Islamic Finance: The Commodity-Sale Home Example

Islamic finance requires the provision of financial services in accordance with the Shari’ah ban on interest (*Riba*). It also requires that the financing provided is asset-based, often resulting in the purchasing, ownership, transfer, and transactions of real goods between counterparties. However, there is a tendency to structure transactions and financing so that Islamic finance contracts mimic conventional (debt) financial contracts: the result is a complex layering of transactions and the involvement of third parties in order to be Shari’ah compliant. This can create complexity and risks (credit, market, operational, and legal) at different stages in execution of the Islamic finance contract. An example is the case of some home mortgages based on *Murabahah* (sale at cost plus profit) which can involve multiple transactions (including with more than one commodity) and multiple transfers of ownership and layering to ensure Shari’ah compliance.



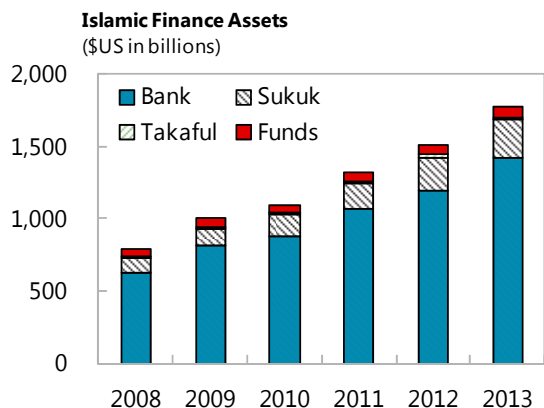
Sources: M.J.T. McMillen; and IMF staff.

In the case illustrated above, a pure *Murabahah* contract can be compared with a more complex *Tawarruq* (purchase of commodities on a deferred payment basis) and *Murabahah* structure combining to provide funds to the purchaser (*Mutawariq*) for the purchase of the property. The transaction involves an agreement between the bank and the purchaser (1) and the property seller and purchaser (2). In the case of pure *Murabahah*, the bank purchases the property (stages 3-5) sells it to the purchaser (6), pursuant to the *Murabahah* agreement (1). The deferred payment obligation of the purchaser is secured by a mortgage on the property (7), while the actual deferred payments are made as in (8). In the *Tawarruq* case, the bank does not itself purchase the property, but instead purchases a commodity, in this case metal, (3) and (4). It then sells it to the home purchaser at a price that includes a profit margin (5) and involves a mortgage agreement (6). The purchaser then sells (7) the commodity for cash (8), which is used (with any equity by the purchaser) to purchase (9) property (10) from the seller. The amount financed from the commodity (metal) *Murabahah* agreement is repaid to the bank over time as deferred payments (11), mimicking the payment structure of a conventional interest-based home loan.

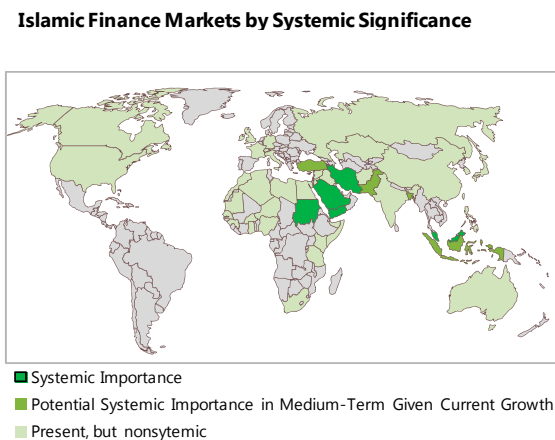
Murabahah transactions allow the contract to mimic a conventional mortgage, but with layering of the initial set of transactions and an increase in the number of counterparties involved through the life of the mortgage.

Figure 1. Growth of Islamic Finance

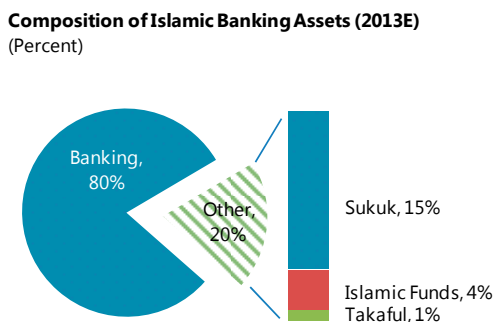
Islamic finance assets have grown rapidly in volume...



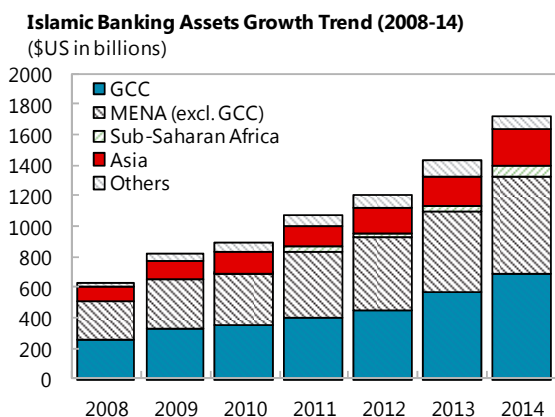
...also in geographical coverage



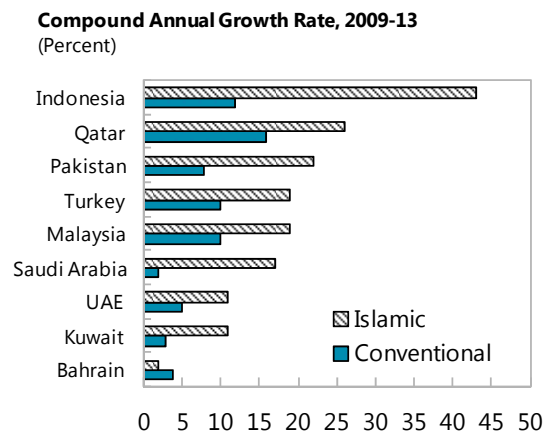
The banking sector dominates, followed by the Sukuk market...



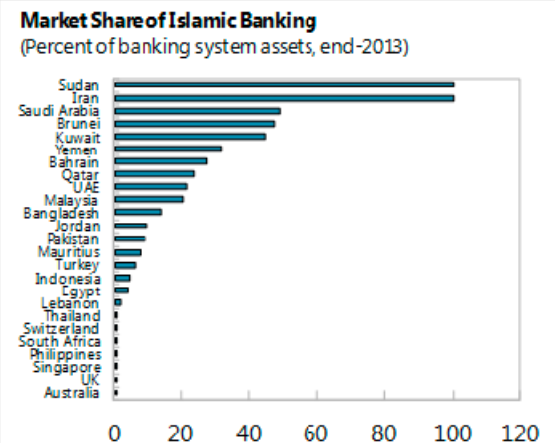
...and banking assets are concentrated in Malaysia and the MENA region, particularly the GCC



Growth of Islamic banks has surpassed that of conventional banks...



...and the Islamic banking sector is now systemically important in several countries

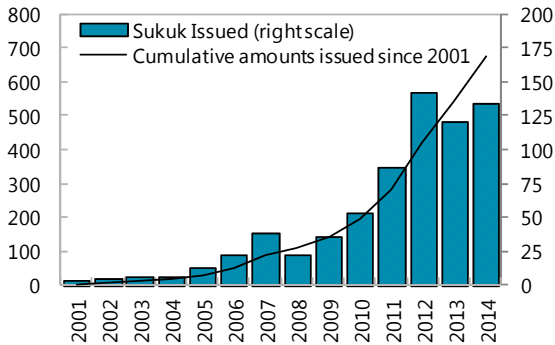


Sources: IFSB Annual reports; Central Banks, IFSB; IFIS; Bloomberg; KFHR; and Ernst & Young.
Note: GCC= Gulf Cooperation Council; MENA= Middle East and North Africa; UAE= United Arab Emirates; UK= United Kingdom.

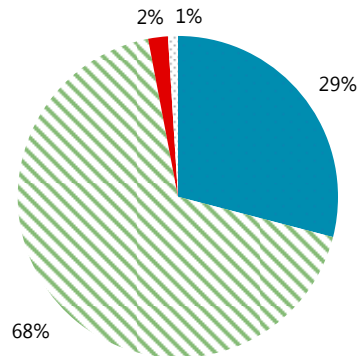
Figure 2. Sukuk Growth and Distribution

The Sukuk market has registered strong growth led by Southeast Asia and the Middle East

Global Sukuk Issuance
(\$US in billions)



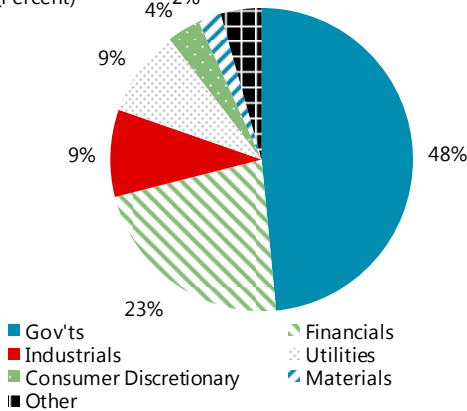
Volume by Region (as of end-2014)
(Percent)



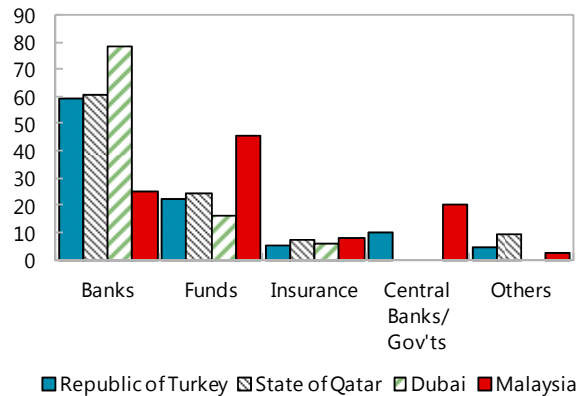
■ Middle East ■ Southeast Asia ■ Europe ■ Others

Sovereigns have dominated Sukuk issuance, but corporates are significant, led by banks who are also major investors

Volume by Issuer
(Percent)



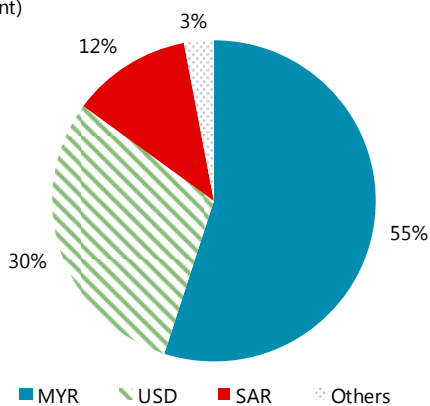
Investor Base for Selected Sukuks
(Percent of total)



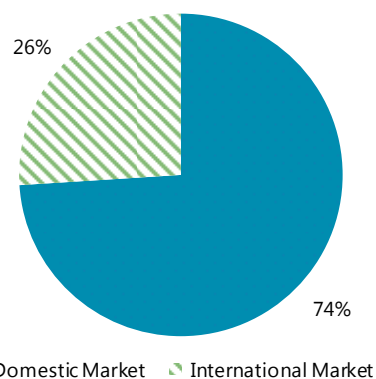
■ Republic of Turkey ■ State of Qatar ■ Dubai ■ Malaysia

Most issues are in Malaysian Ringgit, followed by U.S. dollars, and international issues are increasing, albeit from a low base

Volume by Currency
(Percent)



Volume by Market
(Percent)



Sources: IFSB, HSBC, Kuwait Finance House Research, and Zaywa.

Note: MYR=Malaysian Ringgit; SAR= Saudi Arabian Riyal; USD= United States Dollars.

Sukuk issuance has also increased rapidly. Global issuance has grown significantly since 2006, although from a low base. It reached US\$120 billion in 2013, bringing the outstanding Sukuk to US\$270 billion by end-2013, representing ¼ percent of global bond markets (see Figure 2). Issuance is still concentrated in Malaysia and the GCC countries, although diversification is ongoing with new issuance in Africa, East Asia, and Europe. It is evenly split between sovereigns and corporate Sukuk, and mainly denominated in Malaysian ringgits or U.S. dollars.⁹ Demand is generally outstripping supply, leading to oversubscription on most issuances, lower yields (when the fundamentals of the issuer are strong), and less liquidity as investors prefer to “buy and hold.” These include particularly Islamic banks, which suffer from a shortage of Shari’ah-compliant liquid assets.

The strong growth reflects growing demand from Muslim populations, and strong economic growth in countries where the industry already exists. Islamic finance is also benefiting from innovation in products in trade, corporate, project, and consumer finance, improvements in the regulatory environment, ongoing diversification of Sukuk issuers eager to tap savings from the Islamic world, and strong interest in Sukuk issuance by banks seeking to strengthen their capital bases in line with the Basel III requirements. It remains to be seen, however, whether this strong growth will be sustained in light of the recent decline in oil prices as the industry is still concentrated in oil-exporting countries. Indeed, there is empirical evidence that the oil price is a determinant of IB diffusion (Imam and Kpodar 2010). Moreover, low yields and lack of liquidity could weigh on the long-term growth of the Sukuk market.

Islamic finance has the potential to contribute to higher and more inclusive economic growth. Large segments of the Muslim population are underserved by conventional finance—only 24 percent of adults have a bank account and 7 percent have access to formal financing, compared with 44 percent and 9 percent, respectively, for non-Muslim populations (Demirgüç-Kunt, Klapper, and Randall 2013). Moreover, the principles of risk-sharing and the strong link of credit to collateral means that IB is well-suited to the financing of SME and startups, thereby contributing to more inclusive growth. And at the same time, Sukuk have shown their value in the area of infrastructure finance, and could also help in supporting investment and economic growth.

Islamic finance may also help promote macroeconomic and financial stability. The principles of risk-sharing and asset-based financing can help promote better risk management by both financial institutions and their customers, as well as discourage credit booms. Indeed, IB resembles the proposal made in the 1930s under the Chicago plan, which required full backing of bank loans, and which recent research has suggested would lower macroeconomic volatility and the risk of bank runs (Benes and Kumhof 2012; and Wolf 2014). In the case of Islamic finance, a large portion of bank deposits are offered on a profit-sharing and loss-bearing basis (for example, 55 percent in the Middle East and North Africa region; Ali 2011) and so are explicitly “bail-inable” in the event of a banking sector facing distress. Finally, the underlying ethical precepts of Islamic finance provide, in principle, an important basis for high levels of ethical conduct, governance, and consumer protection.

⁹ Structures of choice are still Sukuk *Ijārah* and Sukuk *Murabahah*, although the latter have tradability issues, because debt is not tradable unless at par in most jurisdictions.

However, much of the potential of the industry remains to be exploited. The empirical evidence does not yet confirm that IB has promoted financial access and depth once structural factors are accounted for (Barajas, Ben Naceur, and Massara 2015). Moreover, there are questions about the extent to which financing by Islamic banks is truly risk-sharing or whether PSIAs are fully loss-absorbing, suggesting that Islamic banks may be just as exposed to risks as conventional banks (López-Mejía, Aljabrin, Awad, Norat, and Song 2014).¹⁰ In addition, true securitization of Sukuk underlying assets is the exception rather than the rule, and asset-backed transactions are often highly complex, layered transactions that are designed to avoid the appearance of paying interest—termed by some as “Shari’ah arbitrage” (El-Gamal 2006).

Islamic finance faces a number of other constraints that may be impeding its development.

Although Islamic regulatory bodies and standard setters have created principles and detailed technical standards, there is further scope for their implementation by national authorities, who are often more focused on global conventional banking standards. Lower economies of scale, and sometimes an uneven playing field with conventional finance, play a role. Similarly, large differences in practice across countries and limited standardization and securitization create additional uncertainty for Islamic finance customers. Scarcity of Shari’ah scholars with financial sector expertise, and a slow pace of innovation are also weighing on the industry. These challenges may not only be impeding its development, but could also encourage practices and products that are complex, thus carrying heightened risks.

IV. ISLAMIC BANKING

A. Regulation and Supervision

Islamic banks are subject to unique risks that pose challenges for their legal and regulatory frameworks:

- Islamic banks may be exposed to *displaced commercial risk*, which is especially relevant where they are competing with conventional banks. This competition may force Islamic banks and their shareholders to forego part of their profits to pay comparable rates of return to their clients, or to avoid subjecting their investment account holders (IAH) to having to bear losses in cases when the return on underlying assets falls short. This has led to complexities in the manner in which Islamic banks build reserves against losses and how these are treated in the calculation of regulatory capital.
- Islamic banks are also subject to *equity investment risk* because their assets are made up of physical investments whose returns are uncertain. In this context, they are also subject to the risk of depositor flight if market interest rates rise beyond the rate of return that can be funded by the Islamic banks’ own assets (the so-called “rate of return risk”).

¹⁰ Seventy-five percent of MENA Islamic bank assets are *Murabahah* (Ali 2010). Similar proportions are found in Malaysia for debt-like instruments (Chong and Liu 2009).

- The requirement of *Shari'ah governance and compliance* on uses and sources of funds also poses risks: a determination of noncompliance could also trigger client flight.
- In addition, *market and operational risks* could be heightened by the complexity of products, a reliance on commodities to structure some operations, and the lack of hedging instruments.
- The difficulty of selling debt, charging accrued interest in case of default, and recognizing nonperforming loans (NPLs) in some profit-and-loss-sharing (PLS) contracts may heighten *credit risk*.¹¹
- In addition, the scarcity of Shari'ah-compliant liquidity instruments and infrastructure may increase *liquidity risk*.¹²
- Similarly, the practice of asset-based financing sometimes leads to a high concentration in real estate and commodities investments, and to the creation of complex corporate structures. Moreover, Islamic banks' greater focus on consumer financing rather than industrial or business financing reflects greater certainty over guarantees, collateral value, and investor rights.

The unique characteristics of IB have been addressed by specialized Islamic standard-setting bodies. Conventional standards apply in all banking systems. However, taking into account the unique nature of IB, special standards have been developed through dedicated standard-setting bodies. The industry has two key standard setters: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1990, for Shari'ah accounting and auditing standards, and the IFSB, set up in 2002, for regulatory and supervisory standards. These institutions have developed a wide range of technical standards and guidance notes, working closely with the Basel Committee and similar conventional standard-setting bodies to ensure coherence and consistency with their standards.¹³

However, application of these standards is not uniform across countries. A recent survey by IMF staff (Box 2) suggests that, to date, standards set by the AAOIFI and the IFSB are applied only in a limited number of countries. Of the 29 countries surveyed, only 8 countries apply AAOIFI accounting standards (not including its other standards), whereas IFSB standards regarding risk management and capital adequacy are applied in only 6 jurisdictions (21 percent of respondents). The lack of consistent application of AAOIFI and IFSB standards, especially in countries where Islamic banks are active, risks undermining transparency and creates scope for regulatory arbitrage. Increased regulatory clarity— set in banking laws and regulations and informed by enhanced dialogue between Islamic standard setters and national regulators— is needed, as is strengthened collaboration between Islamic and global standard setters in developing appropriate standards for the industry.

¹¹ Credit risk could also be lower for Islamic banks as the asset-based nature of Islamic finance may enable repossession and sale of an underlying asset in case of default to partly cover credit losses.

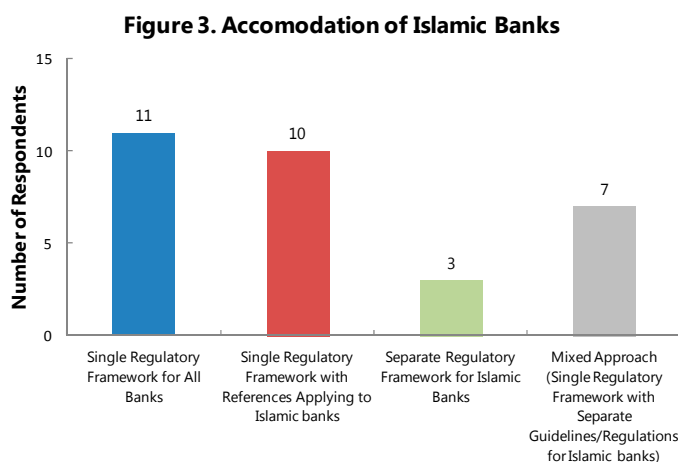
¹² Although still low compared to Islamic bank needs, issuances by the International Islamic Liquidity Management Corporation (IILM) have increased short-term Sukuk supply.

¹³ An example of this is the work the IFSB submitted to the Basel Committee on Banking Supervision (BCBS) in preparation for the latest standards for the liquidity coverage ratio.

Box 2. IMF Survey on the Legal, Regulatory, and Supervisory Frameworks for Islamic Finance¹

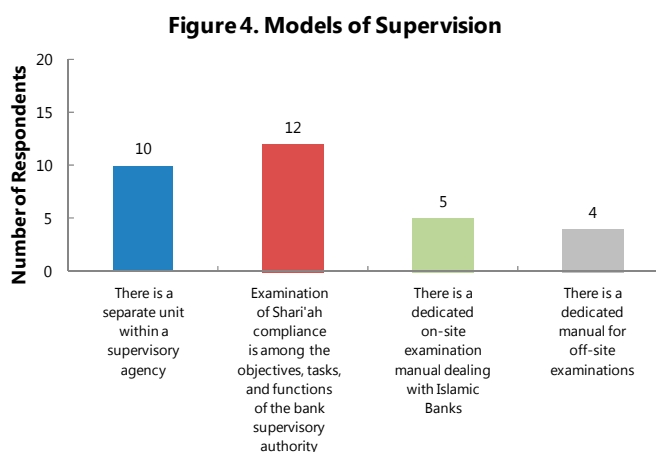
To help enhance the capacity of the IMF to service member countries in the area of Islamic finance, a survey of prudential frameworks governing IB practices was conducted in 2011. Key results remain relevant given that regulatory and supervisory frameworks have not changed significantly. All members of the IMF with a significant IB presence were canvassed, and 39 countries responded. Ten of these countries excluded themselves as not recognizing IB. The main results of the survey are as follows:

- IB practices are relatively widespread and given explicit recognition in regulation.** In particular: (i) 72 percent of the respondents indicated that the legal and regulatory framework explicitly recognizes IB practices, products or institutions; (ii) 76 percent of the respondents noted that IB was being conducted by a stand-alone Islamic bank; and (iii) 55 percent of the respondents indicated that IB was being conducted through a conventional bank.
- There is a wide range of approaches regarding the regulatory framework for IB** (Figure 3). In particular: 11 respondents (for example, Kenya, Saudi Arabia, South Africa, the United Arab Emirates, and the United Kingdom) indicated that a single integrated regulatory framework applied to all banks (with no reference to IB or Islamic banks); 10 respondents (for example, Jordan, Kazakhstan, Qatar, and Turkey) noted that a single integrated regulatory framework applied to all banks (with references identifying provisions applying only to IB); 3 respondents (Bahrain, Iraq, and Kuwait) pointed out that there were 2 separate independent regulatory frameworks (that is, one for IB and another for conventional banking); and 7 respondents (for example, Indonesia, Lebanon, Malaysia, and Syria) indicated the existence of a mixed approach, that is, a similar regulatory framework is adopted for areas that are applicable to Islamic and conventional banks, but separate guidelines and regulations are issued for areas that are specific to IB.



- Jurisdictions take different approaches to the application of capital requirements.** In certain jurisdictions (for example, Ethiopia, Kazakhstan, the United Arab Emirates, and the United Kingdom), the chosen Basel capital framework applies to all banks, including Islamic banks. In other jurisdictions (for example, Bahrain, Jordan, Malaysia, and Sudan), the regulatory capital adequacy requirements contain prescriptions that are often based on IFSB prudential standards and guiding principles on needed adjustments to the Basel capital framework to cater to certain IB features. Accordingly, it may be difficult to compare capital ratios among Islamic banks in different countries. There are different approaches in the adjustments made to the chosen Basel capital framework to cater to certain IB features. For example, certain jurisdictions apply an alpha factor that represents the ratio of actual risk transferred to shareholders of Islamic banks, as proposed by the IFSB. It captures the difference in risk exposure between an IB risk-sharing product and a conventional banking product (Box 3).

- **There are two models of supervision of Islamic banks in jurisdictions where Islamic banks and conventional banks are present** (Figure 4). In the first model, Islamic and conventional banks are subject to the supervision of a single supervisory authority (for example, Ethiopia, Kazakhstan, Kenya, Kuwait, Qatar, Saudi Arabia, Tunisia, Turkey, the United Arab Emirates, and the United Kingdom). In the second model, the supervision of Islamic and conventional banks is separated and lies with separate supervisory units within a single supervisory authority (for example, Bahrain, Indonesia, Jordan, Lebanon, Pakistan, and Syria). In the first model, a single supervisory framework applies to all banks (Islamic banks and central banks), whereas in the second model, separate supervisory frameworks may be applied to Islamic banks by the separate supervisory units, though there is typically substantial information sharing between the different supervisory frameworks.



- **Jurisdictions have different approaches regarding the nature and extent of information which banks are required to disclose to the general public.** In jurisdictions that have Islamic and conventional banks (and *Shari'ah* Law is not a fundamental source of the law of the land), all banks are subject to the same disclosure requirements (for example, Turkey, and the United Kingdom), whereas in other jurisdictions an Islamic bank is not permitted to publish its financial statements until and unless the Shari'ah Board has signed off on the Shari'ah compliance of the financial statements (for example, Malaysia, Pakistan, and Sudan).
- **There is significant heterogeneity among jurisdictions regarding the protection through safety nets of deposits and investments with Islamic banks.** The range of protection varies from no coverage of deposits and investments to full protection (with partial protection in some jurisdictions). In some cases there is a single deposit protection scheme which applies to all banks (for example, Kenya, Lebanon, Luxembourg, Tunisia, Turkey, the United Kingdom, and Yemen), and in others there are separate deposit protection schemes for Islamic and conventional banks, for example, in Malaysia and Sudan.
- **Few countries have comprehensively addressed the issue of bank resolution in the context of IB.** Moreover, practices differ across countries. In most cases, the distress resolution process for Islamic banks does not differ from that of conventional banks (Jordan and Yemen are exceptions). Regarding the corrective and enforcement actions and processes framework, in most cases there are no differences between Islamic and conventional banks (although Afghanistan is an exception).

¹ See Song, In Won and Carel Oosthuizen, "Islamic Banking Regulation and Supervision – Survey Results and Challenges," IMF Working Paper No. 14/220 (Washington: International Monetary Fund, 2014).

As in conventional finance, the supervisory function for Islamic finance can be organized in different ways, but the key is to ensure that certain objectives are met. These include: operational independence of the supervisory agency, supported by adequate resources, a sound legal framework, a well-designed governance structure, and robust accountability practices (Viñals and others 2010). However, in many jurisdictions supervisors appear to lack dedicated licensing and examination procedures for IB. In addition, supervisors of Islamic banks do not seem to have the capacity to oversee both the banking and mutual fund–like activities that Islamic banks undertake, which requires a cross-sectoral approach that covers banking, insurance, and securities market–like activities.¹⁴ These complexities underscore the importance of national authorities implementing the Core Principles for Islamic Finance Regulation (banking segment), which, built on Basel Committee on Banking Supervision (BCBS) core principles, will be issued soon by the IFSB.¹⁵ Development of financial soundness indicators (FSI) for Islamic banks will also be important. In this context, the IFSB is taking welcome steps to develop prudential and structural indicators for Islamic finance based on the IMF’s financial soundness indicators.

An important challenge is proper regulatory treatment of the PSIA of Islamic banks. Although, in functional terms, these accounts closely mimic the shares of a mutual fund, only six countries (Bahrain, Jordan, Oman, Qatar, Sudan, and Turkey) allow for some pass-through of losses on the assets they finance when computing the capital adequacy ratio (CAR), which varies between 50 percent and 70 percent. Moreover, and partly as a result, the PSIAs incentivized banks to hold higher reserve and liquidity buffers. In future, regulatory and supervisory authorities should ensure that PSIAs are not treated like a pure deposit and observe the IFSB guidance in setting the alpha factor (Box 3) to avoid undermining their loss-absorbency feature.¹⁶

Diverging interests between investment account holders (IAHs) and shareholders raise corporate governance issues. One of the major issues is that IAHs share profits and bear losses, but do not have shareholder rights (López-Mejía and others 2014). Thus, IAHs may not obtain full disclosure on the performance of the assets they finance or on the method by which the rate of return for PSIA is calculated. And upon withdrawing funds from the bank, they may be unable to get back their contribution to buffers used to smooth returns and protect capital.¹⁷ To help tackle this challenge, corporate governance could be enhanced, including by mandating that some Board

¹⁴ Cross-sectoral supervision and coordination remains very challenging, even in the conventional banking industry. A case in point is the supervision of financial conglomerates. This proposal of adopting a cross-sectoral regulatory and supervisory approach for Islamic banks was supported by Professor Datuk Rifaat Ahmed Abdel Karim as early as 2003 at the IMF/World Bank Annual Meetings.

¹⁵ A draft for public consultation was issued at end-October 2014.

¹⁶ In addition to supervisory clarity regarding PSIAs, there is also a need to synchronize legal, tax, *Zakat* and other regulatory statutes so that all stakeholders are informed by comparable financial statements.

¹⁷ The profit equalization reserve (PER) is used to smooth returns and is deducted from the overall profit before its distribution, whereas the Investment Risk Reserve (IRR) is used to protect capital and is taken out of the investor’s share.

Directors be held accountable for enforcing the rights of IAHs. Supervisors should ensure full disclosure and transparency on the performance of assets, payouts, and reserves.¹⁸

Box 3. Capital Requirements for Assets Financed by PSIA: The Alpha Factor

In principle, under the *Mudarabah* contract that typically governs the PSIA, all losses on investments financed by their funds are to be borne by the IAH (unless there is misconduct, negligence, or breach of contract), whereas the profits on such investments are shared between the IAH and the Islamic bank as manager of the investments (*Mudarib*) in the proportions specified in the contract. In practice, however, the management of the Islamic bank may engage in a range of practices that cushion the returns paid to the IAH—thus protecting the cash flows from IAHs funds against variations in the Islamic bank’s income from assets financed by those funds—in order to pay market-related compensation to the IAH.

The recently issued IFSB Capital Adequacy Standard recommends that supervisors assess the extent of risks borne by PSIA, based on management decisions regarding the payout to IAHs, and should reflect these assessments in the computation of capital adequacy. This is referred to as the “supervisory discretion formula” for the CAR, which specifies that a fraction “alpha” of the credit and market risk-weighted assets funded by PSIA may be included in the denominator of the CAR, where the permissible value for “alpha” is subject to supervisory discretion.

$$CAR = \frac{\text{Eligible Capital}}{\{[\text{total risk-weighted assets (credit+market risk) + operational risk}] - [\text{risk-weighted assets [RWAs] funded by restricted profit-sharing investment accounts (credit+market risk)}] - [(1 - \Gamma) * \text{total risk-weighted assets (credit+ market risk) funded by unrestricted profit-sharing investment accounts}] - [\Gamma * \text{risk-weighted assets funded by profit equalization reserve [PER] and investment risk reserve [IRR] of unrestricted profit-sharing investment accounts}]\}}$$

When unrestricted PSIA fully bear their own risks (credit and market) as specified in their *Mudarabah* contract and receive returns equal to the returns on the investments made with their funds, IAHs are treated as investors. In this case, alpha will be zero, and therefore no additional capital requirements are necessary.

At the other extreme, when the Islamic bank pays IAHs the market return regardless of the return on assets, and there is no mitigation of displaced commercial risk by the use of profit equalization reserve (PER), then the PSIA cannot be treated as fully loss-absorbing. In this case, alpha will be set to 1. Therefore, in this case, there will be additional capital requirements to provide the necessary capital buffer.

In practice, alpha can be set anywhere between these two extremes, depending on the supervisor’s assessment of the magnitude of the displaced commercial risk and the risk mitigating factors in place.

Sources: Sunderarajan 2007; and IFSB 2005.

A second specific challenge for IB relates to ensuring Shari’ah compliance. Regulators do not always have the capability (or willingness) to ensure that banks have in place a sound framework for Shari’ah compliance—nor do they take responsibility for assessing whether Shari’ah advisors are fit and proper. Moreover, differences in Shari’ah interpretation can lead to a lack of harmonization both within and across borders, which could affect trust in the industry. The IFSB and AAOIFI recommend the establishment, at the bank level, of an independent Shari’ah Supervisory Board (SSB), a well-resourced internal Shari’ah review process, and periodic external Shari’ah reviews. However, a centralized Shari’ah Board can be advantageous in ensuring consistent approaches, and an

¹⁸ Section 6 of IFSB Guidance Note 3 (Smoothing the profits payout to the investment account holders) provides more details.

increasing number of jurisdictions (Bahrain, Indonesia, Malaysia, Morocco, Nigeria, Oman, Pakistan, and Sudan among others) are moving in this direction. Furthermore, to achieve consistency among Shari'ah committees, other requirements may be necessary; for example, supervisory authorities may adopt measures that would standardize policies across Islamic banks, including the appropriate accounting standards to be followed.

The application of Basel III to Islamic banks will pose special but seemingly surmountable challenges. Islamic banks appear to be already well-capitalized (with high levels of Tier 1 capital that is largely in the form of common equity). A complication, however, remains with regard to the calculation of risk-weighted assets given the variation across jurisdictions in the treatment of PSiAs, which are included in capital according to an alpha factor that varies across jurisdictions. This underscores the importance of efforts to achieve greater consistency of the alpha factor where levels of displaced commercial risk and the RWAs are similar. It is also important to clearly identify the instruments eligible for treatment as additional Tier 1 and Tier 2 capital, including through the adoption of the newly revised IFSB standards on capital adequacy (IFSB-15).¹⁹

Islamic banks tend to hold high levels of liquidity, but they suffer from a lack of well-developed markets for Shari'ah-compliant, high-quality liquid assets (HQLA). This tends to force many Islamic banks to hold a higher share of cash, which affects their profitability. The absence of Shari'ah-compliant deposit insurance may exacerbate the need to hold excess liquidity, such that Islamic banks apply higher run-off factors on deposits and PSiAs, exceeding recommended run-off factors as part of the Basel III LCR requirements. Another way Islamic banks could reduce liquidity risk would be to shorten the length of maturity of their financing, ensuring a better maturity match with their liabilities. The growth and broadening of the Sukuk issuer base (for example, recent issuances by China, Hong Kong SAR, and the United Kingdom) could also help alleviate this problem by increasing the supply of highly rated and tradable Islamic securities, as will the efforts of the International Islamic Liquidity Management Corporation (IILM), which is active in creating short-term, Shari'ah-compliant securities. There is a role for national authorities in helping relieve this liquidity shortage, including by: (i) granting highly rated and tradable Sukuk the status of HQLA; (ii) taking steps to deepen local Sukuk and money markets; and (iii) adopting the LCR framework at a pace that is commensurate with local systemic risks.

The application of risk-based supervision to IB is still not well-developed in many countries. There remains the need in many cases to establish the specific tools needed to supervise Islamic banks, as well as the methodologies to assess their unique risks (including transformation of risk) and vulnerabilities. For example, differences in assessing asset quality, sensitivity to some market risks, heightened operational risks, and Shari'ah governance are not always incorporated in the methodologies for risk-based supervision. Supervisors will need to adapt rating methodologies, such as the CAMELS systems to IB, and implement the IFSB standard on stress testing.

¹⁹ IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes]. IFSB, December 2013. Alpha levels at national or institutional levels could be set by authorities as an outcome of an informed data-gathering exercise that would identify existing alpha levels and displaced commercial risk, rather than simply setting alpha using a supervisory judgment.

There are specific consumer protection issues that can arise for Islamic banks. For instance, some contracts, such as *Ijārah Muntahia Bittamlīk* or “lease-to-purchase”, places consumers at a disadvantage. Clients who default before the end of the contract term could lose the equity that they have built, and they cannot take advantage of capital gains to prepay the mortgage. The complexity of some Islamic bank contracts also renders it difficult for consumers to fully understand the risks. In addition, the corporate structure of the banks, which sometimes maintain subsidiaries to operate sales transactions, creates a conflict between the business interests of the group and the fiduciary responsibilities of the Islamic bank. As a result, IAHs may not get the best returns while still bearing the risk of loss. Therefore, national authorities should develop and implement a consumer protection framework that caters to the specific character of Islamic finance, improves financial literacy, ensures strong oversight of related-parties financing by banks to subsidiaries, and strengthens bankruptcy and insolvency regimes (Lukonga 2015).

There appears to have been limited work done by international standard setters on the specific Anti-Money Laundering and Financing of Terrorism (AML/CFT) risks that may be associated with Islamic finance. However, there is no evidence that Money Laundering and Financing of Terrorism (ML/FT) risks in Islamic finance are materially different than those posed by conventional finance. Moreover, the choice of whether to launder the proceeds of crimes or finance terrorism through conventional or Islamic finance institutions would appear to be dictated by convenience and opportunity rather than by inherent differences between them. Nonetheless, while the risks associated with conventional finance are generally well-identified and understood (albeit to varying degrees) by the relevant national authorities, there may be ML/FT risks that are specific to Islamic finance, including those specifically related to: (i) the complexity of some Islamic finance products; (ii) the nature of the relationship between the institutions and their clients; and (iii) the limited experience in the supervision of Islamic finance, especially in jurisdictions that face multiple risk factors. Therefore, there would be value in the Financial Action Task Force, the Islamic finance standard-setters, and the national regulators working together to seek a greater understanding of the ML/TF risks that may be specific to Islamic finance, including the extent to which current AML/CFT obligations require further adaptation (Kyriakos-Saad, El Khoury, Vasquez and El Murr 2015).

B. Safety Nets and Resolution Frameworks

Although, in principle, conventional resolution tools can be applied to Islamic banks, frameworks that address the particular challenges posed by Islamic finance will need to be developed. Deposit insurance schemes that protect depositors of Islamic banks, development of Shari'ah-compliant emergency liquidity instruments, and resolution frameworks that ensure undertaking swift resolution measures are key policies that need to be put in place to preserve financial stability.

Extending deposit insurance protection to Islamic banks in dual systems presents several challenges (Box 4). These include the treatment and insurability of deposits accepted under profit-sharing contracts; the priority of claims of different types of deposits with Islamic banks; and the role of the deposit insurance fund in resolution. A further issue is that funded Islamic deposit insurance schemes also need to be Shari'ah compliant in their investment policies, but may face difficulties in

meeting this objective given the limited depth of markets for Islamic financial instruments. Likely reflecting these challenges, only two countries have a separate and full-fledged Islamic deposit

Box 4. Islamic Deposit Insurance (IDI)— Challenges

Standards: The IFSB has not adopted a standard or guideline on Shari’ah-compliant deposit insurance. The Islamic Deposit Insurance Group of the International Association of Deposit Insurers (IADI) has addressed several views on this matter and has concluded that Shari’ah compliance is a key challenge for an Islamic Deposit Insurance Scheme (IDIS).¹ Four countries have implemented Shari’ah-compliant deposit insurance schemes, including Bahrain, Indonesia, Malaysia, and Sudan. For example, Sudan uses a *Takaful*-based model whereas Malaysia uses a *Wakalah*-based model.

Governing framework: Although governments could take several alternative approaches to implementing an IDIS (for example, government regulation, Shari’ah contract, or a combination of both), the legal enforceability of each approach would need to be undertaken.

Insurability of Islamic ‘deposits.’ There seems to be a consensus regarding the insurability of *Wadiah* (safe-keeping), or *Qard*, but *Mudharabah* (deposits accepted under profit-sharing contracts) remains problematic.² Jurisdictions are divided on the definition and treatment of PSiAs; some countries provide protection to both unrestricted and restricted PSiA holders, some only provide protection to unrestricted PSiAs, and some do not provide any protection to PSiAs.

Risk-based fees. In jurisdictions that apply risk-based fees for the funding of deposit insurance, the unique risks of IB would need to be quantified, implying the development of requisite analytical capacities and underlying data.

Availability and liquidity of Shari’ah-compliant investments. IDISs need to operate in compliance with Shari’ah rules. In case of an *ex ante*-funded IDIS, the management and investment of funds could become problematic if Islamic instruments are limited. Moreover, to ensure a quick payout to depositors, deposit insurance funds need to be liquefied on short notice, which would mean that IDIS funds would, in turn, need to be invested in liquid instruments.

Coexistence with conventional banking. Several options are available for the governance of IDIS where conventional and Islamic banks coexist: Islamic deposits are covered by either conventional deposit insurance or an IDIS, and the IDIS can be housed either in a separate agency or a single agency that manages both a conventional and IDIS. Each option will have its own governance, legal, and operational implications— in particular where Islamic windows are allowed.

Priority of claims. While under a conventional Deposit Insurance Scheme (DIS) all depositors are ranked equally, this is not necessarily the case under an IDIS. In the case of an IDIS, a distinction could be made, first, between actual deposits (*Wadiah*) and *Qard* on the one hand and PSiAs on the other hand; and second, between restricted and unrestricted PSiAs. This ranking of priority in the case of banking stress could affect the attractiveness of Islamic deposits.

Role in resolution. There is growing support for authorizing a DIS to fund bank resolution. Shari’ah compliance of such resolution activity by DIS is unclear.

¹ See also Arshad, “Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry”, (Kuala Lumpur: Islamic Financial Services Board, 2011).

² Al-Ja’Fari and Walker, “Deposit Insurance in the MENA Region” (Washington: World Bank, 2011).

insurance scheme, and very few countries have a dual deposit insurance scheme with premiums from Islamic banks managed on a Shari’ah-compliant basis.

Liquidity risk is compounded by the lack of Shari’ah-compliant emergency liquidity instruments. The ability to provide emergency liquidity to an illiquid, but solvent, bank against

good collateral is important for financial stability. However, it is even more critical for Islamic banks due to poorly developed Shari’ah-compliant money markets (Song and Oosthuizen 2014). However, according to the IFSB (2014), only 6 out of 24 surveyed jurisdictions have developed a Shari’ah-compliant lender of last resort facility. They have done so using different structures, such as commodity sale with mark-up, profit-and-loss sharing financing, and agency contracts. The key challenges will be to address the shortage of compliant HQLAs and, in some jurisdictions, the lack of regulatory clarity or a Shari’ah governance framework at the level of the Central Bank.²⁰

Effective resolution of Islamic banks in line with international best practices appears feasible, albeit with several challenges. In particular, the use of the sale of business tools (“purchase and assumption”) and the application of bail-in power to an Islamic bank may prove difficult—the latter due to the limited availability of “bail-inable” liabilities. In this context, bail-in does not seem possible with restricted investment accounts and *asset-backed* Sukuk, if these are considered secured liabilities. This is not the case for *asset-based* Sukuk and unrestricted investment accounts, since claims are less obviously secured by specific collateral, thus making bail-in feasible. There is also the risk of conflicting interpretations of Shari’ah principles in case of decentralized Shari’ah boards. Hence, further work on the design of resolution frameworks for Islamic banks is needed, in particular, to clarify the rights and liabilities that IB transactions entail. The roles of the resolution authority and the Shari’ah Board in resolution of Islamic banks also need to be clarified, in particular to: (i) avoid uncertainties regarding the Shari’ah compliance of resolution measures; (ii) promote the stability of the financial system; and (iii) support the effectiveness of the resolution measures. There is also a strong case for developing comprehensive recovery and resolution plans for Islamic banks (Chartouni and Tamez 2015).

C. Access to Finance

Financial inclusion has proven to be linked to desirable economic outcomes. The positive association between financial depth and long-term economic growth is consistently stronger in countries that tend to perform better on financial inclusion. Thus, there may be a cost in foregone economic growth when financial services in a country do not reach a sufficiently large share of the population (Barajas, Chami, and Yousefi 2013).

Thus far, IB has had limited impact on access, particularly when structural determinants and/or other country-specific factors are accounted for. Muslim countries exhibit lower levels of financial inclusion than the rest of the world,²¹ whereas the subgroup of Muslim countries having IB had slightly higher levels (Barajas, Ben Naceur, and Massara 2015). Empirical analysis shows evidence of a positive link of IB only to credit to households and to firms for financing investment. However,

²⁰ One possible HQLA could be based on the standardized master collateralized *Murabahah* agreement (MCMA), developed by the IIFM. This works like a ‘repo’ transaction and should help Islamic financial institutions to manage liquidity and credit risk.

²¹ While the world as a whole averages just less than 12 accounts per 1,000 adults, the Organization of Islamic Cooperation (OIC) countries average about 8¾. On average, about 35 percent of firms worldwide report having a loan or line of credit from a formal financial institution, whereas the average for OIC countries is less than 21 percent. Similarly, the OIC countries’ average depth, at 32 percent of GDP, is 25 percentage points below the world average.

this link remains tentative as it disappears once structural determinants of inclusion are taken into account (Barajas, Ben Naceur, and Massara 2015). This finding is consistent with the lack of differences so far in the banking model between Islamic and conventional institutions.

The implementation of a number of policies, however, could facilitate the role of IB in encouraging financial inclusion. For example, steps could be taken to ensure that risk-weights do not unduly discriminate against PLS financing and taxation against equity-like financing. In addition, steps could also be taken to improve the business model of Islamic banks, for example, through the better understanding and adaptation to their customers' needs and optimization of their operating models (Ernst & Young 2014; IFC 2014). Improvements in the financial infrastructure—including reforms to increase competition, the quality of credit information, consumer protection, and financial education—have also been shown to enhance financial inclusion, regardless of whether Islamic banks are present or not. Moreover, as microfinance²² has shown tremendous potential for financial inclusion in East and South Asia, promoting this segment and strengthening its linkages with IB and capital markets would help further increase access to finance.

V. SUKUK AND MARKETS

The Sukuk market has a number of features that have made it attractive to issuers and investors. These include its ability to: (i) meet the changing and differentiated demands of the modern economy; (ii) develop innovative and cutting edge structures and products; and (iii) achieve such issuances at competitive pricing (Aziz 2014). As a result, the Sukuk market has drawn increasing interest from sovereigns, multilateral institutions, and multinational and national corporations from advanced, emerging, and developing economies to finance investments in a wide range of economic activities and development projects. For the investors, Sukuk offer diversification into multiple asset classes and different techniques used to structure medium to long-term instruments. The sovereign Sukuk are generally the first inroad into Shari'ah-compliant funding in the capital market, enabling the creation of reference prices over time, to which private sector entities can benchmark their fundraising activities. Furthermore, sovereign Sukuk also facilitate liquidity management by central banks.

Sukuk can help close the funding gap for infrastructure, and an increasing share of issuance has been in this area. Many countries are struggling to meet their infrastructure needs, while bank regulation has made banks more selective in their allocation of capital to lending for infrastructure. However, a growing dedicated and globally diversifying investor base is raising demand for Sukuk, thus providing an opportunity to help close the infrastructure gap. Appropriately structured Sukuk have a demonstrated track record in financing infrastructure upgrades. For instance, Malaysia has used Sukuk for airports, marine ports, and roads, and the GCC countries are following suit.

Sukuk can readily be structured for infrastructure financing. They resemble Public-Private Partnership (PPP) financing whereby investors finance the assets, own them—leading to true

²² Microfinance development is also supported by some of the Islamic redistribution mechanisms such as *Zakat* (wealth tax), *Waqf* (charity endowment) and *Qard* (benevolent loans).

securitization—and then transfer them back to the government at maturity. A focus on investment would mean a shift toward new asset-backed securities, and allow for a regular and increased volume of issuance, thereby deepening the market (Shabsigh 2011). A version of such a model could be based on establishing a special purpose vehicle—for example, as an autonomous entity of the government—that would enter into business with government through sales and lease back transactions, depending on the types of assets to be acquired. It could also raise financing from investors through Sukuk *Mudarabah*, which are tradable. These could be issued at different maturities, and would generate returns depending on the performance of the underlying assets.

The risk-sharing aspect of Sukuk gives them a clear advantage as a funding instrument for infrastructure. Nearly all conventional infrastructure projects contain separate equity and debt components, especially during the greenfield phase. This leads to a concentration of risk in the equity tranche, as well as complex contracts. Furthermore, there is limited flexibility to handle unforeseen but common events such as delays in revenue generation. Sukuk are designed from the outset to spread the risk more broadly because all investors share in the same manner. Sukuk can also be used more flexibly over time because payments are tied to underlying returns rather than to fixed schedules.

However it would be important for governments to establish a stronger basis for the development of a local Sukuk market. Regular sovereign issuance at different maturities is critical to deepening the market and establishing a yield (or Sukuk) curve that could provide a benchmark for corporate Sukuk. However, very few governments—or central banks for liquidity management purposes (Bahrain, Malaysia, and Qatar)—have Sukuk issuance programs as part of their public debt management strategy, even, when they are maintaining such programs for conventional instruments. Often-cited constraints to market issuance include: (i) excess fiscal savings in some countries, which limit their interest in issuing debt; (ii) difficulty in transferring the ownership of the underlying assets to the Sukuk holders; and (iii) underdevelopment of the legal and institutional frameworks governing Sukuk. These factors suggest that there is scope for authorities to devise and implement a broader strategy to develop local currency Sukuk markets by improving the underlying infrastructure and stepping up sovereign issuance as part of their debt management plans.

Increased sovereign issuance should be underpinned by sound public financial management (PFM). Of particular importance is the accounting and statistical treatment of Sukuk instruments, which are currently largely overlooked in existing international standards. Such ambiguity can have consequences for the calculation of the fiscal position and/or distort debt sustainability analysis projections. International standards for accounting and statistics on Sukuk need to be developed (for example, by the AAOIFI), and aligned with the existing international standards for accounting and statistics (that is, the International Public Sector Accounting Standards Board [IPSASB] and the *Government Finance Statistics Manual* [GFSM]). In addition, good PFM practice would require clear guidelines for treatment of Sukuk instruments and SPVs in terms of budget planning and execution, and fiscal risks associated with these instruments, in particular changes in the valuation of collateral, which may impact on future budgets. All SPV transactions should be included in the planning and execution phases of the budget process, and the proceeds of Sukuk issuance should be consolidated with other government resources in a common single treasury account. Moreover, the earmarking of the proceeds of Sukuk issues for specific investment projects raises the issue as to how to incorporate these expenditures within the government's aggregate spending envelope and policy decisions (Hurcan, Mansour, and Olden 2015).

Similarly, establishing a robust market infrastructure to support Sukuk issuance will be key to supporting further growth of this instrument. Sukuk are becoming increasingly complex, with sophisticated layering of ownership designed to avoid true securitization, ensure Shari’ah compliance, and achieve tax efficiency. These complexities have outpaced the legal and regulatory frameworks in many jurisdictions, where: (i) trust and securities laws are still nonexistent or incomplete; (ii) bankruptcy and insolvency regimes are insufficiently developed; (iii) taxation systems do not take into account the specificities of Sukuk contracts; (iv) credit assessment tools are insufficiently developed; (v) Shari’ah interpretation may vary in the absence of a centralized board; and (vi) the judiciary system has struggled in the past to deal with some defaults. In addition, the lack of interbank money markets and central bank open market operations affect the liquidity of the market.

Sukuk markets have important implications for investor protection and financial stability.

Sukuk instruments are often complex structured products that involve market risk, underlying asset risk, and regulatory and operational risks. These go beyond the typical credit risk of conventional fixed-income securities. Yet, absent true asset sale or securitization, most Sukuk are rated as senior unsecured debt, linked to the credit risk of the issuers/originators. This can expose investors to counterparty risk, compounded by the lack of tradability of some instruments or the illiquidity of the market. Moreover, Sukuk are exposed to risks stemming from the concentration of the issuer and investor base and the weakness of the regulatory environment. There are also risks stemming from the relative illiquidity of secondary and money markets. Sukuk are also exposed to Shari’ah risk—that is, if the transaction is subsequently found to be noncompliant—and equity risk stemming from partnerships. Therefore, it is important to strengthen bankruptcy and insolvency regimes, develop within and cross-border resolution regimes, and foster consumer/investor literacy.

The growth and cross-border reach of Sukuk markets may push toward commonly acceptable structures. This evolution should be encouraged by efforts to promote securitization, tradable structures, a deepening of secondary and money markets, and centralized Shari’ah Boards for Sukuk markets. Developing rating methodologies that are geared toward Islamic finance and Sukuk could help enhance transparency and efficient pricing. Steps to ensure that Sukuk are eligible for meeting the Basel III capital and liquidity requirements (for both conventional and Islamic banks) could also spur the market for this instrument, which would also be stimulated by continued efforts by global (conventional and Islamic) standard-setters on standards and regulations for Sukuk structures.

VI. MACROECONOMIC POLICIES

A. Monetary Policy and Liquidity Management

Money and interbank markets for Shari’ah-compliant instruments have not yet developed in most countries, in part because of a lack of available instruments. Shari’ah-compliant central bank facilities are also limited, reflecting the difficulty in designing market-based instruments for monetary control and government financing that satisfy the Islamic prohibition on *ex ante* interest payments. This has limited the scope for money market trading and the development of central bank liquidity facilities, both of which are necessary for market-based monetary policy.

Implementing monetary policy in Islamic systems also requires an understanding of the implications of Islamic finance for the monetary transmission mechanism. This will be different

than in conventional systems owing to the prohibition of interest, the shallowness of financial markets in many jurisdictions where Islamic banks operate, and typically higher levels of surplus liquidity. Moreover, in many economies where Islamic banks are reaching systemic importance, monetary policy is geared toward maintaining a fixed exchange rate. Nonetheless, some evidence suggests that central banks can maintain effective control over monetary conditions by adjusting bank liquidity and allowing this to affect the economy through the bank lending channel. However, the effectiveness of this approach is likely to wane as financial markets deepen, which suggests the need to explore the extent to which monetary authorities can also influence Islamic banks' cost of credit by targeting the profit-sharing ratio of Interbank *Mudarabah* transactions.

Monetary policy implementation in dual systems will be particularly complicated. Islamic banks often operate in dual financial systems and, as a result, are influenced, especially at an early stage of development, by conventional monetary conditions and instruments through arbitrage between the conventional and Islamic sectors (El Hamiani 2015). However, this transmission channel may have shortcomings given that Islamic interbank markets are often underdeveloped, limiting the scope for using market-oriented instruments to effect policy. This gap may become more important as the Islamic segment of the system grows in size (Basu and Rodriguez 2015). Moreover, as discussed, the shortage of Shari'ah-compliant HQLAs reduce the collateral available for liquidity management, and may also affect the smooth functioning of the payment systems (Al Hashel 2013).

These issues highlight the importance of developing more effective instruments for monetary policy under Islamic finance. Thus far, central banks have tended to focus on changes in reserve requirements and on open market operations that take the form of government and central bank Sukuk issuances or outright purchases and sales of tradable Sukuk (for example, in Iran, Malaysia, and Sudan). Some central banks have also established standing facilities that utilize collateralized *Murabahah*, or reverse *Murabahah* (*Tawarruq*, which is allowed in some jurisdictions) for liquidity management. Some countries have also tried to develop Islamic interbank collateralized and uncollateralized instruments, mainly in the form of *Murabahah* contracts (in the former case collateralized with commodities). However, the key priorities remain to bolster the supply of Shari'ah-compliant liquidity instruments and sovereign Sukuk, and to work to develop the infrastructure necessary to facilitate a deepening of interbank money markets for Islamic institutions.

B. Macroprudential Policy

Macroprudential policies can play an important role in forestalling the buildup of systemic risk in IB systems. Islamic financial transactions are required to be underpinned by real economic activity. IFIs have conglomerate structures that span a broad range of sectors, including banking, investment companies, real estate and infrastructure development and leasing.²³ These interconnections may heighten the potential for procyclical amplification of risks, especially given that balance sheets of Islamic banks exhibit concentrations in cyclical sectors such as real estate and construction. In Southeast Asia, many Islamic banks are exposed to SMEs across diversified sectors

²³ The technical standard IFSB-16 (Revised Supervisory Review Process Standard) identifies a range of activities that cross supervisory boundaries and therefore require supervisory authorities to assess the risks on a consolidated basis.

using leasing type contracts. This diversification of exposures across sectors can add to financial stability. Some of the Islamic banks are not only systemically important in their domestic market, but have also expanded their cross-border operations, potentially posing contagion risks domestically and regionally. The growing reach and importance of IFIs call for close macroprudential oversight of the sector to better understand the macrofinancial linkages they imply, as well as to ensure that macroprudential instruments can be tailored appropriately.

Most macroprudential instruments would seem applicable to IB, with some modifications.²⁴

The countercyclical capital buffer framework, conservation buffers, leverage ratio, dynamic provisioning, and sectoral risk weights could help in mitigating credit risk. PER and IRR reserves could, in effect, serve as countercyclical reserve buffers (Hussain and others 2015).²⁵ Large exposure and sectoral limits could also be applied to manage concentration risks. Stress testing can also be applied to assess tail risks and vulnerability to credit, market, liquidity, and contagion risks. Financing-to-deposit ratio limits and Basel III liquidity measures, including the LCR and the Net Stable Funding Ratio (NSFR), could be used to mitigate liquidity risks.²⁶ Systematically Important Financial Institutions' capital and liquidity surcharges could mitigate risks arising from the interconnectedness across markets and institutions, based on an assessment of the systemic contribution of each Islamic bank. Tools, such as financing-to-value and financing-to-income ratio limits could also help contain borrowers' repayment risk and banks' exposures to real estate, and could also help limit the risk of asset bubbles/credit booms.

However, Islamic finance presents some unique challenges for the implementation of macroprudential policies that deserve policy attention. The identification and monitoring of systemic risk is particularly challenging for Islamic banks due to different interpretations of and practices for Shari'ah-compliant transactions across jurisdictions, limited availability of data and nonstandard disclosure practices, and cross-country differences in the supervisory and regulatory approach to Islamic banks. The effective application of some of the macroprudential tools (such as the LCR) to manage liquidity risk is challenged by the limited availability of Shari'ah-compliant assets and absence of secondary markets for such assets.²⁷ The different risk-sharing features of IB transactions and a wide array of approaches in the application of capital requirements (for credit risk) also affect measurement and comparability of capital buffers. The prevalence of nonfinancial corporations in the banking groups of some countries makes it difficult to monitor and manage group-wide risks and intra-group exposures. Further, the lack of standardization of Islamic products across jurisdictions and harmonization and coordination of prudential standards erode capacity to

²⁴ Chapter 2 of IFSB-15, especially the sections on countercyclical buffer and leverage ratio, cover issues of macroprudential supervision.

²⁵ Although these reserves may be helpful in mitigating some key risks and losses by the Islamic bank, it would not be able to address Shari'ah noncompliance risks.

²⁶ Financing-to-deposit ratios could be defined to include just *Wadiah*-like deposits or more broadly defined to include PSIAAs as well.

²⁷ The IFSB has produced an Exposure Draft—Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions offering Islamic Financial Services (ED of GN-6). It details risk weights, required stable funding factors and key parameter settings for LCR and NSFR determination, including addressing HQLA for Islamic institutions.

assess cross-border risks. The institutional framework to ensure effective implementation of macroprudential policy is also complicated by fragmentation in the Shari'ah governance structures.

Therefore, the application of macroprudential policy under IB would likely need to take into account the specificities of Islamic finance. In particular, there would be a greater need for a cross-sectoral approach to regulation and supervision, taking account of group and cross-border risks, which could be achieved either with a single regulator or strong coordination between banking, nonbanking, and capital market regulatory authorities. In addition, the design of the institutional frameworks for macroprudential policy should cater to the unique characteristics of Islamic finance, particularly Shari'ah governance. In countries with IB, but no capital markets authorities or securities regulation, the mandate for bank regulators could also be expanded to include conduct of business rules. It would also be important to tailor disclosure and reporting requirements of financial soundness indicators to ensure that they provide an adequate signal of the health of Islamic financial institutions.²⁸ Furthermore, given the difficulties in developing Shari'ah-compliant money markets and instruments, macroprudential policies will need to have a particular emphasis on liquidity risks.

There may be a role for multilateral approaches to establishing macroprudential guidelines for Islamic finance. This could involve collaboration between the IFSB, the IMF, and other relevant parties to adopt internationally accepted principles for macroprudential oversight of Islamic banks, and to harmonize regulations to limit arbitrage across borders, while at the same time ensuring a level playing field with conventional banks.

C. Tax Policy

To level the playing field between conventional and Islamic finance, a number of issues will need to be addressed in the context of domestic and international tax systems. These relate primarily to the treatment of Islamic finance under income taxes, sales taxes (for example, value-added taxes), specific transaction taxes, and bilateral tax treaties. They may arise in the context of intermediation, portfolio investment, brokerage activities, insurance, and so on. Whereas some issues can be easily addressed at the national level, others may require international cooperation.

Among these issues, those arising from differences in the notion of debt and equity between Islamic and conventional finance (and the tax treatment of related returns) stand out.

Conventional tax systems (and in particular corporate income taxes) recognize the return to debt (but not equity) as a deductible cost for income tax purposes. This so-called debt bias can, in principle, disadvantage Islamic finance since Shari'ah does not recognize interest. In practice, however, most modern tax systems can deal with this apparent disadvantage by treating the economic substance of Islamic instruments similarly to conventional instruments. Experience shows that this may or may not require changes to countries' tax legislation. In this context, changes to

²⁸ A special annex in the IMF's forthcoming *Monetary and Financial Statistics Manual and Compilation Guide* provides guidance on the classification of Islamic financial institutions and instruments in the context of compiling monetary statistics.

regulations or application rules may be sufficient to provide transparency and certainty regarding the tax treatment of the main Islamic finance instruments.

Differences in the treatment of Islamic and conventional finance, if unchecked, can create cross-border spillovers and international tax arbitrage opportunities. Multinational enterprises exploit differences in tax systems in many different forms, one of which is to treat a transaction as debt in one country and equity in another. It is important that countries collaborate on minimizing these opportunities, both within existing bilateral tax treaty networks, and perhaps more globally.

The tax implications of certain differences between Islamic and conventional finance are less clear cut. For example, Islamic finance may generate higher transactions costs than conventional finance, especially due to the necessity in some cases to set up additional intermediaries between suppliers and demanders of funds, as well as more complex transaction structures. This means that some Islamic financial instruments can be disadvantaged in the presence of transaction taxes (for example, stamp or similar fees). Although it is possible to mitigate such a disadvantage by ignoring certain elements of a transaction for tax purposes, it is preferable to shift away from distortionary transaction taxes and toward more neutral profit-based taxes—not only for the benefit of Islamic finance, but for financial intermediation in general.

International standards can facilitate tax reforms toward leveling the playing field between Islamic and conventional finance. Accounting and auditing standards for Islamic finance are particularly important, especially for ensuring Shari'ah consistency within and across jurisdictions (Hurcan, Mansour, and Olden 2015).

Annex 1. Key Instruments of Islamic Finance

Term	Description
<i>Ijārah</i> (Lease, lease purchase)	A party leases a particular product for a specific sum and a specific time period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.
<i>Istisna'</i> (Deferred payment, deferred delivery)	A manufacturer (contractor) agrees to produce (build) and to deliver a certain good (or premise) at a given price on a given date in the future. The price does not have to be paid in advance (in contrast to <i>salam</i>). It may be paid in installments or part may be paid in advance with the balance to be paid later on, based on the preferences of the parties.
<i>Mudarabah</i> (Trustee finance contract)	An investment which represents the ownership of units of equal value in the equity of the <i>Mudarabah</i> . The provider of capital supplies the funds needed to finance a project while the entrepreneur offers labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by capital's owner. The liability of the entrepreneur is limited only to his time and effort.
<i>Murabahah</i> (Mark-up financing)	A widely-used sale transaction between customers and banks. The buyer approaches the bank to acquire goods. In turn, the bank purchases them from a third party (a supplier) and then resells them to the borrower at an agreed mark-up for immediate or deferred payment. The seller informs the buyer of the cost of acquiring the specified product and the profit margin is negotiated between them. The total cost is usually paid in installments.
<i>Musharakah</i> (Equity participation)	An investment that represents ownership of partnership equity. The bank enters into an equity partnership agreement (joint venture) with one or more partners to jointly finance an investment project. Profits are distributed according to predetermined ratios, and losses are shared strictly in relation to the respective capital contributions.
<i>Qard</i> (Benevolent loan)	These are zero-return loans that the Qur'an encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
<i>Salam</i> (Prepayment, deferred delivery)	The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date.

<i>Sukuk Al Istithmar</i>	Under a <i>Sukuk Al Istithmar</i> (broadly understood as investment <i>Sukuk</i>), it may be possible to package and sell a pool of <i>ijara contracts</i> (and underlying assets), <i>Murabahah</i> receivables, <i>istisna</i> receivables, as well as equity shares or other <i>Sukuk</i> certificates. Although not universally accepted, <i>Sukuk Al Istithmar</i> can be issued when it is not possible to identify a tangible asset or originator. Holders share returns according to stated ratios and bear losses in proportion to their investment.
<i>Tawarruq</i>	A multi-step transaction heavily used for interbank financing and liquidity management, often based on commodities traded on the London Metal Exchange (LME). The AAOIFI (2006, 525) defines <i>Tawarruq</i> as 'the process of purchasing a commodity for a deferred price determined through <i>Musawama</i> (bargaining) or <i>Murabahah</i> (mark-up sale), and selling it to a third party for a spot price so as to obtain cash. <i>Tawarruq</i> is most disliked by Shari'ah scholars when the borrower sells the commodity back to the original seller. These practices have yet to gain AAOIFI's Shari'ah Board consensus.
<i>Wadi'ah</i> (Demand deposits)	Deposits held at the bank as a trustee for safekeeping purposes. They are guaranteed in capital value, and earn no return.
<i>Wakalah</i> (Agency)	One party (either the bank or client) acts as an agent to the other party to undertake transactions on his behalf. For example, the bank invests funds on behalf of a client or the bank appoints the client as an agent to buy the needed merchandise in a <i>Murabahah</i> transaction.

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