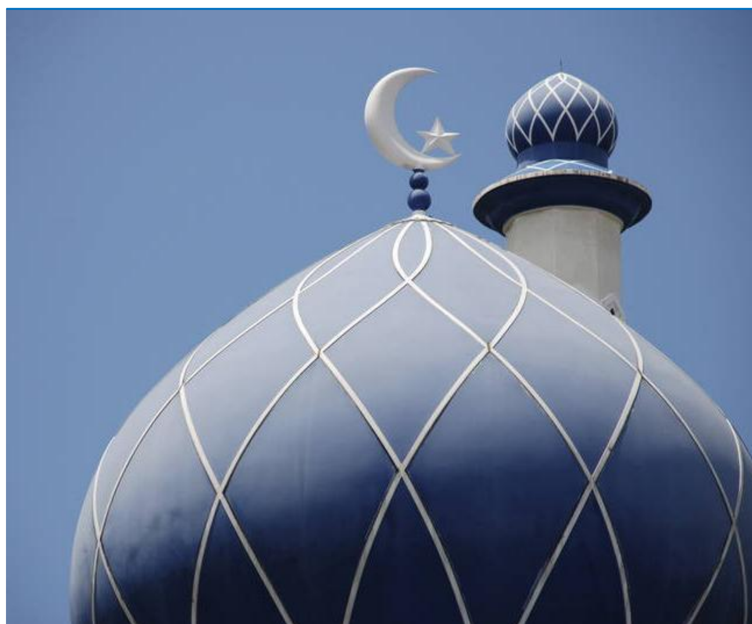
Islamic Finance
in OIC Member Countries



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Islamic Finance in OIC Member Countries

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INTRODUCTION

Islamic finance is emerging as an alternative source of finance in addressing the major development challenges faced by many Organization of Islamic Cooperation (OIC) countries. The global market for Islamic financial services, as measured by the total volume of Shariah compliant assets, is estimated to have reached US$ 1.1 trillion at end-2011. OIC countries, with a collective share of 98% in these assets, continue to be the main actors in the industry's impressive growth story.

Recently, the global financial and economic crisis of 2008-09 has brought to the forefront a wide range of issues concerning the stability and soundness of the conventional financial system. This has prompted an extensive global re-examination by the international community on the adequacy of the existing international economic and financial architecture and the search for a more enduring solution. In the search for a new architecture, there was a general consensus on the need to restore the financial transactions to their basic function – to provide services that add value to the real economy. This, in fact, represents the very essence of Islamic finance, which can be traced back to the Shariah principles. However, concerns remain regarding the compatibility of Islamic financial principles with the conventional performance metrics. Whether socioeconomic goals like sustainability and poverty alleviation can be reconciled with the goals of profitability and market share is strongly challenged. Although certain Islamic products and practices have been lauded for their potential to advance socioeconomic development in OIC member countries, many still argue that the impact of Islamic finance on the development process has primarily been modest. Particularly the development of Islamic financial products has generally been limited to the re-engineering of the conventional products to meet Shariah requirements. All these factors have contributed to Islamic finance's missing the opportunity during the recent financial turmoil to promote itself as a sound alternative to the conventional system, which was then on the brink of collapse. Moreover, the recent crisis has highlighted that the Islamic finance industry remains vulnerable to the similar systemic risks as its conventional counterpart, and its quest for achieving authenticity is still a challenging task.

In the light of these observations, the present report examines the contemporary trends in the Islamic finance industry in the OIC member countries and its inherent potential for developing into a mainstream financing alternative to the conventional interest-based system.

THE RECENT FINANCIAL CRISIS AND ISLAMIC FINANCE

Unprecedented increase in the derivative activity, appetite for excessive risk-taking, disruptive financial innovation and loose regulatory oversight brought the conventional financial system to the brink of collapse in the late 2000s. The surviving financial institutions have lost a significant portion of their market values. Ernst & Young (2009) estimated that respectively the 50 and 56 per cent of the total market capitalization of top 10 largest American and European financial institutions were swept away during the crisis as a result of the quick deterioration in market confidence (Figure 1).[1] The crisis

[1] Change between 1.1.2008 and 13.3.2009 for banks and between 1.6.2007 and 20.11.2008 for insurers.

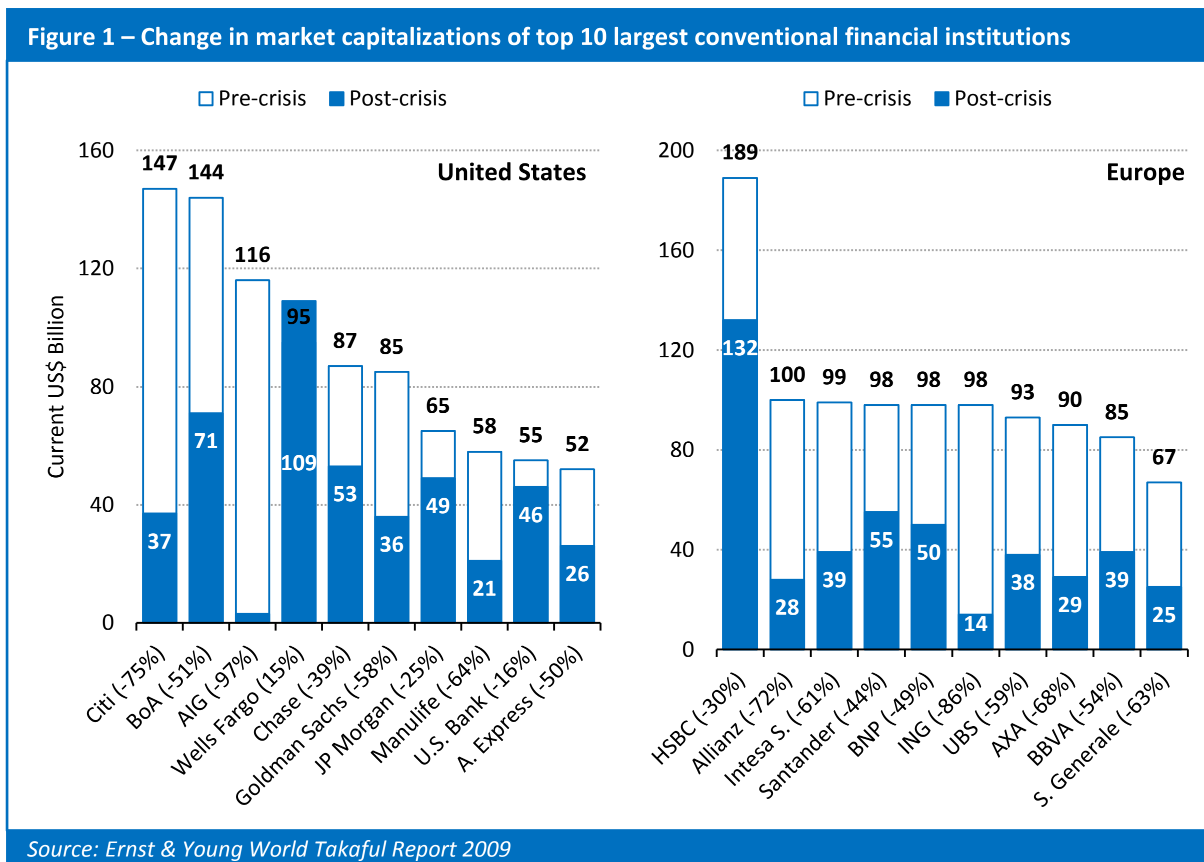


Figure 1 – Change in market capitalizations of top 10 largest conventional financial institutions

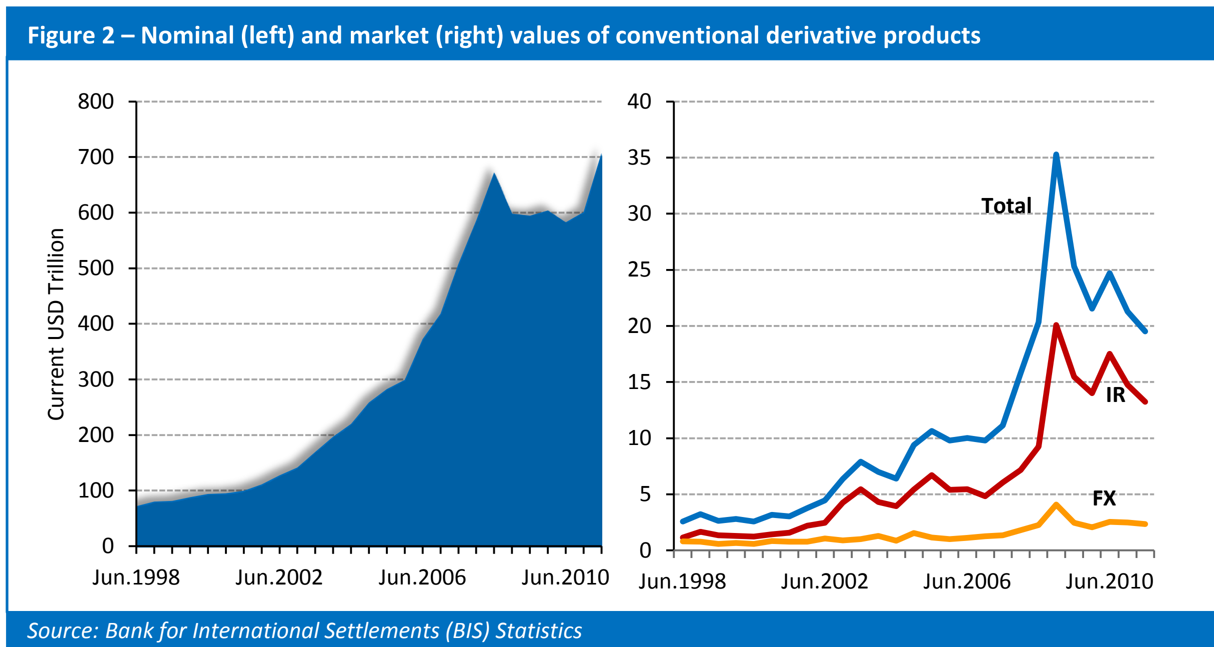
Source: Ernst & Young World Takaful Report 2009

is not over yet and it continues to take its toll on the real economy. The Eurozone countries have seen the crisis quickly spilled over into their economies and are still striving to fix its negative impacts. Opponents of the conventional system, on the other hand, argue that the global financial system has diverged from supporting the real economy, and that it is hardly creating any jobs and real wealth for the society. Supporting their argument, a cursory look at the derivative activity reveals that, the total notional amount of derivatives traded in the global over-the-counter (OTC) markets reached $673 trillion[2] in June 2008 (Figure 2 left), which is around 11 times the total market value of the publicly traded firms[3] and the global output, separately. As far as the total market value of the derivative contracts is considered, the volume of OTC derivatives more than doubled from 2007 to 2008, as a result of a rapid increase from $16 trillion to $35 trillion, with the interest rate (IR) derivatives holding the first place (Figure 2 right). With the break of the global financial crisis, however, the market value of derivatives dropped by $10 trillion in 2009, from $35 trillion to $25 trillion. While the plummeted market value of the derivative contracts has not picked up yet, the nominal value of traded derivatives appears to be back on the mend and the size of the market still goes far beyond that of the global economic activity. Accordingly, another crisis is almost impossible to avoid.

On the other hand, notwithstanding the adverse developments in the conventional financial system, the growth of global Islamic finance assets remained uninterrupted over the past decade. The overall size of the industry increased notably from only $80 billion at the beginning of the last decade to $1.1 trillion at end-2011 (Figure 3). As of 2011, the OIC countries possessed an impressive share of 98% in the Islamic finance assets globally. The exponential trend observed in Figure 3 translates into a

[2] Bank for International Settlements (BIS)
[3] Based on data from World Federation of Exchanges, respectively.

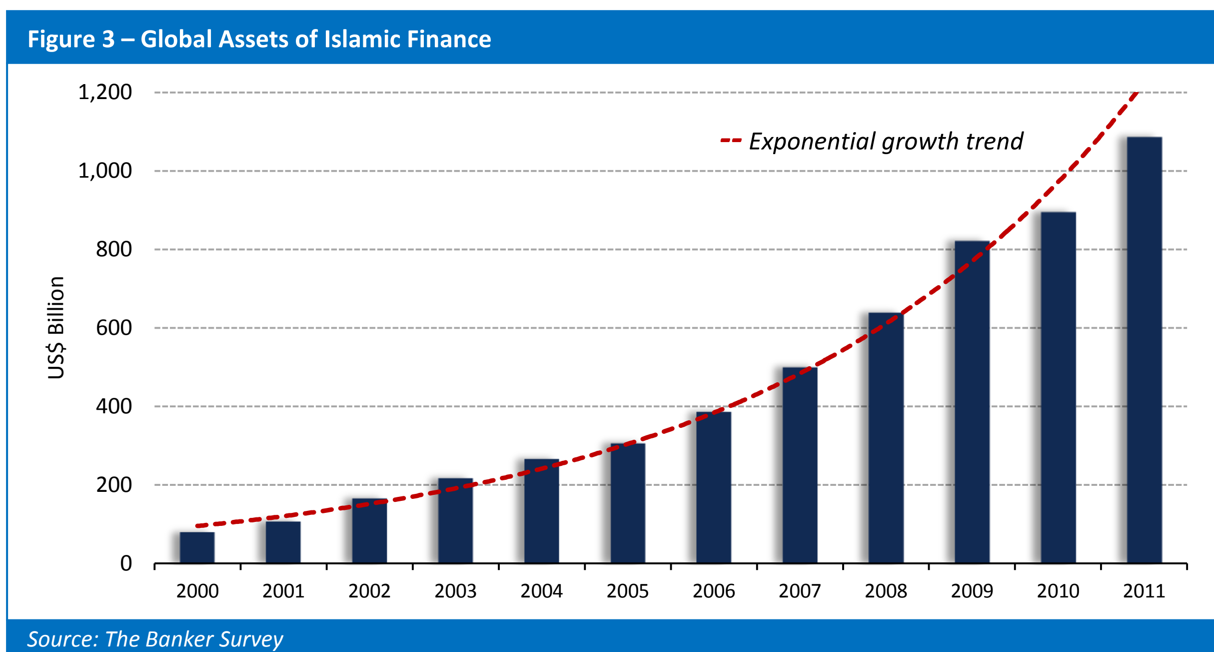
Figure 2 – Nominal (left) and market (right) values of conventional derivative products



Source: Bank for International Settlements (BIS) Statistics

compounded growth rate of 27% for the Islamic finance industry during the period under consideration. The average growth rate for the period 2000-2007 was recorded even higher (30%), however, as the second round negative impacts of the global financial crisis started to be felt on the real economy starting from 2009, the overall performance of Islamic financial institutions, that were mostly involved in asset-based financing activities, was also affected. Despite the slight moderation in the growth pace due to these second round effects, the majority of the many sharia-compliant institutions and their assets have remained unscathed from the direct impact of the financial crisis on the conventional financial institutions. Yet, the phenomenal growth rates have so far translated little into a sound presence in global financial assets: the share of Islamic finance in global financial assets is estimated at around 1%.

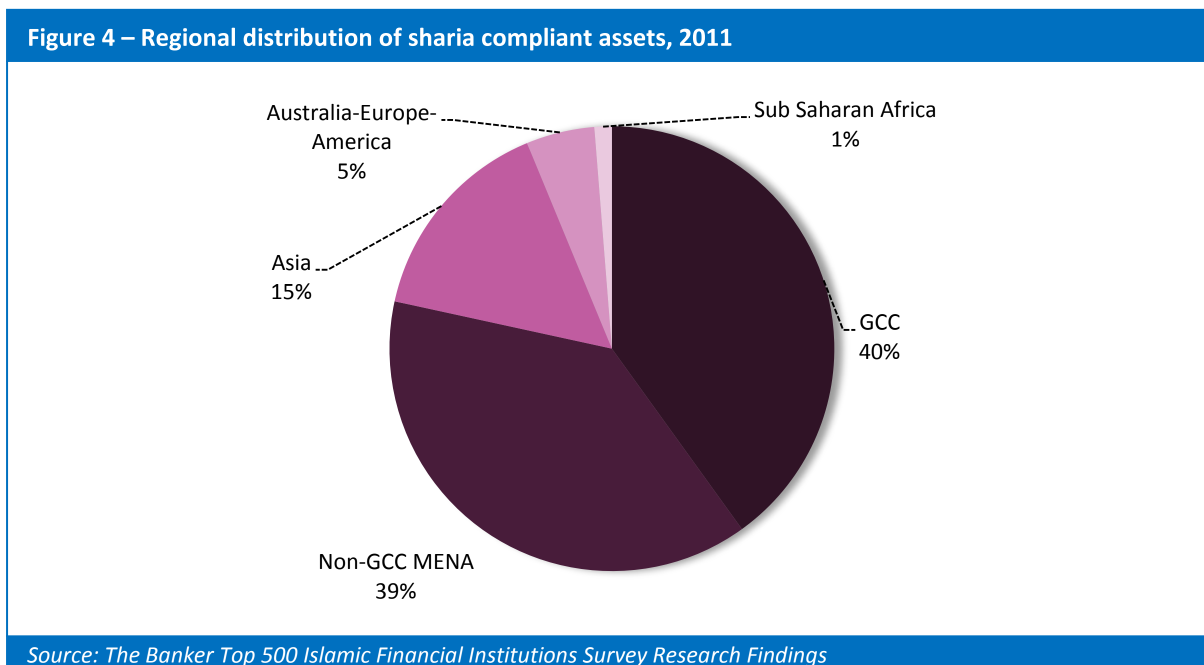
Figure 3 – Global Assets of Islamic Finance



Source: The Banker Survey

OIC countries in the Middle East and North Africa (MENA) region, with a total share of 79% in 2011, are home to the majority of the global Islamic finance assets. The six Gulf Cooperation Council (GCC) countries in the region account for 40% of the $1.1-trillion global Islamic finance industry. In Asia, where the majority of the Muslim population live, the industry is largely underrepresented with a relatively small share of 15%, which, in turn, implies a great potential in the region. Large non-Muslim regions such as Australia, Europe and America hold a collective share of 5% in the global Islamic finance market. On the other hand, the countries in Sub-Saharan Africa (SSA), which face large funding gaps particularly in the area of infrastructure, are missing to tap into the Islamic finance market which is emerging as a new source of funding for large infrastructure development projects.

Figure 4 – Regional distribution of sharia compliant assets, 2011

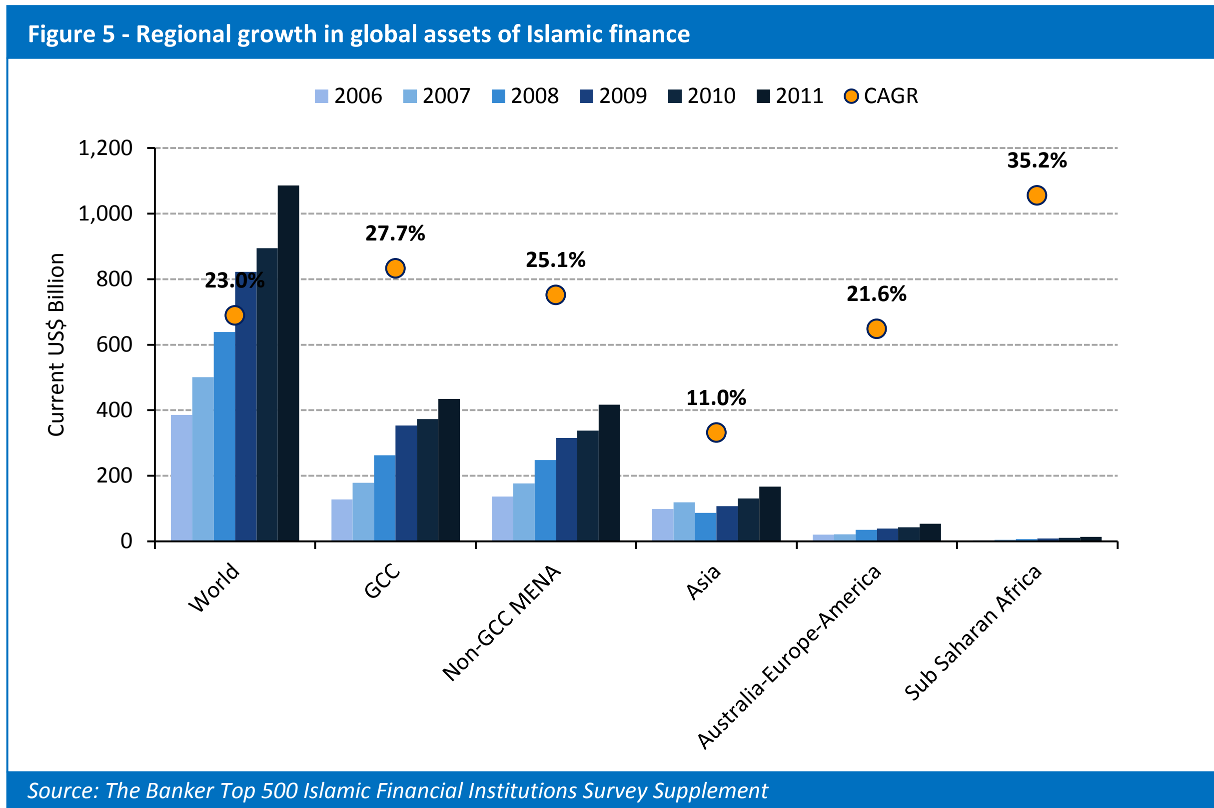


Source: The Banker Top 500 Islamic Financial Institutions Survey Research Findings

In terms of the regional growth, much of the contribution to the growth of the Islamic finance industry again comes from the OIC countries in the MENA region as the industry in the region, which represents almost four-fifth of the global Islamic finance assets, has been expanding at a compounded average growth rate (CAGR) of 26.4% since 2006 (Figure 5). Islamic finance assets in the GCC countries, in particular, have seen an average compounded growth rate of 27.7% over the same period. On the other hand, despite their currently weak presence in the total assets of the industry, non-Muslim regions such as Australia, Europe and Americas are emerging as new centres for Islamic finance. Recording an average growth of 21.6%, Islamic finance assets in these regions have more than doubled during the period 2006-2011, indicating that the Islamic financial services industry is broadening its customer base to non-Muslim regions.

Figure 6 indicates that, at the country level, the largest centres for Islamic finance remain concentrated in Middle East, including Iran, with a share of 35.7% in total Islamic finance assets, Saudi Arabia, 13.9%, United Arab Emirates (UAE), 8.7%, Kuwait, 7.3%, Bahrain, 5.3%, and Qatar, 4.8%, in addition to Malaysia in Asia, with a share of 12.3%. Islamic financial institutions operating in these countries are expected to drive the future growth of the industry and its expansion to new markets. In other OIC member countries in the Middle East such as Turkey, Sudan, Egypt, Jordan and Syria, Islamic finance industry is developing very quickly. In SSA, Nigeria is stepping up the efforts to capitalize on

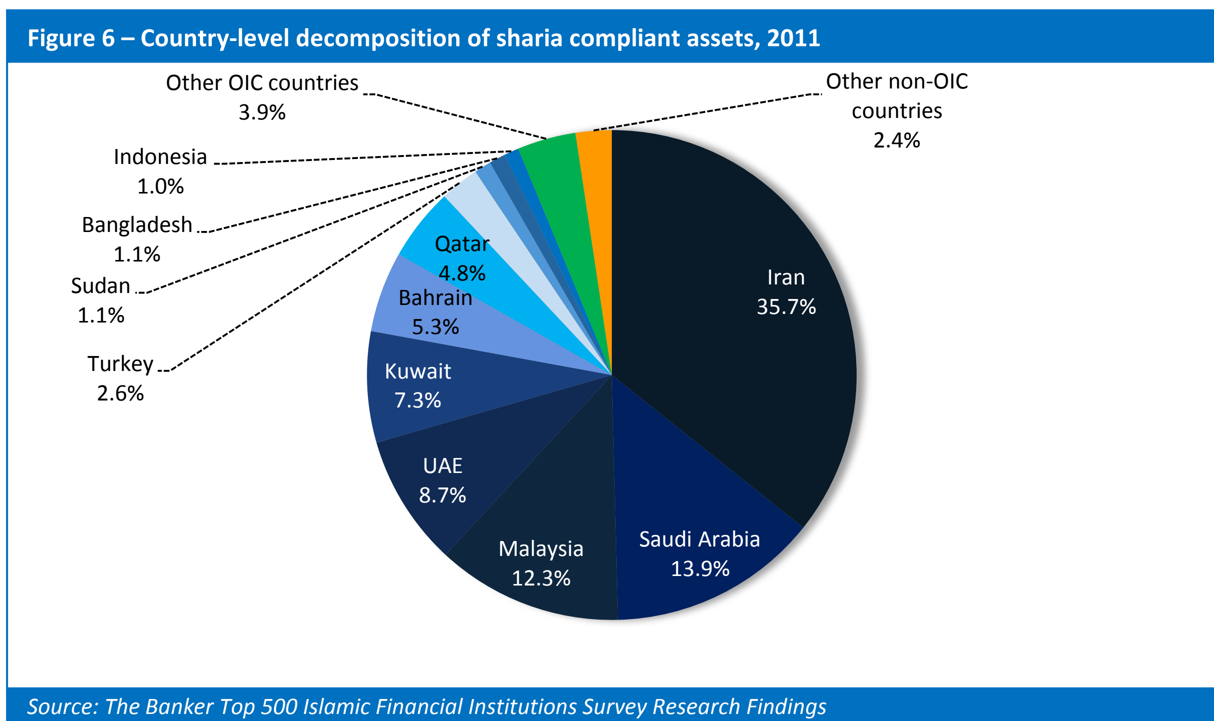
Figure 5 - Regional growth in global assets of Islamic finance



Source: The Banker Top 500 Islamic Financial Institutions Survey Supplement

the Islamic finance industry. Other OIC member countries in Asia such as Indonesia, which has the largest indigenous Muslim population, and Bangladesh each represent around 1% of the global Islamic finance industry.

Figure 6 – Country-level decomposition of sharia compliant assets, 2011

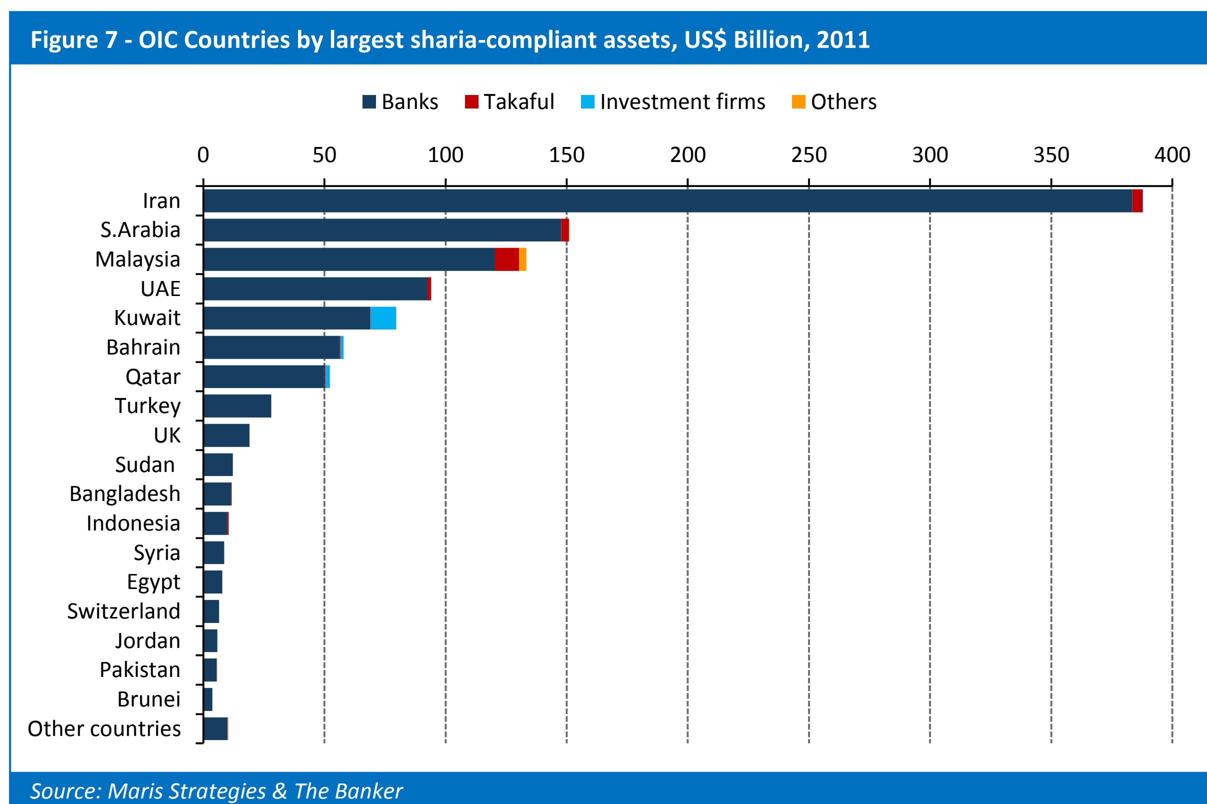


Source: The Banker Top 500 Islamic Financial Institutions Survey Research Findings

Assets of Islamic finance comprise those of Islamic banks, Islamic investment firms, Takaful institutions and others. Figure 7 reveals that, in almost all countries where Islamic financial services

are available, Islamic banking assets represent a predominantly higher share in the overall size of the industry in that country. On the other hand, Takaful has relatively significant presence in countries such as Iran, Malaysia, Saudi Arabia and the UAE. As far as the Islamic investment activity is considered, it is observed that, in Kuwait, Islamic investment firm assets represent an important portion of the industry's assets in that country. In 2011, the overall volume of Islamic finance assets was recorded at $388 billion in Iran, followed by Saudi Arabia ($151 billion), Malaysia ($133 billion), UAE ($94 billion), Kuwait ($80 billion), Bahrain ($58 billion), Qatar ($52 billion) and Turkey ($28 billion).

Figure 7 - OIC Countries by largest sharia-compliant assets, US$ Billion, 2011



Source: Maris Strategies & The Banker

KEY DEVELOPMENTS IN THE ISLAMIC FINANCE INDUSTRY

Since the dawn of this 21st century, Islamic finance has undergone the most dramatic transformation to its landscape. In the current global economic environment of extraordinary challenges and uncertainties, Islamic finance is becoming very much a part of the global financial system, with OIC countries being the main suppliers of Islamic financial services. The last decade in the history of Islamic finance is remarkable for its many significant milestones and for the rapid growth that has been sustained. An important development during the last decade has been the growing significance of the international dimension of Islamic finance and its increased role in the international financial system. Continuing in the same vein, the Islamic finance industry has already witnessed a number of significant developments at the beginning of this decade. A recent report by TheCityUK (2012) identifies the following as significant international developments in the Islamic finance industry in 2011:

Table 1 – Key developments in the Islamic finance industry during 2011	
November 2011	Launch of the world's first Islamic interbank rate, **International Islamic Benchmark Rate (IIBR)**, by Thomson Reuters, Islamic Development Bank (IDB), SESRIC, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), together with a consortium of world's largest Islamic banks.
May 2011	Oman's decision to permit the establishment of Islamic banks in the country – the last of the six GCC states to do so.
February 2011	Qatar's move of preventing conventional banks from offering Shariah compliant products through Islamic windows.

The launch of IIBR was a significant leap towards achieving a fully Islamic capital market and decoupling Islamic finance industry from the conventional system. Since the establishment of the first Islamic commercial bank in 1975, the Islamic finance industry has been searching for an indigenous benchmark that can be used to value a wide spectrum of Islamic financial products ranging from short-term liquidity instruments to long-term investment instruments, such as Sukuk (Islamic securitization). IIBR is expected to fill an important gap by providing the Islamic financial institutions with a reliable alternative to conventional benchmarks such as the London Interbank Offered Rate (LIBOR). Although the IIBR is currently calculated from expected Murabaha returns for Shariah-compliant interbank funding denominated in US dollars, its instrument-neutral nature, as resolved by the IIBR Islamic Benchmark Committee, will no doubt pave the way for further expansion of its rate contribution base into other Islamic finance instruments, such as Mudaraba, Musharaka, Sukuk and Wakala, as these instruments are becoming increasingly widespread.

On the other hand, Oman, with its decision in May 2011 to permit new start-ups by Islamic banks in the country, aimed to tap into the regional demand for Shariah compliant financial services currently being met in other countries in the region, thereby curtailing the current outflow of Islamic investments from the country.

In Qatar, the boundary imposed on the conventional banks is expected to provide opportunities for fully Islamic banks and encourage new conversions to Islamic banking.

CHALLENGES AND PROSPECTS FOR ISLAMIC FINANCE

While Islamic financial institutions have successfully qualified the robustness test by exhibiting greater resilience during the recent global financial crisis, the crisis have also brought under the spotlight some important challenges the industry is currently facing. Going forward, the stakeholders of Islamic finance in OIC countries, and in the global arena at large, will need to address a broad spectrum of issues surrounding the industry. Although these challenges will take time and effort to overcome, none of them appears to be insurmountable.

Muslims make up roughly one-fourth of the world's population and OIC countries are spread over four continents. The penetration level of Islamic finance varies substantially across the member

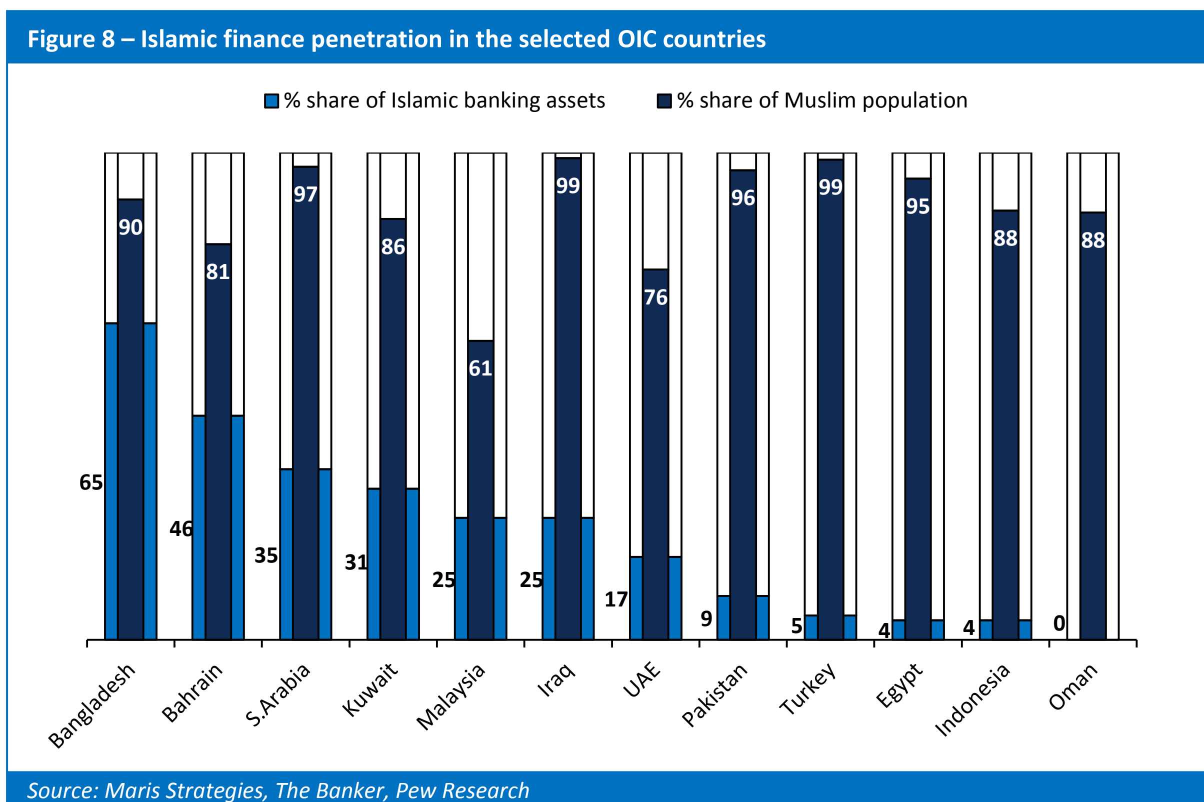


Figure 8 – Islamic finance penetration in the selected OIC countries

Source: Maris Strategies, The Banker, Pew Research

countries. Excluding two OIC member countries, namely Iran and Sudan, where the financial systems are acclaimed to be fully Islamic, Figure 8 illustrates the penetration levels for Islamic banking services in the selected member countries as well as the share of Muslim population in the total population of these countries. In Bangladesh, where the penetration of Islamic finance is highest, the industry accounts for 65% of total banking assets; in Bahrain, for 46%; and, in Saudi Arabia, for 35%. However, in other member countries such as Pakistan, Turkey, Egypt and Indonesia with large Muslim populations (approx. 540 million in total), penetration of Islamic banking is limited to the 4-5% of total banking assets. Apparently, the low with penetration rates vis-à-vis high Muslim concentrations in many OIC countries indicate that there is plenty of room to sustain the recent rapid growth of the Islamic finance industry by reaching more Muslim customers who either remain unbanked due to their religious sensitivities or have no choice but to use conventional financial services to meet their financing needs.

Yet, in many OIC countries, economic development is constrained by a lack of access to finance. Based on data from CGAP Financial Access 2009 Survey, Oliver Wyman (2011) reports that

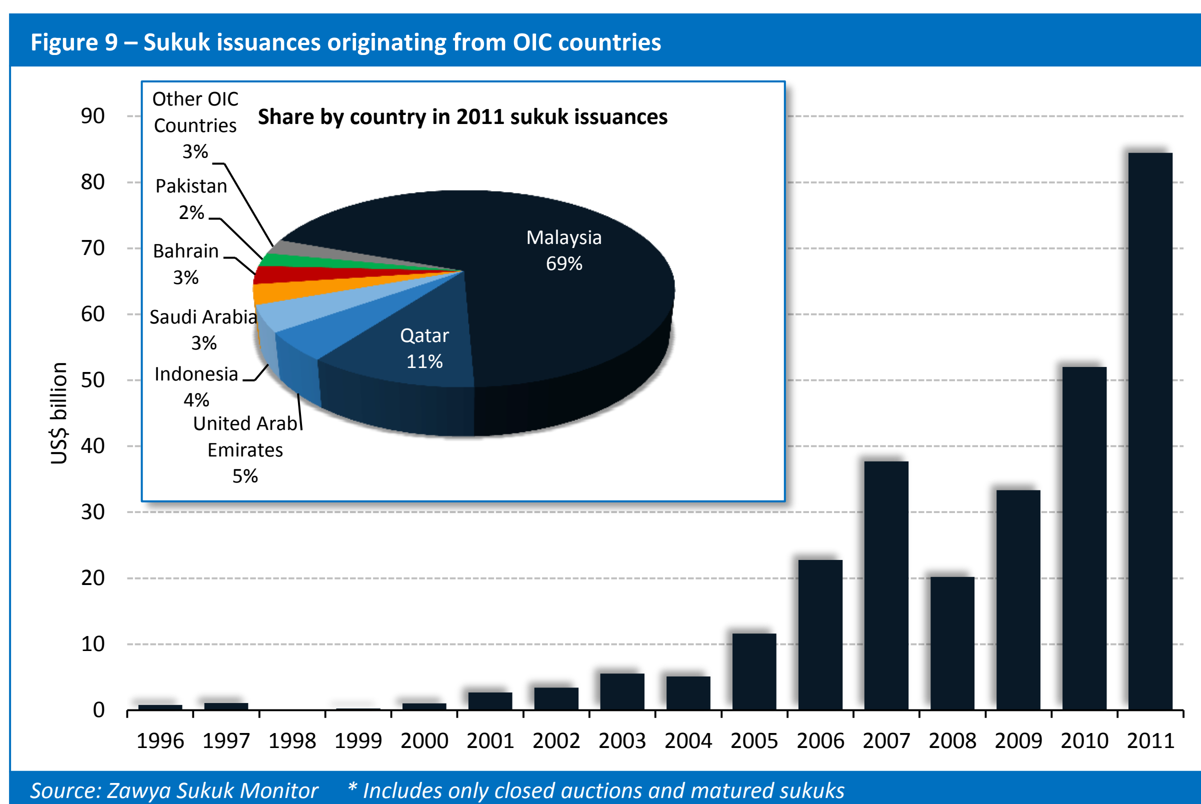
- An estimated that 70% of Muslims have no access to basic financial services;
- Only 28% of the adult population in OIC member countries uses formal financial intermediaries;
- Less than 50% of adults in OIC countries in Sub-Saharan Africa have a deposit account. In developed countries the number of accounts exceeds the number of people by far.

Supporting these findings, the present study also finds that OIC countries have on average 5 physical bank branches per 100,000 adults, while this number is around 10 in other developing countries and 40 in developed countries in the same year (CGAP Financial Access 2010 Survey). The gap in ‘access

to finance' in the Muslim world, in turn, creates attractive opportunities for the Islamic finance industry with positive development effects.

On the other hand, the recent global financial crisis coincided with the growing concerns over the possibility that excessive financial innovation might lead the Islamic finance products to bend certain key precepts of Muslim jurisprudence to breaking point. Perhaps the most prominent example is the Sukuk – sometimes even called the "Islamic bond" – as many Islamic Sukuks have gone too far in mimicking conventional, interest-bearing bonds, which are prohibited in Islam. Over the past fifteen years, the volume of annual Sukuk issuances has increased substantially. Notably, the total annual volume of Sukuk issuances in the OIC member countries increased to US $84.5 billion in 2011,

Figure 9 – Sukuk issuances originating from OIC countries



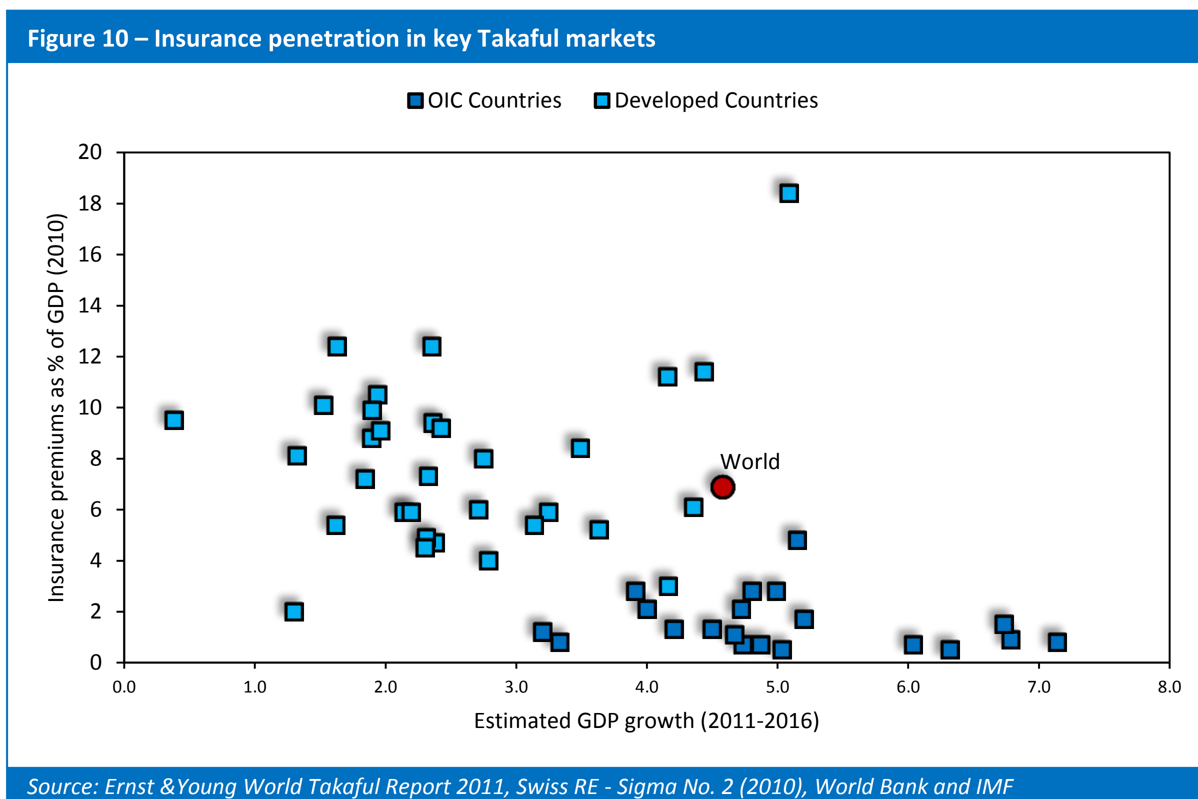
Source: Zawya Sukuk Monitor ** Includes only closed auctions and matured sukuks*

recording an exponential growth history since the beginning of the decade (Figure 9). However, as compared to the enormous amounts of financing that is needed in the area of infrastructure development in the OIC countries, the Sukuk market is essentially a nascent market and needs to be further developed. Compounding the "form-over-substance" arguments, the majority of the Sukuk issuances, be it corporate or sovereign, have so far concentrated more on raising finance for balance sheet purposes than on addressing funding needs of large infrastructure projects with positive developmental impacts.

Furthermore, the low penetration levels of Takaful (Islamic insurance) in OIC countries are posing another challenge for the Islamic finance industry. OIC member countries as key Takaful markets are characterized by low insurance penetration rates versus huge potential for rapid economic growth in the future (Figure 10). This explains to a large extent why the global market for Takaful remains at an early stage of development. Global Takaful premiums are estimated by Ernst & Young (2011b) to

have reached $16.5 billion in 2011. Moreover, Takaful premiums remain highly concentrated in Iran which generated almost 30% of the global Takaful premiums in 2011. The global Takaful market is expected to reach $25 billion by the end of 2015. Similar to the relative size of Islamic finance to the global financial industry, the Takaful market represents only 1% of the global insurance market at present (Ernst & Young 2011c). Issues such as customer reach and cost competitiveness are yet to be addressed.

Figure 10 – Insurance penetration in key Takaful markets

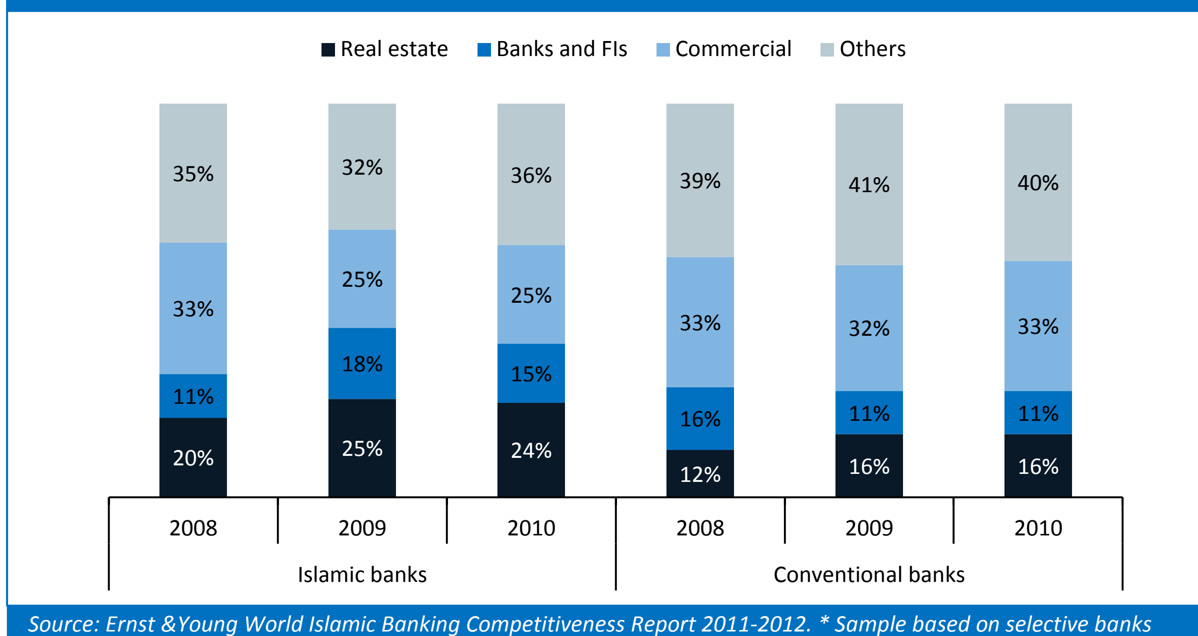


Source: Ernst &Young World Takaful Report 2011, Swiss RE - Sigma No. 2 (2010), World Bank and IMF

Since there is little room for diversification of assets, the risk management capabilities of the Islamic financial institutions are limited. A direct consequence of this was observed in the last financial crisis when large exposure to real estate of Islamic financial institutions resulted in falling asset values in many of these institutions operating in the OIC member countries, particularly in the MENA region. A study by Ernst & Young (2011) reveals that the real estate concentration still remains a concern for Islamic finance industry and may affect its future growth (Figure 11).

Another major impediment to the growth of Islamic finance industry is the weak Islamic finance enabling infrastructure in many OIC countries, as shown in Figure 12. Enabling infrastructure would include, among others, legislative, regulatory, legal, accounting, tax, human capital, and Shariah business frameworks. Although member countries such as Bahrain, Malaysia and UAE are among the major Islamic finance centres with their developed infrastructures, in many others, particularly those in the Africa region, an enabling environment is not in place. This, in turn, increases the operational risks, including the risk of Shariah compliance, and creates a negative incentive for Islamic financial institutions and Islamic windows of large international financial institutions to offer Islamic financial services in these countries.

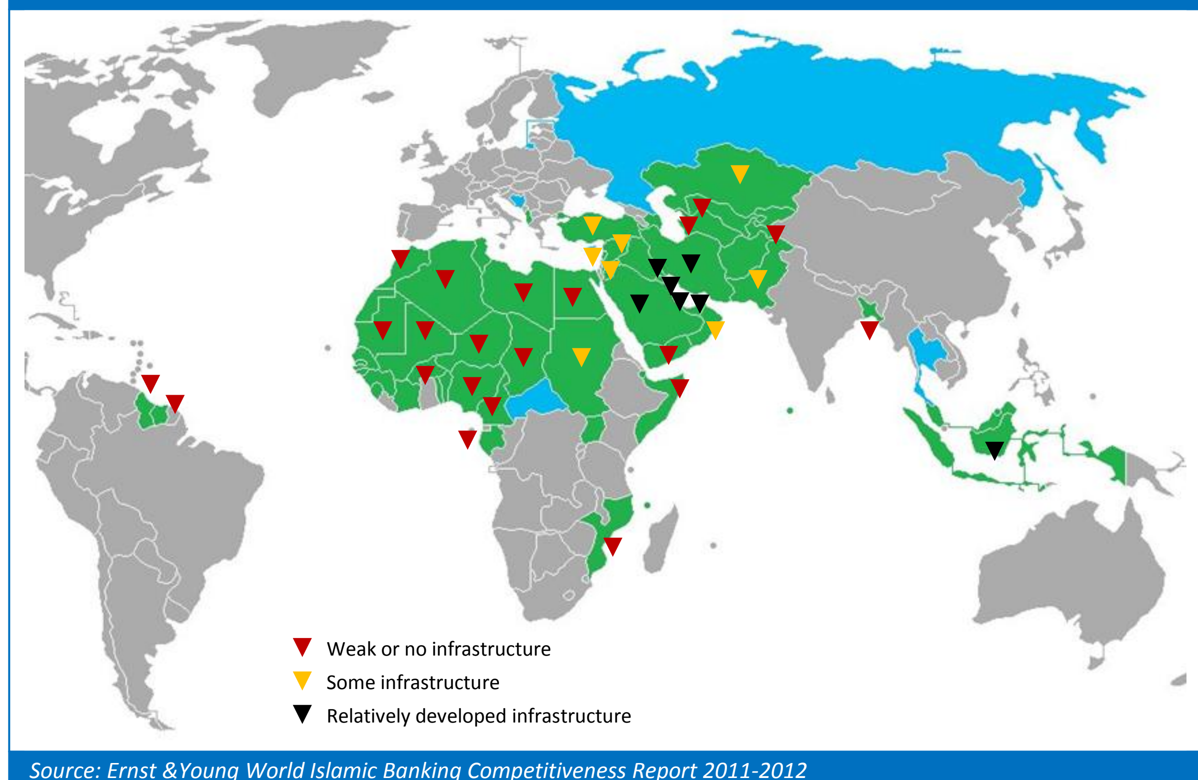
Figure 11 – Concentration of assets in Islamic and conventional banks*



*Source: Ernst &Young World Islamic Banking Competitiveness Report 2011-2012. * Sample based on selective banks*

Development of Islamic money and capital markets, provision of standardized liquidity management tools, improvement of the operational efficiencies of Islamic financial institutions, standardization in products, synchronization of regulatory frameworks, and human capital accumulation are other areas where the Islamic finance industry needs to take structural steps. So far, the geographic reach of Islamic finance standard setting institutions has been limited while enforceability of their standards

Figure 12 – Islamic finance infrastructure in OIC member countries



Source: Ernst &Young World Islamic Banking Competitiveness Report 2011-2012

remains a challenge. The broadening of the global skills base in Islamic finance, on the other hand, is desirable since the number of qualified practitioners, as well as Shariah scholars available for Shariah boards, is currently very low. Representation of Shariah scholars on Shariah boards is highly concentrated. Indeed, a survey by Funds@Work (2011) reveals that only the top 20 Shariah scholars hold 619 board positions which represent more than half of the 1,141 positions available.

Despite the formidable challenges remain, the Islamic finance industry has its own inherent strengths – at both supply and demand sides – that derive from the core values of Islam. These inherent strengths, if employed in true spirit, are expected to drive the future growth of the industry.

Notably, the recent and past surveys suggest that, if given the choice, a significant portion of Muslims would opt for Islamic finance alternatives. Some of these surveys are reported in Table 2 with their respective outcomes. In Palestine, for example, the majority of the low-income households reportedly prefer Islamic financial services over their conventional counterparts, with half of these households having indicated that they would continue to prefer Islamic financial products even if they are required to incur higher costs for these products.

Table 2 – Preference for Islamic finance in the Muslim world

Country	Survey (Year)	Result
Algeria	Frankfurt School of Finance and Management (Bankacademie International) (2006)	A study revealed that 20.7% of microenterprise owners do not apply for loans primarily because of religious reasons.
Indonesia	Bank Indonesia (2000)	In East Java, 49% of the rural population considers interest prohibited and would prefer to bank with Sharia-compliant financial institutions.
Jordan	IFC and FINCA (2006)	Studies show that 25% and 32%, respectively, of those interviewed cite religious reasons for not seeking conventional loans. The study also showed that 18.6% of those interviewed rank religious reasons as the single most important factor in their decision on obtaining a loan.
Lebanon	Hamze (2001)	The success in outreach of Islamic programs relative to conventional microfinance institutions strongly suggests that large numbers of poor people prefer Islamic finance. In addition, microfinance practitioners report that many of the poor refuse financial services unless they are Sharia-compliant.
Palestine	PlaNet Finance (2007)	More than 60% of low-income survey respondents claim a preference for Islamic products over conventional products. More than half of such respondents prefer such products even if they come at a higher price.

Table 2 – Continued		
Syria	IFC (2007)	Survey revealed that 43% of respondents considered religious reasons to be the largest obstacle to obtaining microcredit. In addition, 46 percent of respondents who had never applied for a loan stated that religious reasons were the primary reason they had never applied. Nearly 5 percent of current borrowers said they would not apply for another loan for religious reasons
Yemen	National Microfinance Foundation	An estimated 40% of the poor demand Islamic financial services, regardless of price
Afghanistan, Indonesia, Syria, and Yemen	FINCA (Afghanistan), German Technical Cooperation (Indonesia), Sanadiq in Jabal-al-Hoss (Syria), Social Fund for Sustainable Development (Yemen), and Hodeidah Microfinance Program (Yemen)	Microfinance practitioners (please see left) indicate That in these countries some conventional microborrowers tend to switch over once Islamic products become available (CGAP, 2008).

Furthermore, the Islamic finance industry has already successfully weathered the global financial crisis, turbulence in Europe, and the challenges introduced by the recent political unrest prevailing in some of the member countries. The financial crisis of late 2000s provided us with a natural experiment to evaluate the resilience of Islamic finance industry. There is now growing evidence that the Islamic finance institutions were more stable before, during and after the last financial crisis. Most notably, an recent empirical study by International Monetary Fund (IMF) (Working Paper No: WP/10/201), capturing 80% of the global Islamic finance industry in assets, concludes that although the average profitability of Islamic banks were similar to that of conventional banks in the crisis period, the profits of Islamic banks' were more stable while their asset and credit growth rates were at least twice higher than that of their conventional counterparts and external ratings generally favourable. The stability and resilience arguments were indeed previously echoed by a number of OIC Central Banks governors, including Zeti Akhtar Aziz of the Central Bank of Malaysia and Durmus Yilmaz of the Central Bank of Turkey. They essentially argued that the inherent strengths of Islamic finance, including the close link between financial transactions and productive capital flows, the built-in dimensions of governance and risk management, limitations on excessive leverage and disruptive financial innovation, had contributed to its viability and resilience.

On the other hand, some others like Chapra (2009) and Saddy (2009) argue that claims of adherence to Islamic principles by Islamic financial institutions are not borne out by the facts and, as a result, they were not immune to the direct (primary) impacts of the last crisis. According to them, some Islamic financial institutions have not only relied on leverage and undertaken significant risks, but also

funded western corporations, some of which have risky profiles and low credit ratings, without conducting the needed due diligence. A third group, including The Economist (2009), El-Said and Ziemba (2009), and Ali (2011), while agreeing that Islamic banks have avoided direct exposure to toxic subprime assets, stress that they were subject to the second round effects of the global crisis due to the fact that many Islamic banking contracts were backed by real estate and property, both of which experienced a downturn during the crisis.

All in all, with the challenges ahead, the growth of Islamic finance, free from interest and subject to high moral codes, would be slow in the long-run. And the slow growth of the industry would also slow down economic growth and wealth creation. However, the wealth created would be real, more equitably and profitably distributed, and would encourage spin-offs into real economy, creating jobs, increasing trade both domestically and internationally.

CONCLUDING REMARKS

As one of the fastest growing segments in global financial services industry, Islamic finance has become systemically important in many OIC countries and too big to ignore in some others. While conventional intermediation is to a large extent debt-based and allows for the transfer of risk, Islamic intermediation, in contrast, is asset-based, and centres on the sharing of risk between the depositor, bank, and the entrepreneur. Although these characteristics leave Islamic financial institutions with additional operational burdens, these features make their activities more closely related to the real economic activity and tend to reduce their contribution to financial anomalies, such as excessive risk-taking and speculation on prices.

While the global crisis gave Islamic financial institutions an opportunity to prove their inherent stability and resilience characteristics, it also highlighted the urgent need to address important challenges. Building a well-functioning Islamic finance infrastructure is imperative for providing the industry with a level playing field. Moreover, regulators and standard-setters in OIC countries should ensure that the supervisory and legal infrastructure for Islamic finance remain relevant to the rapidly changing Islamic financial landscape and global developments. Infrastructure development efforts should interface with the global financial reform agenda.

Furthermore, greater convergence and harmonization of regulations and products among the member countries is needed to facilitate an efficient and sustainable growth of the industry. Synchronisation of policies and actions across different jurisdictions and markets in the group of OIC countries is a major task, and therefore, a broad-based and constructive strategic platform to build cross-border consensus is necessary. This is also important for the promotion of financial stability within the Islamic financial system

As the demand for financing for infrastructure projects will be strong in OIC countries, particularly in GCC countries and those in the Africa region, Islamic financial institutions should look closer into the opportunities in the field of infrastructure by promoting appropriate Islamic instruments, such as Sukuk, innovating new products, and cooperating with the regional and international development organizations.

Developing the industry and improving its competition skills will require, inter alia, the establishment of large, well-managed, and operationally efficient Islamic financial institutions that can compete in the global arena; better accounting, auditing and disclosure standards; development of a macro-prudential surveillance framework; improvement of rating process and transparency; as well as capacity building.

Above all, addressing these challenges will require that the stakeholders of Islamic finance in the OIC countries conjoin their efforts in developing the needed human capital and broadening the skills base of the industry.

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