CIBAFI

General Council for Islamic Banks and Financial Institutions

GLOBAL ISLAMIC BANKERS' SURVEY

Risk Perception, Growth Drivers, and Beyond

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General Council for Islamic Banks And Financial Institutions

CIBAFI

المجلس العام للبنوك والمؤسسات المالية الإسلامية

About The General Council For Islamic Banks And Financial Institutions (CIBAFI)

The General Council for Islamic Banks and Financial Institutions (CIBAFI) is a not-for-profit organisation that represents the interests of Islamic financial institutions worldwide. Founded in May 2001 in the Kingdom of Bahrain by the Islamic Development Bank (IDB) and a number of leading Islamic Financial Institutions, CIBAFI is recognised as a key institution within the international architecture of Islamic finance. CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC).

CIBAFI was established with the objectives of developing the Islamic Financial Services Industry (IFSI) and promoting the industry in various fields through policy and regulatory advocacy, research and publication, information sharing, raising of awareness of the IFSI, and the development of human capital.

Contents

Statement by the Secretary General

I am delighted to present CIBAFI's inaugural Global Islamic Bankers' Survey. As the voice of the Islamic finance industry and its advocate, we feel that it is important that we 'take the pulse' of our industry and report on its health, on its feelings and on its concerns and aspirations for the future.

That is why, in April 2015, we sent a detailed questionnaire to our member banks and others. We asked them how optimistic they were about the future; we asked them to identify the greatest risks they are facing; we asked them to tell us how they are approaching some specific aspects of Islamic financing activities; and we asked them to tell us how they are addressing – and overcoming – the challenges that they face.

The result surpassed our hopes. Eighty three institutions, from 35 countries, responded. Of course, we received responses from the heartlands of Islamic finance – the GCC, East and Central Asia – but we also received detailed responses from Islamic banks in sub-Saharan Africa (many grappling with legal systems and regulations which barely acknowledge their existence), from Central Asia (one of the most exciting areas of Islamic banking growth) and from Europe and the US (where Islamic banks often operate in overwhelmingly secular societies containing small Muslim minorities).

The results of our Survey can genuinely claim to be representative of Islamic banks worldwide. The results show that our industry is in good health and is optimistic for the future. Islamic bankers believe that conditions in their markets will improve in the years ahead, that prospects for Islamic banking are good, and that they will be able to outperform their conventional counterparts. Our bankers attach importance to creating value for their shareholders, but they also know how important it is to meet the expectations of their customers. They are concerned that the 'talent pool' within the Islamic banking industry is not expanding fast enough. Islamic bankers recognise the importance to the industry of equity-based financing, of profit and loss sharing investment accounts, and of serving the needs of micro, small and medium sized enterprises (MSME), but they also point to real challenges that they face in serving those sectors.

I believe that this inaugural Survey does much more than 'take the pulse' of our industry. It also highlights the things that we need to do to make it stronger. We need to identify our competitive advantages – and disadvantages – vis-à-vis our conventional counterparts; we need to do more work on 'Islamic bank risk management'; we need to develop new financial products; and we need to strengthen the laws and regulations that underpin Islamic finance in our 'frontier' markets.

The Secretariat is very proud of this inaugural Survey, and I offer my thanks to all those institutions that have contributed to it and made it possible. But this is only a beginning. Next year we will compare the health of the industry as it is then to its health as it is today, and from there we will start to make judgements about whether we are heading in the right direction. Over time, I hope to expand the scope of our Survey to include the views of Takaful companies and of those involved in Shariah-compliant capital markets. I welcome your comments on this Survey. Though I am proud of it, I know we can make it better. Your comments and suggestions will enable us to improve it in the years ahead.

Abdelilah Belatik
Secretary General

Acknowledgement

"The Global Islamic Bankers' Survey" is published as part of the second strategic objective under CIBAFI Strategic Plan 2015 – 2018. The objectives of the report are to monitor Islamic bankers' perspectives towards the Islamic financial services industry on the year-by-year basis, and provide annual recommendations that are of high relevance to the industry's needs.

The Secretariat would like to express its gratitude to members and non-members banks from various countries who responded to the survey.

We are also grateful to those who have contributed in making the publication a success. In this regard, we would like to extend our special thanks to Dr. Ginanjar Dewandaru, Saad Bakkali and Aziza Yarlaeva from CIBAFI Secretariat, Ken Dorph and Andrew Cunningham CIBAFI consultants, for their contribution and reviews throughout the various stages of this publication until final completion. The publication and survey also benefited from the deep review and comments of Peter Casey, CIBAFI consultant as well as Abdulrazzak M. Elkhraijy from the National Commercial Bank, Peter Szalay from Al Baraka Banking Group, Mahsuri Mustaffa from RHB Group, Jamshaid Anwar Chattha from Central Bank of Kuwait, Samir Safa from Misys, Dr. Adam Ng from INCEIF and Mushtak Parker.

CIBAFI would also like to express its appreciation to the Islamic Development Bank (IDB) for its financial support in developing this report.

It is hoped that this Publication will provide deep insights to the stakeholders of the global Islamic finance industry, with respect to various issues, challenges, and opportunities, facing Islamic banks across jurisdictions to encourage the advancement of the Islamic finance industry.

Abdelilah Belatik
Secretary General
CIBAFI

CIBAFI'S INAUGURAL GLOBAL ISLAMIC BANKERS' SURVEY

CIBAFI's Inaugural Global Islamic Bankers' Survey

CIBAFI's Global Islamic Bankers' Survey expressed the views of 83 Heads of Islamic banks from 35 different countries. The survey asked about the current state of the Islamic banking industry, the challenges that it is facing and its prospects for the future. It is the first global survey of Islamic bankers' views and we hope that it will make a positive contribution to the Islamic financial industry.

CIBAFI's Global Islamic Bankers' Survey shows how the Islamic banking industry views the current state of its development, its prospects for the future, the risks that it is facing and its core values. This inaugural industry survey reflects the views of 83 Heads of Islamic banks from 35 countries, stretching from the United States to Indonesia.

Specifically, the annual survey measures three aspects of how the industry sees itself:
1. The level of confidence that the industry feels about its future;
2. The key risks that the industry believes it is facing; and
3. The factors that the industry believes will drive growth or may impede it in the future.

The Survey also sought the views of Islamic bankers on three aspects of Islamic finance that are widely considered to be among its core activities: the provision of equity finance; the offering of profit sharing investment accounts (PSIA); and the financing of micro, small and medium sized enterprises (MSME).

Among the Islamic banks that responded to the CIBAFI survey, two thirds were full-fledged Islamic banks, while the remainder were either subsidiaries of conventional banks or were organised as windows of conventional banks. Half of the respondents described themselves as retail and wholesale banks, while one third of the other half described themselves as pure retail banks. In terms of the size, nearly half of respondents had less than $1 billion in assets and one quarter had asset sizes ranging from $1 billion to $5 billion. Banks with assets greater than $10 billion accounted for nearly one fifth of the total.

Thirty one of the 83 respondents were based in the GCC – by far the largest single group to respond to the survey, reflecting the large proportion of Islamic banks that are based in that region. Eight banks in non-GCC Middle East countries responded, and 14 responded from North Africa. Banks in Asia comprise 16 of the respondents, divided between those in South East Asia (Malaysia and Indonesia), and those in West, Central and South Asia (for example, Pakistan, Afghanistan and Bangladesh). Seven banks, from six different countries, responded from sub-Saharan Africa and seven banks responded from a variety of other countries, including the UK, the US and Turkey.

The CIBAFI Secretariat is delighted by this strong response to its questionnaire. With such a large number of banks responding from such a wide range of countries, we believe that the survey results represent fairly the perspectives of the Islamic banking industry as a whole. In the years ahead, we hope to extend the scope of the survey to include other types of Islamic financial institutions and to include Islamic capital markets.

The results of the survey are based on responses to a questionnaire sent to the CEO's office of CIBAFI members and to non-member Islamic banks in April 2015. The responses were received by CIBAFI between April and June. The Survey therefore expresses the views of the Islamic banking industry as they were over the summer of 2015. The Survey took the form of 'closed' questions and 'open' questions.

Closed questions asked respondents to score their perspectives on a scale of 1 – 5. For example, on a question about banks' level of optimism, respondents gave a score of 1 to represent a feeling of extreme pessimism and a score of 5 for a feeling of extreme optimism. A score of 3 indicates that the respondent is 'fairly optimistic' about the future of the industry. Similarly, when respondents were asked whether they expected to over-perform or under-perform against their peers, they use a score of 5 to indicate an expectation to over-perform heavily and a score of 1 for an expectation to under-perform heavily. A score of 3 indicated an expectation of similar performance.

With regard to 'open' questions, respondents were asked to write their responses to the questions. For example, one question asked respondents to describe two key challenges that their banks were facing; another asked what they considered to be the optimal structure of profit sharing investment accounts.

CIBAFI has undertaken this survey in pursuit of two of its strategic objectives: 'Research and Publications' and 'Awareness and Information Sharing'. The compilation and publication of this survey is in line with CIBAFI's role as the leading voice of the Islamic finance industry that both solicits and articulates the industry's views on key issues related to its future and development.

The Survey comprises four sections:

I. The CIBAFI Islamic Banking Confidence Index
II. The CIBAFI Islamic Banking Risk Dashboard
III. The CIBAFI Islamic Banking Growth Monitor
IV. The CIBAFI Survey of Core Values: Risk Sharing and Shariah-compliant MSME Finance

Each section includes a description of the results of the survey and a short commentary on the results.

Table 1. Respondents by regions and countries

Group Number	Region	Countries from which banks responded	Number of banks in this group that responded
Group 1	GCC	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE	31
Group 2	Middle East ex-GCC	Egypt, Iraq, Jordan, Lebanon, Syria, Yemen	8
Group 3	South East Asia	Malaysia, Indonesia	7
Group 4	West, Central and South Asia	Afghanistan, Azerbaijan, Bangladesh, Kazakhstan, Maldives, Pakistan, Sri Lanka	9
Group 5	North Africa	Algeria, Sudan, Tunisia	14
Group 6	Sub-Saharan Africa	Djibouti, Ethiopia, Kenya, Mauritania, Nigeria, South Africa	7
Group 7	Europe, Turkey U.S. and others	Bosnia, Russia, Turkey, U.K., U.S.	7
Total number of countries and banks		35 Countries	83 Islamic Banks

PART I
THE CIBAFI ISLAMIC BANKING CONFIDENCE INDEX

Part I.
The CIBAFI Islamic Banking Confidence Index

Islamic banks in the GCC feel more confident about the future of the banking sector in their home markets than do Islamic banks in Asia.

The Confidence Index presents the views of Islamic banks on three issues: the future of the banking industry as a whole, the level of optimism among Islamic bankers, and their revenue expectations for the year ahead. The broad picture is one of moderate confidence and optimism across all regions of the world. Perhaps surprisingly, banks in Algeria, Sudan and Tunisia (Group 5) consistently display the highest levels of confidence and optimism. No region expresses pessimism about its future.

Islamic banks are 'fairly optimistic' about the future of banking in their home markets

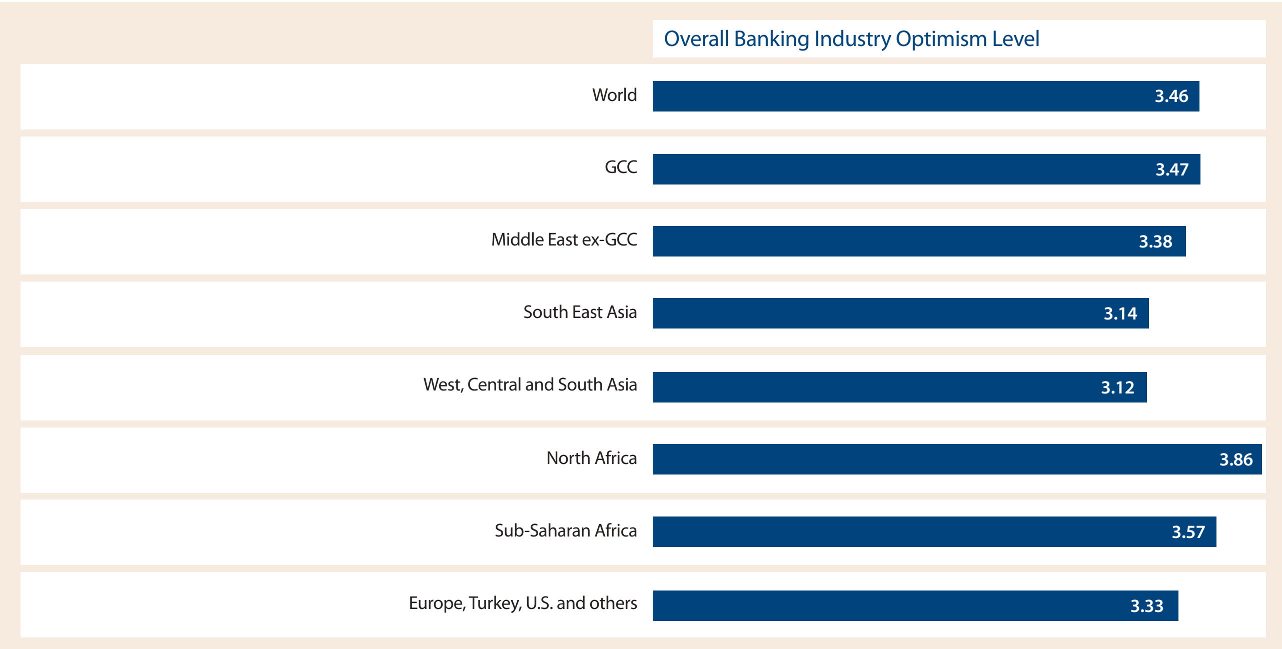
The survey's first question addressed the level of optimism that Islamic bankers have about the banking market as a whole in their home markets. Islamic banks were asked the question

"What is your level of optimism on the state of the banking market in your jurisdiction this year?"

The combined score for all the respondents was 3.46, indicating that they are 'fairly optimistic'. All geographic groups, taken individually, expressed themselves 'fairly optimistic'. North African banks were the most optimistic, giving a score of 3.86 while Asian banks were least optimistic: banks in West, Central and South Asia (Group 4) gave a score of 3.12 while those in South East Asia (Group 3) gave a score of 3.14.

The uniformity of the responses from such different regions is striking. No region's Islamic banks described themselves as 'very optimistic' or 'very pessimistic' despite considerable differences in economic and financial conditions between the regions. Even after taking account of the effects of lower oil prices, the prospects for banks in the GCC would appear to be far better than for those in countries in West, Central and South Asia, yet the difference in sentiment between banks in these regions is not great.

Figure 1. Optimism level on overall banking industry



1. Extremely pessimistic; 2. Very pessimistic; 3. Fairly optimistic; 4. Very optimistic; 5. Extremely optimistic

As to confidence about the prospects for Islamic banking itself, North African and Sub-Saharan Islamic banks are the most optimistic while those in GCC and Asia are fairly optimistic.

Islamic bankers are also 'fairly optimistic' about the prospects for Islamic banking

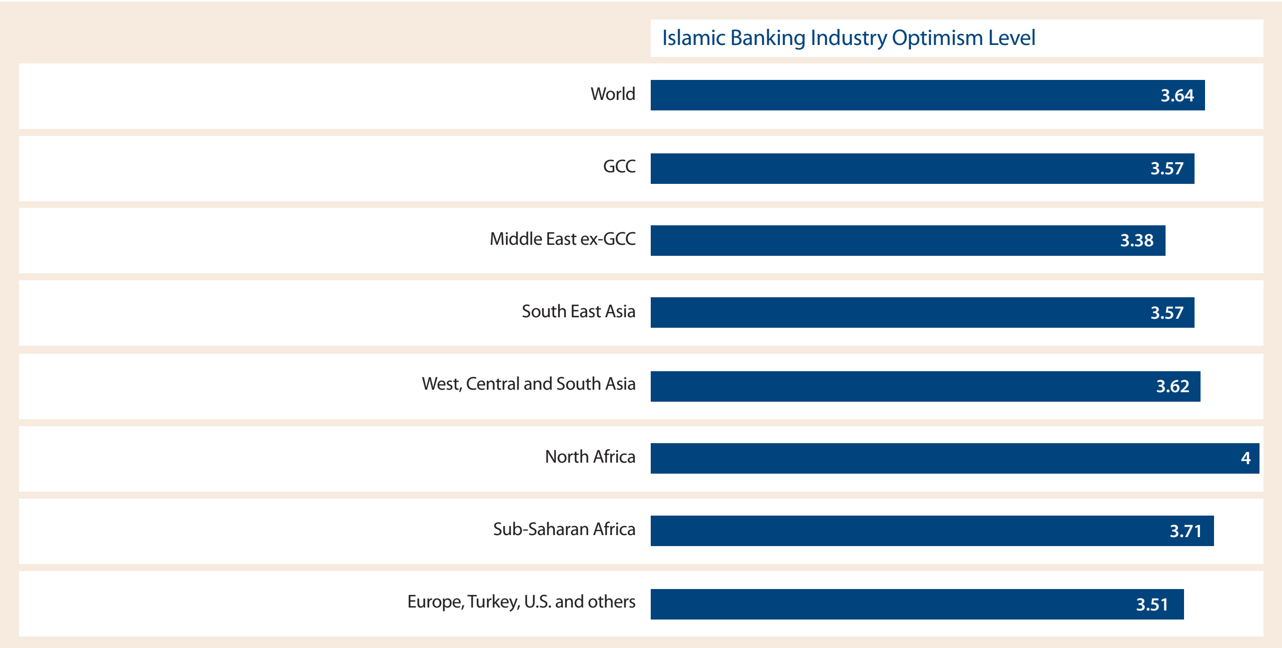
The Survey's second question addressed banks' level of optimism towards the Islamic banking industry itself and, specifically, in relation to how optimistic they were feeling a year ago. Islamic banks were asked the question

"What is your level of optimism on the future of Islamic banking in your jurisdiction today, compared to your level of optimism in 2014?"

The combined score for all respondents was 3.64, indicating that banks are 'fairly optimistic'. In no region was the level of optimism about Islamic banking less than that about banking generally, but in some regions it was materially higher. This is particularly notable in Asia, where the level of optimism about Islamic banking is close to the global average, while for banking generally it was materially lower.

Overall, banks in Algeria, Sudan and Tunisia are the most optimistic with a score of 4, indicating that they are 'very optimistic' today in comparison to how they felt last year. The least optimistic region is Group 2: the Middle East excluding the GCC. This group includes countries such as Iraq Syria and Yemen where conditions in financial markets have deteriorated over the last few years due to political instability.

Figure 2. Optimism level on Islamic banking industry



1. Extremely pessimistic; 2. Very pessimistic; 3. Fairly optimistic; 4. Very optimistic; 5. Extremely optimistic

Islamic banks across all regions display the same levels of confidence in their ability to show similar performance to their conventional peers.

Islamic banks expect performance similar to that of their conventional peers in terms of revenue growth in 2015

The Survey's third question asked respondents the extent to which they thought they could outperform conventional banks in their jurisdictions, in terms of revenue in 2015. The question asked,

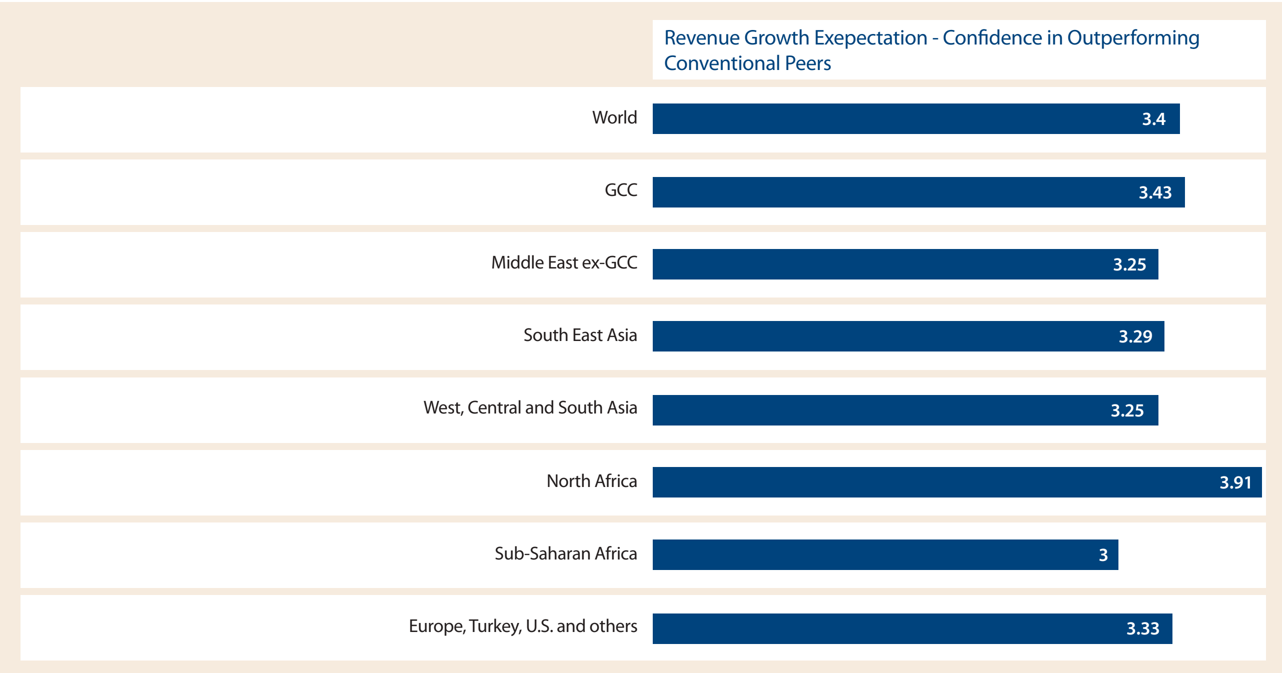
"Considering the current economic and GDP growth outlook, what is your expectation of revenue growth in your institution in 2015 relative to conventional banks in your jurisdiction?"

Taken as a whole, the respondents thought that they would be able to show levels of growth similar to those of their conventional peers. Their combined score was 3.4. Again, banks in Algeria, Sudan and

Part I. - The CIBAFI Islamic Banking Confidence Index (continued)

Tunisia are most optimistic about their prospects, presenting a combined score of 3.91. In contrast, banks in Sub-Saharan Africa are least optimistic.

Figure 3. Confidence level on revenue growth expectation



1. Extremely underperform; 2. Underperform; 3. Fairly similar; 4. Outperform; 5. Extremely outperform

Shareholder value, service quality, human resources and customer centricity, and expansion are the biggest priorities for Islamic banks.

Satisfying shareholders and enhancing the quality of service remain key concerns of Islamic banks

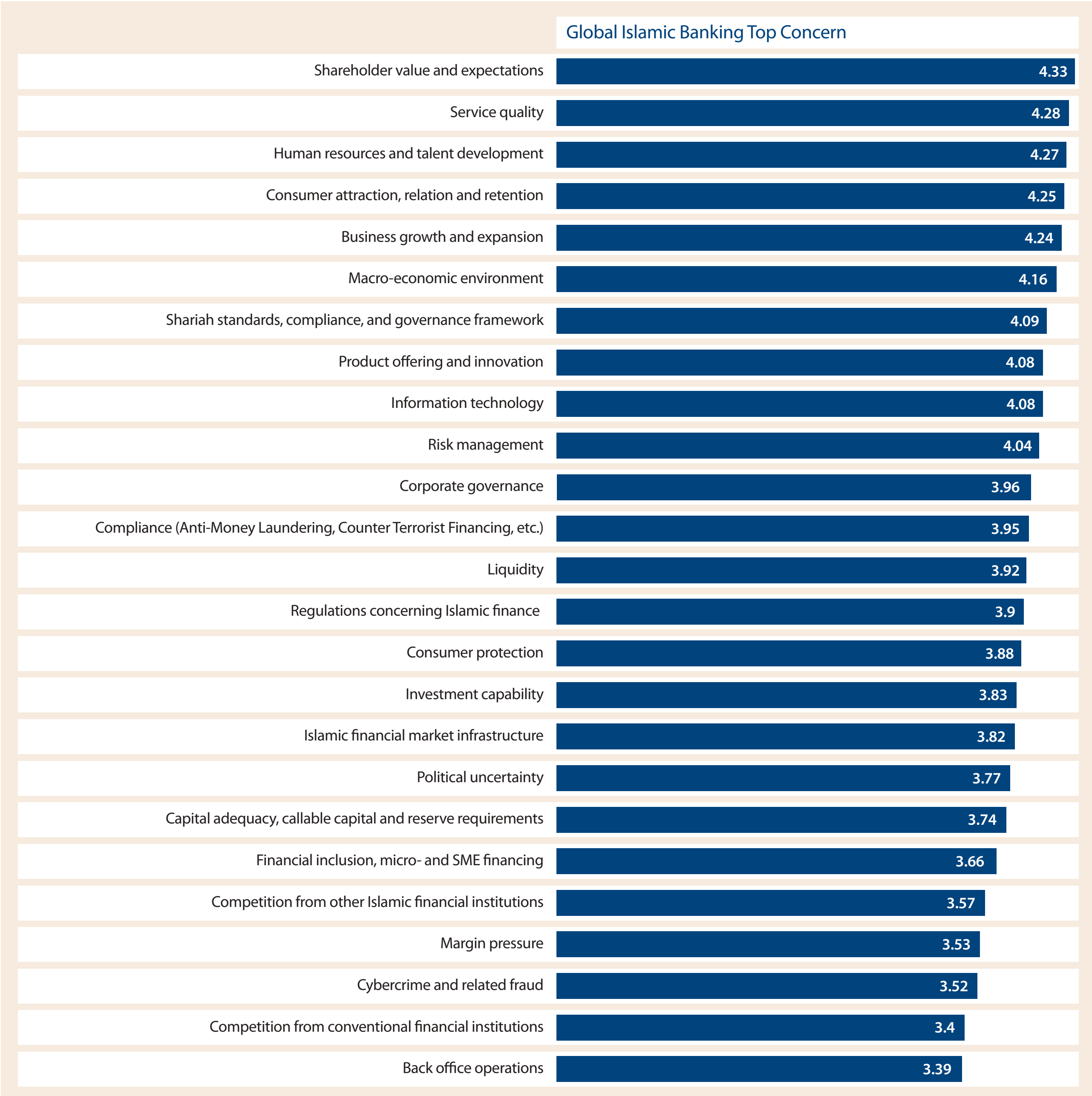
The final question in the Confidence Index asked banks to say how significant certain issues and challenges would be over the next 1 – 3 years. Each Islamic bank was asked to,

"Score your concerns regarding the following issues and challenges that face your institution in the next 1 – 3 years."

The issues and challenges presented ranged from broad macro and political issues, to issues related to regulation, competition, Shariah-compliance and internal management. The respondents scored the issues and challenges on a scale of 1 to 5 where 1 was 'Not important at all', 3 was 'Fairly important' and 5 was 'Extremely important'. The results are intriguing.

Shareholder value and expectations was ranked the most important issue, with a score of 4.33. The second, third and fourth most important issues were 'Service Quality' (4.28), 'Human Resources and Talent Management' (4.27) and 'Customer Attraction, Relations and Retention' (4.25). The fifth most important was 'Business Growth and Expansion' (4.24). However, the priorities did vary significantly between regions.

Figure 4. Major concerns of Islamic banks



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

As Table 2 below indicates, concerns in the GCC were dominated by commercial issues – shareholder value and expectations, and business growth – that one might expect to be important in any mature business environment. However, overall levels of concern were relatively low in comparison with other regions, with only these two areas scoring 4 or more. A broadly similar focus on commercial issues can be seen in Group 7, with perhaps a hint that competitive pressures there may be stronger. By contrast, the Middle East outside the GCC showed high levels of concern on a whole range of factors, several of which were related to the external environment.

Part I. - The CIBAFI Islamic Banking Confidence Index (continued)

The two African groups both displayed high levels of concern but, as already noted, in the context of a generally optimistic outlook. This can perhaps be interpreted as reflecting Islamic banking industries that are trying to grow rapidly from a small base and are facing constraints in infrastructure – market, regulatory and human – as well as those of organisational development and business expansion.

It is less easy to draw clear conclusions about the two Asian groups, except that the relative prominence of "Regulations concerning Islamic finance" in the South East Asia group may reflect the coming into force of the Malaysian Islamic Financial Services Act, whose impact was known to be a source of concern for some banks in that country.

Table 2. Major concerns of Islamic banks across regions

Geographical breakdown of top concerns*		
	Top Concern	Score
Group 1 GCC	✓ Shareholder value and expectations	4.39
	✓ Business growth and expansion	4.25
	✓ Risk Management	3.18
	✓ Service Quality	3.18
	✓ Human resources and talent development	3.18
	✓ Customer attraction, relations and retention	3.18
Group 2 Middle East ex-GCC	✓ Service Quality	4.88
	✓ Customer attraction, relations and retention	4.88
	✓ Macro-economic environment	4.62
	✓ Political uncertainty	4.62
	✓ Investment capability	4.62
	✓ Compliance	4.62
	✓ Human resources and talent development	4.62
	✓ Business growth and expansion	4.62
Group 3 South East Asia	✓ Human resources and talent development	4.14
	✓ Business growth and expansion	4.14
	✓ Regulations concerning Islamic finance	4.00
	✓ Product offering and innovation	4.00
	✓ Information technology	4.00
Group 4 West, Central, and South Asia	✓ Service Quality	4.12
	✓ Shariah standards, compliance and governance framework	4.12
	✓ Customer attraction, relations and retention	4.12
Group 5 North Africa	✓ Information technology	4.64
	✓ Macro-economic environment	4.57
	✓ Service quality	4.57
	✓ Shariah standards, compliance and governance framework	4.57
Group 6 Sub-Saharan Africa	✓ Business growth and expansion	4.57
	✓ Shareholder value and expectations	4.57
	✓ Islamic financial market infrastructure	4.43
	✓ Service quality	4.43
	✓ Human resources and talent development	4.43
	✓ Customer attraction, relations and retention	4.43
Group 7 Europe, U.S. and others	✓ Shareholder value and expectations	4.29
	✓ Margin Pressure	4.14
	✓ Service Quality	4.14
	✓ Compliance	4.14
	✓ Human resources and talent development	4.14
Global	✓ Shareholder value and expectations	4.33
	✓ Service quality	4.28
	✓ Human resources and talent development	4.27

**For every group, the top three risks are identified, except that all concerns with the same score are listed, even if that means that more than three are listed in total.*

Despite regional differences, some overall themes can be discerned.

Islamic banks need to identify key Islamic finance values that will be able to generate sustainable returns for shareholders over the long term

Since most of the Islamic banks surveyed operate in dual banking environments (that is, alongside conventional banks) they need to identify business models which will enable them to compete with conventional banks while also providing a distinct Shariah compliant service. This entails not only matching conventional banks' levels of service and operating efficiency but also establishing a clear position in the market, based on a distinct set of values. One issue for the industry is the extent to which it can rely on the simple claim to Shariah compliance as the core value which it communicates, and how far it needs to go beyond that, for example by emphasising its linkage to the real economy or the fairness with which it treats its customers. It remains unclear which of the values of Islamic finance can best offer a distinctive business proposition. For any such proposition to be sustainable, those values will have to be manifest in the banks' behaviour as well as in their advertising. In other words, there is no necessary contradiction between shareholder expectations and Islamic values, but Islamic banks should start to identify the values that are most likely to facilitate strong returns for shareholders over the long term.

Service quality, product offering, and customer relations are key priorities in a competitive environment

The identification, across a range of regions, of service quality, product offering and innovation, and customer relations as very important indicates that banks are very focussed on their ability to provide value to their customers. The evidence suggests that, even where the values of Islamic finance are appreciated, for many potential customers they are not sufficient to overcome the absence of products that meet their needs, or deficiencies in service as compared with conventional counterparts. In addition, as markets develop, customers may also have choices available between different Islamic banks, when product offering and quality of service may well be key differentiators. At present, it appears that Islamic banks fear that they do not have a broad enough product suite to compete against their conventional counterparts, although the survey results do not allow us to understand where the gaps are thought to be. As a result, Islamic banks should seize the opportunity to promote greater product innovation and to create their distinctive competitive space, rather than trying to replicate products and strategies pursued by conventional banks.

Risk management and technology score highly

Risk management and information technology (IT) were identified by respondents as important challenges over the medium term. These two issues are seen as challenges across the banking industry, both Shariah compliant and conventional, as banking becomes more complex and IT systems have to expand and develop in parallel. The detailed discussion of the two is provided in the next sections of this report.

Several regulatory issues are prominent, including liquidity

Several issues that are directly or indirectly related to financial regulation appear prominently among Islamic bankers' concerns. Globally, the most prominent is Shariah standards, compliance and governance, although the extent to which these are regulatory issues depends on geography, since some national regulators take a greater role than others in such matters. Compliance with anti-money laundering and related regulations, the regulation of Islamic finance generally, and liquidity all sit in the middle of the table globally although, regulation is seen as particularly important issue in South-East Asia. The written comments by respondents suggest that because these issues are related, there have been some differences between banks as to whether a particular problem is assigned to one category or another.

The middle-ranking score given to liquidity is at first sight a little surprising, given the considerable attention that has been given to it following the publication of the new Basel liquidity standards (the Liquidity Coverage Ratio and the Net Stable Funding Ratio). The explanation may lie in a more subtle interpretation of what is meant by liquidity. In practice, Islamic banks hold large amounts of cash and very liquid instruments because they are unable to invest in interest-bearing bills and

Part I. - The CIBAFI Islamic Banking Confidence Index (continued)

bonds, which conventional banks frequently use to manage their liquidity profiles. Liquidity itself is not a challenge for Islamic banks; it is the difficulty of earning a return on liquid funds that presents a difficulty. The comments made by respondents to the 'open' questions in the survey make clear that liquidity, in all its forms, is an important area of concern for the industry.

Similarly 'Islamic financial market infrastructure' scores 3.82 – at the higher end of the scale but not one of the challenges identified as most important, despite the industry's frequent invocation of the need to improve financial market infrastructure (such as the development of tradable instruments and liquidity instruments). In practice, many Islamic banks are able to operate in countries with only limited regulatory and legal infrastructure for Islamic banks, though under sub-optimal conditions.

Islamic banks face a wide variety of challenges, depending on their individual circumstances
After scoring the concerns and issues presented by CIBAFI, Islamic banks were asked to describe the two biggest challenges that they were facing and to describe what they were doing to overcome those challenges. Banks were asked to,

"Describe the two main challenges faced by your institution and the initiatives that you are taking to overcome those challenges in the next 1 – 3 years"

What is striking in the responses is the diversity of answers given. All the 25 concerns and issues presented by CIBAFI were raised by one or more of the 83 responding Islamic banks. The concerns described by banks are often specific to the environment where a bank is operating or to the state of development of Shariah-compliant markets in the respective country. For example, an Omani bank was concerned about competition from other Islamic banks, fearing that Islamic banks would eat into each other's market shares rather than creating new business. The bank's solution was to develop the nascent Omani Islamic banking market and to educate customers. The same bank was also concerned with Shariah non-compliance risk, especially during the early stages of establishment as "any breach on this front will cause irreparable damage to the industry" according to the bank. In response, the bank is focussing heavily on developing a Shariah-compliance 'culture' at all levels of the bank.

Another GCC bank, in a more mature Islamic banking market, also identified the challenge of Shariah compliance. The bank indicated that it has developed a strong Shariah compliance team that operates within different bank functions, including Shariah non-compliance risk, Shariah audit and Shariah advisory. Banks in the Middle East, which include those in Egypt, Syria, Iraq and Lebanon, were concerned about political and macro-economic risks, with an Egyptian bank citing challenges such as "unemployment, inflation, and GDP growth, which affects credit quality, default rates and recovery rates." Since political risk is systemic and cannot be diversified, the bank's response is to tighten its credit policies.

A bank in South East Asia described the talent pool within the Islamic banking industry as "very shallow". Its response was two-pronged: to develop a talent pool from within the bank and to hire professionals from the conventional banking industry, which is more advanced than the Islamic banking industry in the bank's country. Another bank from this region said that it had established an education fund that employees could use to finance their participation in training courses and conferences. By enabling employees to enhance their skills, the bank aims to upgrade its talent pool and also to retain its staff. Another bank in the GCC highlighted that it had established an internship programme to introduce young people to the Islamic finance industry.

A Mauritanian bank lamented the lack of market infrastructure in its country. The bank said that, at the time of writing, there were no Islamic financial regulations or infrastructure for the issuance of Sukuk. Another Sub-Saharan bank said that it was lobbying its Ministry of Finance and its Debt Management Office to issue Sukuk in order to initiate a Shariah-compliant money market. The problem of market infrastructure is not confined to Sub-Saharan Africa. A Tunisian bank noted the need to upgrade the legislative framework for Islamic finance in Tunisia and for greater knowledge sharing among customers about Islamic financial principles and products. In response, the bank has been working with the financial authorities and is organising its own programme to spread knowledge and understanding of Shariah-compliant finance.

Challenges related to liquidity and capital are scattered throughout the responses but they do not provide a coherent picture of concern nor are they concentrated in any one particular area. Many of the challenges are rooted in the macro-economic conditions, the state of the financial infrastructure, and the level of competition in the market where each bank operates, in addition to internal issues such as customer relations, staff quality, and Shariah compliance.

Banks in different regions identify different concerns and challenges as the most important. Banks in Sub-Saharan Africa and in West, Central and South Asia are most concerned about market infrastructure, reflecting the lack of regulations and laws to govern the emerging Islamic finance markets in these regions. In contrast, banks in the more mature financial markets of the Gulf are more concerned about financial metrics such as capital adequacy and liquidity, and competition from other Islamic institutions. Issues of capital adequacy and liquidity also feature prominently in the concerns of North African banks, although macro-economic concerns also gain prominence alongside organizational matters such as human resources and customer retention.

PART II
THE CIBAFI ISLAMIC BANKING RISK DASHBOARD

Part II.
The CIBAFI Islamic Banking Risk Dashboard

Islamic banks face two challenges in the changing world of risk management. They face the risk challenges common to a relatively young industry but many of the existing risk management standards are not appropriate for their distinct and evolving business models.

The CIBAFI Risk Dashboard presents the views of Islamic bankers on the biggest risks that they believe the industry will face over the next 1-3 years. Participants were asked to score each of a series of risks from 1 (No risk at all) to 5 (Extreme risk). They were also asked to describe more fully the top two risks, as they perceived them, and to describe their initiatives to mitigate those risks over the same period.

Risk management becomes more critical in a rapidly changing environment

Islamic finance has grown strongly in recent years, often showing annual growth in double digits, and has reached systemic significance in a number of countries. It continues to expand in Muslim-majority economies while making inroads elsewhere, outpacing the growth of conventional banking. This rapid growth has brought the risk profiles of Islamic banks into sharp focus. The CIBAFI survey revealed considerable concerns about the risks that Islamic banks are facing today, and are likely to face in the future, and in their capacity to deal with them.

The global practice of risk management has seen deep and dramatic changes in recent years as the business of financial intermediation has morphed and globalized, with financial crises prompting changes both in regulations and business practices. Regulatory oversight in the US and Europe has pushed financial institutions to radically transform their risk management methodologies, and make significant changes in areas as governance, capital requirements, liquidity management, proprietary trading, and financial intermediation with consumers. New Basel standards have revolutionized national approaches to capital requirements and risk governance.

Islamic banks face a triple struggle in the changing world of risk management. They face the risk challenges common to a relatively young industry, where norms have yet to solidify and rapid growth uncovers contradictions and inconsistencies. At the same time, many of the principles of emerging risk management standards are not appropriate for them, given the often different structures of IFIs which straddle the domains of classic deposit-taking institutions and investment companies or collective investment schemes. They often have to manage their risks within more difficult environments than their conventional counterparts: for example with less-developed money markets available to them.

Despite its growth, the Islamic finance industry has not yet achieved the size or influence to develop the depth of risk management approaches and tools in areas where the fit is inexact. Moreover, the definitions of what constitutes Shariah compliance, the raison d'être of Islamic finance, vary sufficiently among jurisdictions and within markets to generate persistent reputational and market acceptance risks.

The various Islamic finance standard-setting bodies (IFSB, AAOIFI, and others) have made strong progress in developing specific standards, but these have not been applied in all jurisdictions and, more importantly, regulatory regimes overseeing financial systems have generally not caught up with the evolution of Islamic products and approaches, even in several Muslim-majority countries. This issue is becoming more important as IFIs develop cross border products, services, and client bases. The need for greater clarity and more effective harmonization will require Islamic and conventional standard-setting bodies to engage in closer cooperation.

The hybrid nature of much of contemporary Islamic finance – on the border between debt financing and equity – also creates regulatory confusion and therefore risk. While it is commonly argued that Islamic finance should be essentially equity finance, where risks are equally shared among investors, whether the client or the Islamic institution, in fact most Islamic banks evolved initially as low-risk financing institutions, focusing on short-term assets with contracted paybacks in terms of both amount and profit rate, typically structured as Murabahah, and to some extent on real estate financing through mortgages. As such, their risk profiles have been more reflective of conventional deposit-taking institutions.

On the liability side, investment accounts were aligned with classic deposits, with a high degree of certainty expected by the account holders in terms of both the security of principal as well as the expected rate of return. As a result, regulators in many jurisdictions have not only viewed classic Islamic banks as deposit-taking institutions but have effectively treated them like conventional banks, in terms of liquidity and capital requirements, making no allowance for risk sharing even when it is in fact present.

The tendency to treat investment accounts as equivalent to conventional deposits may have negative consequences. To the extent that an Islamic bank has profit-smoothing mechanisms and the capacity to absorb losses, as quasi-equity, its impact on financial stability and systemic risk may differ substantially from that of a conventional deposit taker. This divergence requires greater regulatory understanding and analysis and, consequently, divergent regulatory treatment where appropriate. Moreover, rules governing consumer protection and deposit guarantees will also differ to the extent that investment account holders are liable for sharing losses suffered by an Islamic bank.

These differences need to be better understood and regulated accordingly. This evolution must include mechanisms to create acceptable guarantee schemes and lender of last resort approaches that can help ensure systemic stability during times of crisis, whether triggered by institutional insolvency, liquidity crunches, or any other cause.

> Respondents generally perceived the risks they currently face to be manageable, in the aggregate hovering near the medium range, but at the same time nearly all felt the need to invest in improving risk management capacity, both in recognition of current weaknesses and also in anticipation of a changing risk environment.

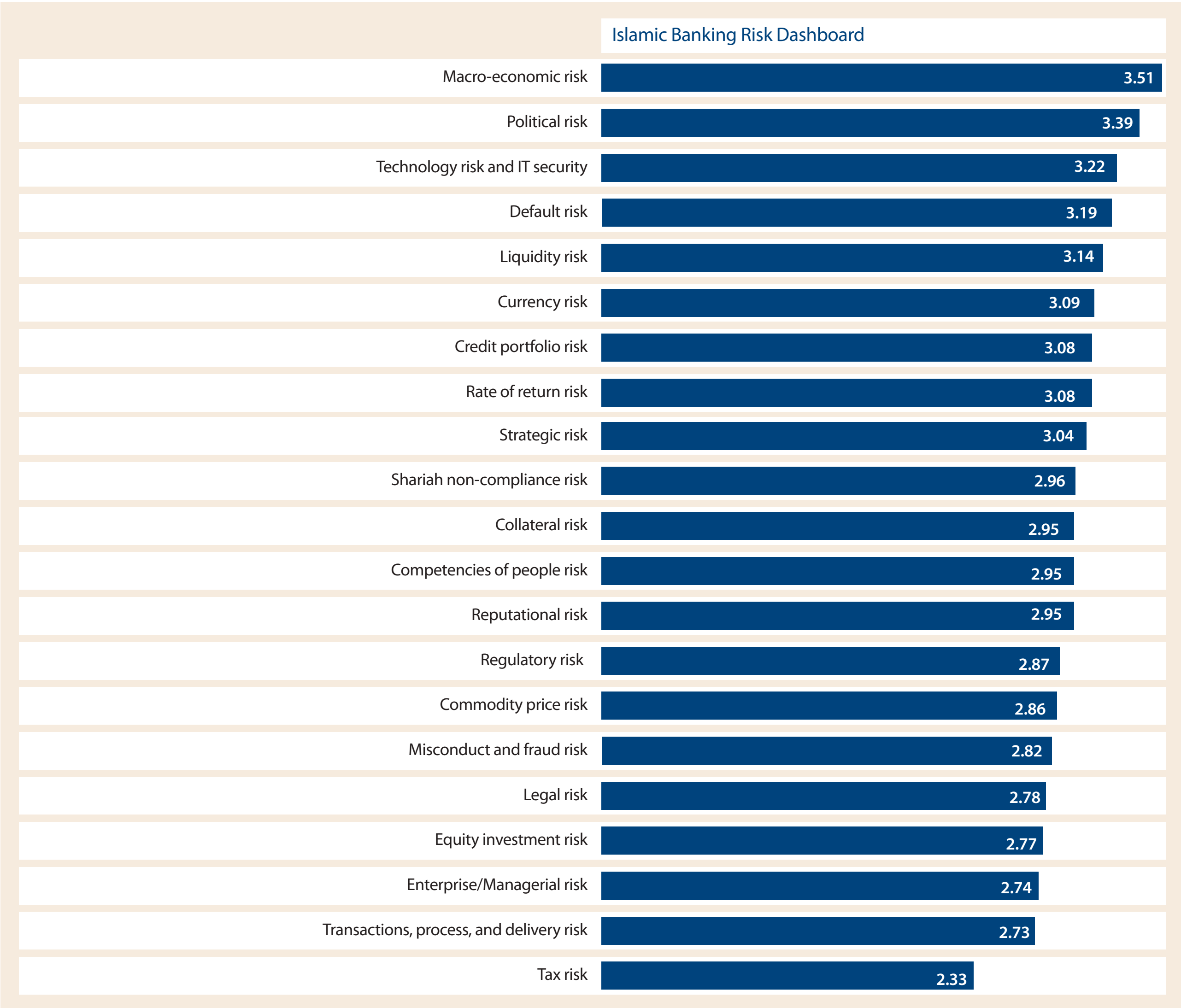
All over the world, as the wall between debt and equity breaks down, as with the demise of the Glass-Steagall Act in the United States, risk parameters are changing. At the same time, Islamic banks are offering an increasingly wide range of structures to meet client needs, and in business financing they are seeking products more in the spirit of risk sharing. As this evolution unfolds, the overall risk paradigm will continue to shift and regulations will have to evolve. In particular, there is a real risk that regulatory treatment may unnecessarily force Islamic banks to offer close economic equivalents of conventional products.

CIBAFI's survey revealed substantial uneasiness about the changing risk environment. Islamic bankers who responded to the CIBAFI survey were concerned about a broad array of risks. They generally perceived the risks they currently faced to be manageable, in the aggregate hovering near the medium level, but at the same time virtually all felt the need to invest in improving risk management capacity, both in recognition of current weaknesses and also in anticipation of a changing risk environment.

Most Islamic banks surveyed believe that the risks they face are within tolerable levels, with most of the risks presented for consideration identified as low to medium risks, although a few were placed at the higher end of the scale.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 5. Global responses on risk dashboard



1. No risk at all; 2. Low risk; 3. Medium risk; 4. High risk; 5. Extreme risk

Those banks that expressed concern about significant political and macroeconomic risk linked to stressful domestic situations are reacting by tightening credit and ensuring avoidance of higher risk sectors. Some banks note the expansion of disaster recovery efforts to deal with political and other possible serious contingencies, raising the profile of operational risk.

Political and economic risks are consistently placed at the higher end of the scale

Although most risks are perceived as within tolerance, a significant number of Islamic banks rank political and macroeconomic risks as high. This is true, not surprisingly, of the Islamic banks located in the MENA region (groups 1, 2 and 5) but also for European and North American Islamic banks (group 7).

Political upheavals that began with the Arab Spring have raised political uncertainty broadly across the MENA region, with respondents in North Africa and the Middle East citing the political environment as a key risk. A respondent in Egypt, for example, points out that it and its customers are "suffering from economic problems in line with the political transition" with resulting volatility and difficulty to plan and to grow.

In Sudan and Tunisia, respondents also worry about the unstable political environment and its impact on economic prospects, including currency risk. A Sudanese banker noted that the loss of exports, especially since the separation of South Sudan, meant that customers are "exposed to high rates of imported (cross) inflation," negatively impacting their cost structures and thereby having an impact on Islamic banks' income and risk profiles. Another North African Islamic bank regrets that the Ministry of Finance's inability to pay its obligations on time led in turn to a delay in payments to the IFI's investors. This negatively impacts "confidence in the securities issued by the Company."

At the same time, Islamic banks located in oil-exporting economies worry about the effect of the drop in oil prices. Islamic banks in the GCC and elsewhere note the impact on state spending and on the broader economy. One Algerian banker notes that oil represents over 90% of national income and the austerity policies with which the Algerian government responds to lower oil prices trickles through the national client base, both corporate and individual.

Those banks that expressed concern about significant political and economic risk linked to stressful domestic situations are reacting by tightening credit and ensuring avoidance of higher risk sectors. Some banks note the expansion of disaster recovery efforts to deal with political and other severe contingencies: as a result, 'operational risk' is assuming a higher profile.

Banks from outside the MENA region, for example from Group 7, are conscious of their linkages to the MENA region since that is where the preponderance of Shariah compliant assets, as well as funding sources, are currently domiciled. Respondents suggest that the best way to manage such political risk is to maintain a conservative credit approach while constantly seeking diversification.

Credit risk management remains a broad concern

Several respondents, across all regions, note the continuing concern about credit quality and default risk. As one GCC banker points out, "Credit portfolio quality is key to the bank's sustained growth and profitability." Since the financial assets of most Islamic banks are in credit financing rather than equity or equity-like transactions (musharakah, etc.), credit risk is naturally a leading concern. Credit risk is inevitably linked to political and economic risks since the declining financial condition of domestic corporate clients flows through into the banks' balance sheets and revenue streams.

> Credit risk remains a key challenge both on the micro level – extending credit and using the various advanced risk management tools needed to do so properly, as well as on the macro level – , managing concentrations and correlations in the credit portfolio as a whole.

Many Islamic banks complained about the lack of bankable customers, especially given stringent credit conditions, and the inability of some potential customers to post acceptable collateral. As one central European banker put it, there is a "lack of profitable and stable new companies and projects from one side and there are a lot of banks on [...] the other side."

The more stringent requirements of many Islamic banks (for example, in terms of contracts) may serve to place them at a disadvantage vis-à-vis conventional banks when competing for clients who are indifferent to the Shariah. They may risk losing market share or find themselves at a disadvantage when pricing certain products. Higher competition calls for strong credit risk management to ensure that any competitive disadvantage does not lead towards adverse selection, i.e. clustering with higher risk clients (without the compensating pricing) or to Islamic banks taking higher risk positions than their competitors when financing the same clients. Since many Islamic banks are newer entrants compared with their conventional competitors, this is a particular concern.

Islamic banks have made varying degrees of progress in incorporating modern credit risk management techniques, such as advanced scoring approaches or credit portfolio modelling. The uneven degree of adoption of modern credit practices seems to be at least part of the reason for the high concern about credit risk, since several Islamic banks note the need to enhance their credit risk management capacity, especially in terms of specific tools.

Credit risk remains a challenge both on the micro level – the granting of individual credits – , and the various tools needed to do so properly; and at the macro level, in terms of managing concentrations and correlations in the credit portfolio as a whole. Portfolio risk can be higher for Islamic banks given the more limited nature of products, and in some cases clients, that they are able to deal with, compared to conventional banks.

At the same time, in a number of countries, such as Turkey or Bosnia, risks in the credit book are explicitly linked to rising macro risks, such as economic or political risks, that impact the profitability of the bank's client base. An Egyptian Islamic bank also notes volatility in the exchange rate as impacting risks, including default rates. In order to manage emerging client credit risks, a few Islamic banks focus on taking high quality collateral as security. However, the unavailability of such

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

capital in many cases has already been noted. Several other banks cite on-going investments in advanced credit management tools, such as improved scoring models. For aggregate credit risks, respondents suggest various solutions including "diversification into various sectors and granular portfolio to avoid concentrated positions," taking appropriate provisions, and, more broadly, developing more sophisticated portfolio management techniques.

Liquidity management continues to be a challenge

Since Islamic banks are restricted in their dealings with their domestic interbank markets, for example for conventional overnight funds, liquidity management has always been a challenge for them. Moreover, the need to smooth profits to maintain competitive position and market expectations leads to Rate of Return risk, a risk that increases with a higher portfolio of longer-term or fixed assets, risking a mismatch against depositor expectations. Liquidity risk is highlighted as a particular worry among Islamic banks located in Groups 3, 5 and 6 while Rate of Return risk is ranked as medium to high (> 3) in all groups except Group 4.

High reliance on liquid funds and high liquid asset buffers impede liquidity optimization and hence compromise profitability. This challenge is compounded by the predominance of fixed-rate products, further reducing flexibility. Some respondents point to a conscious strategic shift towards variable rate instruments to help mitigate these risks. Meanwhile, there is a lack of breadth and depth of alternative Shar'iah-compliant instruments.

Unsurprisingly, GCC area Islamic banks do not put liquidity risk management amongst their highest concerns, given the still strong liquidity positions of most banks in the region. Nonetheless, even in the GCC and broader MENA regions, this is a growing concern linked to rising regulatory oversight since the 2008 financial crisis.

Overall, liquidity risk appears to be a broadly rising concern globally, with many Islamic banks commenting about it as an emerging challenge. This is partly attributed to the need to meet new international liquidity standards which are being implemented, or are expected to be implemented, in the jurisdictions in which they operate.

In explaining liquidity and related risks, several respondents note mismatches and possible fund shortages as concerns, for example due to the short-term nature of depositor funds. Mismatches are difficult to manage since, unlike conventional banks, it is much harder to cover them with current liquidity management tools. A North African bank states a common perception: liquidity risk is high due to "the absence of an Islamic money market at the national level and the lack of liquidity management products."

This challenge is compounded by the predominance of fixed-rate products, further hampering flexibility. Some respondents point to a conscious strategic shift towards variable rate instruments to help mitigate these risks. One Sub-Saharan banker notes that his Islamic bank is working with the Central Bank on a guarantee arrangement using Time Multiple Counter Guarantees to help contain liquidity risks. At the same time, the Islamic bank is raising its position in assets "with a floating rate of return [such as Ijarah]" while trying to better benchmark its asset pricing to manage rate of return risk.

Other Islamic banks employ different devices to manage liquidity risk. A Group 3 banker notes that his bank requires a maximum fixed deposit ratio of 92%-95%, putting the deposits "into a money market portfolio." Another Group 3 banker notes that the high reliance on heavily liquid funds puts downward pressure on returns and as a result, their "net profit margin [is] below industry average," a concern of many Islamic banks with short term assets and liabilities.

Many bankers are aware of efforts to build liquidity management alternatives for Islamic banks, such as those of the IILM (The International Islamic Liquidity Management Corporation) and the LMC (The Liquidity Management Centre), but their scale, and the depth of the market overall, still fall short of meeting global needs. A Group 2 respondent calls on the Islamic liquidity management leadership "to develop flexible tools in order to create an active Islamic money market." Another banker in a Group 7 country complains that such institutions remain regional and "are unable to serve a global market." As a result, Islamic banks may have to manage their liquid asset buffer with highly liquid instruments or cash on their nostro accounts, impeding liquidity optimization and hence compromising profitability.

The lack of high quality liquid assets also creates regulatory issues, as central banks tighten requirements in response to the 2008 global financial crisis and the new global standards that have resulted. These requirements, even with the additional flexibilities that have now been allowed, may be challenging for Islamic banks, especially since the volume of tradable and liquid Sukuk on most markets is exceedingly low or non-existent. These challenges cannot be addressed by the banks themselves, and require not only regulatory responses but also development of Islamic finance infrastructures, both national and international.

Managing equity-based finance is an area in need of development: Venture Capital skills and profitable exit routes

Several Islamic bankers identify equity risk as a growing concern. Some see increasing risk in legacy equity investments, such as shares in unlisted companies, which need new approaches to measure and manage.

Other Islamic bankers note the need to migrate from credit financing to investment approaches, a common theme among Islamic banks, and the resulting need to better understand the different nature of equity risk. Globally many Islamic banks are under pressure, including from Shariah boards, to evolve away from their heavy reliance on fixed-return financing instruments such as Murabahah credit financing towards more risk-sharing approaches that incorporate an equity or equity-like component. Because of the importance of this subject in current thinking about Islamic finance, the CIBAFI Survey included a specific question about it, and the responses are discussed in detail later in section IV of this report. However, the point that emerges most clearly is that the assessment and management of equity-like risk needs greater skills from analytical staff, in view of the different nature of equity risk with its non-specific term and non-contracted exit price. Additionally, a shift towards more risk sharing will require greater clarity among regulators on the divide between deposit-taking institutions, which typically fall under the purview of the central bank, versus investment companies.

> Respondents seeking to improve equity risk management recognize that they must increase the income yielding portion of their investments and look into "profitable exits" in order to manage the risk. Islamic banks need to build strong Venture Capital-type of equity financing skills and capacities, feasible exit routes (such as a secondary equity market for SMEs) A and equity-based scoring/rating

Several Islamic bankers express a desire to migrate towards greater risk sharing, and with it to acquire the toolset needed to build and manage a proprietary equity portfolio. Equities, unlike debt, do not normally have an exit with a contracted price. (Although Islamic equity-like structures may have a fixed term, they are not at present a large part of the market.) Traded equities suffer from both price and liquidity risk whereas untraded equities are even more illiquid, and the bank faces risks in securing a profitable and reasonably timed exit. Respondents seeking to improve equity risk recognize that they must, as one puts it, "increase the income yielding portion and look into orderly and profitable exits" in order to manage the risk. In other words, to achieve sustainable returns from equity-based finance, it needs to build strong venture capital-type equity financing skills and capacities, as well as feasible exit routes, such as secondary equity markets for SMEs. The methods of scoring or rating that are currently used for credit financing, need to be adjusted to cater for the specificities and risk-return profile of equity-based financing.

Technology risks are an emerging concern

Islamic banks are generally perceived to face greater IT challenges than conventional banks both because of the more traditional origins of many Islamic banks but also because of the more specialized nature of their products and transactions. Additionally, they often need dedicated software which may differ from jurisdiction to jurisdiction. As a result, in addition to the usual IT risks, such as security breaches and data losses, Islamic banks face somewhat higher IT risks thanks to the complexity of many Shariah-compliant products, the lack of standardization, and the consequences of working within a specialized sub-market with specific needs, often tailored to the legal, regulatory, or Shariah regime of the particular economy or institution. Technology risks may also be more serious for Islamic banks because a technical error may not only have financial repercussions, such as an understated amount, but could also impact Shar'iah compliance, risking the integrity of a transaction or relationship.

> Technology risks are perceived in terms of IT security issues as well as risks related to the technology needed to upgrade operational processes and improve customer interfaces and experiences (CRM, etc.).

The CIBAFI Survey shows that technology risks are indeed widely perceived as a major and growing category of risk, with special concern for Islamic banks in countries in Groups 2, 5, 6, and 7. Technology risks are perceived in terms of IT security issues as well as related to the technology for upgrading operational processes and for customer interface and experience (CRM, etc.). Some bankers note that Islamic banks are often seen as slower in adapting new technologies. At the same time, technology change is rapid and lagging behind can be costly in terms of catch-up as well as opportunity cost.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Many Islamic banks were concerned about Shariah compliance and its impact on reputation

Shariah compliance did not score as one of the top risks, though it was significant across all geographical groups. It was, however, an issue very much in the minds of respondents, as evidenced by their comments. In responses from individual bankers, this is often tied to the particular reputational concerns of institutions whose founding principles are linked to religious beliefs. Any institution that is associated with a moral calling requires even higher barriers to reputational failings, especially those that might call into question the ethical underpinnings of the institution, such as fraud or malfeasance. Clients that choose an institution whose name links to their core moral beliefs are keenly sensitive to any breaches of trust, since trust is one of the biggest competitive advantages that attracts and keeps such clients. As one respondent puts it, since the bank is providing services that are aligned with the customers' beliefs and values system, the Islamic bank faces "a much higher responsibility to stay true to our name." This higher need to maintain trust touches on all aspects of the Islamic bank's dealings with its customers and its internal operations, but it has particular resonance in terms of convincing the client that the prime reason that justifies their business over conventional peers is Shariah compliance. As such, the capacity to convince the client that the Islamic bank is complying with the Shariah in all products and activities is fundamental.

The concern about Shariah compliance, although not the top risk, is widely shared. Several respondents raised the broader question of the need for shared perceptions of Shariah authenticity, calling for both greater standardization of Shariah standards and practices, globally and nationally, as well as for strong and autonomous Shariah governance systems. Islamic banks also face higher legal risks due to the possibility of misalignment with conventional legal concepts and practice.

Several respondents raise the broader question of the need for shared perceptions of Shariah authenticity, calling for both greater standardization of Shariah standards and practices, globally and nationally, as well as for strong and autonomous Shariah governance systems. One respondent in a Group 2 Islamic bank notes that he had to insulate his own Shariah board from "the decisions of inexperienced Shariah boards in other banks." Some IFIs are also concerned about the quality of Shariah decision-making in new banks that are appearing in their markets, especially in mixed conventional/Islamic environments (e.g. Group 7) where it may not be clear "to what extent they will adhere to the Islamic banking principles."

Islamic banks also face unusual legal risks, both due to the greater number of contracts inherent in Shariah-compliant financing but also because of occasional dissonance or uncertainty (misalignment, etc.) with conventional legal concepts and practice, in both common law and civil law. Islamic banks note a need to harmonize Shariah contract language and concepts with prevailing conventional law to avoid confusion and lower legal risks.

A Group 2 respondent calls for greater coordination between global Islamic Finance bodies (IFSB, AAOIFI, etc.) and the various international governing bodies in the formulation of global regulations "to ensure their coherence with Islamic Finance operations." Respondents said that the best protection of an Islamic bank's reputation is "strict adherence to internal compliance policies and external regulations" in order to maintain a spotless reputation. This adherence includes both national regulations as well as global Shariah standards. In order to ensure proper alignment, several IFIs note initiatives to better coordinate regulatory compliance. One Group 3 Islamic bank has established a project taskforce to track changes in both prudential and Shariah rules "to manage the transition of affected products, services and processes" beyond mere compliance. A Group 4 Islamic banker notes that the lack of full set of regulations overseeing Islamic banks is a concern. To address this, he "currently discuss matters with regulators as a uniformed body of Islamic finance practitioners" to help coordinate and lobby for improved regulatory oversight.

To protect specifically against Shariah compliance risks, a common observation is that Islamic banks must ensure strong autonomy for the Shariah governance process within the Islamic bank, both of the Shariah board and of its supporting Shariah functional units, such as Shariah audit. Seamless integration of the Shariah support units into the product development process is imperative. As one respondent put it, the Shariah function must "be independent and supported by the management to ensure that pre-product approval and post-product approval process are in line with Shariah principles." A strong alignment between product development and Shariah compliance not only lowers Shariah risk but also raises overall efficiency. Many Islamic banks have clear processes to ensure optimal Shariah compliance involvement at specific phases of the product development process with a view to incorporating appropriate and cost-effective guidance at each stage: not too much but never too little.

Respondents also note that those staff closely involved in Shariah must enjoy continuous education and coaching so as to "take informed decisions and know the business sensitivities" since they guard the Islamic bank's Shariah reputation while at the same time supporting its profit-making objectives. Moreover, the Islamic bank should be capable of seeking feedback to overcome shortcomings and heed customer concerns.

On a global level. more standardization is needed, led by global standard setters to avoid the situation, as one GCC bank put it, where some approaches and practices "are allowed by Shariah scholars in one region or country and banned in others," leading to confusion in the market and possibly casting doubts on the authenticity of some banks' practices. To counter any lack of distrust or confusion, respondents urged an emphasis on transparency. Raising the transparency of process mechanics, including the processes by which Profit Sharing Investment Accounts are managed as well as the Shariah compliance process itself, is seen as a broad need for many Islamic banks. Standardization of Shariah compliance must also include better consistency on disclosure requirements as part of the evolution of Shariah governance standards.

Another concern is the degree to which the national authorities are responsible for ensuring Shariah compliance, if at all, among the Islamic banks within their jurisdiction. In some systems, the central bank itself will play a role in assuring consistency and in setting the outer limits of what is acceptable, essentially with a national-level Shariah board. Others prefer to let the market decide, focusing more on the integrity of the Shariah governance requirements to ensure that processes are in place to affirm that a financial institution that attests Shariah compliance can in fact attain that goal. In some jurisdictions, especially where Islamic banks are new or a small minority of financial players, the regulators may have little or no say in what determines Shariah compliance.

Each tactic has its risks and benefits, but in all cases the government and global bodies must have some larger objective in mind both to protect consumers, and therefore encourage financial inclusion in areas where significant portions of the population are sensitive to Shariah compliance in finance, and to permit greater transparency, including for the oversight bodies responsible for protecting confidence in the financial system and its players.

More broadly, the world's standard setting bodies are seeking to build greater consistency in regulation across a spectrum as wide as accounting rules, laws, capital adequacy, governance practices, and disclosure. In the midst of these attempts, better coordination between global decision-making bodies on one hand and Islamic regulatory and advisory bodies on the other will be critical to ensure that Islamic banks align with evolving global regulations as appropriate and that any specialized rules needed to reflect Islamic banks unique characteristics are considered, agreed upon, and implemented.

Islamic banks universally see the need to invest in enhanced risk governance

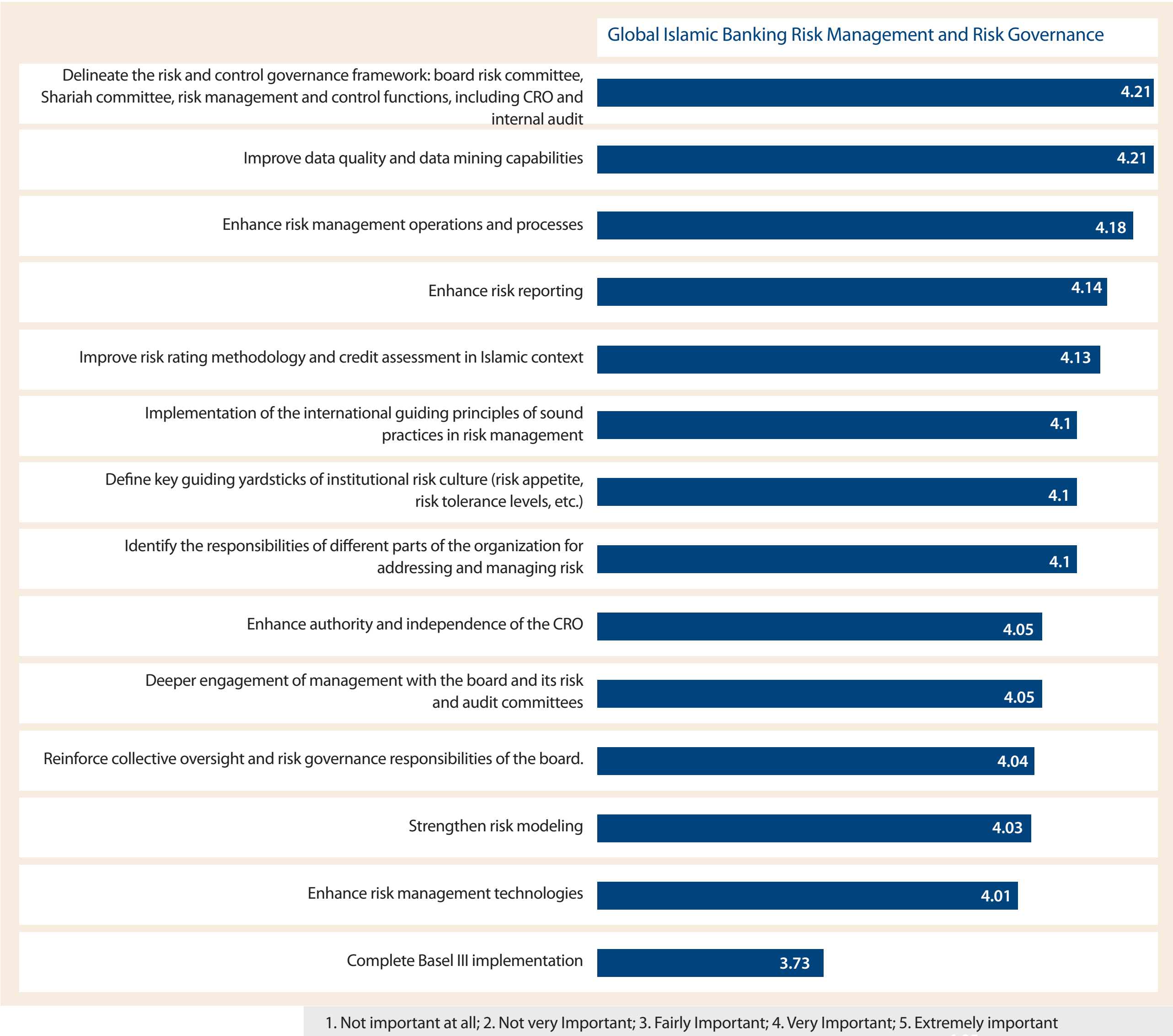
Even though the CIBAFI Survey found that most Islamic banks see the risks that they individually confront as manageable, averaging around "3", or medium risk, the Islamic bankers surveyed nonetheless broadly feel that they need to invest significantly in improving their own risk management processes across the board in the context of the rapidly changing risk environment. The survey found that Islamic banks see risk management, in all its forms, as a key challenge going forward, with the potential to impact both expansion and profitability. Virtually every area of the risk management chart below is viewed as 'very important' with a need to invest in all the major functional areas.

> Most Islamic banks see the need to strengthen risk governance as critical, focusing on the overall framework that underpins risk culture, including the relationships among the various stakeholders upholding the institutional risk culture, such as the board of directors.

Most Islamic banks see the need to strengthen risk governance as critical, focusing on the overall framework that underpins the risk culture, including the relationships among the various stakeholders upholding the institutional risk culture, such as the board of directors. In individual responses, several Islamic bankers place improving risk management capacity as one of their top priorities. This appears to be driven more by business imperatives than the requirements of regulators, and stresses specific risk management techniques, such as strengthening data quality and risk rating methodology and operations.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 6. Global responses on risk management and risk governance



Improved data quality and data mining capabilities is of greater concern to GCC, South East Asia, European and North American Islamic banks, as well as those in North Africa, whereas South and West Asian Islamic banks tend to focus more on basic risk governance enhancements and credit tools. Several Islamic banks note the need to strengthen human resource capacity in risk management

The need to invest in enhancing data quality and data mining capabilities as well as risk management processes is described as very important by bankers in all regions

Differences of opinion among the Islamic bankers surveyed in the seven groups of countries were not large, but some trends emerged among priorities for risk investment. Improved data quality and data mining are of greater concern to GCC, South East Asia, European and North American Islamic banks, as well as those in North Africa, whereas Islamic banks in South and West Asia tend to focus more on basic risk governance enhancements and credit tools. Sub-Saharan IFIs express the strongest concern for improving risk governance, including clarifying relationships and strengthening board oversight. Several Islamic banks note enhancements made to strengthen risk governance and the control environment, a key concern, including the coordination among functional areas: "The risk management committee is assisted in its oversight role by internal audit [who undertake] both regular and ad hoc reviews of risk management controls and procedures." The results of these internal audit reviews are then presented to the risk management committee as an independent confirmation of the risk area's own functioning..

Several Islamic banks note the need to strengthen human resource capacity in risk management, in credit risk and other areas. Some respondents focus on raising overall staff capacity by recruiting qualified staff and through more targeted training. One Islamic banker notes that the speed of change in the market, including product complexity, raises the risk that longer tenure employees are unable to keep up with the changing parameters. The solution, the banker says, is to set up succession programs with associated training to ensure skill continuity.

There is broad concern in the Islamic bank community about human resources. This includes not only the skill and capacity levels of the staff within the IFIs but also of the supporting cadres, such as Shariah board members, Shariah scholars, regulators, and associated professionals (lawyers, auditors, etc.). Bottlenecks in capacity affect Islamic banks' growth and raise risk levels, creating succession concerns and hampering the maturity of processes and approaches.

PART III
THE CIBAFI ISLAMIC BANKING GROWTH MONITOR

Part III.
The CIBAFI Islamic Banking Growth Monitor

The Growth Monitor presents the views of Islamic banks about the key drivers that they perceive are of importance to achieve sustainable growth. The survey ranks the most important factor under each key driver to grow over the next few years ahead.

Islamic finance continues its robust growth worldwide

The Islamic finance market has grown rapidly over the past two decades, currently reaching almost US$ 1.8 trillion in assets. This rapid growth is rooted both in the expansion of Islamic finance into new client bases within the core geographic areas and beyond, as well as in the higher than average growth rates of the economies where Islamic finance is concentrated. Islamic finance growth continues to outpace conventional finance in its traditional core in the GCC and Malaysia, but has also begun to expand more quickly than conventional finance in pioneering territories, such as Turkey and Indonesia.

The current volatile political situation in many Middle Eastern countries is expected to have a dampening effect on Islamic finance, and indeed on economic growth, in the region. Some countries, of course, are directly and dramatically affected by the situations, such as Libya and Yemen. As one banker in Yemen put it, given the current situation there, they have "no specific agenda for growth" since the goal is survival. Even in relatively peaceful areas such as Saudi Arabia, Jordan, or Tunisia, the secondary repercussions are affecting economic growth expectations, e.g. military spending in Saudi, refugees in Jordan, a drop in tourism in Tunisia.

Segment focus: Islamic banks remain concentrated in a few business lines

Business finance, real estate, and project finance segments continue to be the main drivers of revenues

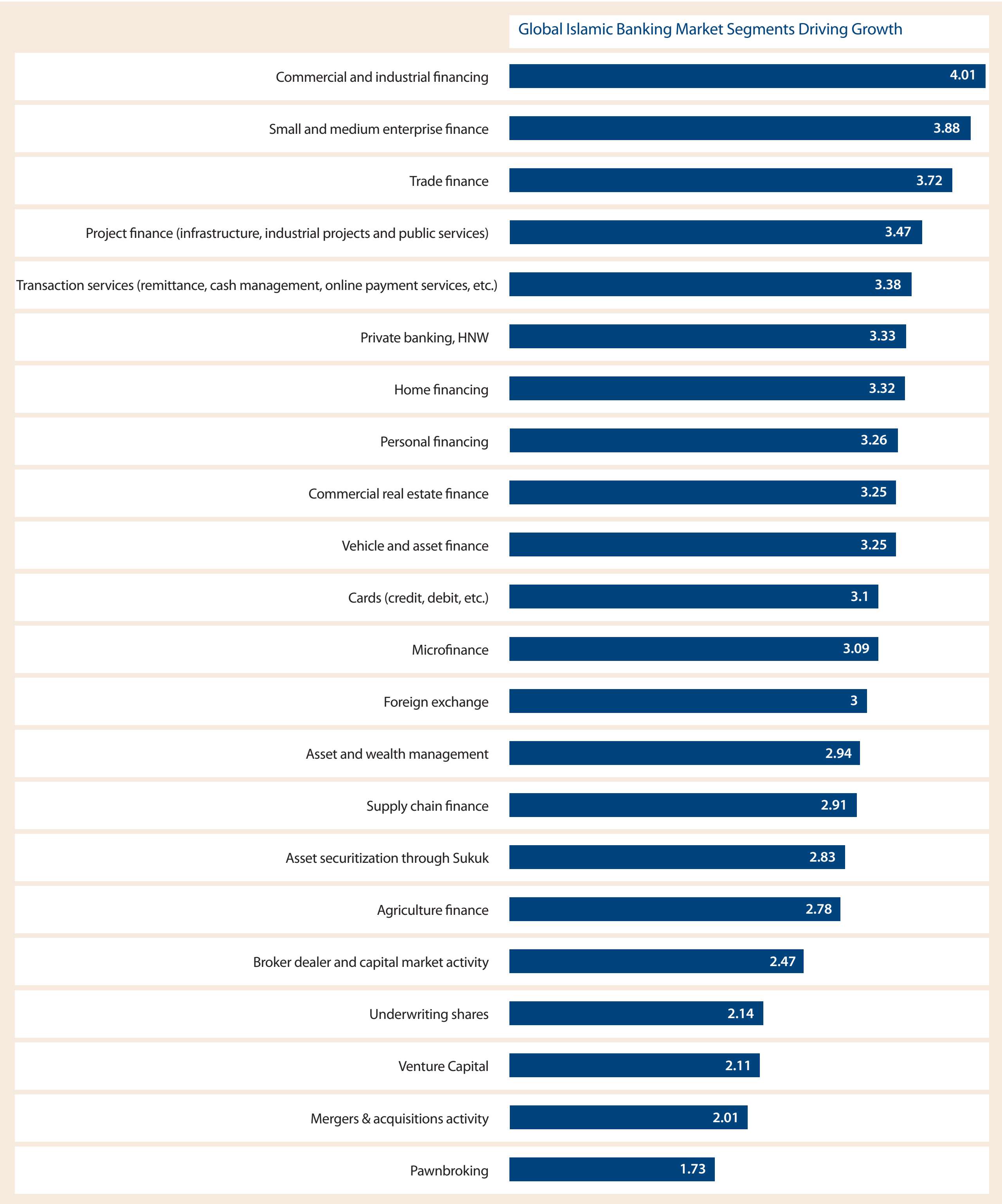
> Commercial and industrial financing, SME financing, trade finance, project and commercial real estate finance, transaction services, private banking and retail financing are at the top of the list.

The survey reveals that Islamic bankers see many ways in which they will be able to expand in future. Over a dozen business lines are considered important in driving growth. Not surprisingly, the traditional main drivers of Islamic bank revenue generation – commercial/industrial financing and trade finance – continue to dominate, with project finance and commercial real estate finance not far behind.

SME financing, a relatively new area of focus, now ranks just behind commercial and industrial financing, illustrating the trend of many Islamic banks in moving more down-market in size terms to grow their customer bases. Other forms of commercial finance, including agricultural finance, supply chain finance, and microfinance, rank somewhat lower, hovering below 'somewhat important' in average rating.

GCC respondents rank the financing of businesses, including project and commercial real estate, as top drivers of growth, just ahead of project financing, reflecting the traditional mega-project driven economies of the oil-exporting Gulf economies. The drop in oil prices has put pressure on the GCC economies as surpluses turn into deficits, potentially worrying local banks. As one GCC banker put it, since his bank works solely within the domestic market, its revenue "is reliant on the government to continue its spending so as to sustain or improve economic growth of the nation." The bank's growth will continue "assuming the government spending continues" but will be threatened otherwise.

Figure 7. Global responses on market segments driving growth

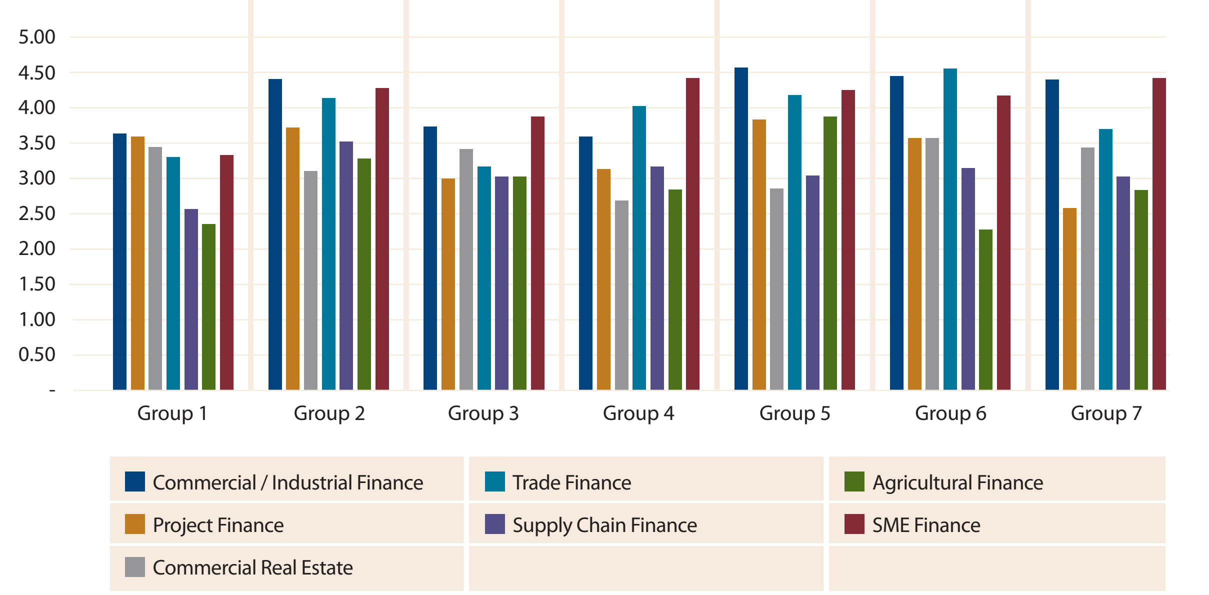


1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Part III. - The CIBAFI Islamic Banking Growth Monitor (continued)

Commercial and industrial financing ranked highly in all zones, but trade finance was also prominent in all except South-East Asia. However, Sub-Saharan Africa is the only region where trade finance was viewed as the leading business driver, at least partly explained by the enormous growth of the export sector in several African economies. Commercial real estate financing was prominent in some areas, but not to the extent that might once have been expected.

Figure 8. Regional responses on business finance segments driving growth



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

SME financing has emerged as a leading driver across all regions, partly due to the potential profitability of the segment once critical mass has been achieved.

Many Islamic banks are turning to building SME lines of business

SME financing has emerged as a leading driver in all regions, but especially among South West, South, and South East Asian Islamic banks where the predominance of SMEs in the local economies has appeared as a leading impetus for revenues. A Turkish respondent points out that "in Turkey, SMEs constitute more than 95% of commercial enterprises" and so his bank is creating a special division to focus on this market. A South East Asian banker declares that the two key growth drivers are "(1) to focus on financing growth in the small and medium enterprise and micro segment and (2) to focus on an Islamic business ecosystem for sustainable and responsible financing/ investment." Each will in turn require development of an appropriate model as well as infrastructure enhancement to achieve fruition. SMEs are also considered the second most important driver of growth by bankers in North Africa.

SME financing is also beginning to emerge as an area of focus in the GCC, partly as a result of the concern about over concentration on the larger corporates, who are more dependent on government contracts, and partly as a result of government pressure, with the knowledge that SMEs generate a disproportionate amount of much-desired private sector jobs, and partly due to the potential profitability of the segment once critical mass has been achieved. As one GCC respondent put it, SME and venture capital lines of business "offer job opportunities for graduates and entrepreneurs [and] achieve economy growth and diversity."

In all regions, SME is a long term business that takes commitment, knowledge, and the size of book to achieve economies of scale and diversification. The issues faced by Islamic banks in this sector are discussed in more detail in Part IV.

Consumer financing segments stand out among the Asian Islamic banks, while Middle Eastern and GCC banks see this segment as a means to diversify their portfolios away from the increasingly competitive commercial finance market. North Africa remains the region with the least focus on consumer finance.

Islamic banks are increasingly focusing on consumer financing to foster greater growth

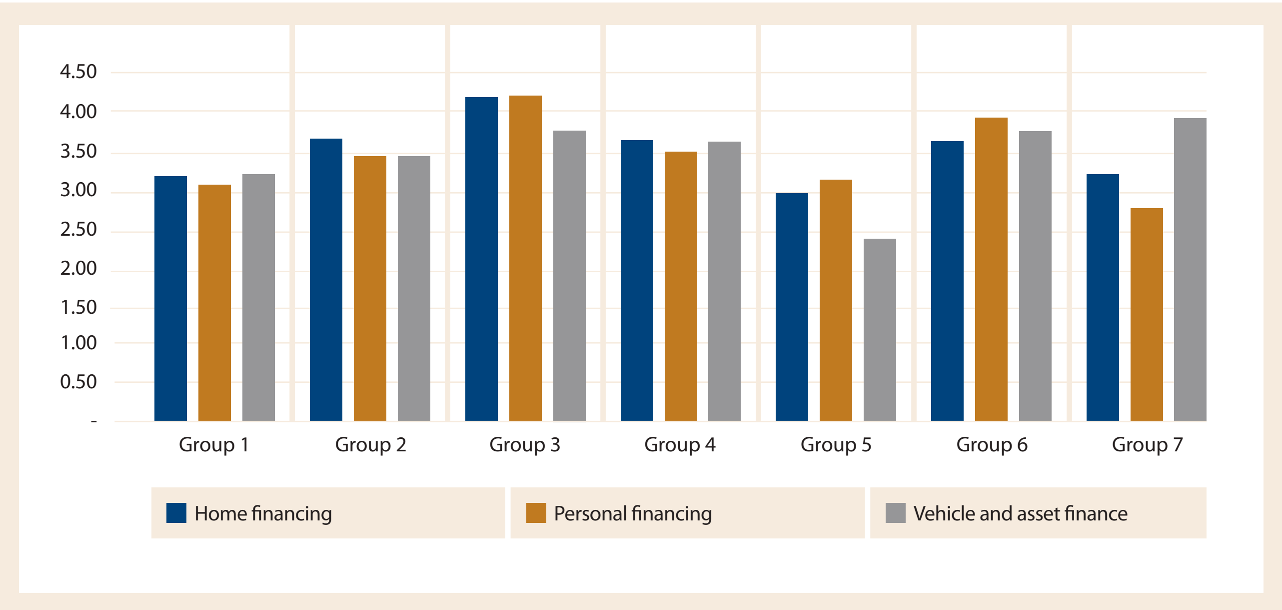
For most Islamic banks, consumer financing emerges as an area that is expected to spur new growth, with personal finance, vehicle finance, home finance, and private banking all considered important. Home finance, a rapidly growing area of both need and interest throughout those economies where Islamic finance is significant, is ranked first among consumer finance business lines, hovering between fairly and very important. Consumer financing segments rated highly in almost all geographies, but stands out especially among the Asian respondents, with both home and personal financing reaching 'Very important' in South East Asian Islamic banks.

Middle Eastern and GCC banks also see consumer finance as somewhat important, with respondents seeing consumer finance as a means to diversify their portfolios. One GCC banker says that his bank, along with its traditional business offerings, is "seeking solutions which also target the affordable and social housing segment of the economy." This expansion serves as part of their diversification strategy "into many and granular sectors to avoid concentration risk." GCC banks, especially, are seeing the top end of commercial banking facing increasing competition, with spreads narrowing and the beginning of disintermediation, making consumer and small business financing more attractive with their traditionally higher spreads and stickier deposits.

North Africa is the region with the least focus on consumers as the IFIs seek to gain footing in those markets. Vehicle and asset finance has particularly low ratings, ranking as "Not very important." Islamic finance is still relatively new in the region and, as in most areas, is starting more with larger corporations.

Europe and the US are the only areas where vehicle and asset finance clearly outpace home and personal finance. This is at least partly related to the vast, already established home finance markets, making newcomer entry more difficult. Vehicle finance is relatively straightforward and in economies where control over movable assets is clear, such as the US and Europe, fairly easy to securitize, lowering credit risk. Moreover the lease-to-own structure is already well known in vehicle finance and the Ijarah structure offers a close Islamic analogue.

Figure 9. Regional responses on consumer finance segments driving growth



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Islamic banks view financing activities as the key drivers of growth, rather than non-financial services. Nonetheless, several banks noted that they were keen to expand fee-based services to bring higher returns against their existing assets.

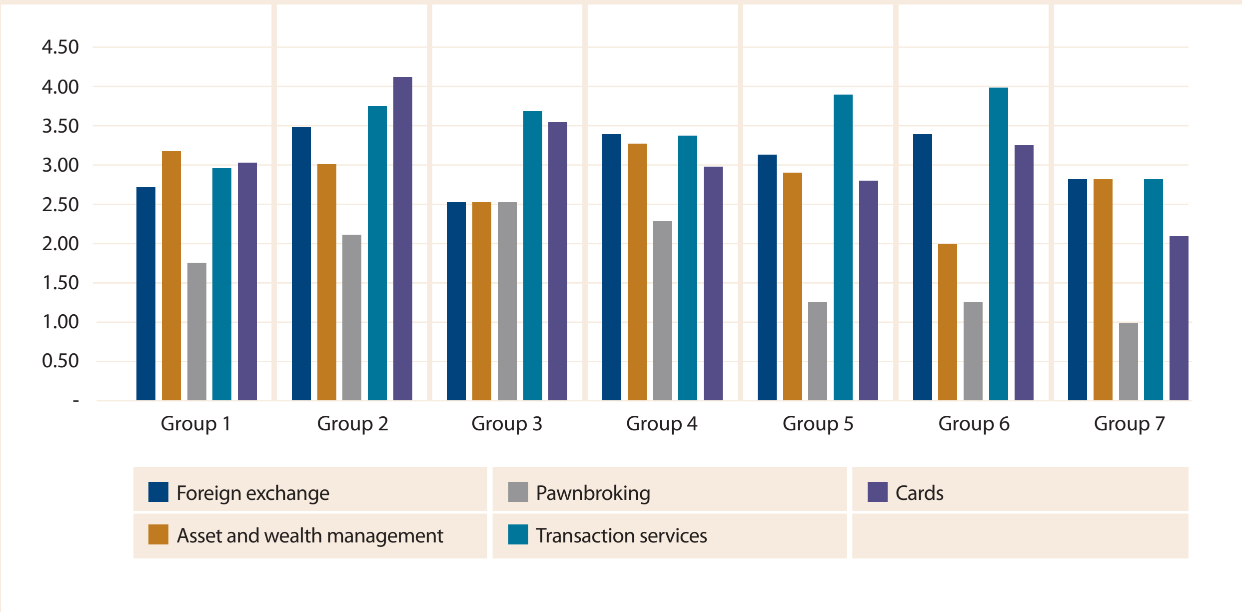
Service and fee based activities remain secondary

Islamic banks view financing activities as the key drivers of growth, rather than advisory or transaction services. The only non-financing activity that ranks as very important is transaction services, such as remittances. Nonetheless, several respondents note that they are keen to expand fee-based services to bring higher returns against their existing assets.

Some strong regional variations emerge. Cards rank first among services as a revenue driver in the Middle East and second in the GCC and South East Asia, all of which are relatively advanced markets. Asset management, not surprisingly, is a leader in the GCC (Group 1) with its long history of wealth management, but it also ranks high in Group 4 (South and South West Asia) and Group 7 (Europe and the US). A European bank observes that, for asset and wealth management, "Islamic investors and consumers are underserved and demand products such as insurance and pensions." Yet the industry remains small due to the lack of competitive products. "This market will be a significant source of fees for the Islamic finance sector and an important growth driver."

Foreign exchange ranks high in both South and South West Asia and in Sub-Saharan Africa, regions where trade finance is a key driver. Pawnbroking is ranked as the least important for most Islamic banks,) where this segment has higher ranking in Southeast Asia compared to other groups, reflecting the higher penetration of pawnbroking as a financial strategy in Malaysia and Indonesia.

Figure 10. Regional responses on service- and fee-based segments driving growth



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

The skew towards commercial banking is not surprising, given the traditional make-up of Islamic finance globally, generally slanted towards earlier stage of financial systems.

Investment banking and equity activity are less important

At the low end of the scale, some business lines are considered less critical or even unimportant in driving growth. Investment banking activity is still seen as a low impact area of Islamic finance. Segments such as share underwriting, mergers and acquisitions, and venture capital are all ranked around '2' or not very important, with broker/dealer and capital market activity below 2.5.

This skew towards commercial banking is not surprising, given the global profile of Islamic finance, which is generally slanted towards earlier stage financial systems. Most of the respondents to the survey represent Islamic commercial banks as opposed to investment firms, i.e. focusing on traditional low-risk commercial activities rather than investments. The survey does not break out investment banks from commercial banks but this bias is likely to be representative.

Global figures indicate that traditional commercial financing still represents over 80% of all Islamic financial transactions, and perhaps more. This is partly a result of Islamic banks' level of evolution, with the traditional emphasis remaining with the initial businesses of trade finance, shorter-term commercial financing, and real estate. The banking systems in the core regional areas where Islamic finance began also tend to be disproportionately concentrated in these financing activities. The Middle East, for example, has traditionally been heavily geared towards trading and real estate as economic drivers.

Moreover, capital markets in the areas where Islamic finance is growing fastest tend to be, to varying degrees, somewhat less developed. The tendency to disintermediate the banking system through direct investments (commercial paper, IPOs, private equity) is much less common than in the advanced economies. At the same time, the legal and regulatory regime has not yet fully evolved to encourage the expansion of more investment banking approaches.

Additionally, many Islamic banks do not have the skill capacity to engage in equity financing, with their higher risks (shared partially or fully by the investor) and required exits. A North African banker laments that their capital financing product class, "is facing a problem of dishonesty and mismanagement." Nonetheless, many Islamic bankers feel the need to migrate towards more risk-sharing, equity or equity-like products, both to move closer to what many feel (and many Shariah boards feel) is the spirit of Islamic finance and also to respond to client needs. As one GCC respondent puts it succinctly, "The banks will have to move to equity based products from fixed-income based products." Another Southeast Asian respondent notes that, in order to grow their financing assets, the institution expects to see "further contribution from the Islamic Capital Markets and Wholesale Banking operations, apart from growing our traditional consumer financing segment," targeted to reach at least 20% contribution of the parent bank's financing assets by 2017/2018. If this migration towards more capital market and equity-based products is to happen, it will entail significant consideration of the impact of the change in terms of client perception, risk profile, and regulatory oversight.

One area that may foster the link between traditional commercial banking and investment management is the prospect of securitization. As many Islamic banks find themselves burdened with longer term assets mismatched against shorter term liabilities, and especially given the need for liquidity, securitization of well-performing assets becomes an attractive option. This has begun to occur in regions with deeper and more evolved markets, such as the GCC and Malaysia, but will certainly expand as assets mature and as securities markets evolve (assuming that they do).

Several respondents note the attraction of, and growing need for, securitization to strengthen their balance sheet and hope for its continued growth. One GCC respondent shares a need to "find Shariah solutions to restructure/ securitize the company's debt." Respondents seem to agree that the whole discipline of transforming Shariah compliant assets into tradable securities, whether highly performing or not, is an area in great need of nurturing by IFIs, by their regulators, and by the supporting institutions. This effort would not only support the healthy transformation of Islamic banks' balance sheets, generating greater liquidity, but would also lead to the generation of a greater stream of Sukuk issuance, which in itself would help to facilitate liquidity management for the Islamic banks. There are, however, real issues here, centring on the Shariah restrictions on trading in debt.

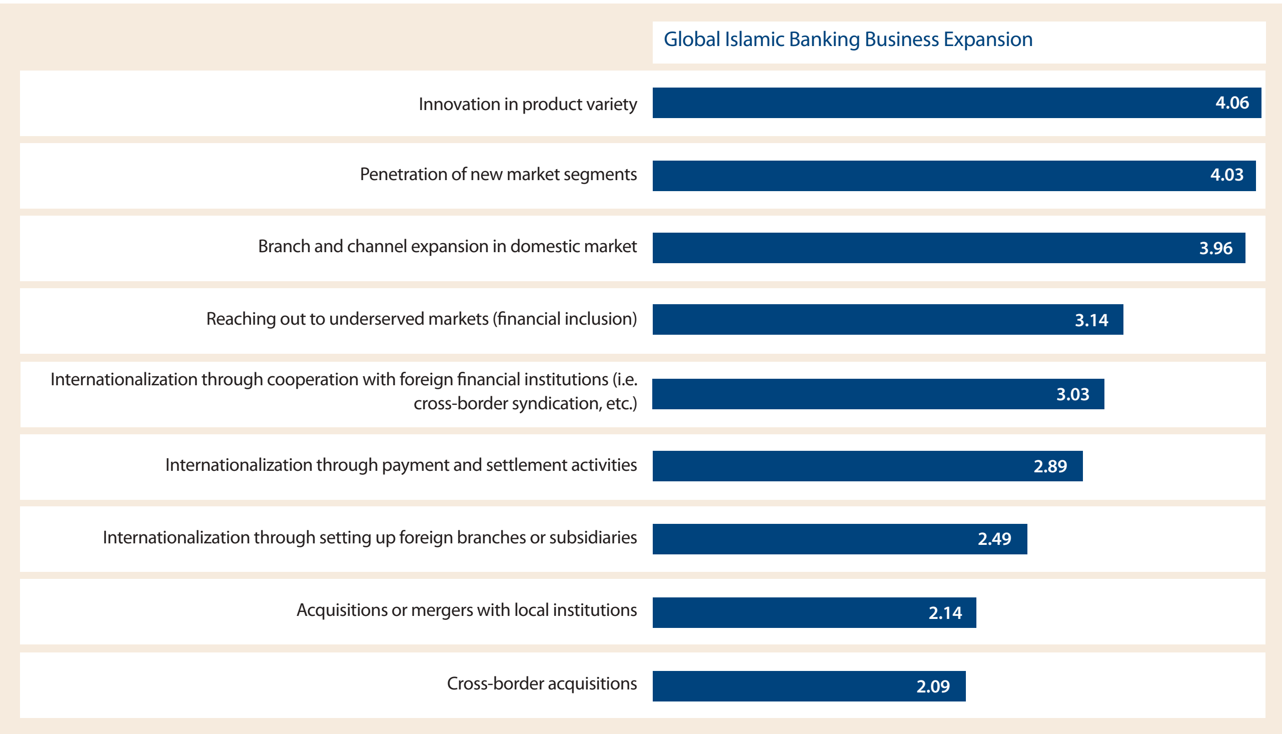
Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Islamic banks cite product innovation and expansion in their domestic market as the primary drivers of business growth, considered 'Very Important' in all groups. In contrast, cross border growth is seen as a low priority for most. The only cross border strategy that attains an average score is cross border cooperation with international financial institutions, for example through syndications.

Business expansion: New products, new segments, and distribution channels will drive business expansion

Respondents were asked what would be their main areas of business expansion to achieve competitive positioning. They cite product innovation and expansion in their domestic market as the primary drivers, considered 'Very important' in all groups. Domestic market expansion includes penetration of new market segments as well as extension of distribution channels to reach new clients. The strategy of specifically reaching out to under-served markets is also considered an attractive component of market expansion, but is viewed as only 'Fairly important' on average among all respondents and is least important as a goal in Groups 5 and 7.

Figure 11. Global responses on business expansion priorities



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Many Islamic banks express the need to increase product innovation, both to help differentiate in the market but also to ensure full satisfaction of all customer requirements. As one Group 1 banker puts it, "once a customer walks into your outlet he shouldn't go out without fulfilling his financial needs." A respondent in the UAE hopes to focus on "product innovation in home finance" benefiting and supporting the stability of the residential real estate sector in the Emirates.

Many Islamic banks perceive product innovation to also mean new approaches to product structure and delivery, including greater use of electronic channels. As one Middle East banker puts it, to attract new customers and raise customer satisfaction they must "develop new services and products in particular electronic."

Domestic growth is generally a highly sought goal among all regions. A South Asian Islamic banker states that his bank's strategy calls for a push towards universal banking, reaching out to all client segments including micro and SME, and that as its strategy nears fulfilment, the bank will be "present in all regional centres over the country via expanding its sales network."

To fuel such growth, expanding distribution channels is a high priority. This is driven by many goals but especially accessing more and cheaper funds. A GCC banker states that branch expansion is aimed mainly at attracting core deposits and that the size of the network must be "directly proportional to core deposits." A respondent in an African Islamic bank (Group 6) notes that "retail liability generation is one of the growth drivers" of the Islamic bank, mainly through branch expansion but also via "virtual channel development" supported by investments in high-availability network resources. Additionally, some Islamic banks are specifically seeking foreign currency resources to support their expansion, including deposits. According to a North African respondent (Group 5) this can be done through "relationships with third parties and operations to attract more resources in foreign currencies..

A GCC banker points out that service quality drives market growth. Improved quality in turn is initiated by "product innovation and expansion of branch networks." A Turkish banker states that his bank intends to continue the current pace of expansion of 20 to 25 branches per year in order to reach untapped regions of Turkey and to "increase the share of participational Islamic banking." At the same time the bank seeks to grow alternative channels such as XTM, an alternative unmanned branch system, and a digital banking platform. A respondent from Southeast Asia notes a similar objective in their institution: "We foresee a structural shift from traditional banking activities to alternative modes of banking channels, in a landscape where innovation is an inevitable factor of success." This shift will primarily be supported by digital solutions and efforts to raise overall efficiency.

Domestic growth strategies do not differ significantly among groups. Islamic banks in Sub-Saharan Africa (Group 6) are keenest on innovations in products and in markets, including underserved markets, but the least interested in domestic mergers. Islamic banks in the US and Europe are at the other end, with low interest in product innovation and new markets, but more welcome to domestic mergers.

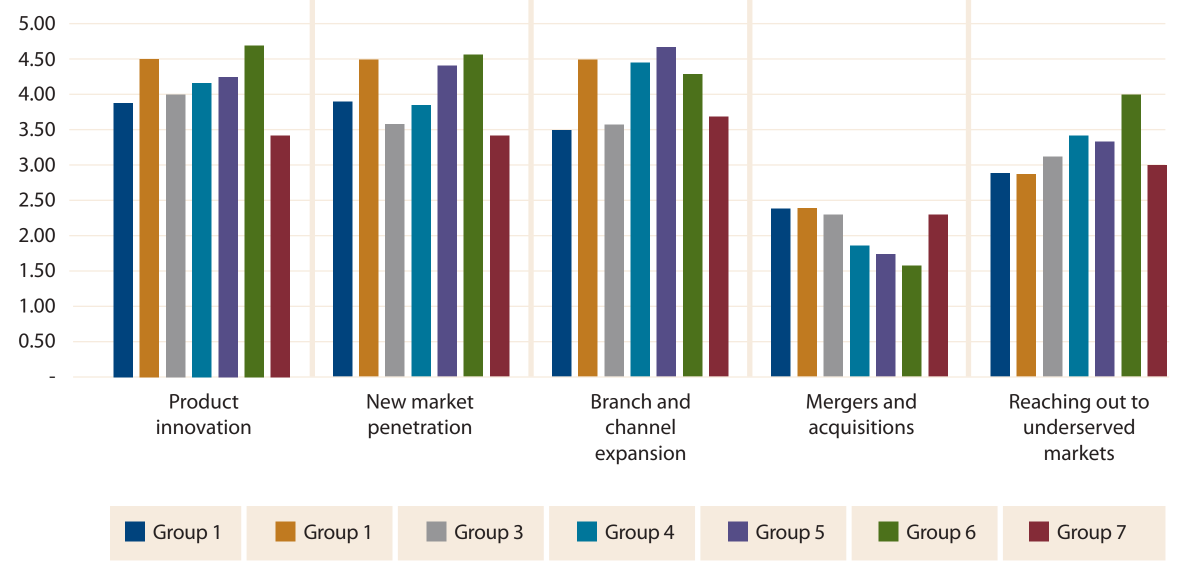
Cross border growth is a low priority for most, apart from the focus on cross-border syndications

Across the board, Islamic banks do not view international expansion as a high priority and are focusing on domestic markets. The only cross border strategy that attains an average of "3" or more ("Fairly important") is cross border cooperation with international financial institutions, such as via syndications. Internationalization through setting up activities overseas, for example with foreign branches, or through payment and settlement activities, are rated between "2" ("not very important") and "3".

Although none of the groups had an overall strong interest in globalization, the degree of focus is not the same across the regions. North African Islamic banks (Group 5) show the strongest interest, particularly in cooperation with foreign IFIs but also through operational relations. On the other extreme, Islamic banks in West, Central, and South Asia, showed the least interest in cross border activities, generally ranking such strategies not very important.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 12. Regional responses on business expansion priorities



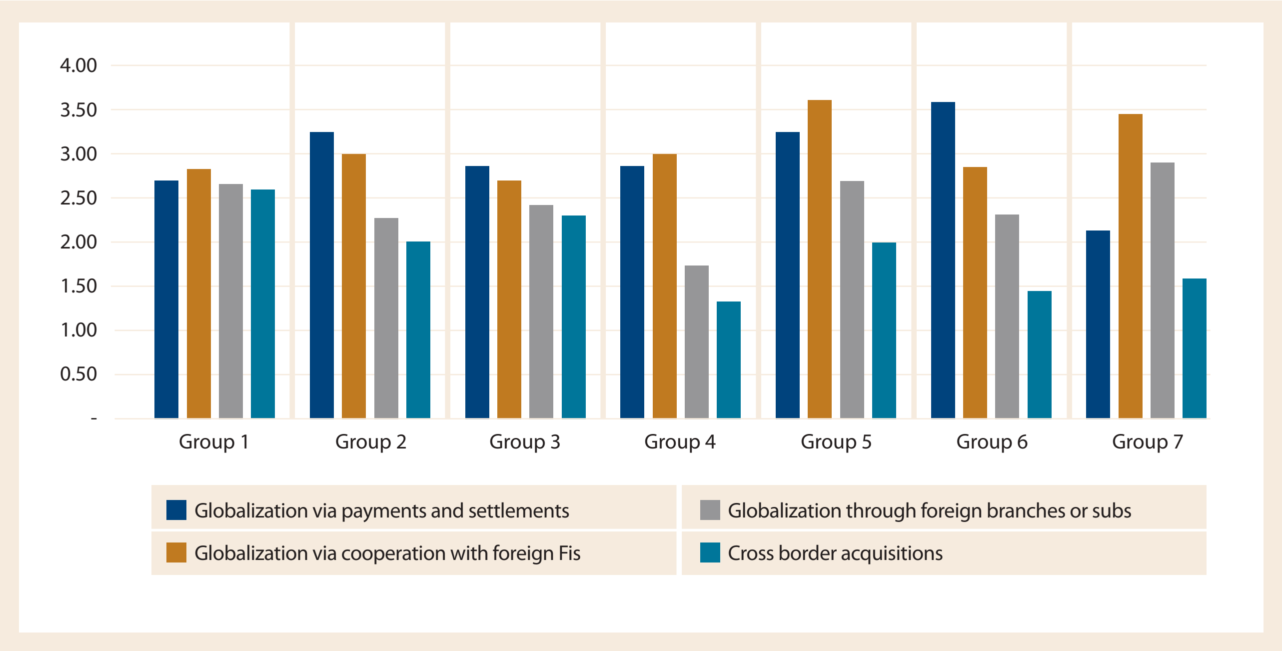
1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Few Islamic banks show an interest in cross border mergers and acquisitions

Cross border acquisitions are not seen as very important in any region at this time and indeed overall rank the lowest in interest among all strategies. The financial crisis may have restricted any appetite for such expansion, both because of retrenchment back home as well as fears of volatility overseas. Moreover, Islamic banks generally are younger and smaller than their conventional counterparts with a more fragmented market given the many start-ups. Many are also family run, which hampers mergers given the tendency of family-run businesses to try to retain control. The few mergers that have succeeded, for example in Dubai, tend to be at the behest of regulators rather than as a result of strategic plans.

Cross border mergers are even less common, partly due to the legal and regulatory obstacles that accompany them.

Figure 13. Globalization Strategies by Group



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

The GCC remains the region most drawn to cross border acquisitions activity

Of all regions, the GCC shows the greatest interest in foreign acquisitions, rating such a strategy as 'fairly important' on average. Islamic banks appear to have diverse cross border strategies. One GCC respondent mentioned that they plan to focus on MENA expansion, "focusing on HNW by studying the potential sectors in (MENA) region." Another aims to diversify the business model by developing outreach to overseas clients and focusing on "fee-paying activities."

The greater GCC interest in international expansion is not surprising given that the region's IFIs have some of the strongest cash positions. The high level of capital and the natural limits on domestic growth are encouraging Saudi banks, including Islamic banks, to seek overseas expansion. Indeed Saudi and other GCC banks pioneered cross border growth. Al Baraka Banking Group, based in Bahrain, has established a presence in twelve countries, although with a limited footprint in the GCC itself. Among Saudi Islamic banks, Al-Rajhi has led the way with branches in Kuwait, Jordan, and Malaysia. But even Al-Rajhi's focus has more been on consolidation in the past few years rather than rapid expansion.

> Multi-channel experience is perceived as competitive customer engagement. A clear thrust is to tailor the client experience, both through expanding and enriching channel interaction as well as through customized products. The aim is to effectively compete with conventional counterparts, since merely being Shariah compliant is not sufficient to broaden the market base.

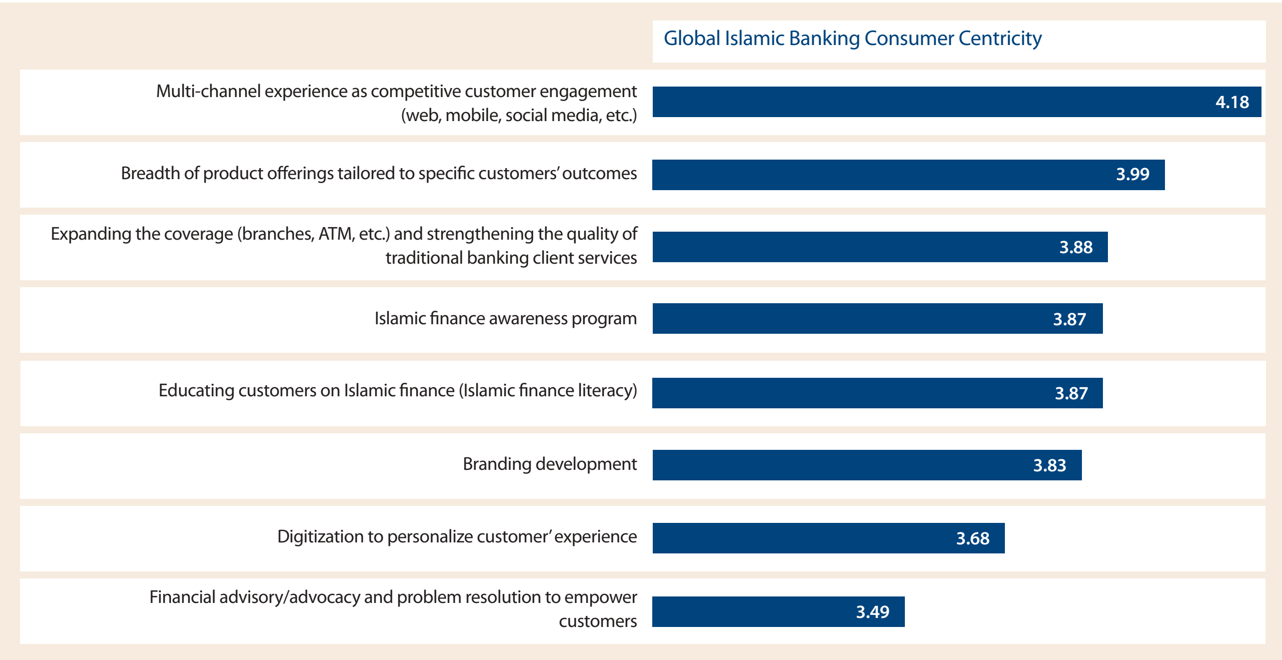
Consumer centricity: Islamic banks are keen to create a more client-friendly multi-channel experience

Respondents were asked which of a range of strategies to enhance customer centricity were high on their businesses' agendas. Each strategy ranks at least 3.5 so clearly the need for client centered strategies has become a central concern of Islamic bankers, and this is true across all geographical groups. Several respondents comment on the need for greater client centricity in Islamic banks, with suggestions that there was residual complacency from a period where a certain subset of customers were captive in markets with little competition. As the markets expand, both in terms of new entrants and also in terms of capturing clients who are less tied to Islamic finance (i.e. less strictly Shariah sensitive), the need to focus on more proactively understanding client needs and satisfying them grows rapidly..

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

A GCC respondent (Group 1) notes that that his institution more than anything must now "focus on improving strategy and performance in order to effectively compete with conventional counterparts." In order to do this, the Islamic bank must invest in "greater customer centricity, operational efficiency and innovation." A Middle Eastern banker (Group 2) adds that for their institution their main goal today is "to make sure customers are satisfied with current banking services so as to achieve the principle 'we grow with customers, we partner with customers."

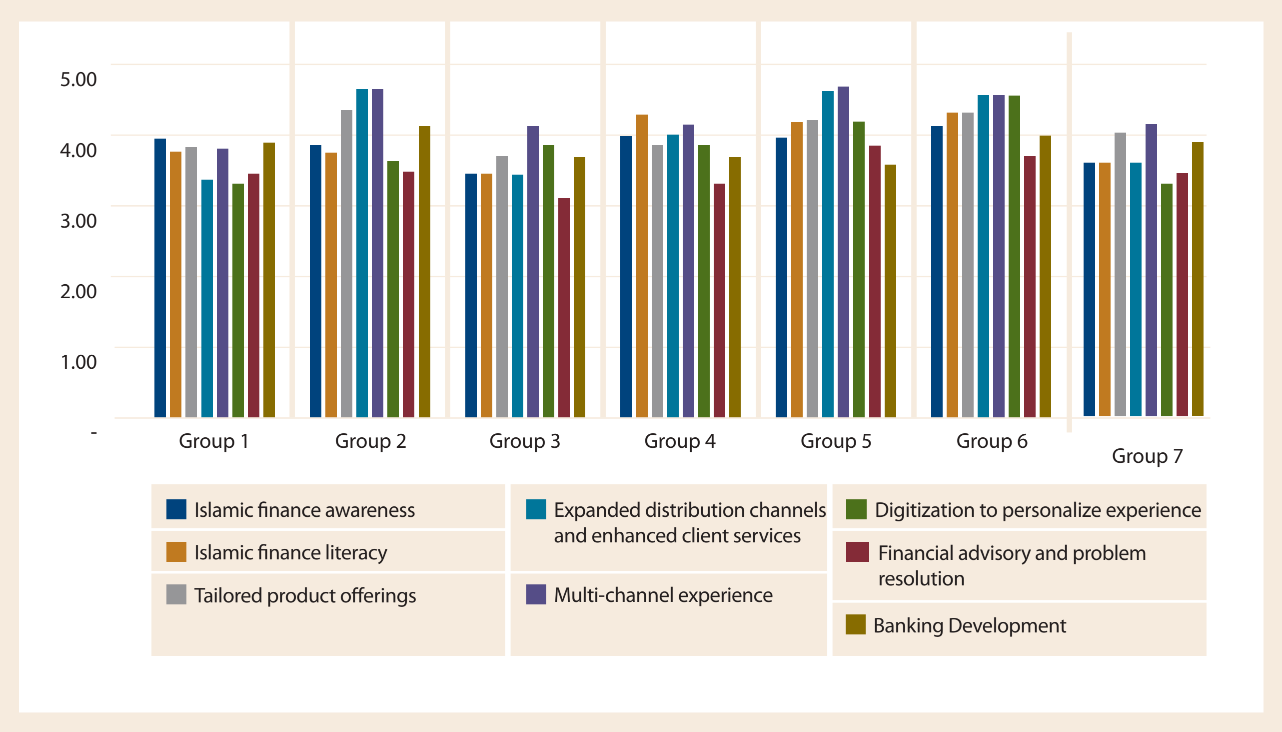
Figure 14. Global responses on consumer centricity strategies



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

All strategies rank high, but a clear thrust is to tailor the client experience, both through expanding and enriching channel interaction as well through customized products. This is especially clear in Groups 2, 5, and 6 (MENA and Africa), where this approach is considered of utmost importance (see Figure 15, below). One African respondent says that for their institution "the second growth driver is virtual channel development. We are investing in high-availability network resources to support this initiative."

Figure 15. Client Centricity Strategies by Group



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Respondents do not differentiate strongly between building awareness of Islamic finance and raising Islamic finance literacy: both score highly but South East Asian and European/American respondents are slightly less concerned than the rest. Although also considered important, the strategy of least concern overall is financial advisory and (tailored) problem resolution. For most Islamic banks, the latter is an integral part of customer service but financial advisory as a separate line of service may not be highly evolved.

Besides looking for new investment opportunities, Islamic banks show a strong preference for developing their own internal capacity for managing investments through "state-of-the-art advanced analytics in investment", including creating fresh investment strategies, and building their own teams of investment professionals.

Investment capabilities: Most Islamic banks prefer to build investment capacity in-house through advanced analytics and a proprietary team

Banks were asked about their main concerns to enhance their portfolio investment capabilities and performance. Across the board, respondents show a strong preference for developing their own internal capacity for managing investments, through the state-of-the-art advanced analytics, along with creating fresh strategies and building their own teams of investment professionals. Cost reduction and expanding into new sectors are also viewed as important. The high priority rank given to human resources issues, echoes concerns expressed in other parts of the survey.

As to shifting towards advanced analytics in investment to generate sustainable returns over the long term, the analysis in asset allocation needs to account for all possible expected returns across all asset classes available (i.e. equities, Sukuk, real estate, private equity/venture capital, infrastructure projects, etc.). In the context of advanced investment analytics, the allocation needs to also incorporate a dynamic and tactical approach, since profitable return premiums vary and fluctuate across different market and economic regimes. In that case, controlling risk exposures from various market and economic factors accounting for a dynamic nature of the market serve as a key.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 16. Global responses on investment capabilities

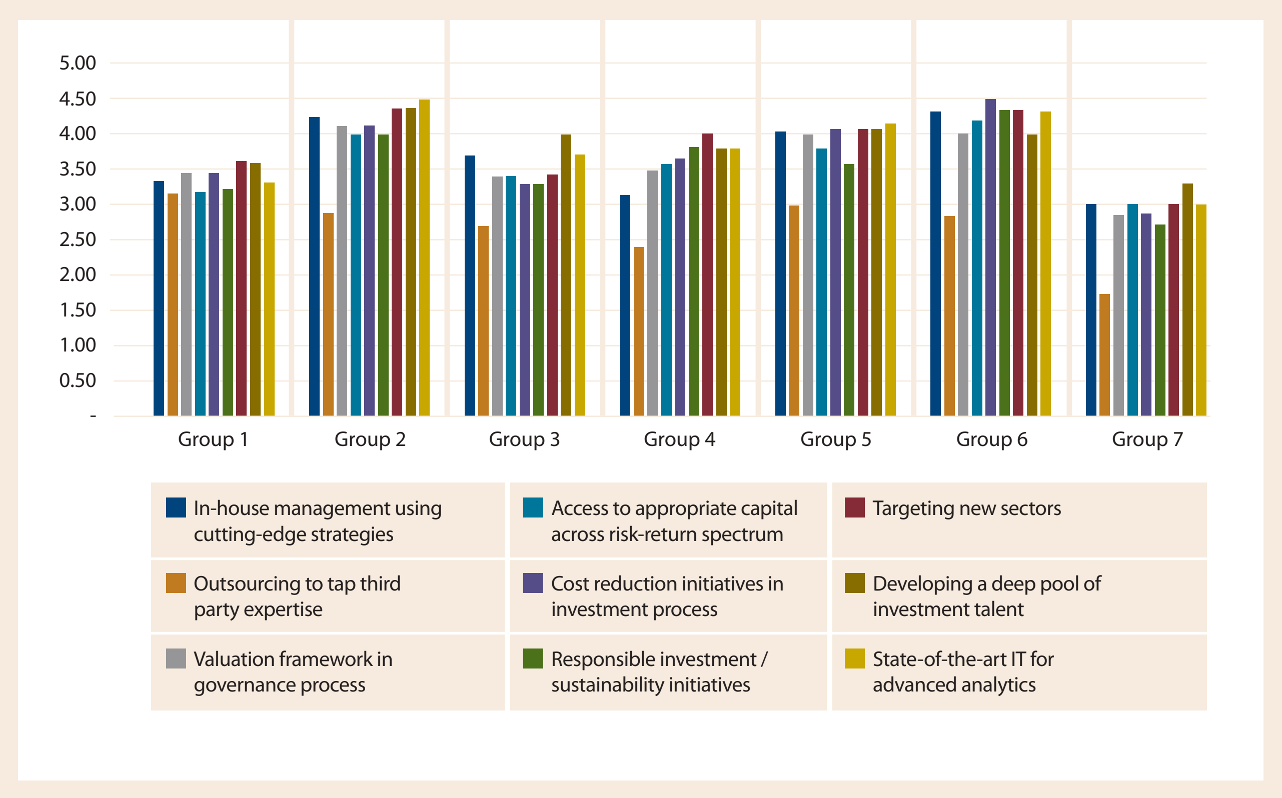
1. Not important at all; 2. Not very Important; 3. Fairly Important; 4. Very Important; 5. Extremely important

Islamic bankers also highlight the need to improve access to capital across the risk/return spectrum, as is the need to build a valuation framework for the governance. This concern reflects a rising awareness of risk capital and the gradual embedding of RAROC (risk-adjusted return on capital) among banks in the regions, to better optimize the deployment of scarce capital against financial assets. This appreciation for risk capital has arrived somewhat later in MENA and Africa but is becoming increasingly entrenched in those region's financial communities, both thanks to the rising implementation of Basel directives as well as an emerging awareness of the competition for capital and the imperative to employ capital effectively.

Some regions appear to be more tuned into raising investment capacity

Groups 2, 5, and 6 (MENA and Africa) are more enthusiastic about developing their investment capabilities, and all are keen on targeting new sectors and strengthening IT capacity for advanced analytics in investment. Bankers in Europe and the US (Group 7) are less interested in enhancing investment capacity, which might be explained by already higher capabilities among banks in the region. The GCC (Group 1) is the region most comfortable with outsourcing to experienced investment firms. This is not surprising given the strong GCC history of employing experts to help develop capacity and to manage aspects of the business.

Figure 17. Investment capabilities by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

The survey reveals widespread desire among Islamic bankers to enhance their information technology. Investing in improvements in IT infrastructure functioning, such as IT security enhancement, data strengthening, risk technologies, CRM, and heightened access and flexibility, rank high across all groups.

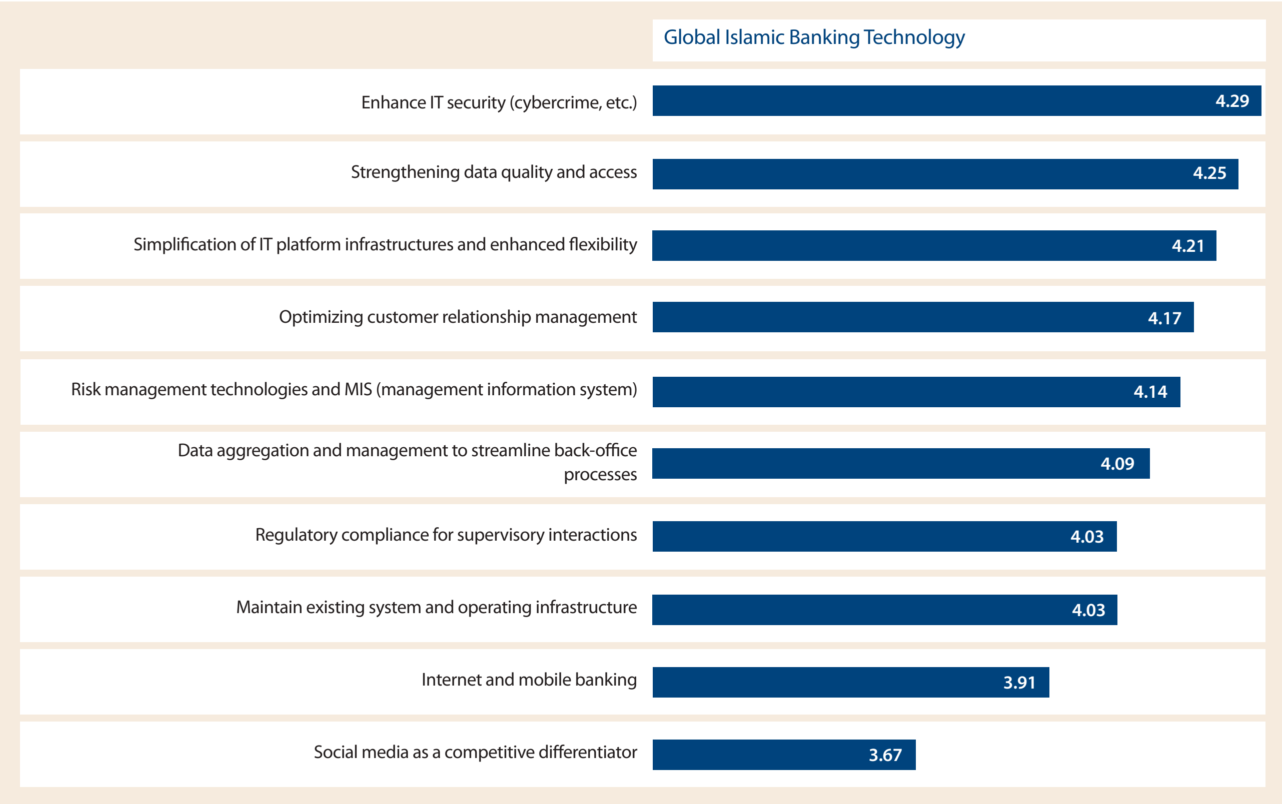
Banking technology: Islamic banks are aware of the importance of investing in IT infrastructure

Islamic bankers were asked about their main focus for improving banking technology. Islamic banks, younger than their conventional counterparts and competing in a niche market, have historically had special needs in terms of information technology. The structure of Shariah-compliant products calls for tailored IT programs to capture extra contract and operational steps that, if they fail, may jeopardize the compliance of the product or activity. Moreover financial and accounting information flows have their own complexities, for example with the treatment of returns on profit-sharing investment accounts, which differ considerably from conventional deposits. As a consequence, IT systems must reflect divergent standards, from core banking systems to customer credit workflows. Although the global IT vendors have in many cases tried to keep pace with the growing Islamic finance market, the market is inevitably younger with a higher proportion of untested products and a growing need for innovative solutions.

The survey reveals widespread desire among Islamic banks to enhance information technology with almost all of the options offered scoring over 4, or "Very important". Core improvements in IT infrastructure functioning, such as data strengthening, security enhancement, and heightened access and flexibility, all rank high across all groups. These issues are permanent concerns of IT users in all banks and, not surprising, are consistently viewed as critical among all respondents.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 18. Global responses on banking technology



1. Not important at all; 2. Not very Important; 3. Fairly Important; 4. Very Important; 5. Extremely important

Strengthening IT in risk management, CRM, and data quality

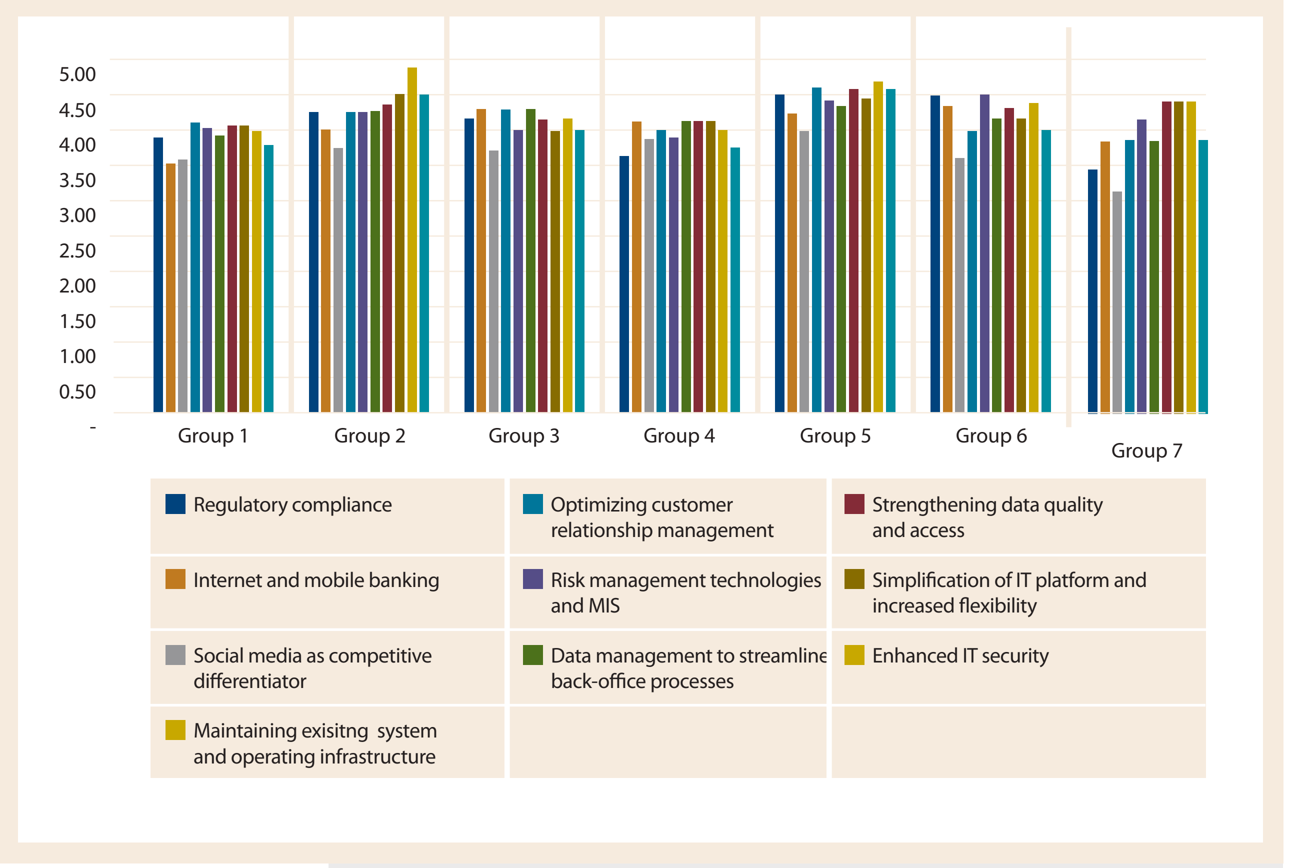
Africa and MENA tend to rank IT enhancements highest but all regions share an interest in improving capacity, especially in core functioning. As one North African respondent explains, his institution needs IT enhancement at all levels and must invest in "technological development at the level of operating systems, the collection and data mining, control, and dealing with customers." IT investment is seen first and foremost as a means of driving base processes to create efficiency and therefore bolster competitive positions. A South East Asian respondent affirms that his bank will focus on "developing an IT-based operational process to support business growth as well as decision making process."

Improved risk management also drives IT investment. An African banker also speaks of his drive to enhance IT systems but also to focus on "mitigation of IT related risks." Another African respondent notes that, to manage IT risk, his bank must engage in "measuring end of life technologies and proactively understanding the risks that may affect the bank."

Many Islamic banks are worried about IT security

Bankers in the GCC (Group 1) and Europe/America (Group 7) seem to be somewhat less concerned about IT investment, especially in core functioning, perhaps demonstrating the higher degree of IT evolution in those regions. However, IT security is a widespread concern: every group ranked it "Very important" or higher, and it is of particular importance among Middle Eastern respondents who see it as critical. As one GCC respondent puts it, "Islamic Banks have to enhance IT security measures to overcome [technology risk]."

Figure 19. Key IT enhancement goals by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Several respondents mentioned the enhancement of IT as a means of improving customer centricity and of boosting product innovation; in other words as a marketing support tool. One South East Asian respondent noted that his goal is business transformation based on “enhancing the proportion of our fee-based income through digitization efforts and innovative financial structures” where new product approaches are aligned with innovative technologies. These developments are a by-product of the way in which banking activities will be conducted moving forward, where optimising costs and improving efficiency are at the heart of banking operations in this challenging economic environment.

For most, social media is not yet a major priority

The area that attracts the least concern is a focus on IT for marketing and client contact via social media, with Europe/America least interested of all. Apparently social media as a marketing and customer management tool is still relatively new within the Islamic finance industry, or at least not as high a priority as upgrading internal functionality. On the other hand, all regions vote strongly to improve IT for overall enhancement of customer interaction, e.g. for customer relationship management purposes. A GCC respondent notes that a key goal of his institution is to enhance customer centric banking services. Achieving this will require “adoption of latest technology to improve the internal and external customer experience.” This emphasis on improving in-house IT to improve client interaction seems to reflect the focus on raising the quality of internal systems rather than relying on social media and other external formats.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Islamic bankers are having difficulty finding sufficient staff who are highly qualified in banking and finance operations while at the same time proficient in the specific product and operational needs of Islamic finance.

Human resources: High exposure to talent risk

Human resources has emerged as a significant issue in a number of the areas of Islamic banking already discussed. Banks were asked specifically about their main priorities in human resources and talent development. Islamic banks face unique challenges in developing staff and other human capacity that is sufficiently qualified in banking and finance while at the same time proficient in the specific product and operational needs of Islamic finance. Over the years, finding a satisfactory cohort of staff who are proficient in both has always been challenging. As the Islamic finance market matures, this has become gradually less of a pressing issue in those markets that have led the development of Islamic banking, such as the GCC or Malaysia. But in newer markets, the challenge remains fresh. And even in more mature markets, human resources remains a pressing issue, due to competitive pressures, the constant skills challenges of a niche market, and the unique human resource characteristics of many Islamic finance markets, such as pressures to employ particular nationalities. Overall respondents ranked HR challenges as just below "Very important" (3.9), slightly less than the overall score for IT enhancements but strong nonetheless.

Attracting the best talent and retaining it remain key issues

The need to attract talent from the market ranks very high across all groups except Group 6 (Sub-Saharan Africa) where it is viewed as fairly important. But the strongest need was to invest in the satisfaction and retention of existing staff. This ranked at or near the top for all Groups and was considered highly important overall. Turnover has been a problem at many Islamic banks, especially in more mature and competitive markets, and keeping staff happy and retaining them is a key consideration.

The concern about turnover and retention is particularly great for staff in highly specialized areas such as risk management and IT. Retention requires not only competitive salaries, which squeeze operational costs, but also career satisfaction. Many Islamic banks are relatively young institutions that have less sophisticated human resource functions, lacking such contemporary HR concepts as career path planning or performance management. The evolution towards modern HR approaches is a key area of development needed to help the market mature.

The survey also revealed a strong desire to improve incentive and compensation schemes, clearly a critical component of staff retention. Focus on incentives also ranked quite high, averaging around 3.8 for all regions, with MENA expressing the greatest concern and South West Asia and Europe/US the least.

Figure 20. Global responses on human resources development

1. Not important at all; 2. Not very Important; 3. Fairly Important; 4. Very Important; 5. Extremely important

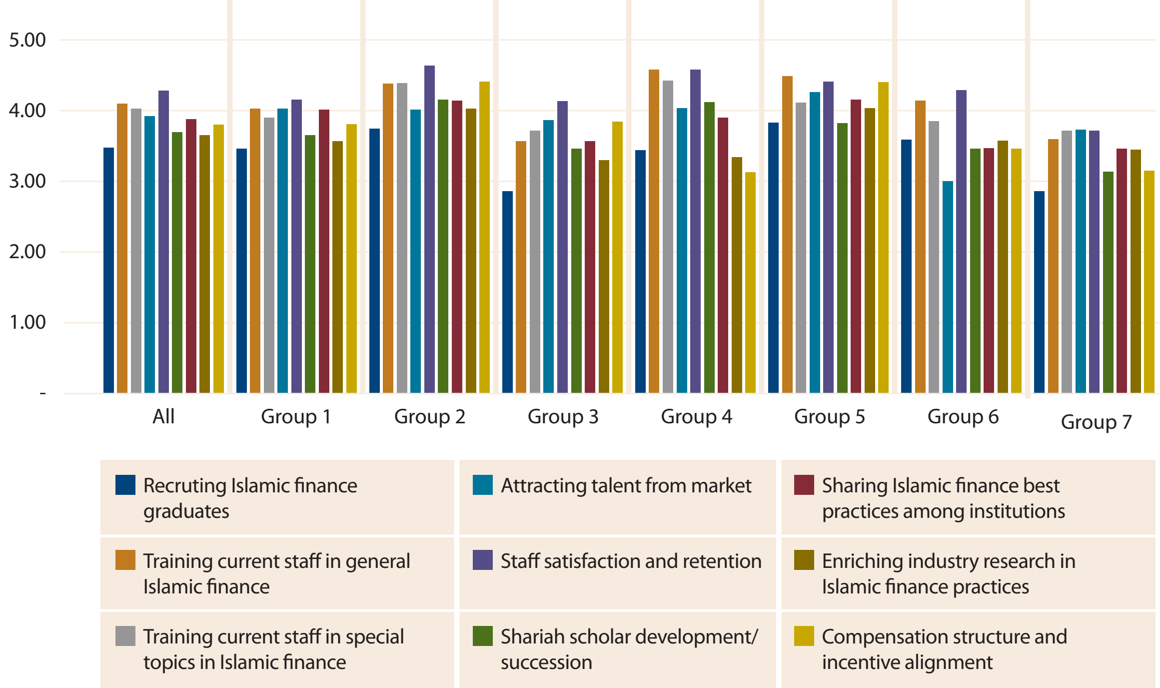
Emphasis on training: Islamic banks are focused on developing HR skills in Islamic finance

A critical component of staff retention is ensuring that staff are confident that they will maintain the skill sets needed in a changing market. Building strong and appropriate training programs is a major success factor for a strong HR function. Effective training has been shown to build staff loyalty and to raise satisfaction. Moreover, measurably successful training raises staff capacity and increases performance quality. As one South West Asian respondent puts it, his goal is to use training to build capacity in HR in order to make staff "competent enough to steer the bank in right direction."

Other respondents share this view, ranking training, both generalized and specialized, among the highest of HR needs. Both ranked around 4, "Very important," with generalized training preferred in all Groups except Group 7 (US and Europe) and Group 3 (Southeast Asia). The recruitment of talented graduates in Islamic finance also polls strongly, ranking around 3.4 on average, but is considerably less desired in all regions than training. In other words, Islamic banks remain focused on developing their HR capacities in the area of Islamic finance. Educational institutions in Islamic finance need to produce graduates who are not only strong in Islamic finance theories but also highly qualified in practical and technical skills in banking and finance, which are of importance to the business and operations of Islamic banks, i.e. legal and documentation in securitization, quantitative investment and risk analysis, etc.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 21. Key HR concerns by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Deepening Shariah education and awareness is strongly desired

Islamic bankers rated all areas surrounding the expansion of Shariah knowledge at greater than 3.5: hovering between fairly important and very important. IFIs in particular wanted to see greater sharing of Islamic market best practice among industry players. This would also help to address concerns about consistency and market knowledge. In addition to training already noted, most Islamic bankers liked the idea of enriching industry-driven research in Islamic finance. This, too, would be likely to generate greater consistency and consensus.

Along related lines, many Islamic bankers noted the need to strengthen development of Shariah scholars and to improve succession processes, with all groups ranking this as between fairly and very important, with Groups 2 and 4 the most concerned and Group 7 the least. Greater scholar education and consistency would help to allay concerns about discrepancies and knowledge gaps in the Islamic finance markets, with some institutions expressing concern at the inexperience of some of the scholars in their markets. This touches on an interesting tension: many in the market have concerns about a concentration of Shariah scholars, which raises issues of time availability, conflicts of interest, and concentration risk, but a broadening of the community without strong training and consensus-building mechanisms exposes the industry to the risks of inexperience and inconsistency.

Islamic banks are recognizing that good corporate governance is often the key to institutional success. Specifically, most Islamic banks rank transparency and disclosure, along with internal controls, and Shariah governance as the most important area of concern. Meanwhile, interest in the governance framework of for Profit Sharing Investment Accounts (PSIA) remains relatively low.

Corporate governance: Islamic banks acknowledge the need to strengthen governance in a few key areas

Islamic bankers were asked about their concerns in the area of corporate governance. The scores were again high, averaging over 4, or "Very important" across the board. Islamic banks are recognizing, as much of the financial world has, that good corporate governance is often the key to institutional success. Good governance sets in place the institutional and ethical framework to ensure that shareholder and stakeholder objectives can be clearly articulated, understood, and achieved. The recent focus by global regulators underlines the key role that an institution's governance plays in ensuring healthy functioning of banks.

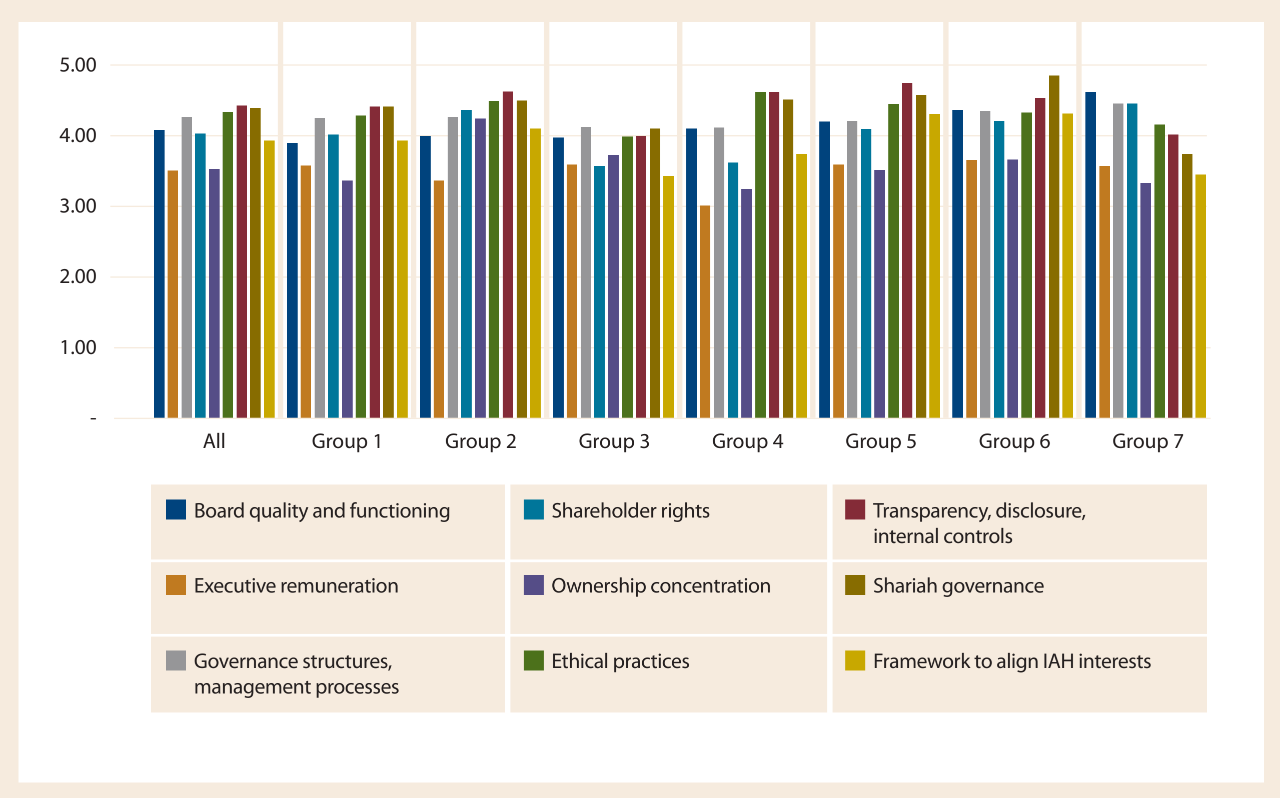
Figure 22. Global responses on corporate governance

1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Respondents clearly want to strengthen governance, with all regions rating governance concerns as very important on average. Bankers in MENA and Africa were particularly concerned, while those in South East Asia expressed the least interest – but still high.

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Figure 23. Main governance concern by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Governance starts with the Board of Directors

Most regulators affirm that the Board is the fount of good governance practices and the Islamic banks generally agreed that solid Board functioning is critical. Islamic bankers in Europe and the US (Group7) are the most concerned about the quality of the Board and its functioning, ranking it near the top. This may reflect the special scrutiny that corporate governance has witnessed since the 2008 financial crisis in the US and Europe, where bankers and regulators recognised the damage that poor governance can cause. Concerns are somewhat lower in other areas, including the GCC. This could reflect the greater incidence of family ownership, where the Board has a less independent role. However, GCC respondents, like most groups, place rather higher weight on overall governance structures, including management processes. The breadth of the category may itself have raised the ranking. On the other hand, executive remuneration is ranked among the lowest by all groups.

Transparency and robust controls are viewed as the most critical areas

Most Islamic banks rank transparency and disclosure, along with internal controls, as the most important area of concern, typically as "Extremely important." Transparency has emerged as a key issue in Islamic finance. The newness of approaches, the lack of consensus among Shariah scholars, and low levels of understanding of Shariah finance principles among many stakeholders, including customers, all contribute to a need for greater transparency in decision-making, operational processes, and governance frameworks. Clients, potential clients, and competitors hold a wide range of views about the Islamic finance market, from strong trust and confidence to extreme scepticism. Raising transparency and presenting an honest face, including sharing discussions on discrepancies and disagreements, is often the best way to neutralize distrust.

According to the survey, Islamic bankers themselves perceive the benefits of greater disclosure and transparency and encourage their expansion. Respondents ranked transparency, disclosure and internal controls between "Very Important" and "Extremely Important" so their concern is clear.

However, the survey was not sufficiently detailed to draw conclusions about the specific areas of transparency that most concerned the industry.

> The highest rated goal among respondents is for regulators to stress the legal bases for Islamic finance. The other areas of regulations such as Shariah governance, prudential standards, and financial reporting, remain crucial to ensure a level playing field in the market

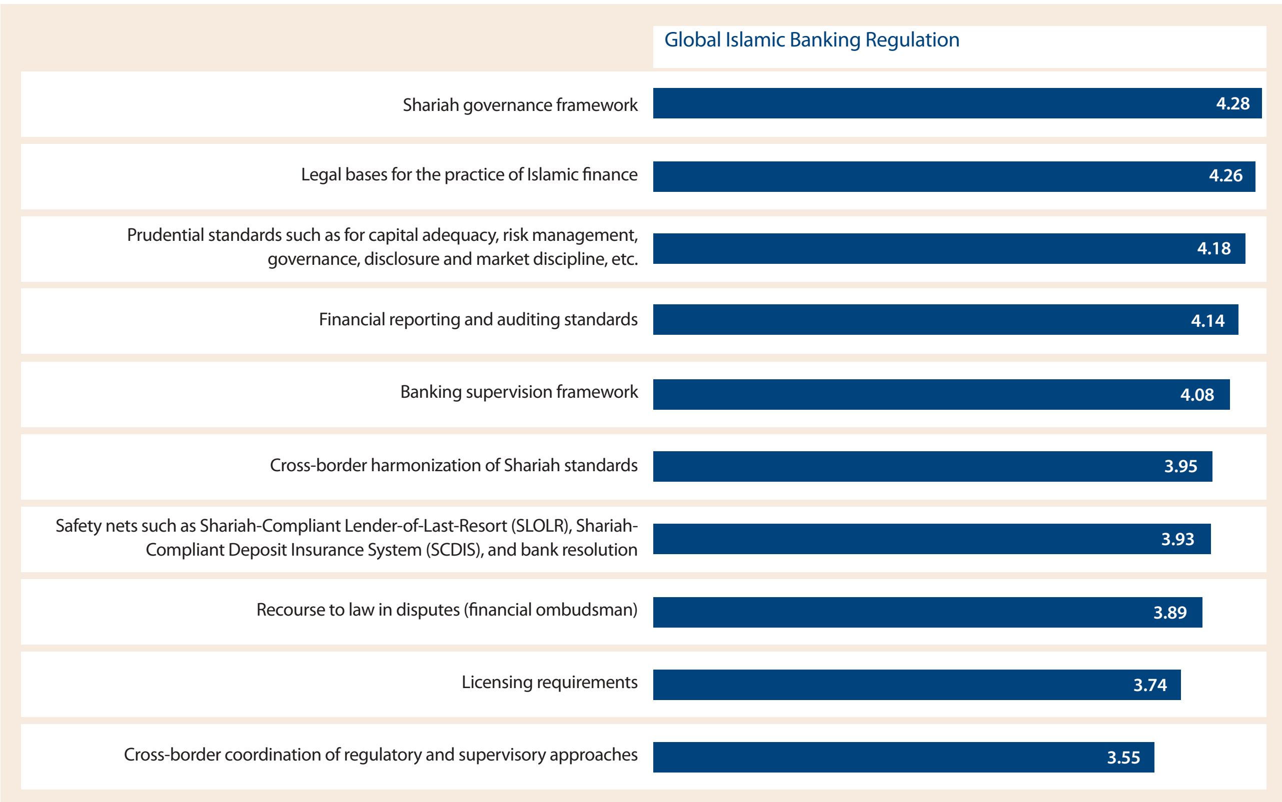
Regulations: Appropriate regulation in fundamentals, prudential, and reporting can help drive growth

Many bankers tend to see regulatory oversight as an impediment to growth since regulators are focussed on financial stability, the continued availability of core functions, such as credit and payment systems, and the maintenance of a level and competitive playing field. Regulators are less concerned with performance, provided that performance is sufficient to enable banks to continue to function and grow safely. Nonetheless, robust and appropriate regulation can foster growth since it give assurance to investors and, in theory, prevents bank failures, both individual and systemic.

Regulatory approaches to Islamic banking and finance are divergent and in some cases underdeveloped, partly depending on national strategies and partly depending on the stage of evolution of the national financial system. Some jurisdictions, for example, take a centralised approach to Shariah oversight; some rely mainly on Shariah boards in each institution, while others leave it entirely to the market. Some do not allow "Islamic windows", while others do. Some treat PSIAs as just like conventional deposits, while others treat them as at least partly like risk-bearing investments.

Against this background, Islamic banks were asked which areas of regulation they would like regulators to emphasise to ensure a level playing field for their institutions. Scores were consistently high, especially strong among respondents in MENA and Sub-Saharan Africa (Groups 2, 5, and 6) with African Islamic banks ranking this category overall as extremely important, hinting at the early stage of regulatory oversight of Islamic finance in most African economies. The lower scores tended to be in the GCC and South-East Asia, where regulatory regimes for Islamic finance are more highly developed.

Figure 24. Global responses on Islamic banking regulations



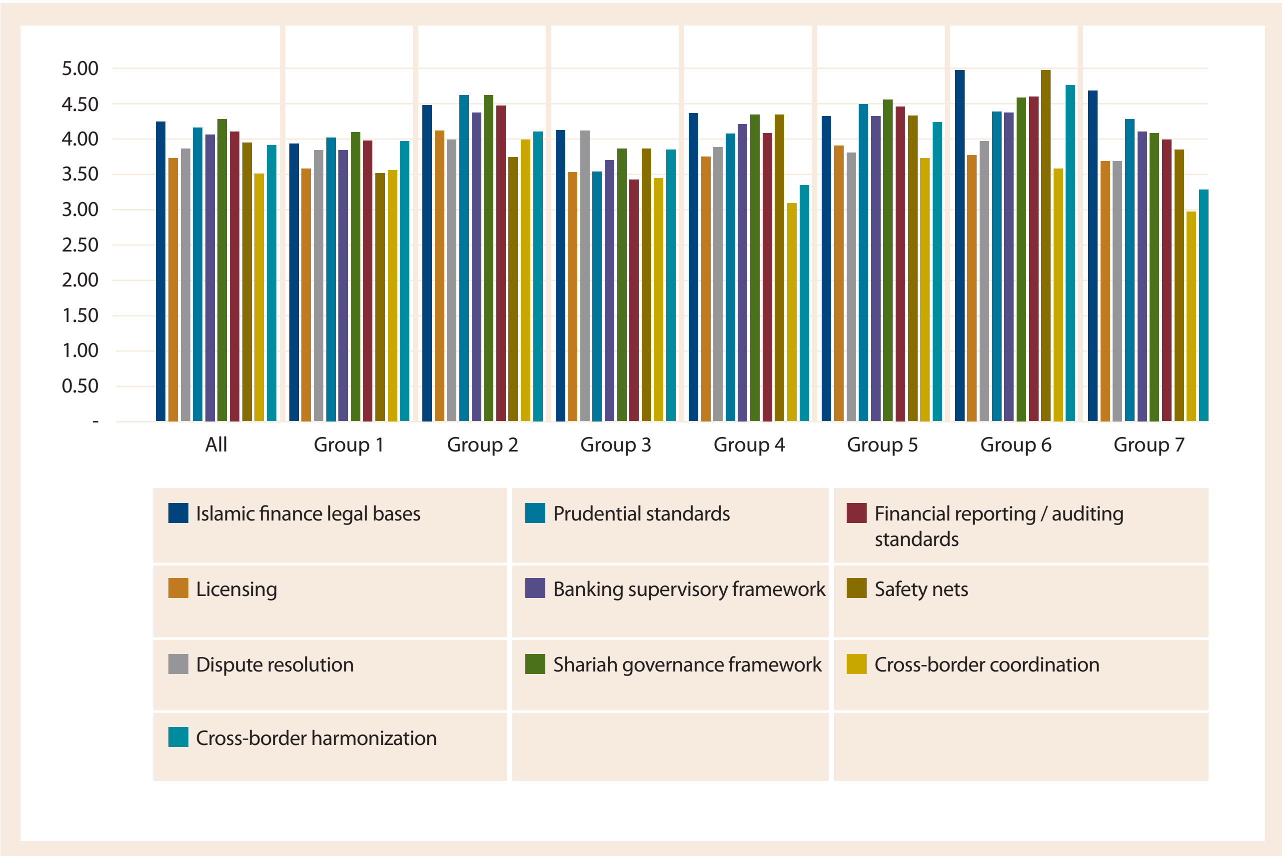
1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Islamic banks desire regulatory clarity on the fundamentals

The highest rated issue overall was the Shariah governance framework, which scored relatively high in all geographies, even those where frameworks have already been established nationally. A very close second was for regulators to establish the legal bases for Islamic finance. This desire has a wide geographical spread: it ranked as "Extremely Important" in both Sub-Saharan Africa and in the US and Europe. Islamic banks feel that their governments must strengthen the regulatory foundation of Islamic finance, especially in terms of legal clarity. This may reflect a wish to reform the tax framework for Islamic finance to achieve tax neutrality, which is a common issue and was mentioned explicitly by one respondent. It may reflect a need for clarity on the legal aspects of certain Islamic finance transactions or, depending on the legal and regulatory structure of the jurisdiction, it may be that new law is required for Islamic banking to be recognised as different from its conventional counterpart. A South East Asian respondent was hoping "to engage regulators so that level playing field can be achieved […] with the conventional banking industry." The same respondent sought to encourage regulators to reform the tax framework for Islamic finance to achieve tax neutrality.

Figure 25. Desired regulatory focus by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

The wide divergence of opinion – or lack of opinion – among regulators, on how to tailor prudential regulations for Islamic banks is borne out in the survey. Standards such as those promulgated by Basel on capital adequacy, risk management, governance, and market discipline (including reporting and disclosure requirements) have not been deeply considered for Islamic banks. The IFSB has in many areas produced corresponding standards for Islamic banks, but these have not been as widely implemented as their Basel counterparts. Respondents strongly desire greater consistency and clarity in prudential standards, ranking it "Very Important" or higher. Similarly the banking supervision framework overall is ranked almost as high, as are financial reporting and auditing standards.

The regulators' role in providing safety nets must be clarified

The global financial crisis has led to greater emphasis in the global standards community on financial safety nets, including lender of last resort facilities and deposit insurance. Shariah scholars have grappled with the appropriateness of deposit insurance for investment account holders and what mechanisms are available, and also with the options for the lender of last resort in times of financial crisis. However, only a handful of regulators have adopted mechanisms in these areas specifically tailored to Islamic finance. Respondents in all regions view this as a very important need, with those in Africa and South and Southwest Asia particularly concerned..

As noted elsewhere, Islamic banks are keen to see greater coordination and consistency in Shariah rulings and practices. However cross-border harmonization was ranked lower. This may represent uncertainty on the appropriate role of regulators in this capacity, or it may reflect a primary focus by respondents on consistency within the national markets in which they function.

At the top of Islamic bankers agenda is the need to promote ethical practices and responsible investment, and to spread awareness in Islamic finance. These have been considered as long-term competitive advantages to sustain business growth.

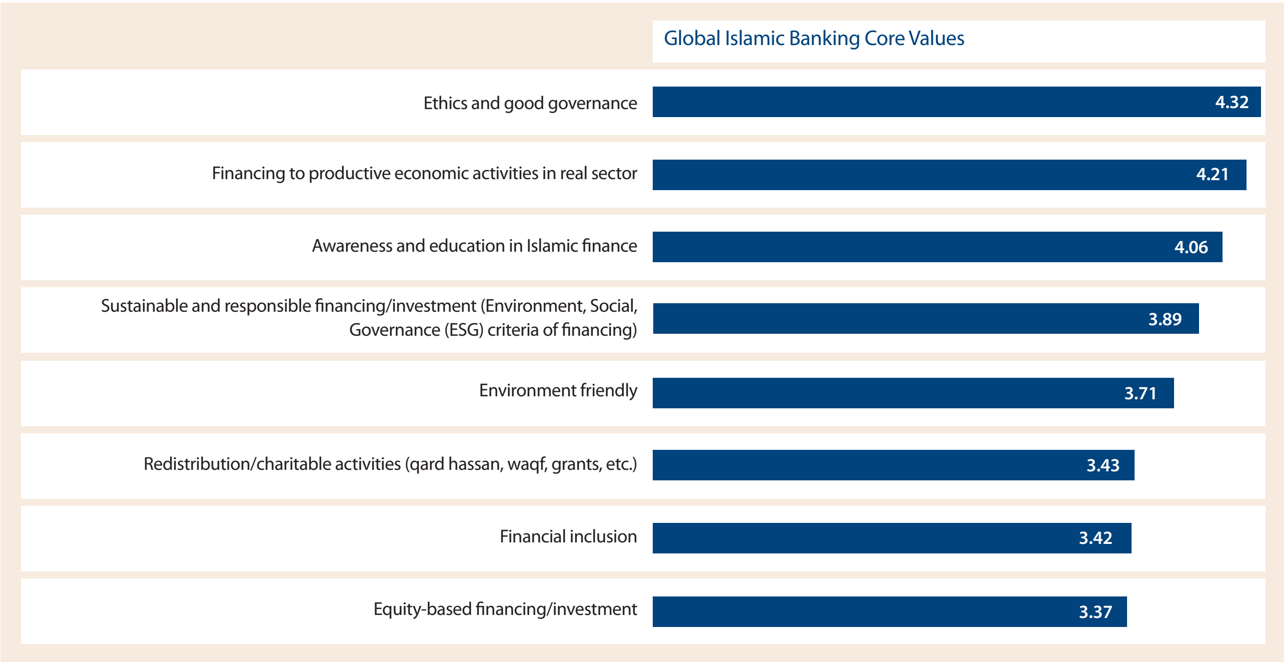
Islamic banks are promoting values as competitive drivers of growth

Islamic bankers were asked which values they saw it as important to promote. A commitment to ethics and good governance is given the highest importance but it is closely followed by a commitment to financing productive economic activities in the real sector. The third and fourth most important values are identified as awareness and education in Islamic finance and sustainable and responsible financing.

Islamic banks seek to ensure that their activities are ethical

As organizations founded on religious principles, Islamic banks clearly have a need to respect ethical standards: not only to communicate a shared value system to their customers but also to adhere to their own foundational raison d'être of their establishment. The survey responses demonstrate broad concern for following an ethical path, however defined. Islamic banks in all regions believe that robust ethics and governance must drive the institutions, with this consideration universally ranked as very important or higher.

Figure 26. Global responses on core values of Islamic finance



1. Not important at all; 2. Not very Important; 3. Fairly Important; 4. Very Important; 5. Extremely important

Part II. - The CIBAFI Islamic Banking Risk Dashboard (continued)

Islamic banks need to identify core values that generate sustainable returns, with a step-by-step approach, in order to satisfy various stakeholders' interests

Real sector and responsible (ESG) investment as key criteria in financing

Islamic bankers acknowledge the relevance, in their financing activities, of environmental, social and governance (ESG) factors, and of the long-term health and stability of the economy as a whole. This can act as the Islamic banks' key differentiation through financing activities that emphasises strengthening relationships and engagement with various stakeholders. The next stage will follow with a shift of business model from satisfying shareholders into meeting stakeholders' values and well-being, which has a broader concept of centricity accounting for consumers, society, environment, etc. This is a value that has the potential to resonate with non-Muslim stakeholders, particularly in the aftermath of the global financial crisis.

To achieve this, Islamic banks need to identify core values that generate sustainable returns, after taking into account potential risk exposures, with a step-by-step approach, in order to satisfy various stakeholders' interest at all points in time. The commitment to productive finance also reflects the obligation on Islamic banks to use the funds entrusted to them productively.

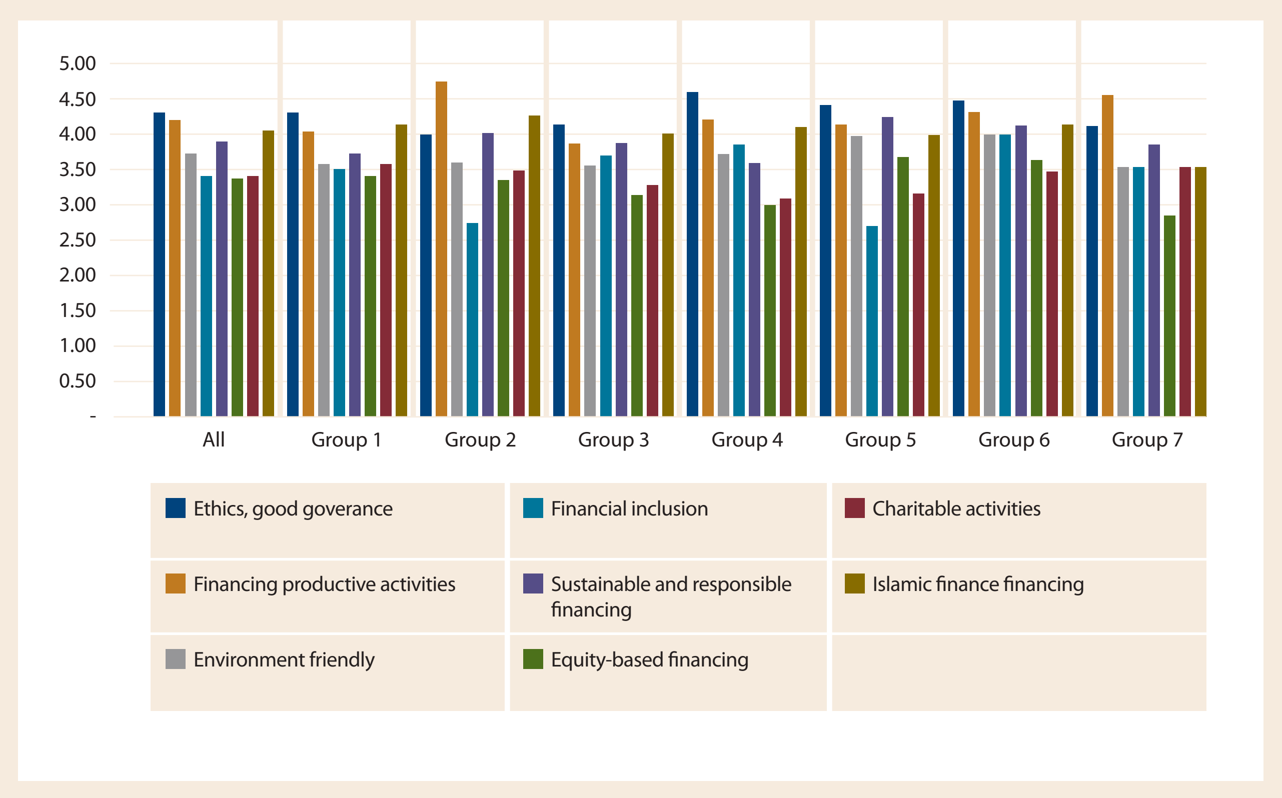
Broadening the market base, customer retention and loyalty are the key for business growth. This can be effectively achieved through collaborative efforts among Islamic banks to invest in strategic awareness programs about the role of Islamic finance in society

Expanding awareness in Islamic finance is a strong theme

A strong universal commitment emerges for building awareness and knowledge of Islamic finance. For end-users, there is a strong need to create awareness about Islamic finance in the broader society. Broadening the market base, customer retention and loyalty are the key for business growth. There is also a need for building an understanding of Islamic finance among counterparties, regulators and other stakeholders. This implies a more general educative task, which probably needs to be undertaken collaboratively if messages are to be clear and seen as unbiased. This can be effectively achieved through investing in strategic awareness programs about the role of Islamic finance in society. In that case, the collaborative efforts among Islamic banks in this matter can improve Islamic finance development through the increase of new customers and their loyalty, supportive regulations, and so on. The theme of expanding awareness of Islamic finance and building consistency and consensus on its principles is a strong theme emerging from the survey's results.

An additional mechanism is to educate employees in order to enhance their skills and knowledge in Islamic finance. This is primarily to enable Islamic banks' human capital resources to implement best practices within the boundary of Islamic rules and principles, thereby achieving stronger linkage between financial skills and faith.

Figure 27. Promoted values by regions



1. Not important at all; 2. Not very important; 3. Fairly important; 4. Very important; 5. Extremely important

Commitments to equity investment and financial inclusion are low

Financial inclusion and equity financing investment score low in the responses despite being frequently cited as the core values in the Islamic finance literature. The low score for equity finance can perhaps be explained by the difficulties that Islamic banks face in offering this type of finance: the Survey asked bankers open ended questions on "equity financing investment" and the responses made clear that they find this type of financing difficult to execute, however much they would like to offer it. Financial inclusion has mixed results, from "Very important" among Group 6 Islamic banks (African) to not very important among Group 2 (Middle East). Given the low levels of participation among citizens in non-GCC Middle East nations, there may be room for further development in this area in future.

PART IV

RISK SHARING AND SHARIAH-COMPLIANT MSME FINANCE

Part IV.
Risk Sharing and Shariah-compliant MSME Finance

This part of the CIBAFI Survey dealt with values that Islamic banks and others in the Islamic finance community believe are core to its purpose. It asked Islamic banks about three types of business that are widely seen as important for Islamic banks: equity-based financing, profit-sharing investment accounts; and financing of micro, small and medium-sized enterprises.

Equity-based financing: Difficult to execute and often hampered by regulation and participation culture among society

Equity-based financing has been considered as a core activity for Islamic banks because it clearly fulfils the principle of risk sharing between a bank and its customer that is one of the core values of Islamic finance.

Banks were asked to identify the main obstacles that they faced in implementing equity based financing. Three key obstacles were consistently identified by banks in all regions of the world.

Legislation and regulation often do not support equity-based financing

Banks from all regions identified inappropriate legislation and regulation as the key obstacles preventing greater use of equity-based financing. Bankers in Asia noted the lack of legal clarity on risk sharing and cost bearing with respect to equity-based financing, while bankers in the Middle East and North Africa stated that the legislation did not give them sufficient protection to engage in profit sharing activities, i.e. the absence of adequate safeguards in the case of negligence and infringement. This appeared to be especially true for equity-like forms of financing such as Musharakah. In particular, it was unclear in asset-based financings whether and how the bank would be able to take possession of and realise the asset in the event of a default.

While these points largely relate to legal infrastructure, regulatory restrictions are also a factor. In some cases there are specific restrictions on equity participation. For example, in Ethiopia, banks may not hold more than 20% of any project or venture. In others, the issue appears to be more one of attitude. A GCC banker noted that regulators are unenthusiastic about equity based financing since they believe it exposes banks to risks that are too great. More specifically, banks pointed to the higher capital charges associated with equity financing (in both the Basel and the IFSB standards), due to the greater risks and volatility of such investments. This connects to some of the commercial issues discussed below, since higher capital charges would naturally lead banks to seek higher returns, whether or not they perceive the risks to be higher.

Banks' capacity to manage and absorb risk in equity-based financing

Bankers believe that equity-based financing requires a strong alignment with internal risk management policy, appetite and capacity. Bankers in the GCC, Middle East, and Asia all mentioned that equity-based financing does not form the core business and risk appetite of their banks. Bankers in most of the regions noted that such financing requires specialized resources for equity-based financing, including professionals with strong expertise and experience in equity finance, risk infrastructure and IT, monitoring tools, managerial cost, etc. These skills are closer to those generally associated with venture capital than to those normally found in banking, and are needed both at the stage of initial product evaluation and in subsequent monitoring. Depending on the form of the investment they may also be needed to evaluate possible exit routes. Furthermore, the available external data are less useful because, even where good credit reference agencies exist, their operations are naturally geared to evaluating credit rather than equity risk. All this may imply that the banks need a shift in resource allocation partially to a private equity/venture capital business model to ensure sustainable return from such financing. One banker in South-East Asia mentioned a specific difficulty in achieving such a change, because it shares a system backbone with its conventional counterpart, and any substantial system change would impact the conventional counterpart too. In other words, operating with equity-based financing requires substantial system enhancement while the "demand remains unsure" from the client / entrepreneur side.

An Asian banker also commented, "Higher risk assumed by the financier would rightfully mean higher yields but, especially in dual banking systems, it is unclear that clients will be willing to provide those yields where cheaper debt (or debt-like) financing is available. In addition, existing evaluation is normally based on credit alone and so the additional risk does not translate into better pricing." This is due to the fact that most Islamic financial products are operated via the same system, which result in similar economic effects.

Bankers in Asia also raised the issue of difficulty in managing equity risk in order to satisfy the investment account holders' and shareholders' expectations. These investors and shareholders may not have the appetite for the higher levels of risk involved. Another concern also involved asset tagging – the difficulty in matching the asset with the investment, i.e. mismatch of asset tenure between longer-term investment funds and shorter term assets.

Customers are often unfamiliar with equity-based financing, reluctant to take it, or do not provide sufficient information and transparency

A third obstacle lies with the customers themselves, bankers say. Some bankers pointed to a lack of awareness among entrepreneurs with respect to equity financing. One Asian banker noted that because equity-based financing often entails a combination of Shariah contracts (e.g. a combination of Musharakah with Ijarah, Wa'd, and Wakalah), they are harder for customers to understand, leading them to prefer simpler non-equity-based products. Offering such equity finance would require more investment on delivering knowledge and education to customers before the rolling out of product is possible.

In addition, there is a lack of acceptance and a participation culture among entrepreneurs in terms of raising financing. As already noted, the additional risk for the bank needs to be offset by a higher yield, making it more expensive to the entrepreneur than debt or debt-like financing. One bank in Sub-Saharan Africa commented specifically on the risk of adverse selection: "The main challenge is that customers with a good credit rating are averse to equity-based financing, believing that it will increase their cost of funding. On the other hand, customers with poor credit rating are those seeking funding under equity-based modes." One North African bank also suggested that some may also be reluctant to accept Shariah restrictions on the assets that may form part of such financing.

More fundamentally, equity-based financing requires greater transparency from customers about their operations, both at the stage of project approval and subsequently. In emerging markets, and perhaps especially in family-owned businesses, customers are often not willing, or not able, to provide the additional information that banks need to approve the transaction. In some cases there may be active dishonesty. A North African banker laments that their capital financing product class "is facing a problem of dishonesty and mismanagement." Another comments on the difficulty of proving infringement or negligence in the case of losses. In other words, they found it difficult to assure the quality of customers and the businesses so that the bank had a clear and transparent risk around the financing. Banks in North Africa noted that there has been a lack of customers' commitment in partnership, while it is difficult to prove infringement and negligence in case of losses.

Competitive pressures from conventional peers

Some banks mentioned that the main obstacle comes from a highly competitive market where conventional banks, which do not have an equity-like profile, offer similar products. This is related to the low level of client loyalty, where clients tend to be more sensitive to rate changes. They may shift to the conventional banks when they receive a better rate of financing.

A strong need to establish industry infrastructure for equity-based financing: Equity-based rating/scoring and a secondary market

Appropriate infrastructures need to be established to support banks in providing equity-based financing. These include information infrastructures. Bankers in the Middle East and North Africa stated that there is a lack of specialized institutions that provide sufficient information to enable the decision-making required of equity finance. As a result, rating or scoring system need to be adjusted to accommodate the risk exposures of equity-based financing.

Part IV. - Risk Sharing and Shariah-compliant MSME Finance (continued)

In addition, some bankers in Asia raised the issue of illiquidity and the lack of exit options from equity financing. In this respect, secondary markets for such financing would be valuable so that the banks can share the equity risk among themselves through this platform. However, if equity participations are to be traded then levels of disclosure and transparency will need to be still higher than when the relationship is purely between the entrepreneur and the bank. Fundamentally, the challenge is to find modes of equity-based financing that allow combinations of risk and return acceptable to both sides and, correspondingly, mutually acceptable levels of monitoring and disclosure.

Profit Sharing Investment Accounts (PSIA): The challenge of tracking assets and allocating returns

Profit-sharing investment accounts (PSIA) are a key offering for Islamic banks since they conform to the principle of risk sharing. They are not in general repayable on demand, and their return is in principle linked to the return achieved on the investments that they fund (though some banks use smoothing mechanisms to mitigate the variability of returns). Depending on the type of PSIA (unrestricted or restricted), the assets that they fund may be either the general assets of the bank, or they may be ring-fenced assets linked directly to specific groups of PSIA liabilities. Banks were asked to describe what they believe is the optimal structure for profit-sharing investment accounts and identify obstacles to achieving that structure.

Differences in provision of PSIA, and in underlying structure, is sometimes driven by regulation

Not all Islamic banks offer PSIA, and this is not only due to the regulatory restrictions which exist in some of the less well-developed Islamic finance markets. A banker in a new Islamic banking market noted that PSIA are not defined in the country's banking law and are not permitted by the banking regulator. A British banker said that the British bank regulator treats a Wakalah contract for general investment as a "regulated deposit" and that UK banks are obliged to treat this deposit as "protected" – that is to repay the amount deposited in full, regardless of the performance of the investments that the PSIA has financed.

Challenges in risk management and liability management to meet customers' expectation

Bankers say that the challenges in meeting customer expectations, in terms of profit rates offered, are due to several reasons. A GCC banker mentioned that there is limited understanding among depositors for Mudarabah-based deposits, including how the pool structure is run. This is due to the fact that depositors are used to fixed rate deposits, which are entirely different from the concept of Mudarabah. Another bank in the GCC noted competitive pressure on pricing PSIA with respect to defining an appropriate return for investment account holders, the setting of the Mudarabah percentage, and the pricing on deposits by competitive peers. A UK bank said that the fact that some of the customers are too sensitive to price changes appears to be a challenging issue.

On the other hand, some bankers stated that PSIA can compromise the way in which banks manage their risks and liabilities. For example, a Middle Eastern banker said that its optimal management of PSIA accounts would comprise limiting concentration risk, diversifying 'time buckets', and matching asset and liability maturities. The obstacles to achieving these risk mitigation objectives included an inability to restrict customers' withdrawals from PSIA and customers' preferences to invest only short term.

A banker in South-East Asia also said that his institution was reducing its PSIA due to the difficulties of matching investors with assets that conformed to their risk/return expectations. In other words, linking directly to investment opportunities remains a challenge. Furthermore, large investors will put their money in mutual funds, where they can earn a higher return, the banker said. Profit-sharing accounts in an Islamic bank will only expose account holders to credit facilities which earn credit spreads, thus there is no potential upside at all. The fundamental point underlying a number of these concerns appears to be that some customers seem to want a close analogue of a conventional savings account, offering some return, very limited risk, and reasonable access to their money. This is a market traditionally served by banks, whereas those prepared to accept higher levels of risk and/or to tie their money up for longer are generally more affluent and have alternative products available to them, for example equities or mutual funds. The challenge for the banks is to find products which offer an acceptable combination of risks and returns for their lower-risk customers, and acceptable risks for the banks themselves (for example the liquidity risk arising from maturity transformation), while remaining true to Shariah principles.

There is also an issue on the governance structure of PSIA. A GCC banker raised the point that there should be an appropriate governance framework around the asset, profit and expense allocation of the PSIA. This is to ensure market discipline from investment account holders towards various risk exposures in PSIA. Another bank in the region suggested that PSIA should be moved into a fully-owned subsidiary as a way of addressing regulatory requirements and governance issues related to PSIA.

Multiple tranching of Mudarabah pools and allocating returns remains difficult

One of the challenges faced by Islamic banks is the extent to which they should divide the assets funded by PSIA into multiple tranches in order to be able to pay different rates of return to investors (i.e. reflecting different holding periods for investments and different amounts invested, as well as different risk appetites). A Gulf banker noted that due to the lack of an automated solution to comprehensive profit distribution, it is difficult to set-up multiple Mudarabah pools and allocate various percentages of investments/incomes within these pools. A North African bank also noted the technological constraints, but added that Shariah rulings on issues such as making different payments to different types of investor need to be studied carefully. Most bankers that addressed the issue in the survey said that they used a General Mudarabah Pool. One bank noted the difficulty of devising an IT system to allocate assets and track returns on those assets.

Not all banks used a Mudaraba structure. A South East Asian bank advocated use of Wakalah fi al-Istithmaar with a performance fee. The bank said that this structure is more appropriate than Mudarabah because some jurisdictions do not allow an up-front 'Tanazul' to be paid on the upside.

Structural issues in Shariah-compliant micro- and SME (MSME) finance

Banks were asked what obstacles they encounter to financing micro, small and medium sized enterprises (MSMEs). Financing of MSMEs is seen as an important aspect of Islamic banks' moral obligation to intermediate funds for the good of society as a whole. MSMEs are generally seen as having less access to funding than large, well-established companies; they provide considerable amounts of employment in less developed countries; and in some cases they can be drivers of social mobility and economic growth.

Some Islamic banks have set up separate departments for MSME finance under the corporate department, due to the fact that this sector has been gradually recognized as an organic growth of the banking business, along with regulators' initiatives to diversify the economy.

Enhancing Islamic finance awareness and financial inclusion among underserved sectors of society

Some banks argue that there is a lack of awareness with respect to Islamic finance amongst the underserved sectors of society: this group may prefer to choose conventional financial institutions due to their more competitive rates, or remaining unbanked due to religious reasons. Also, bankers in Middle East and North Africa mentioned that there is not sufficient client familiarity with banking culture and its requirements among owners of small and micro companies, indicating a key problem in the level of financial inclusion.

Part IV. - Risk Sharing and Shariah-compliant MSME Finance (continued)

The legal framework is sometimes significant

One of the most frequent points put forward, across a range of geographies and in terms very similar to points made in the context of equity financing, was that legal frameworks often make it difficult to take and to enforce collateral. The ability to do this is, however, thought especially important in a sector where the business itself is inherently risky. The banks expressed a lack of support from the public sector, including the weakness of regulations dealing with securities/collateral, calling for initiatives to strengthen secured transaction laws.

Some bankers also mentioned that prudential standards still impose a punitive risk weight on MSME finance which prevents Islamic banks from allocating a higher percentage of financing to this sector. There is also an absence of an Islamic MSME finance standards, along with a lack of standard definition of MSME. In some cases, particular types of financial institutions are not allowed to provide financing to this market segment. For example, bankers in the GCC mentioned that wholesale banks are restricted from dealing with micro and small medium enterprise financing. Moreover, a banker in the Middle East noted that in his country there is no law designed specifically to regulate Islamic banks for this business activity, where the key issue is that Islamic banks remain subject to the same regulatory standards and tools governing conventional banks.

Risks are high, and there are large information asymmetries

Another challenge facing Islamic banks in evaluating MSMEs relates specifically to the characteristics of the financed firms themselves. The following points elaborate the key issues in basic information, sensitivity to macroeconomic environment, over-financing, and acceptable collateral.

Sensitivity to macroeconomic shocks and the nature of the sector

Some bankers raised the issue of high sensitivity of MSMEs to the macroeconomic environment. The banks in the Middle East stated that any shocks, including currency fluctuations, can have a huge impact on MSMEs. A banker in Europe mentioned that the detailed breakdown of total loans indicates that the NPL ratio is highest in MSME loans. The underlying reason behind this is mainly due to the structural and economic system influencing the MSME businesses, the difficulties in lending processes, and the insufficient financial management knowledge of MSMEs. Other banks in the GCC stated a different issue, where micro- and MSME finance is a small market, heavily concentrated in a particular sector.

Non-availability of basic information and transparency

Islamic bankers from all the regions said that a major hurdle remains the availability of transparent documentation for the MSME sector. In many cases, MSMEs do not have sufficient basic documentation, i.e. legal, current account statement, audited/management accounts, business profile, clear business plan, cash flow and financial statement, in order to support evaluation and due diligence. For instance, some MSMEs do not have a current account with a bank, and therefore an Islamic bank is unable to assess patterns of sales and purchases in order to structure appropriate financing. Other MSMEs are new start-ups without sufficient track record.

In some cases, the financial information of MSMEs does not reliably reflect the reality of their businesses. For example, a North African banker said that the financial statement produced to the tax authority may be different from that produced to the bank. In order to reduce the risk of asymmetric information, bankers in South-East Asia and North Africa mentioned that the regulator requires a certain level of documents as evidence for repayment in the context of responsible financing. GCC banker also raised the point of ambiguity in the economic feasibility of the borrower's project. On the other hand, a banker in South East Asia mentioned that companies usually operate from rented premises and therefore could close business and resume business operations elsewhere without repaying debts. Tracking these entities could prove difficult.

Lack of quality in MSME business process

Some bankers stated that MSMEs commonly lack an effective and efficient business model. This includes an underdeveloped IT infrastructure to support and sustain their business given the dynamic nature of competition. A banker in the GCC mentioned that limitations in the quality of resources have resulted in high reliance on collateral support for MSMEs to get financing. Another banker in Europe suggested that MSMEs need to enhance their financial skills, such as cash management, in order to be sustainable.

Over leveraged and poor credit rating

Many bankers mentioned that some of the MSMEs are usually over leveraged, and some of the business owners have poor credit rating reports. Bankers in the GCC were concerned about the credit worthiness of MSMEs, and the doubtful viability of their projects. A banker in South East Asia commented that because of the limited creditworthiness of business owners, the firms often secure financing from unregulated money lenders (i.e. loan sharks) with high interest rates (e.g. 10%-20% per month). Because of the exorbitant monthly instalments due to them, and the inability to maintain a stable cash flow, these MSMEs often default on payments, and this causes business failure.

Lack of acceptable collateral and guarantees: The need to restructure the secured transaction law to bring MSMEs into the value chain

Bankers in all regions clearly mentioned that a lack of acceptable collateral or guarantees has impeded MSME finance. In particular, a majority of MSMEs, especially the small ones, do not have acceptable collateral and guarantees required, which makes it harder for banks to finance this market segment. In some cases this is intrinsic to the business, but one banker suggested that his regulators needed to adjust the relevant law to broaden the range of acceptable collateral. For example, he said, the regulator could adjust the secured transaction law to broaden the variety of acceptable collateral which are closely integrated to the value chain of the economy.

Industry infrastructure for MSMEs finance

The industry infrastructure to promote MSME finance is crucial to increase the volume of such financing. Most bankers stressed that incomplete information is a factor with respect to MSMEs, particularly the absence of legal, financial, and other documentation. In a similar vein, a banker in the GCC mentioned that a lack of credit information serves as the biggest hurdle, which suggests the importance of establishing a strong credit bureau specific to MSMEs, including the use of MSME scoring. A bank in South East Asia also expressed the need for good infrastructure to support recovery efforts in MSME finance. Some banks in North Africa also stated that there is a need to strengthen professional unions and associations, including infrastructure to accommodate innovative ideas such as incubators. There is also a lack of statistical information on the different business sectors and professions used to evaluate the prospect of the MSME business.

Challenges in the technical infrastructure of Islamic banks

Many bankers pointed out that the technical infrastructure to provide Islamic MSME financing remains underdeveloped. Islamic banks require essential resources to enter into this market segment in order to ensure a sustainable risk-adjusted return. Below are the key technical infrastructures identified as missing.

The need to build in-house expertise for Islamic MSME finance: Specialized MSME unit

The issue most frequently expressed, in a number of forms, was that the poor quality of information, and the inherent riskiness of many MSME business plans, required banks to maintain strong analytical capacity both for initial evaluation and for monitoring. Capabilities such as qualified human resources, process and risk control tools, and good monitoring systems are crucial, since many MSMEs do not maintain proper financial records. This can be achieved through establishing a dedicated MSME unit, with strong capabilities in screening, mentoring, and monitoring. Moreover, a strong technology infrastructure is necessary, tailored to the specific needs of MSMEs (i.e. digital banking).

Weak expertise may result in high monitoring costs, with personnel-related and administrative costs as a major barrier. A bank in South East Asia mentioned that a heavy operating cost has been factored into higher pricing, which on many occasions prompted concern on ethical issues since it resulted in charging higher rates in underserved markets. This also involves the readiness of IT infrastructure as well as an effective and efficient business process for supporting MSME businesses.

Islamic bankers in other regions such as the Middle East and North Africa raised the issues of monitoring and provisioning capabilities, skilled and trained manpower, arrears tolerance levels, and scale, while a banker in Asia and Sub-Saharan Africa pointed out the importance of a distribution network in smaller and remote areas. To enter the MSME sector, a bank in Europe requires additional infrastructure and human resources, which is not always recovered through higher financing returns.

Lack of variety of Shariah-compliant financing products for MSMEs

The key issue in Islamic MSME finance also involves a lack of appropriate Shariah-compliant financial products designed to fit the needs of MSMEs. MSMEs usually prefer to obtain working capital finance in the form of cash and open credit lines. Some banks state that they need a high level of liquidity to perform this business line. In terms of product innovation, a bank in Asia mentioned that there is a lack of suitable Shari,ah-compliant products, except Salam, while others express the need for Islamic financial products to cater for short-term cash needs. Bankers in North and Sub-Saharan Africa also mentioned the weakness of product quality and the inability to market such products, implying the use of traditional methodology to provide funding and lack of diversified products.

Highly-competitive landscape

A number of bankers cited competition as a hurdle. Some Islamic banks consider that they face uneven competition with conventional peers, which usually provide loans in the cash form preferred by the borrowers. This is not in line with the sale-based financial transactions of Islamic banks that require the presence of an underlying asset. A banker in South East Asia said that there is high competition with conventional banks with respect to providing competitive rates and pricing, where cost leadership and cultural approach are key success factors in this business line. In another region, a banker in the GCC also mentioned that Islamic banks are also competing among themselves for the same market, focusing on competitive pricing instead of broadening the market coverage in this sector.

CONCLUDING REMARKS

Concluding Remarks

In this inaugural Global Islamic Bankers' Survey we have covered a number of areas of importance to the Islamic banking industry. The industry highlighted its concerns, its growth opportunities and outlook for the future. The key arising from the survey include the following:

1. **Enabling Islamic banks to compete more effectively**
   Islamic bankers who responded to the survey were fairly optimistic about their ability to outperform conventional counterparts in their jurisdictions, but when identifying specific challenges and risk factors, many seemed concerned that they were at a disadvantage in relation to conventional banks, either due to the legal and regulatory environment in which they worked, or because of their internal technical infrastructures and capabilities. There is a need to have a clear view of the competitive status of Islamic banking industry vis-à-vis its conventional peers, i.e. through a wide-ranging review of its competitive position, identification of areas of strength and weakness.

2. **Implementing advanced risk management tools, risk governance, and developing best practices in risk management for Islamic banks**
   Most Islamic bankers think the risks they face today are manageable but at the same time they universally share the desire to enhance risk management capacity to close perceived gaps and to prepare themselves for a rapidly changing environment.

   Firstly, many Islamic bankers feel a need to strengthen risk management both to neutralize emerging risks in their portfolios as well as to align with evolving best practices. The example of these are to implement advanced risk management practices, including to enhance specific risk management techniques, data quality, data mining capabilities, risk rating methodology and operations. Virtually all respondents noted a need to strengthen human capacity in risk.

   Secondly, Islamic banks want to strengthen risk governance, focusing on the overall framework that underpins the risk culture, such as the relationships among the various stakeholders setting the institutional risk culture.

   Thirdly, Islamic banks think non-financial risks are growing in importance, especially technological, legal, and Shari'ah non-compliance risks. The banks mention the importance of shared perceptions of Shari'ah authenticity, calling for both greater standardization of Shari'ah standards and practices, globally and nationally, as well as for strong and autonomous Shari'ah governance systems. In particular, Shari'ah governance is expected to be more fully clarified and universally standardized to avoid inconsistencies and reputational risks.

   Fourthly, liquidity risk remains a key challenge for Islamic banks. Mismatching, with longer term financing against potentially shorter term liabilities, is also a concern for many Islamic banks. High reliance on liquid funds and high liquid asset buffers impede liquidity optimization and hence compromise profitability. As a result, improving liquidity management appears to be a widespread desire for many Islamic banks, and they are calling for the further development of liquidity management tools, including the bolstering of Sukuk markets across geographies. Finally, Islamic banks can cooperate to find innovative solutions in managing liquidity risk jointly among themselves. Developing best practices for addressing the liquidity risks that Islamic banks face should be encouraged, and widely circulated in the industry.

3. **Enhancing capabilities in consumer centricity and banking technology**
   Islamic banks identified several issues in the field of customer relations as among their most important concerns. These included customer attraction and retention, and service quality. The evidence suggests that, even where the values of Islamic finance are appreciated, for many potential customers they will not be sufficient to overcome the absence of products that meet their needs, or deficiencies in service as compared with conventional counterparts.

As the Islamic banking industry expands, both in terms of new entrants and in terms of capturing clients who are less strictly Shari'ah sensitive, the need is to focus on more proactively understanding client needs and satisfying them. Hence, to emphasize "greater customer centricity, operational efficiency and innovation" appears to be critical. Product innovation is highly important not only as a key differentiator of Islamic banking in the market but also to ensure full satisfaction of all customer requirements. To fuel the growth, expanding distribution channels is a high priority. Islamic banks also raise a concern of initiating a structural shift from their traditional banking activities to alternative banking channels. As the banks feel that merely being Shari'ah compliant is not sufficient to broaden the market base, multi-channel experience is perceived as a tool to engage customers in a competitive way. The example of this is to tailor the client experience through expanding and enriching channel interaction (i.e. greater electronic channels), as well as customized products. The survey also reveals that the strategy of providing financial advisory and (tailored) problem resolution designed specifically for customers' needs – to enhance customer retention – remain secondary. Finally, Islamic banks note that investing in the rapid development of banking technology is essential to achieve competitive positioning in the market. A strong emphasis is placed on improvements in IT infrastructure functioning, such as IT security enhancement, data strengthening, risk technologies, CRM, and heightened access and flexibility.

4. **Expanding and enhancing the Islamic banking 'talent pool'**

   The future success of Islamic banking is dependent on the industry having a large number of highly-qualified people. More needs to be done to upgrade the skills of existing Islamic banking cadres, and to bring into the industry greater numbers of talented people. Organisations that offer professional development programmes need to prioritise those programmes and where possible expand them. Educational institutions in Islamic finance and professional development programmes should include areas of high-technical specialisation to enable Islamic banks to operate at the cutting edge of the global financial industry at both strategic and operation levels. Education institutions in Islamic finance need to produce graduates who are not only strong in Islamic finance theories but also highly qualified in practical and technical skills in banking and finance, which are of importance to the business and operations of Islamic banks, i.e. legal and documentation in securitization, quantitative investment and risk analysis, etc. The programmes should also include more basic courses to enable conventional bankers to make the professional transition to Islamic banks.

5. **Extending business lines and modes of expansion as growth drivers**

   The survey reveals that the traditional forms of commercial business financing – project finance, and trade finance – continue to dominate expected revenue growth. In addition to well established relationships with larger commercial clients, many Islamic banks have witnessed growth, and continue to expect growth, with SME clients. The consumer business is expected to be the second biggest driver of revenues.

   The survey shows the concern of Islamic banks to extend their business lines as growth drivers. Firstly, some Islamic banks feel a need to expand their non-financial services, mainly in service and fee-based activities such as advisory, transaction services, and asset and wealth management. The aim is not only to be able to generate greater returns but also to broaden the market base as well as achieve greater consumer centricity. Islamic banks also express their desire to build strong capabilities in these areas to achieve a competitive edge. For example, to start a structural shift from traditional forms into modern forms of investment through strengthening their own internal capacity such as "state-of-the-art advanced analytics in investment", creating modern investment strategies, and building their own teams of investment professionals.

Concluding Remarks (continued)

Secondly, the survey shows that investment banking and capital market activities tend to remain a lower priority for most Islamic banks, with some respondents noting various business and regulatory obstacles to expanding in this direction, as well as internal resource constraints. Islamic banks express their concern to expand in capital markets, such as underwriting shares, M&A, private equity, or in the area of securitization to unburden balance sheets.

Thirdly, some business lines such as supply chain finance, value chain finance, and agriculture finance remain secondary, even though these segments are important not only to improve the contribution of Islamic finance to the value chain system but also to serve as organic growth once the critical mass is achieved.

Finally, the survey shows that cross border growth is a low priority for most, where the main internationalization activity remains in cooperation across regions such as cross-border syndications. Yet, the industry still face challenges in this area, such as the absence of standard Islamic finance documentation, Shari'ah approval processes, sharing collateral, taxation, governing law, inter-creditor issues, the integration between conventional and Islamic tranches, etc.

6. **Identifying Islamic finance values that generate sustainable returns for shareholders over the long term**

   The survey shows that satisfying shareholder expectations was one of the most important issues for Islamic banks. As most of the Islamic banks surveyed operate in a dual banking system, they have a concern in identifying business models which will enable them to match in broad terms the returns achieved by conventional banks. This means not only matching conventional banks' levels of service and operating efficiency but also establishing a distinctive position in the market, based on "a distinctive set of values", as a competitive advantage. In such cases, there is no necessary contradiction between shareholder expectations and Islamic values, i.e. to identify the values that serve as key differentiators, as well as are most likely to facilitate strong returns for shareholders over the long term.

   One of the survey findings shows that Islamic bankers acknowledge the relevance of environmental, social and governance (ESG) factors. These three elements are supposed to be incorporated in various business activities, including product innovation, financing criteria, operations, etc. This may drive a structural shift of the banks' business model from satisfying shareholders into meeting stakeholders' values and well-being, which has a broader concept of centricity accounting for consumers, society, environment, etc. This is a value that has the potential to resonate with both Muslim and non-Muslim stakeholders. Developing best practices for implementing ESG criteria in various business lines should be developed for the industry.

   In addition, expanding awareness in Islamic finance is also a strong theme, which can be effectively achieved through collaborative efforts among Islamic banks that invest in strategic awareness programs about Islamic finance for the society. This consequently can broaden the market base, and enhance customer retention and loyalty, serving as the key for business growth.

7. **Building capabilities and strong industry infrastructures for equity finance**

   The clear picture from the survey emerges that Islamic banks find great difficulty in executing equity-based financing and finding an optimal structure of Profit Sharing Investment Accounts (PSIA), despite their centrality to the values of Islamic banking. For equity finance, many Islamic banks identified key obstacles including legislation and regulation, banks' capacity to manage and absorb risk in equity-based financing, unfamiliarity of customers towards equity finance, competitive pressures, etc. As for PSIA, the banks have technical difficulties in matching and allocating rates of return to different profiles of investors. While regulations sometimes hamper the implementation of PSIA, Islamic banks still face challenges in risk management and liability management to meet account holders' expectations.

The key theme in executing equity finance is to build strong Venture Capital-type of equity financing skills and capacities, as well as to have "profitable exits" at any point in time in order to manage the risk. Hence, there is a strong need to establish industry infrastructures for such exit routes such as a secondary market for equity financing for those firms, mostly SMEs, which are not listed in the main equity market. PSIA rates of return will be matched directly to the underlying assets of such equity finance, while withdrawal risk is mitigated through available exit routes. There is also a concern to establish an infrastructure for equity-based rating/scoring, which strengthens the quality of decisions to extend such financing.

8. **Achieving greater legal clarity for Islamic finance**
   Many bankers who responded to the survey lamented the lack of legal clarity that underlay their operations. In some areas, this lack of legal clarity increased banks' risk profiles and in others it prevented them from developing new areas of activity. Some banks mention the importance of working with legislators in their countries to improve the legal framework for Islamic banking. In practice, legal development is likely to go hand-in-hand with the development of banking regulations so that working with bank regulators and legislators is necessary to move the legal frameworks towards parity with the list of basic legal and regulatory conditions such as legal bases, prudential and supervisory framework, governance, reporting, etc.

9. **Developing the capacity and best practices to meet the needs of MSME clients**
   Meeting the needs of micro, small and medium sized enterprises (MSMEs) is not just a matter of developing appropriate products. Providing financing and other services to MSMEs requires policies, training, and skills that are very different from those employed in both corporate and retail financing. Islamic banks emphasize the importance of developing departments that are dedicated to MSME business. The required capacities include risk-based market segmentation, pricing model, innovative forms of collateral, screening techniques, alternative data sources/non-traditional data, strategic resources, monitoring tools and strategies, customer orientation process, etc. Some banks are also concerned to establish supporting infrastructures such as credit scoring, secured transaction laws, equity market and securitization for SMEs, etc. Developing a guidebook of best practices in Islamic MSME finance should be widely distributed in the Islamic finance community.

APPENDIX 1

Appendix 1. Overview of CIBAFI

The General Council for Islamic Banks and Financial Institutions (CIBAFI) is a membership-based organisation, based in Bahrain that acts as the voice of the Islamic finance industry. CIBAFI was founded in 2001 by the Islamic Development Bank and other leading Islamic financial institutions. Today, it has nearly 120 members from 30 countries and is proud to say that membership is increasing.

The Council is governed by a Board of Directors that is chaired by Shaikh Saleh Kamel, who is the Chairman of Al Baraka Banking Group. An Executive Committee of the Board is empowered to take certain decisions in between meetings of the full Board. The day-to-day management of CIBAFI's affairs is in the hands of the Secretariat, which is led by the Secretary General, Mr. Abdelilah Belatik.

CIBAFI has a unique role in the global architecture of Islamic finance: it is the only member-based organisation that exists to promote the interests of Islamic finance practitioners whether they are banks, insurance companies, financial regulators, customers and the users of Islamic financial products, or others who encounter Islamic financial services in their professional or personal lives.

CIBAFI works with other organisations within the global architecture of Islamic finance. These organisations include the Islamic Financial Services Board (which sets regulatory standards), the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) (which sets accounting and other standards), and the International Islamic Financial Market (which sets standards and documentation for Shariah-compliant financial instruments). CIBAFI also work closely with global organisations such as the World Bank and the IMF, the Basel Committee on Banking Supervision and the International Accounting Standards Board (IASB). We have a close relationship with the Islamic Development Bank and share its objectives to promote and strengthen the Islamic Financial Industry.

CIBAFI's strategic plan for 2015-2018 identifies four Strategic Objectives:

1. **Policy and Regulatory Advocacy** In an increasingly complex regulatory environment, new regulations are constantly being proposed and implemented for the financial industry. CIBAFI ensures that regulators and standard setters understand how the Islamic financial services industry will be affected by their proposals. For example, CIBAFI has participated in meetings of the IMF's External Advisory Group on Islamic Finance and in the International Accounting Standards Board's Consultative Group on Shariah-compliant instruments and transactions. We solicited the views of our members on the new Liquidity Standard being prepared by the Islamic Financial Services Board and made representations to the Board on behalf of our members.

2. **Research and Publications** CIBAFI conducts research and produces publications on issues of interest to our members and which are relevant to the development of the Islamic finance industry. For example, we are producing a series of Islamic Finance Country Reports in partnership with Thompson Reuters and the Islamic Research and Training Institute of the Islamic Development Bank. The most recent reports were on Malaysia and on Oman. This inaugural Survey is part of our initiative to increase our output of publications and research. We have also begun to publish a newsletter ("InFocus") to keep members and others informed about CIBAFI activities and about significant developments in Islamic finance.

3. **Awareness and Information** Sharing As the voice of the Islamic finance industry, CIBAFI plays an important role spreading awareness of the industry externally and facilitating the exchange of information and best practices within the industry. For example, we were told by our members that they faced difficulties expanding their activities beyond their home jurisdictions. In response, we organised a two-day Roundtable Meeting (RM) on "Internationalisation Strategies for Islamic Financial Institutions," drawing together both industry experts (such as accounting firms and corporate branding companies) and industry practitioners. The results of the RM were written up and published, along with policy recommendations, in a CIBAFI booklet. In September 2015, we partnered with the World Bank to co-organise a conference in Amman entitled, "Corporate Governance of Islamic Financial Institutions and Markets: Lessons from Recent Global Developments..

4. **Professional Development** Our members have identified as one of their priorities the need to strengthen the talent pool within the Islamic finance industry. In response, CIBAFI organises a variety of technical workshops and executive programmes, and we also offer professional qualifications. For example, in February 2015, we held a professional development programme in Almaty, sponsored by the Islamic Development Bank and hosted by the National Bank of Kazakhstan; and in March 2015, we held a technical workshop (in Arabic) in Riyadh in partnership with the Saudi Arabian Monetary Agency's Institute of Banking.

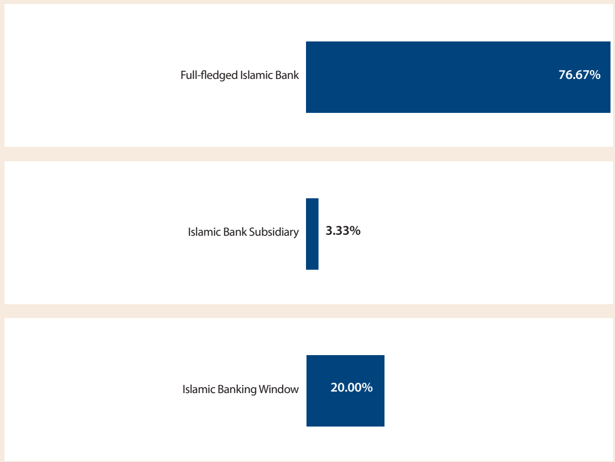
CIBAFI welcomes suggestions from members and non-members for ways in which we can strengthen the work that we do.

APPENDIX 2

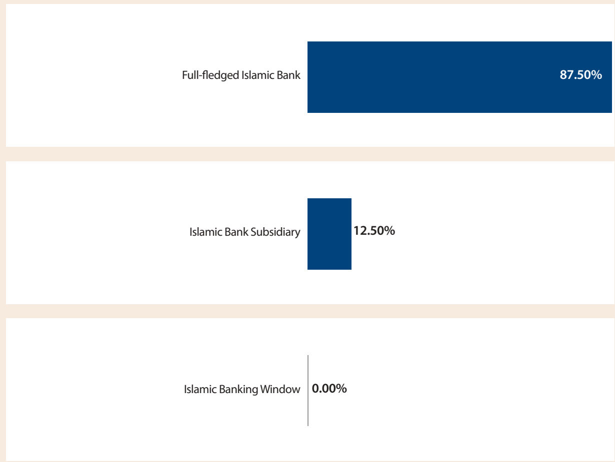
Appendix 2. Survey Findings: Region-focused

In which category is the Islamic banking operation of your institution?

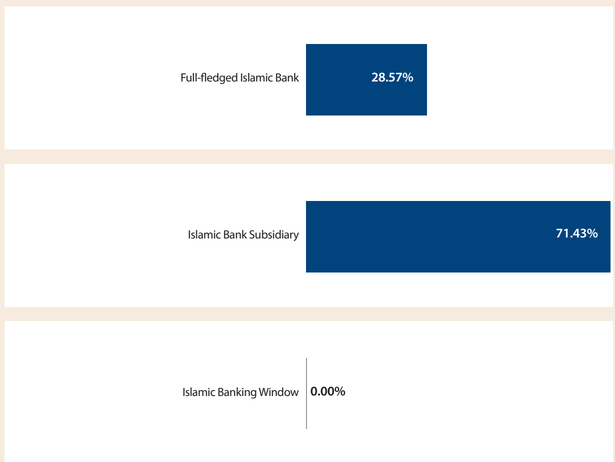
Group 1 Banking Operation



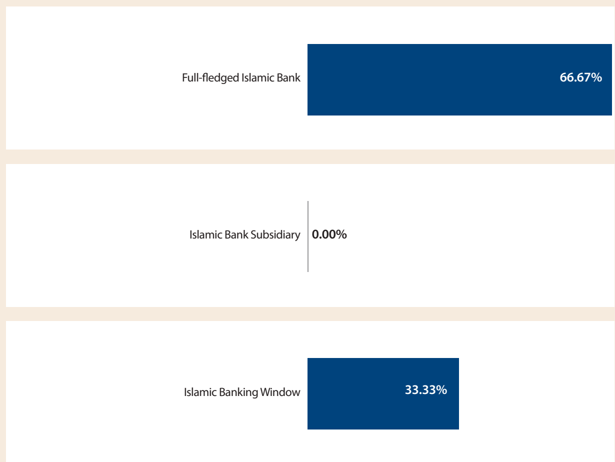
Group 2 Banking Operation



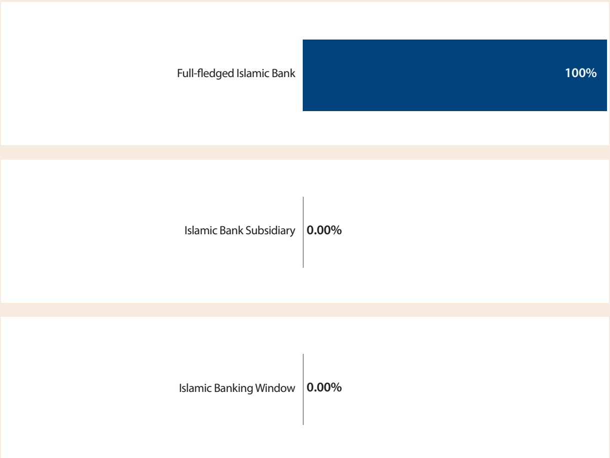
Group 3 Banking Operation



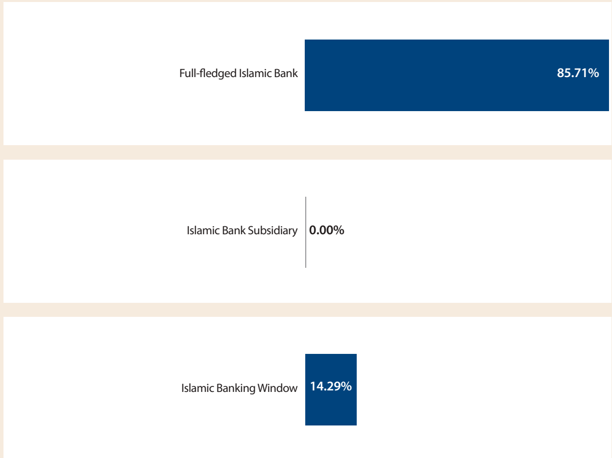
Group 4 Banking Operation



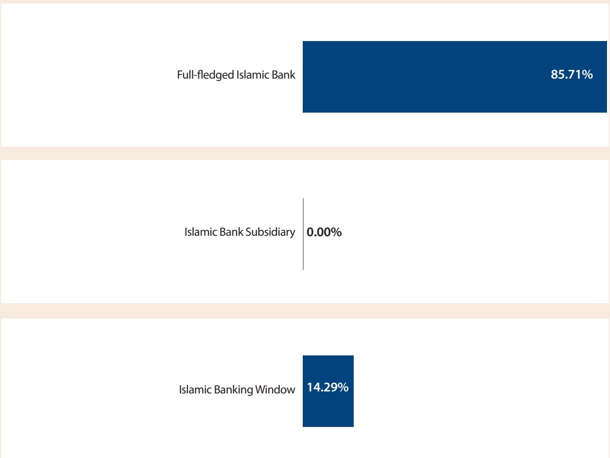
Group 5 Banking Operation



Group 6 Banking Operation

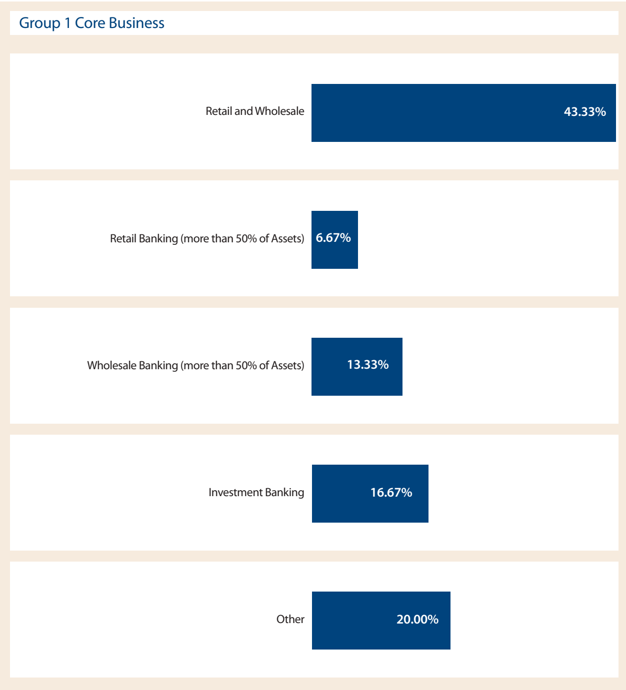


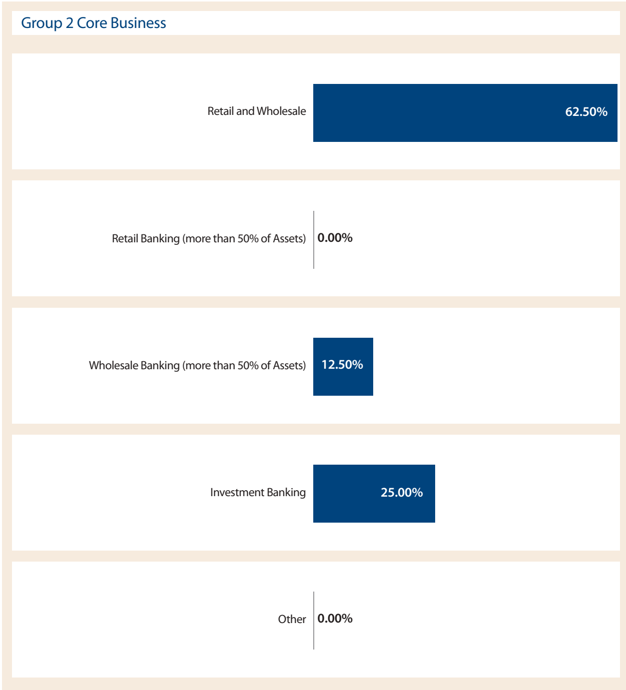
Group 7 Banking Operation

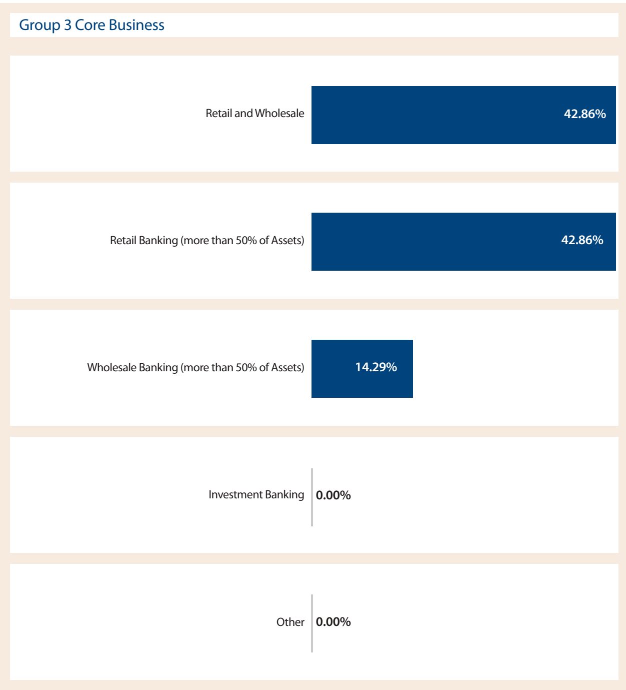


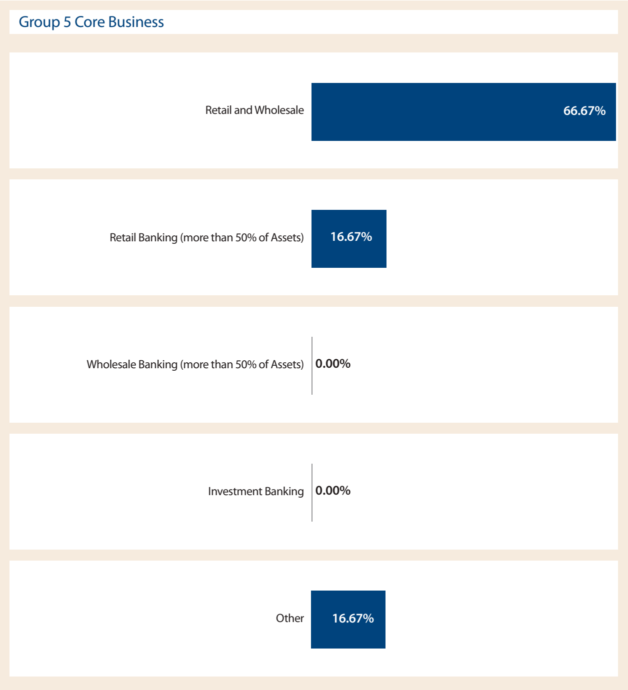
Appendix 2. Survey Findings: Region-focused

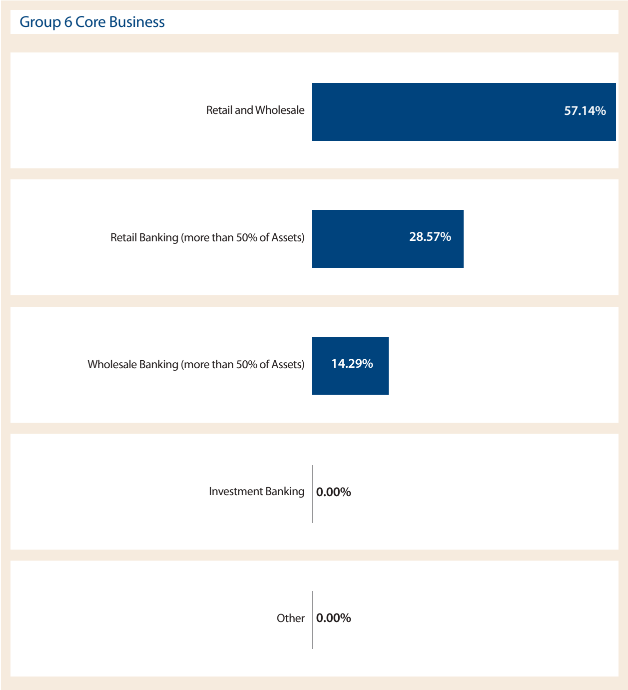
What is the main business of your institution?

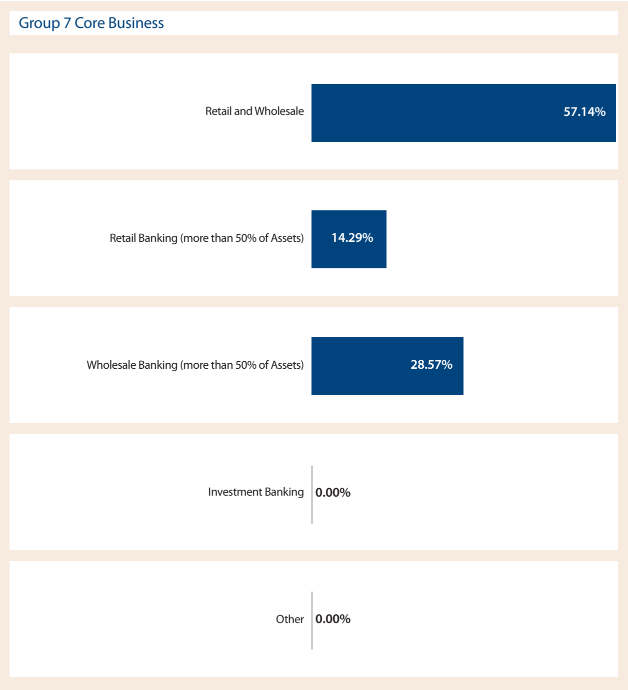






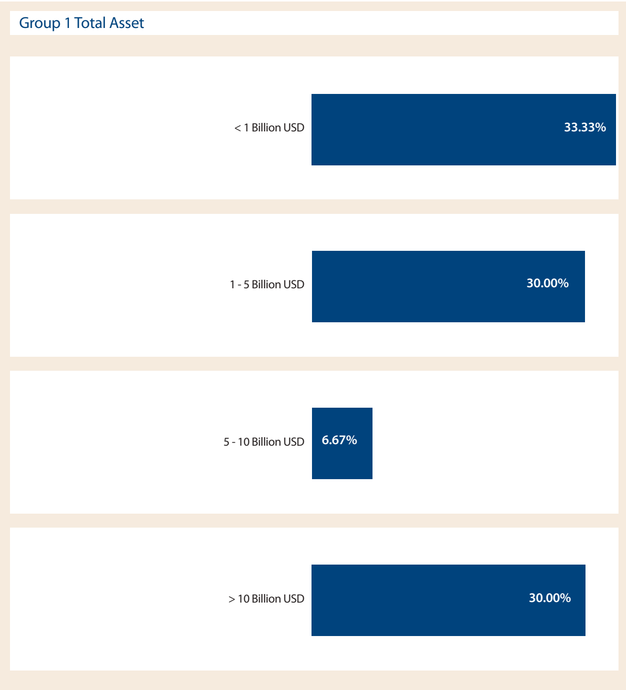

Group 5 Core Business
Retail and Wholesale
66.67%
Retail Banking (more than 50% of Assets)
16.67%
Wholesale Banking (more than 50% of Assets)
0.00%
Investment Banking
0.00%
Other
16.67%

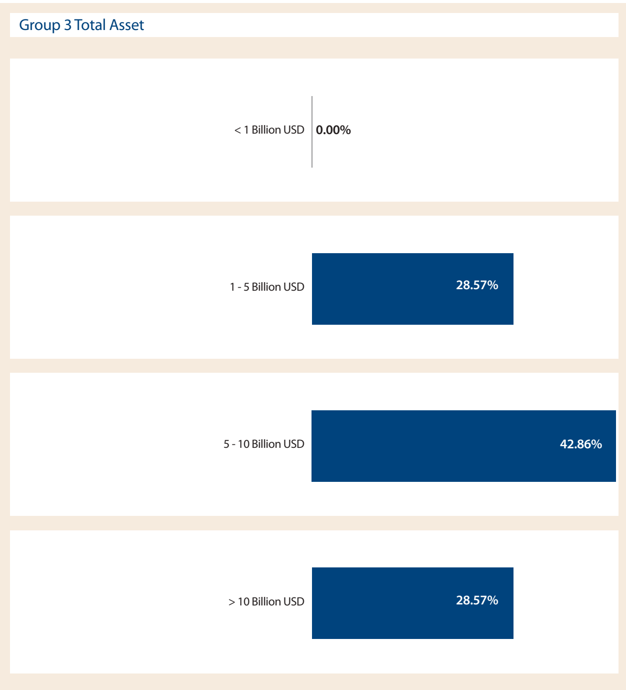

Group 6 Core Business
Retail and Wholesale
57.14%
Retail Banking (more than 50% of Assets)
28.57%
Wholesale Banking (more than 50% of Assets)
14.29%
Investment Banking
0.00%
Other
0.00%

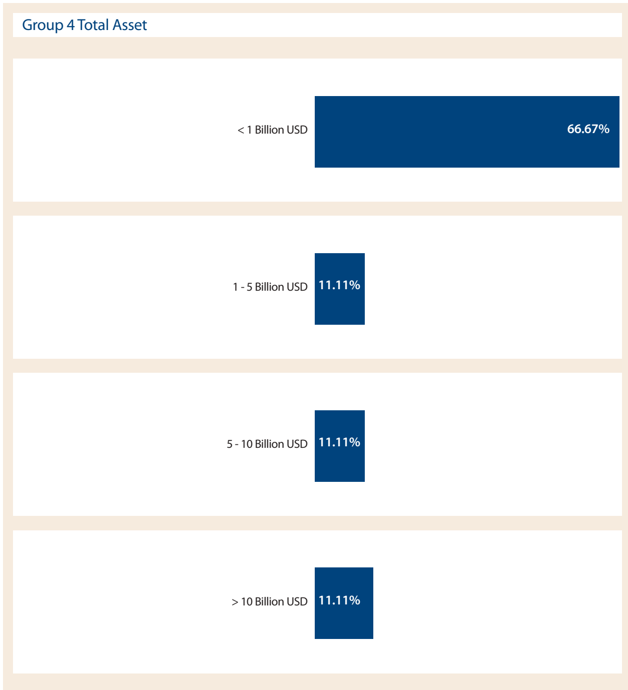

Group 7 Core Business
Retail and Wholesale
57.14%
Retail Banking (more than 50% of Assets)
14.29%
Wholesale Banking (more than 50% of Assets)
28.57%
Investment Banking
0.00%
Other
0.00%

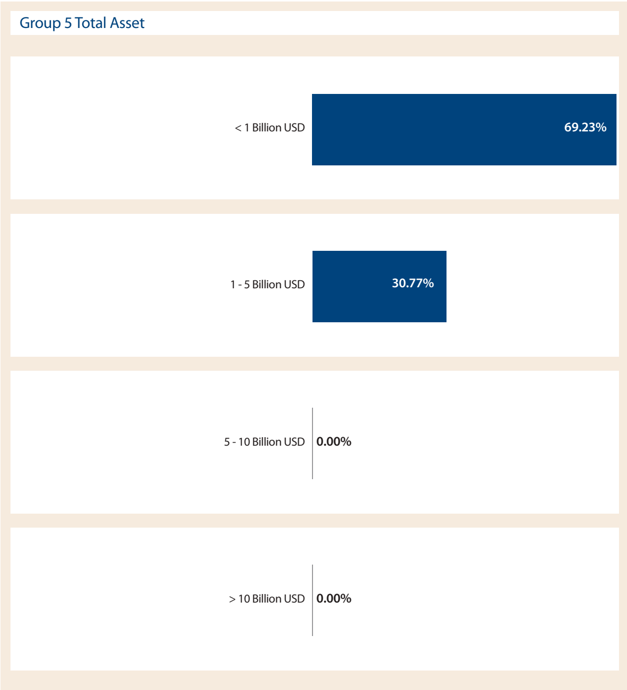
Appendix 2. Survey Findings: Region-focused

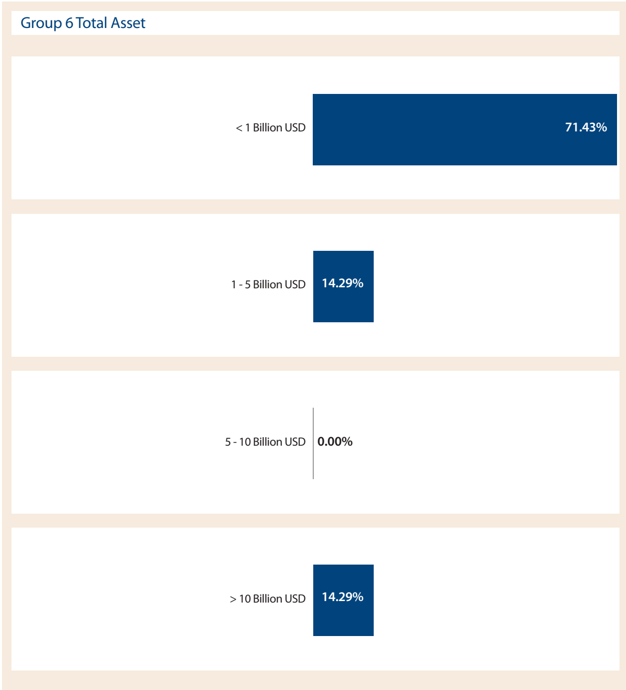
In which range is the size of total Islamic assets of your institution?

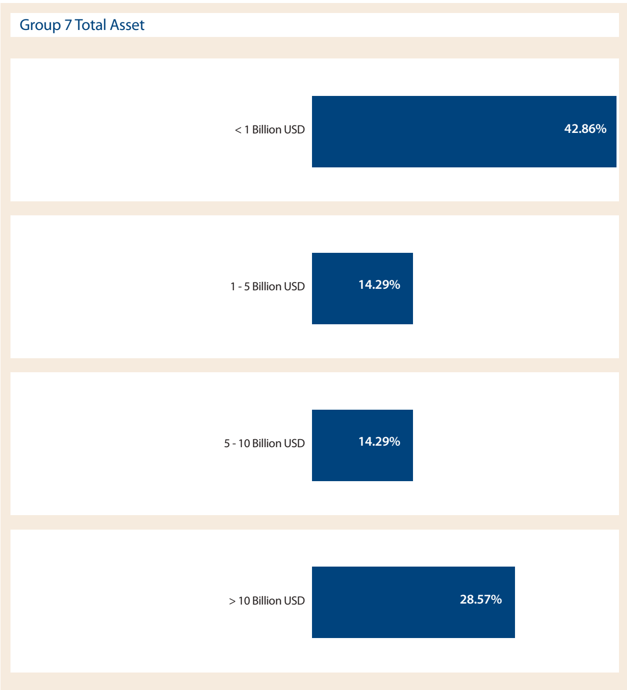






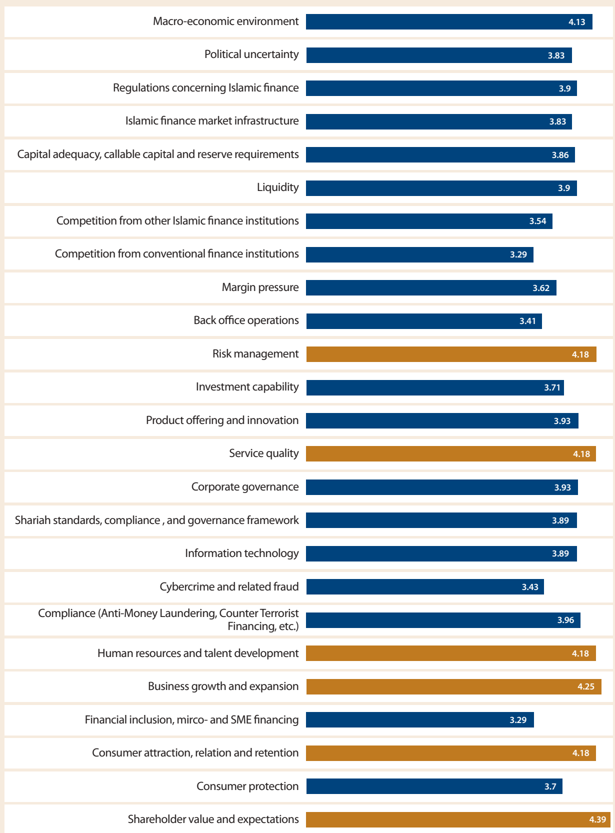

Group 5 Total Asset
< 1 Billion USD
69.23%
1 - 5 Billion USD
30.77%
5 - 10 Billion USD
0.00%
> 10 Billion USD
0.00%


Group 6 Total Asset
< 1 Billion USD
71.43%
1 - 5 Billion USD
14.29%
5 - 10 Billion USD
0.00%
> 10 Billion USD
14.29%

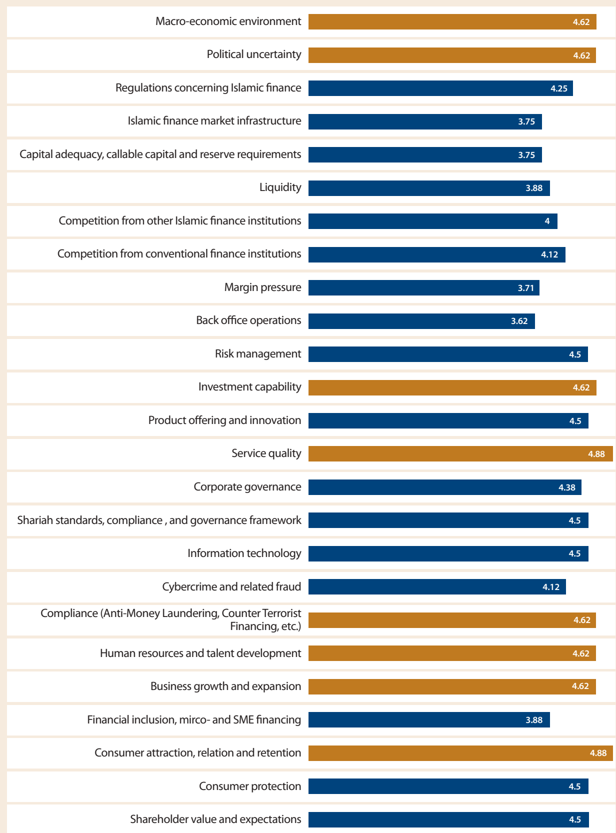

Group 7 Total Asset
< 1 Billion USD
42.86%
1 - 5 Billion USD
14.29%
5 - 10 Billion USD
14.29%
> 10 Billion USD
28.57%

Part I. Islamic Banking Confidence Index

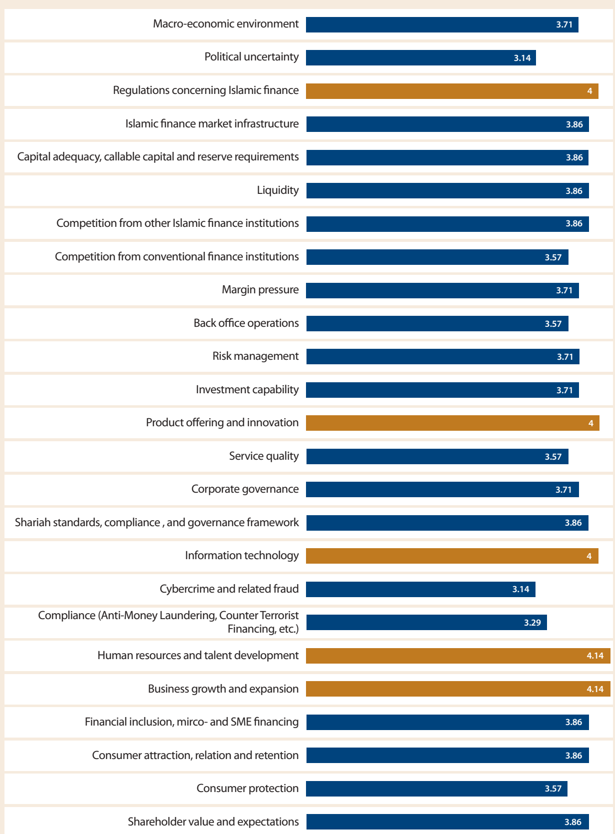
Group 1 Major Concern



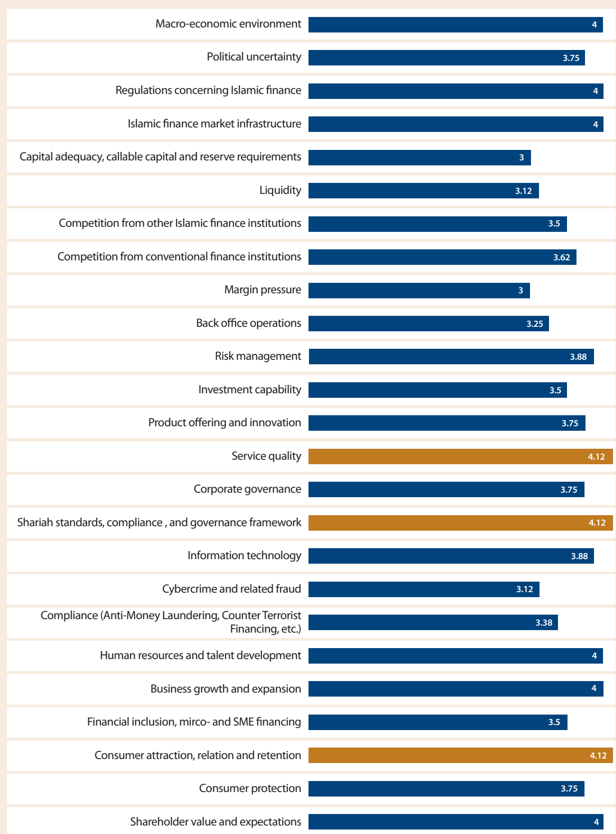
Group 2 Major Concern

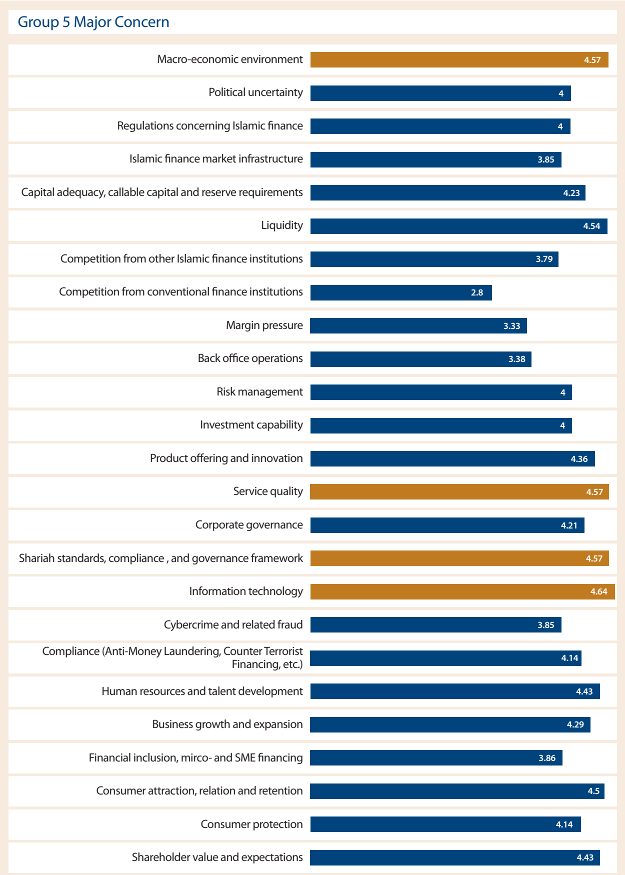


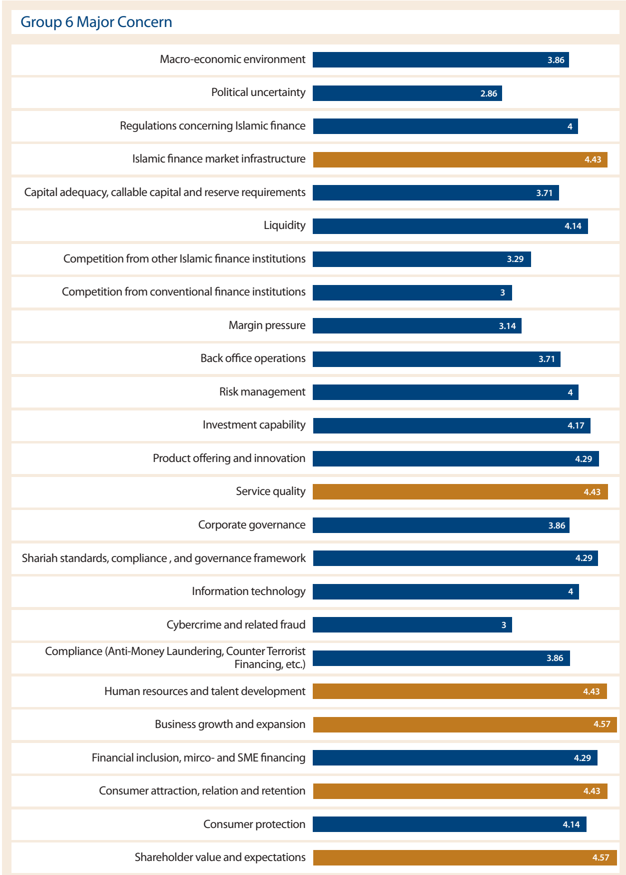
Group 3 Major Concern

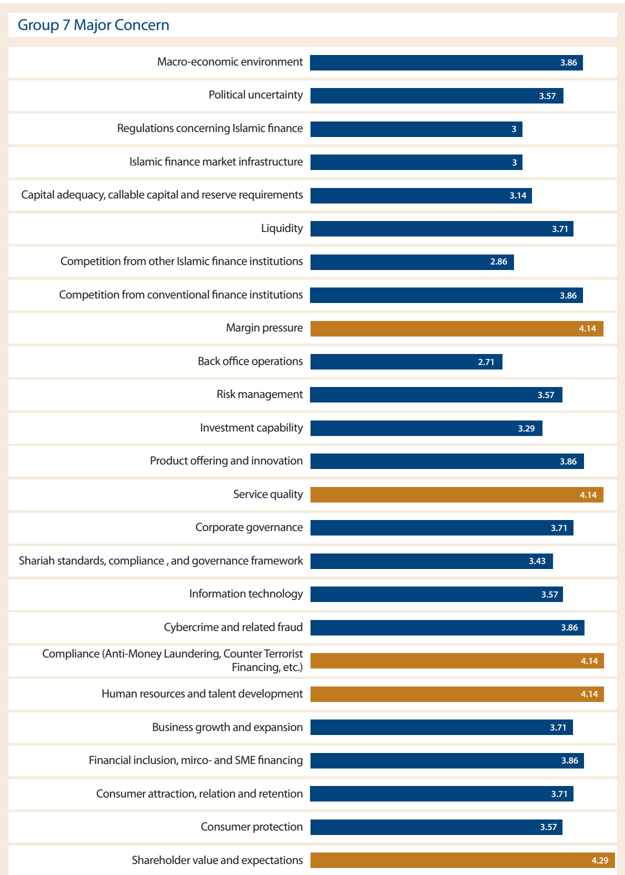


Group 4 Major Concern




Group 5 Major Concern
Macro-economic environment 4.57
Political uncertainty 4
Regulations concerning Islamic finance 4
Islamic finance market infrastructure 3.85
Capital adequacy, callable capital and reserve requirements 4.23
Liquidity 4.54
Competition from other Islamic finance institutions 3.79
Competition from conventional finance institutions 2.8
Margin pressure 3.33
Back office operations 3.38
Risk management 4
Investment capability 4
Product offering and innovation 4.36
Service quality 4.57
Corporate governance 4.21
Shariah standards, compliance , and governance framework 4.57
Information technology 4.64
Cybercrime and related fraud 3.85
Compliance (Anti-Money Laundering, Counter Terrorist Financing, etc.) 4.14
Human resources and talent development 4.43
Business growth and expansion 4.29
Financial inclusion, mirco- and SME financing 3.86
Consumer attraction, relation and retention 4.5
Consumer protection 4.14
Shareholder value and expectations 4.43


Group 6 Major Concern
Macro-economic environment 3.86
Political uncertainty 2.86
Regulations concerning Islamic finance 4
Islamic finance market infrastructure 4.43
Capital adequacy, callable capital and reserve requirements 3.71
Liquidity 4.14
Competition from other Islamic finance institutions 3.29
Competition from conventional finance institutions 3
Margin pressure 3.14
Back office operations 3.71
Risk management 4
Investment capability 4.17
Product offering and innovation 4.29
Service quality 4.43
Corporate governance 3.86
Shariah standards, compliance , and governance framework 4.29
Information technology 4
Cybercrime and related fraud 3
Compliance (Anti-Money Laundering, Counter Terrorist Financing, etc.) 3.86
Human resources and talent development 4.43
Business growth and expansion 4.57
Financial inclusion, mirco- and SME financing 4.29
Consumer attraction, relation and retention 4.43
Consumer protection 4.14
Shareholder value and expectations 4.57


Group 7 Major Concern
Macro-economic environment 3.86
Political uncertainty 3.57
Regulations concerning Islamic finance 3
Islamic finance market infrastructure 3
Capital adequacy, callable capital and reserve requirements 3.14
Liquidity 3.71
Competition from other Islamic finance institutions 2.86
Competition from conventional finance institutions 3.86
Margin pressure 4.14
Back office operations 2.71
Risk management 3.57
Investment capability 3.29
Product offering and innovation 3.86
Service quality 4.14
Corporate governance 3.71
Shariah standards, compliance , and governance framework 3.43
Information technology 3.57
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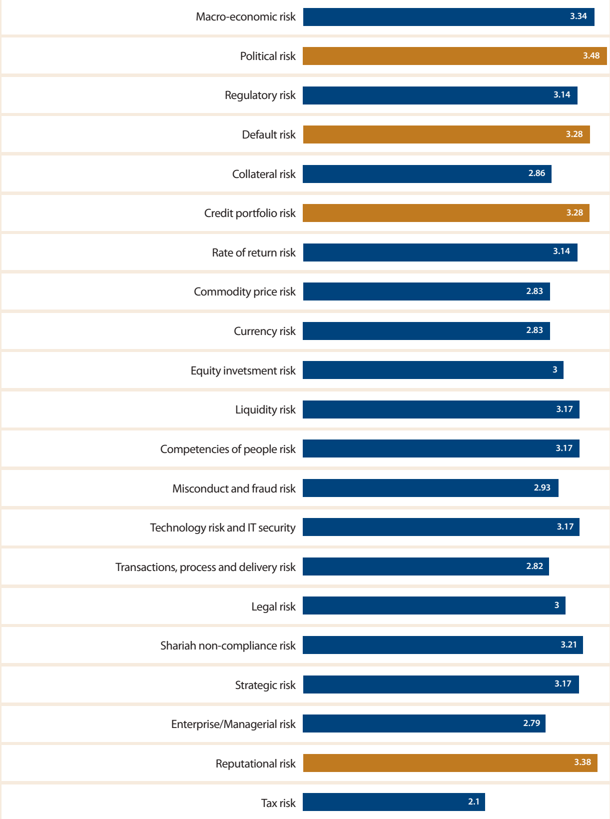
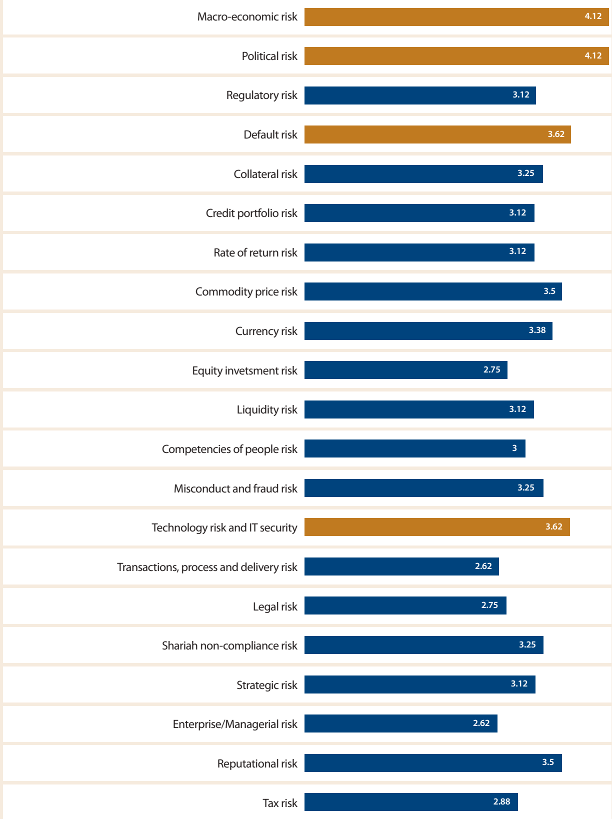
Compliance (Anti-Money Laundering, Counter Terrorist Financing, etc.) 4.14
Human resources and talent development 4.14
Business growth and expansion 3.71
Financial inclusion, mirco- and SME financing 3.86
Consumer attraction, relation and retention 3.71
Consumer protection 3.57
Shareholder value and expectations 4.29

Part II. Islamic Banking Risk Dashboard

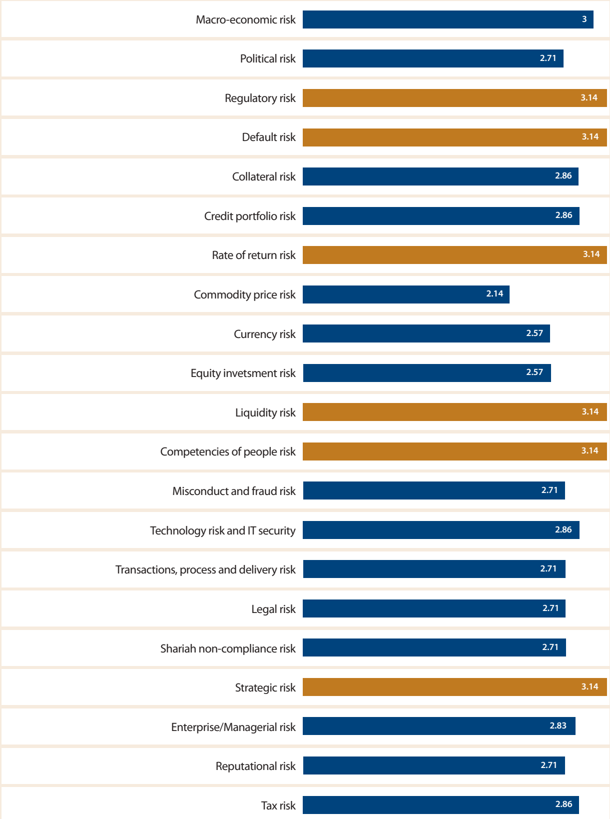
Group 1 Islamic Banking Risk Dashboard



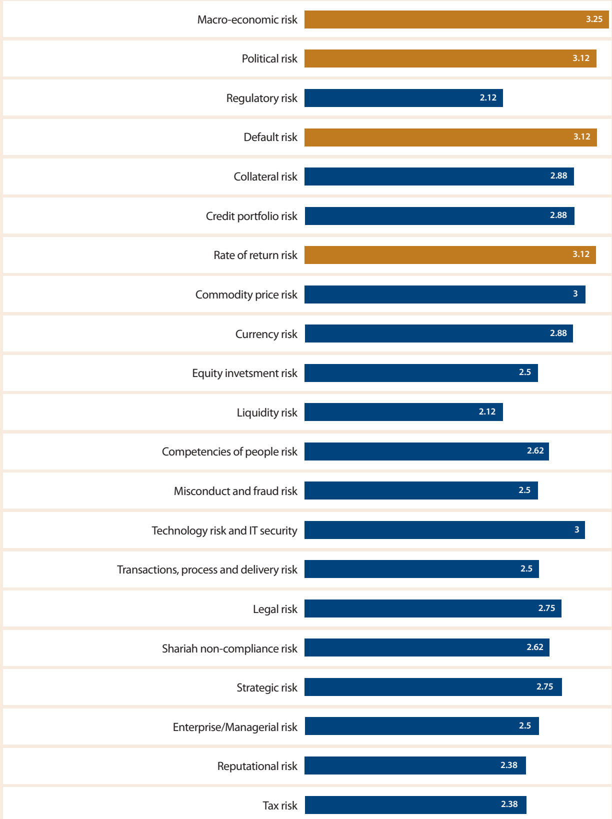
Group 2 Islamic Banking Risk Dashboard



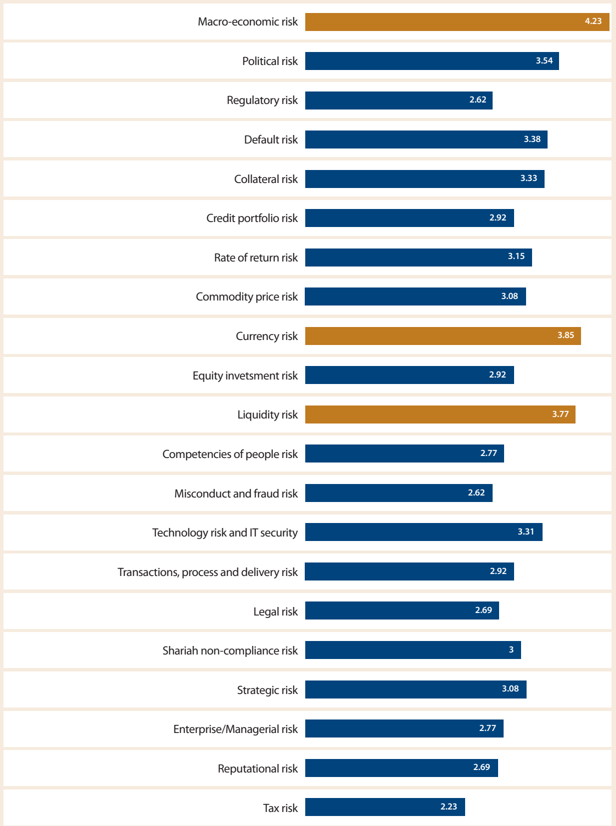
Group 3 Islamic Banking Risk Dashboard



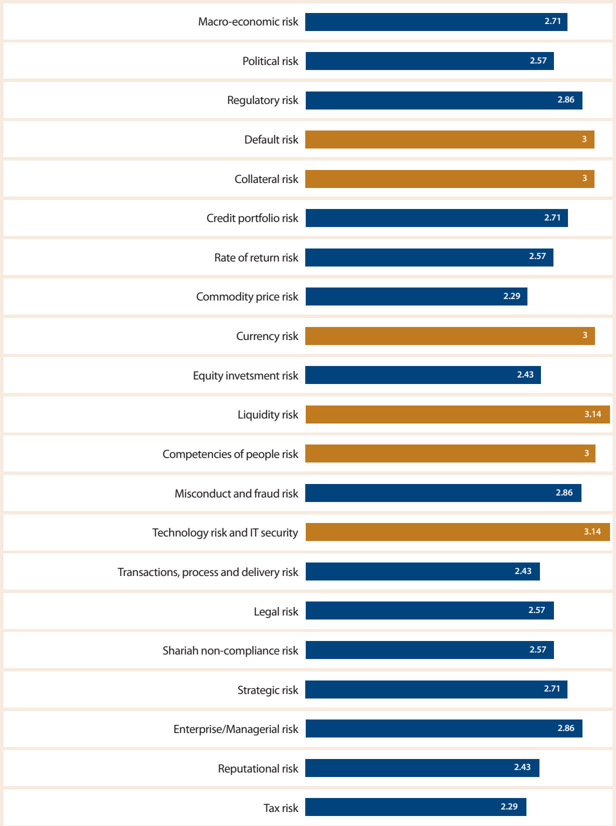
Group 4 Islamic Banking Risk Dashboard



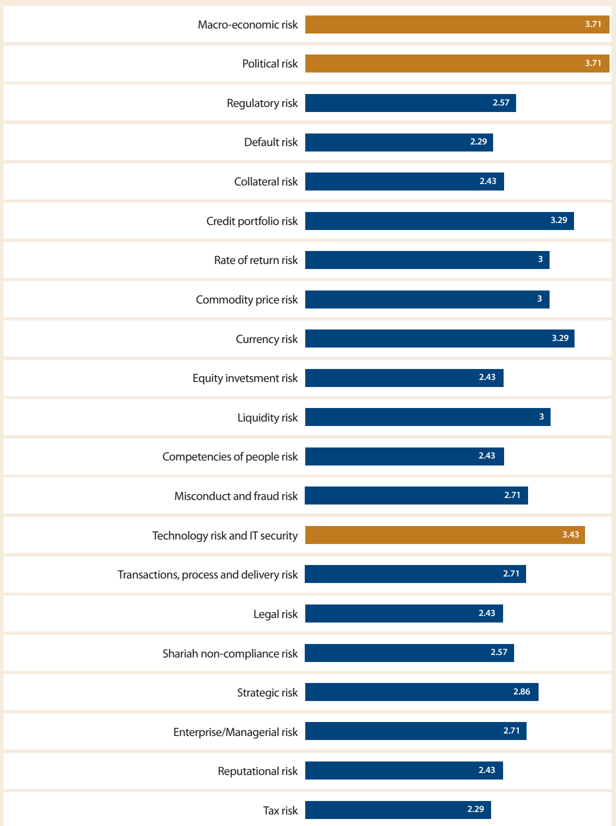
Group 5 Islamic Banking Risk Dashboard



Group 6 Islamic Banking Risk Dashboard



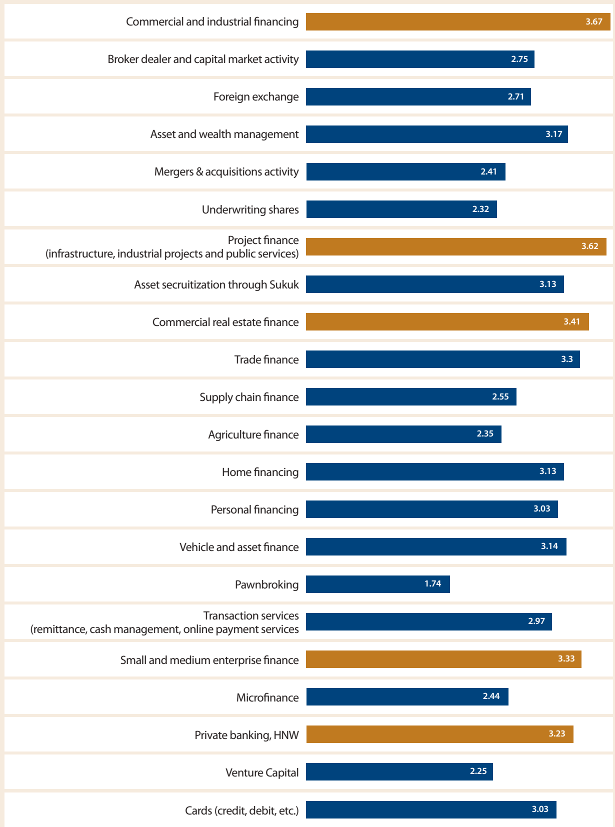
Group 7 Islamic Banking Risk Dashboard



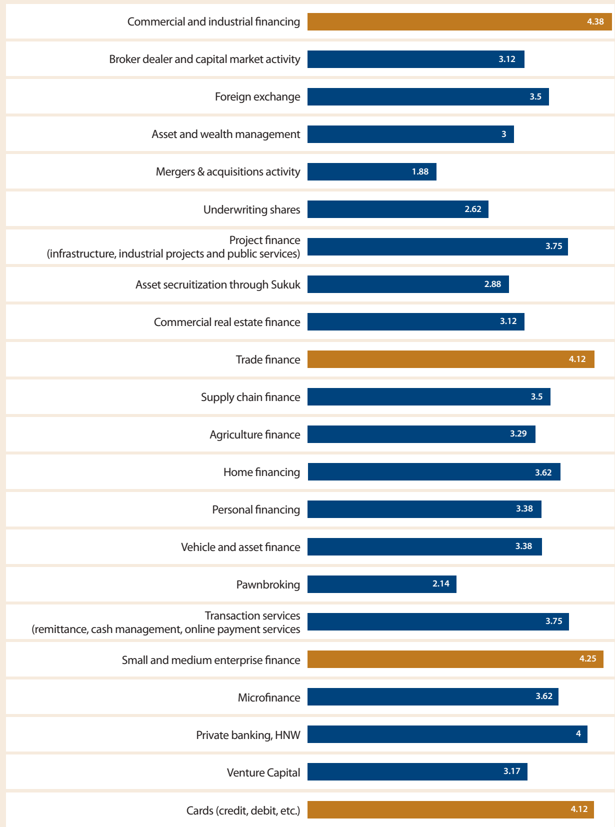
Part III. Islamic Banking Key Drivers of Growth

III.1. Market segments

Group 1 Islamic Banking Market Segments

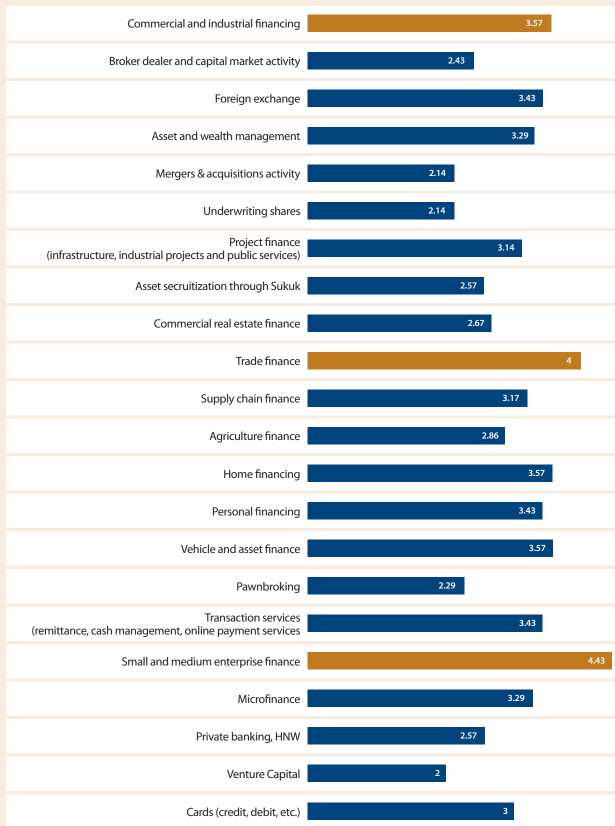


Group 2 Islamic Banking Market Segments

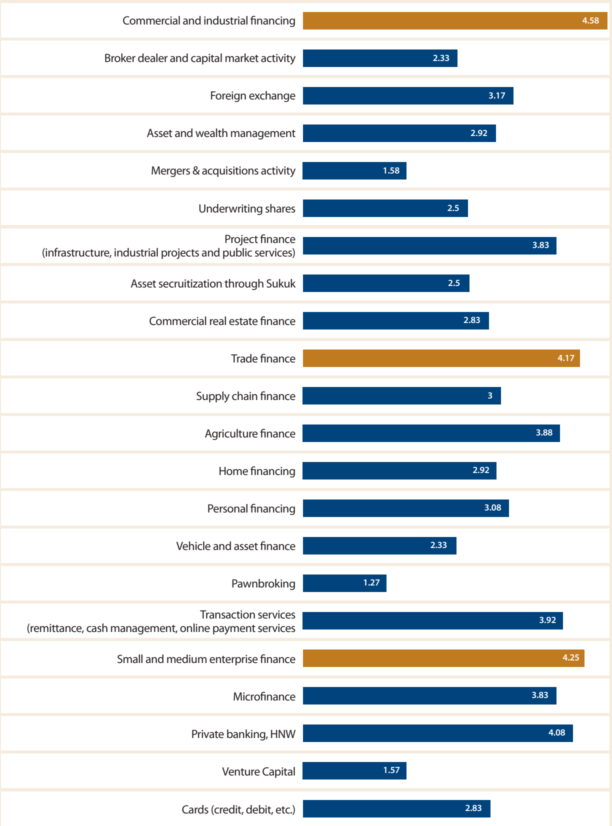


Group 3 Islamic Banking Market Segments

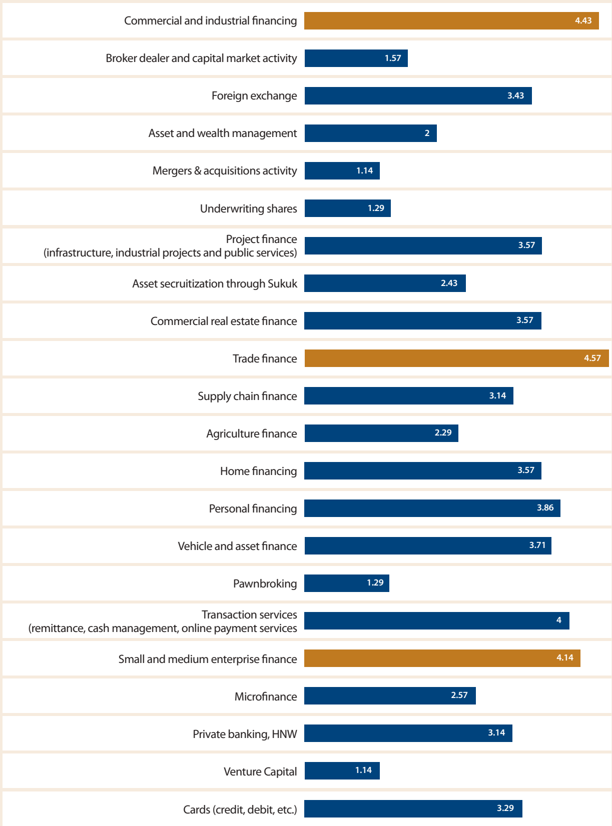
Group 4 Islamic Banking Market Segments



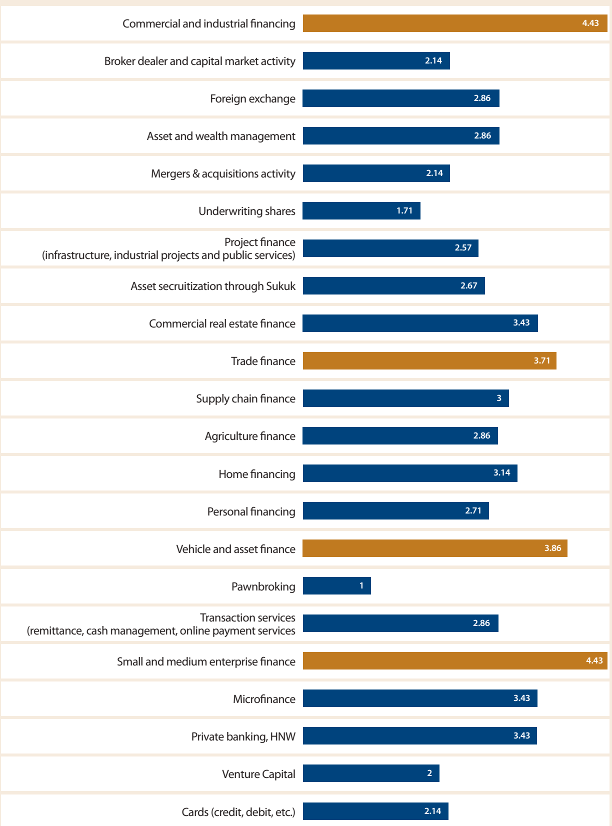
Group 5 Islamic Banking Market Segments



Group 6 Islamic Banking Market Segments



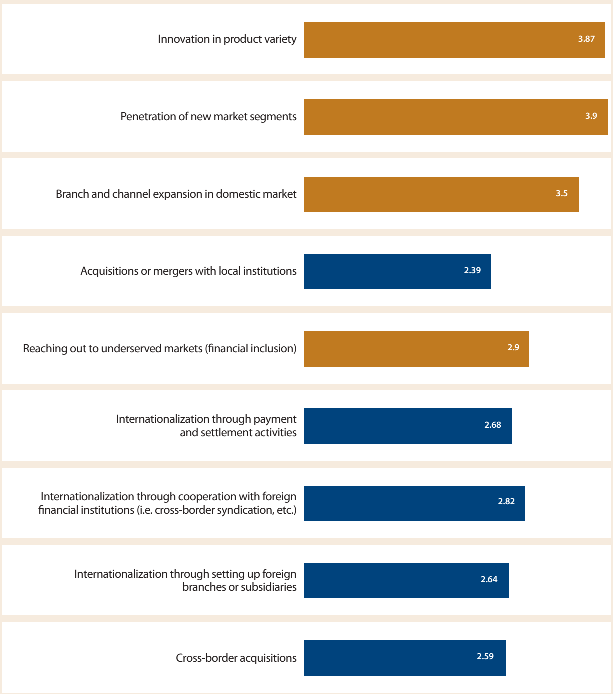
Group 7 Islamic Banking Market Segments



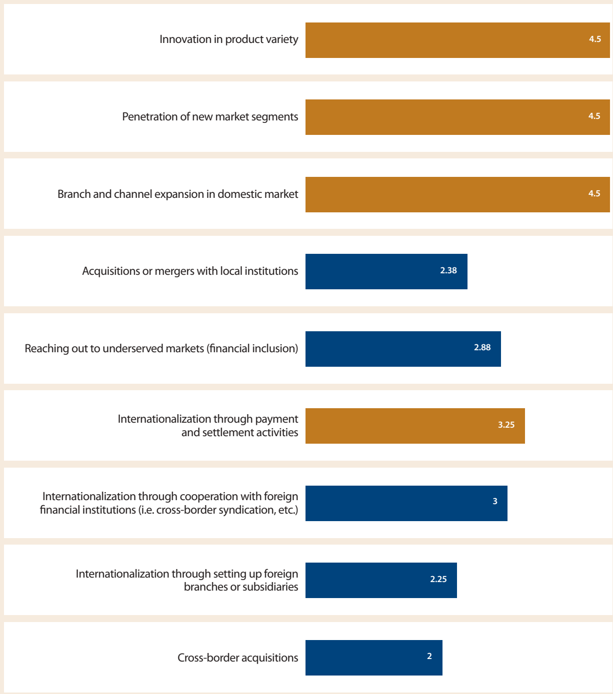
Part III. Islamic Banking Key Drivers of Growth

III.2. Business expansions

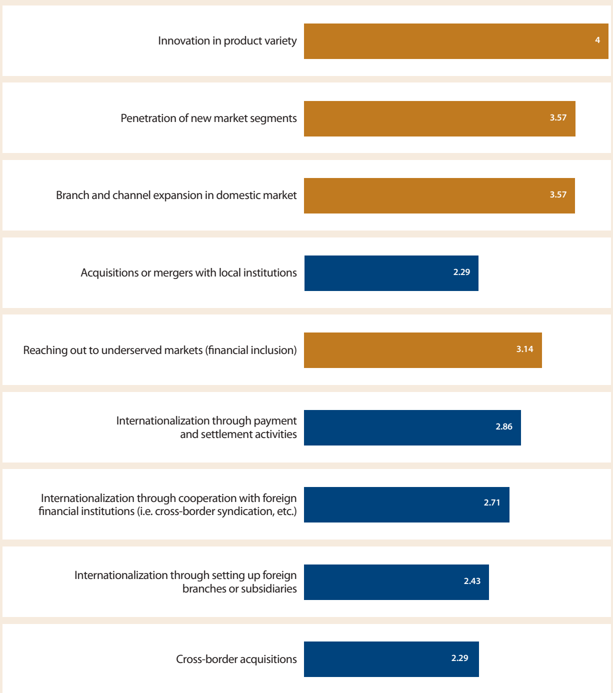
Group 1 Islamic Banking Business Expansion



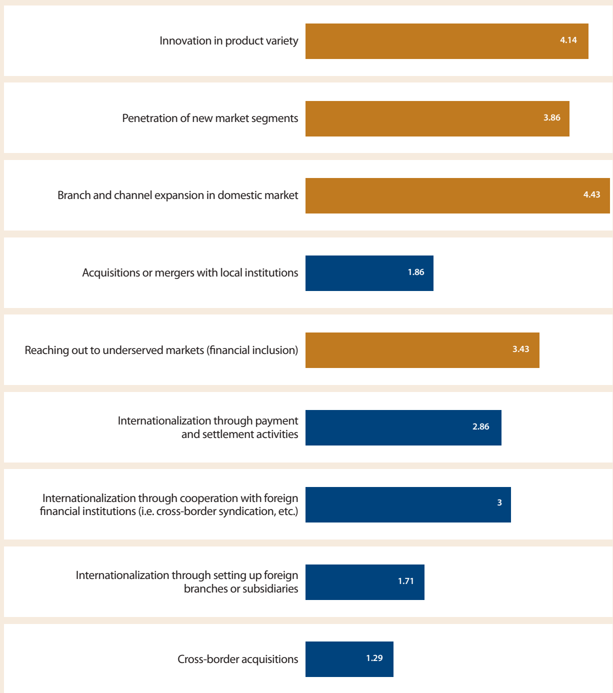
Group 2 Islamic Banking Business Expansion



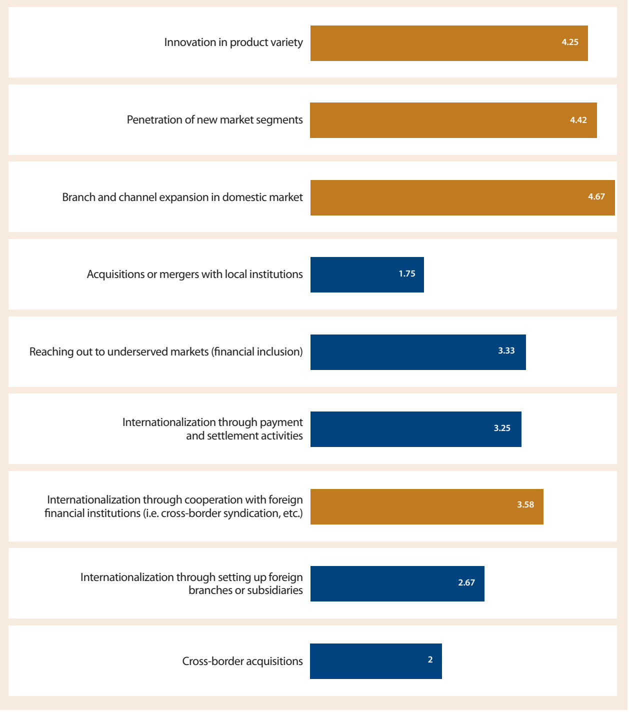
Group 3 Islamic Banking Business Expansion



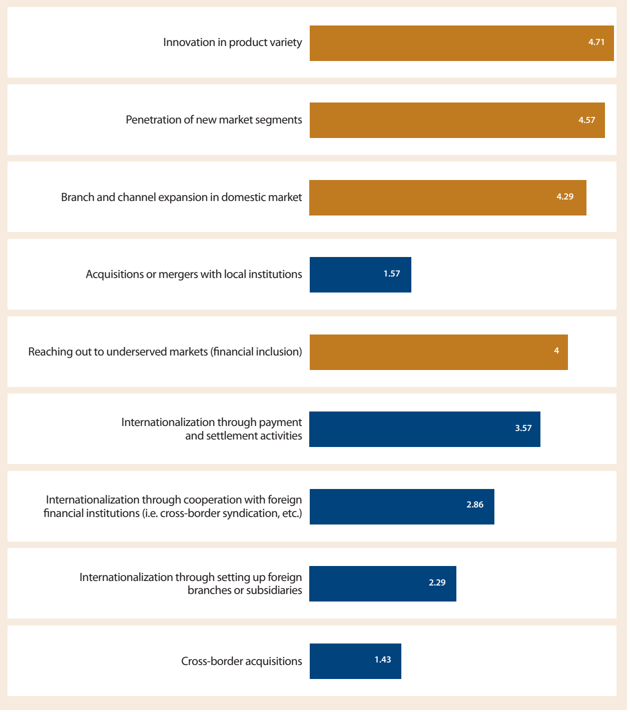
Group 4 Islamic Banking Business Expansion



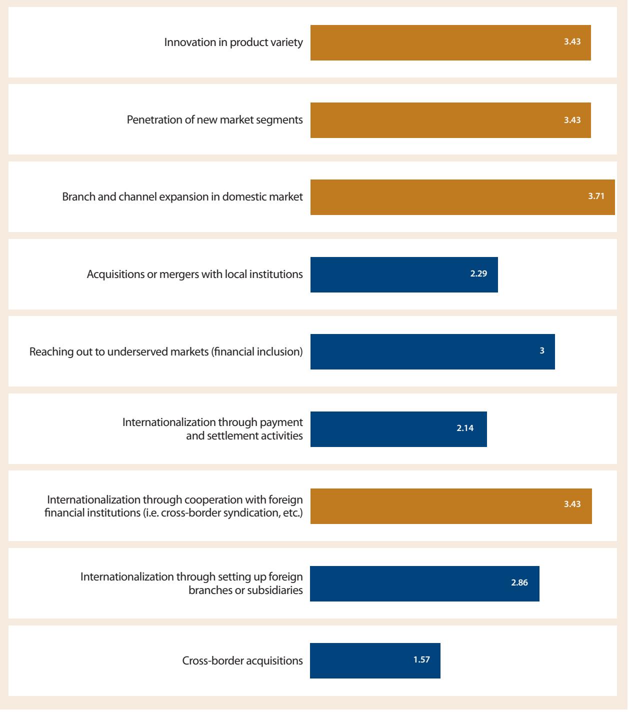
Group 5 Islamic Banking Business Expansion



Group 6 Islamic Banking Business Expansion



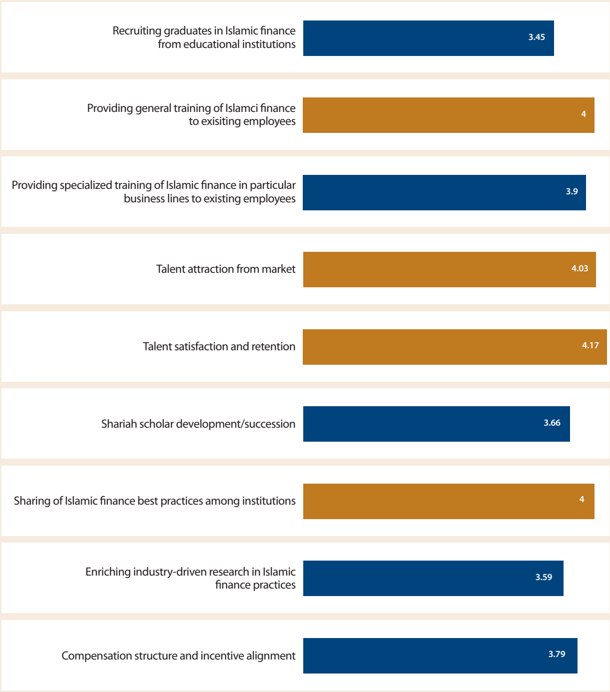
Group 7 Islamic Banking Business Expansion



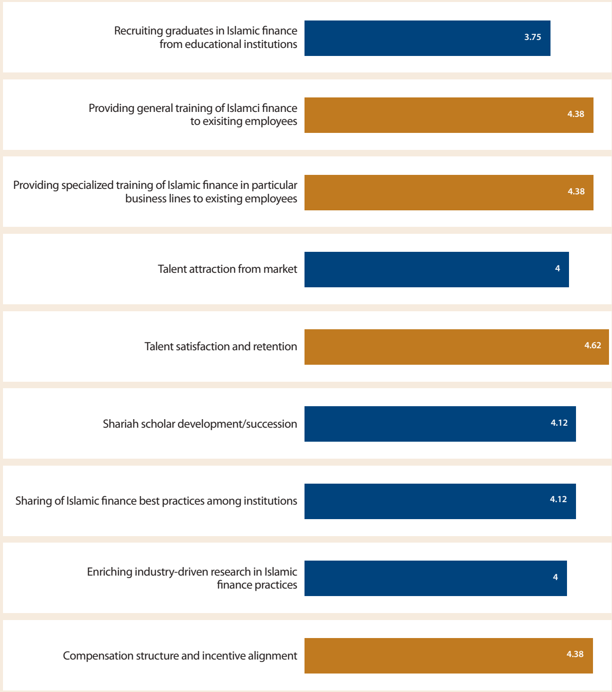
Part III. Islamic Banking Key Drivers of Growth

III.3. Human resources development

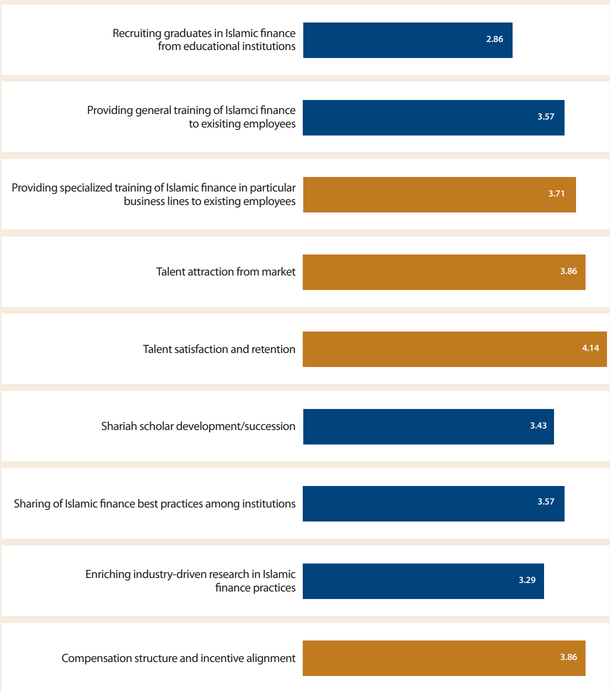
Group 1 Islamic Banking Human Resource Development



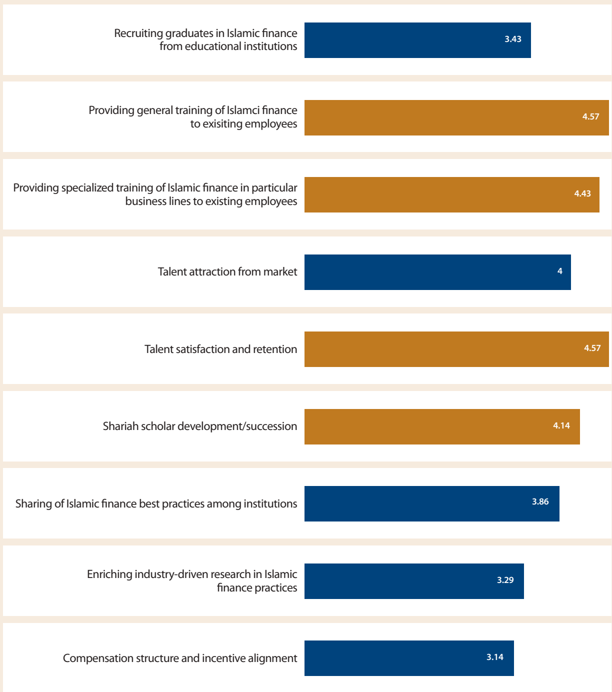
Group 2 Islamic Banking Human Resource Development



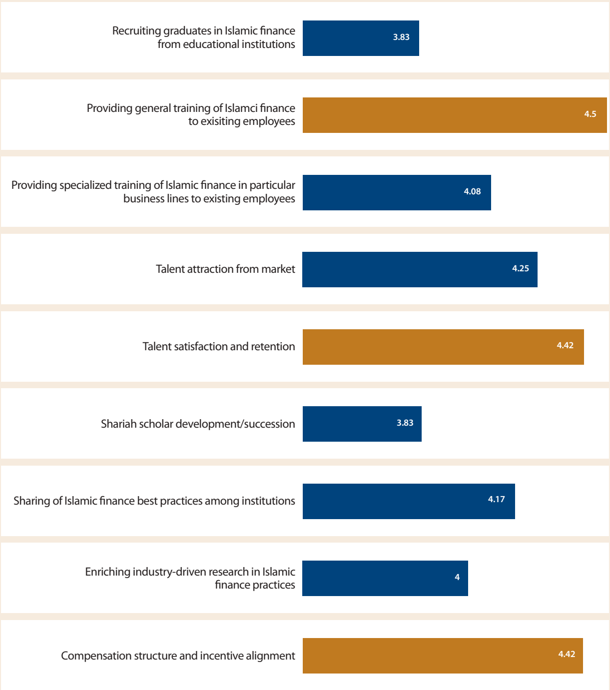
Group 3 Islamic Banking Human Resource Development



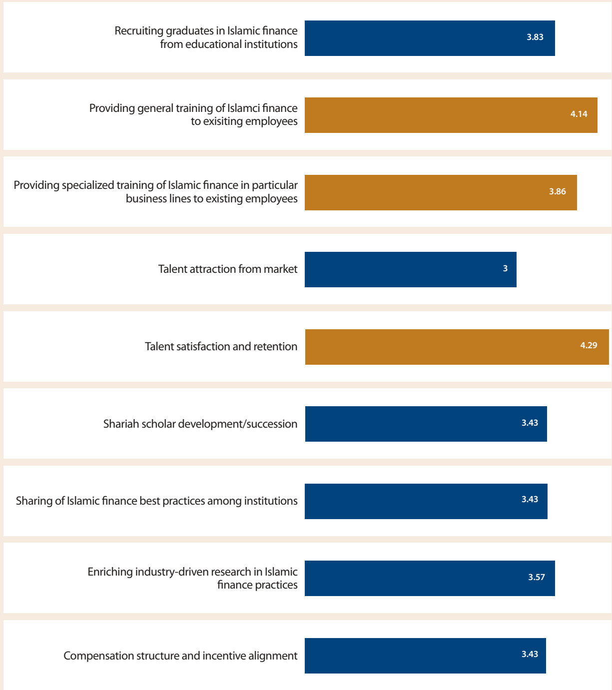
Group 4 Islamic Banking Human Resource Development



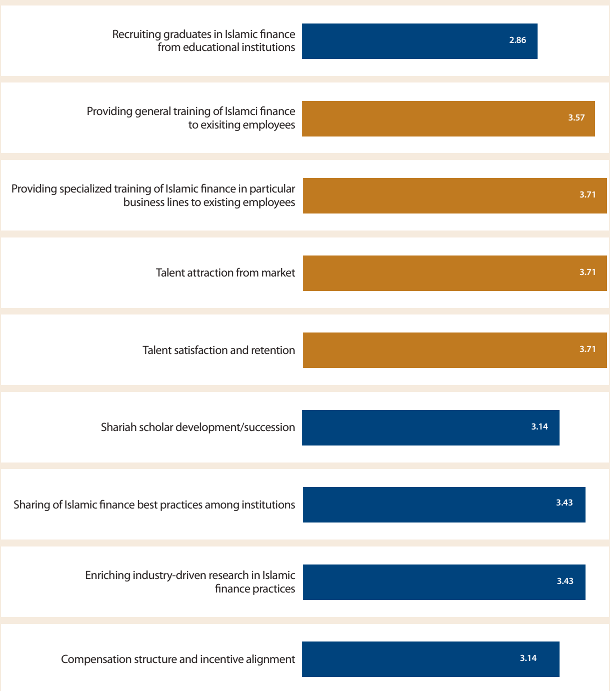
Group 5 Islamic Banking Human Resource Development



Group 6 Islamic Banking Human Resource Development



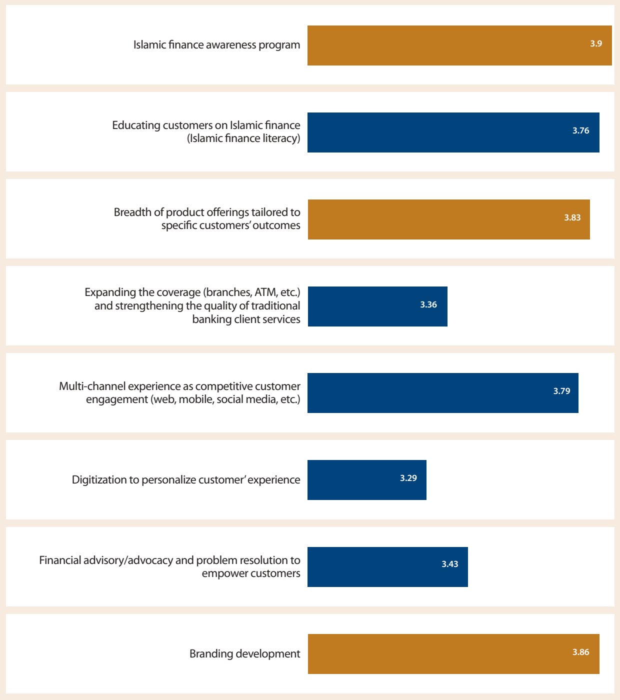
Group 7 Islamic Banking Human Resource Development



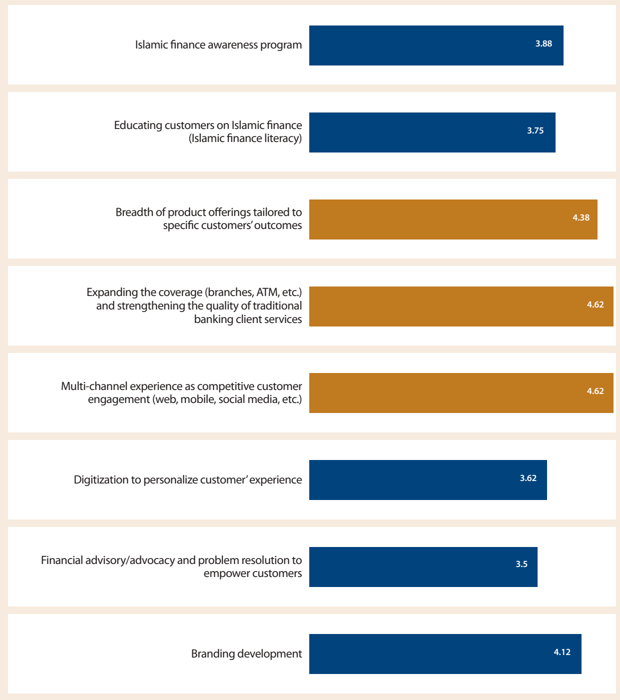
Part III. Islamic Banking Key Drivers of Growth

III.4. Consumer centricity

Group 1 Islamic Banking Consumer Centricity

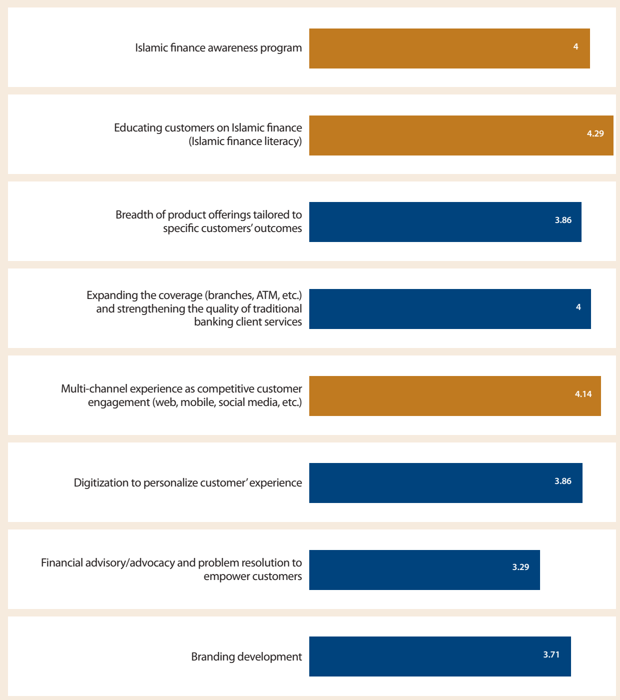


Group 2 Islamic Banking Consumer Centricity



Group 3 Islamic Banking Consumer Centricity

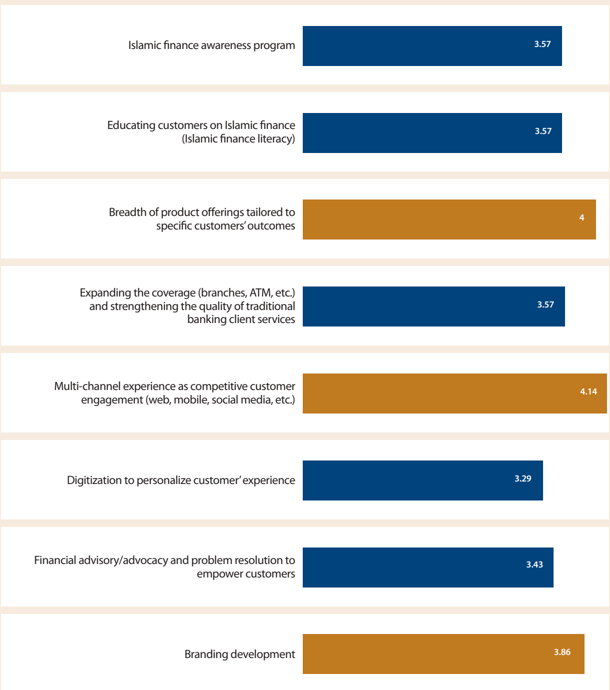
Group 4 Islamic Banking Consumer Centricity



Group 5 Islamic Banking Consumer Centricity

Group 6 Islamic Banking Consumer Centricity

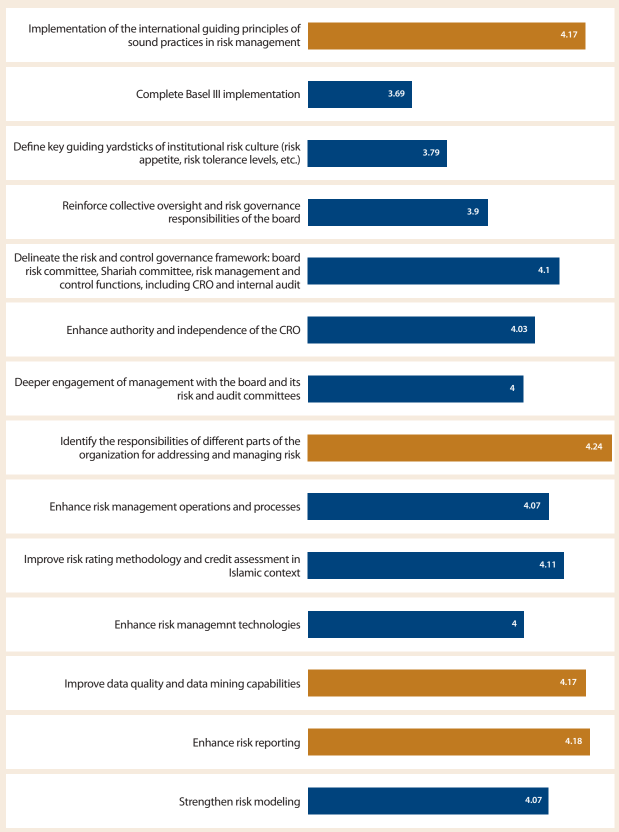
Group 7 Islamic Banking Consumer Centricity



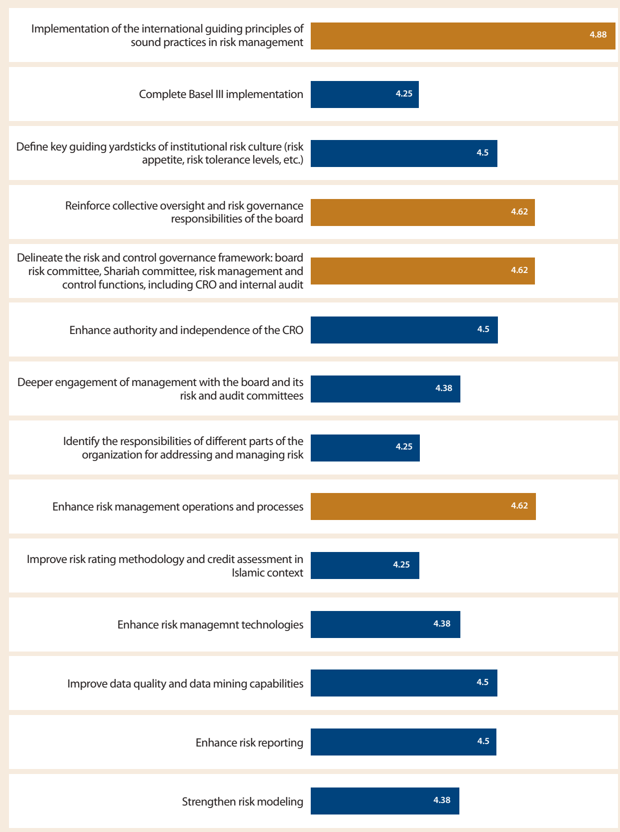
Part III. Islamic Banking Key Drivers of Growth

III.5. Risk management and risk governance

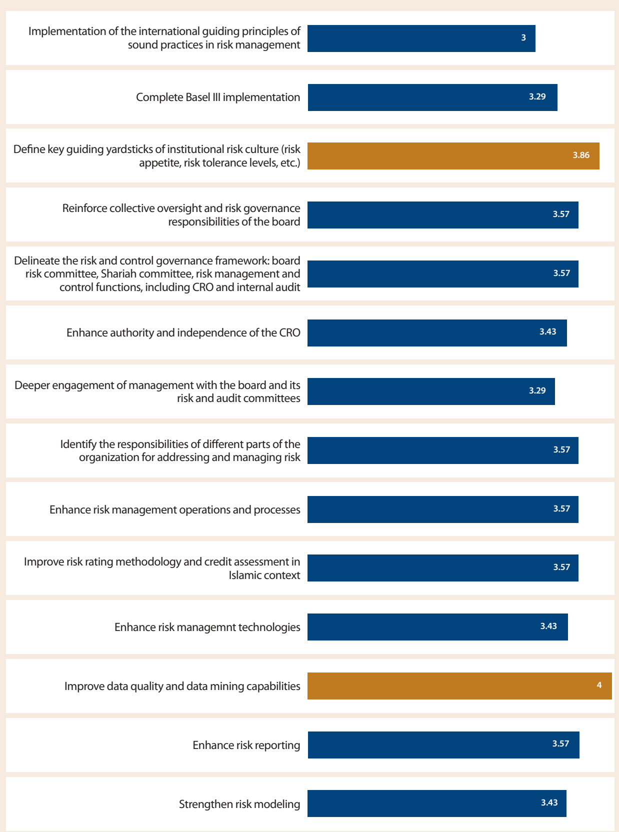
Group 1 Islamic Banking Risk Management and Risk Governance



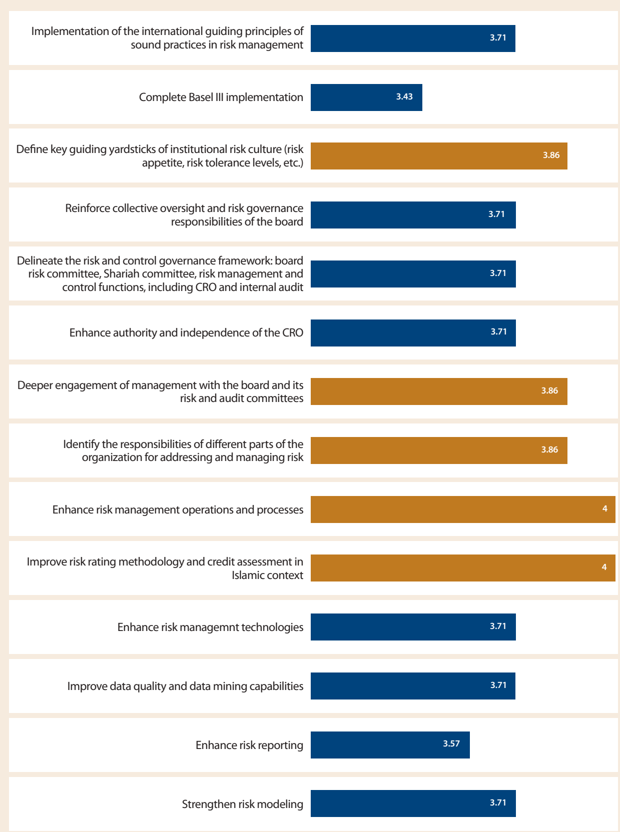
Group 2 Islamic Banking Risk Management and Risk Governance



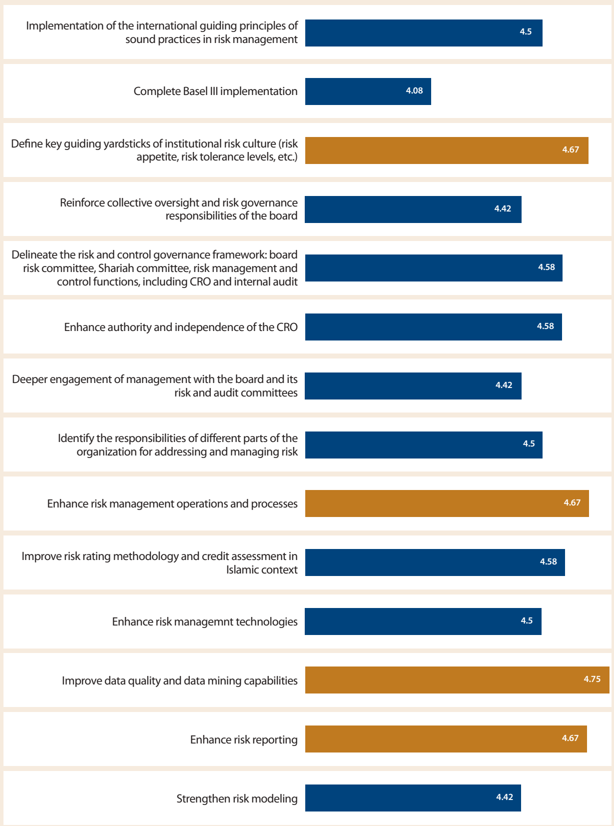
Group 3 Islamic Banking Risk Management and Risk Governance



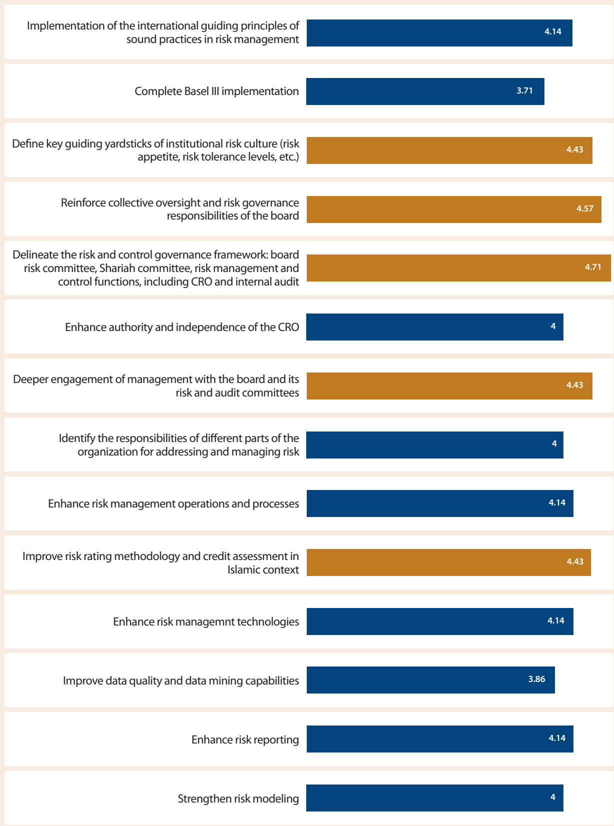
Group 4 Islamic Banking Risk Management and Risk Governance



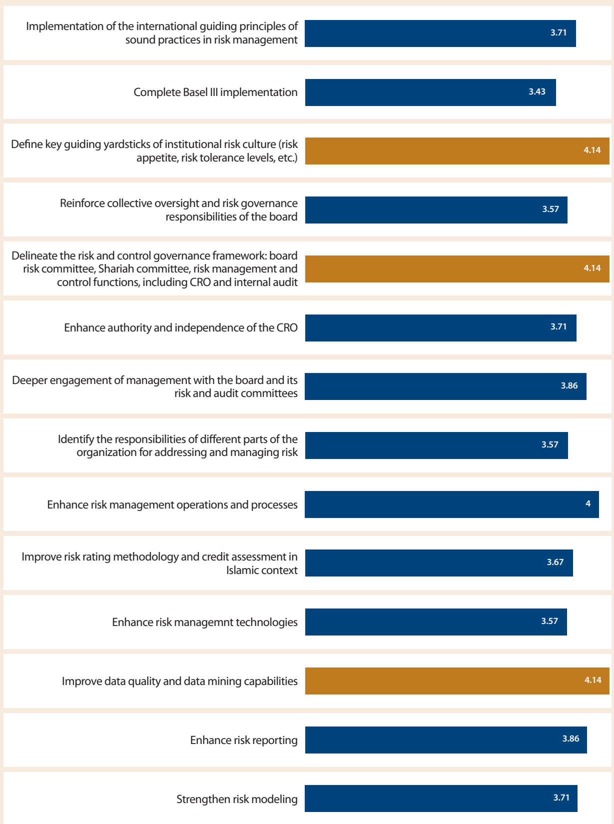
Group 5 Islamic Banking Risk Management and Risk Governance



Group 6 Islamic Banking Risk Management and Risk Governance

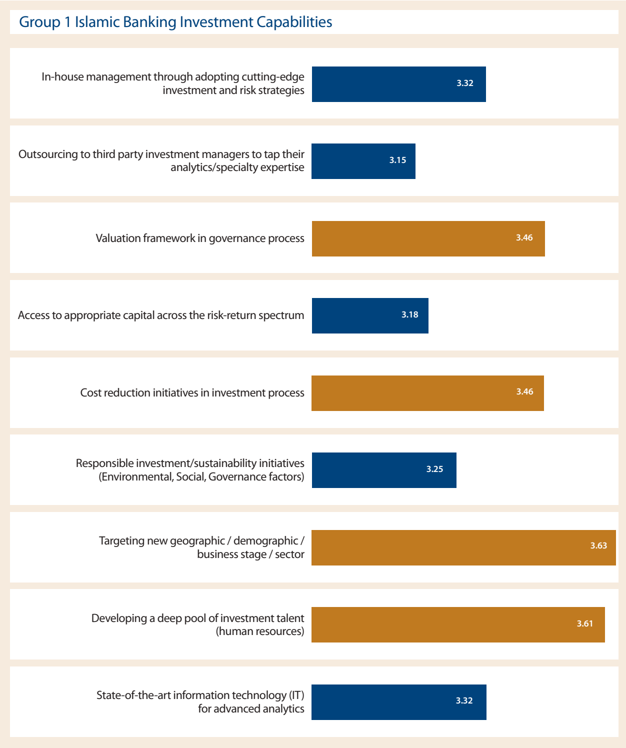


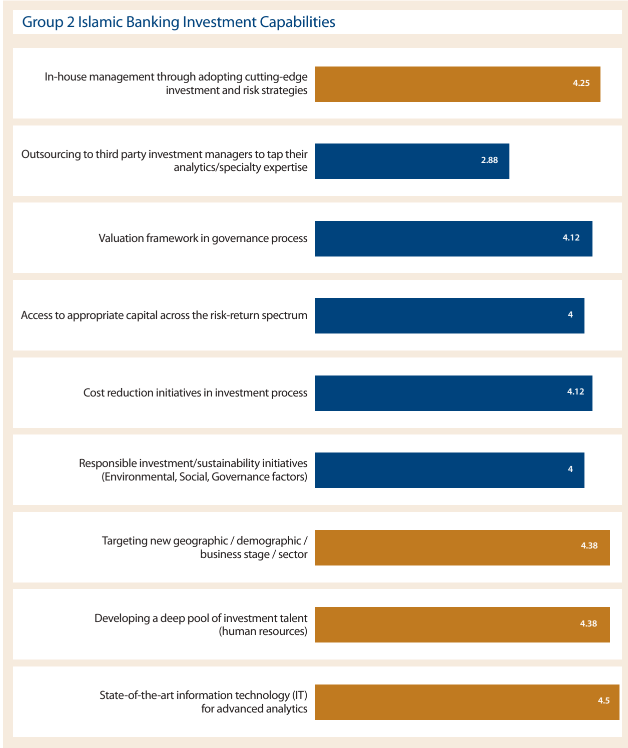
Group 7 Islamic Banking Risk Management and Risk Governance

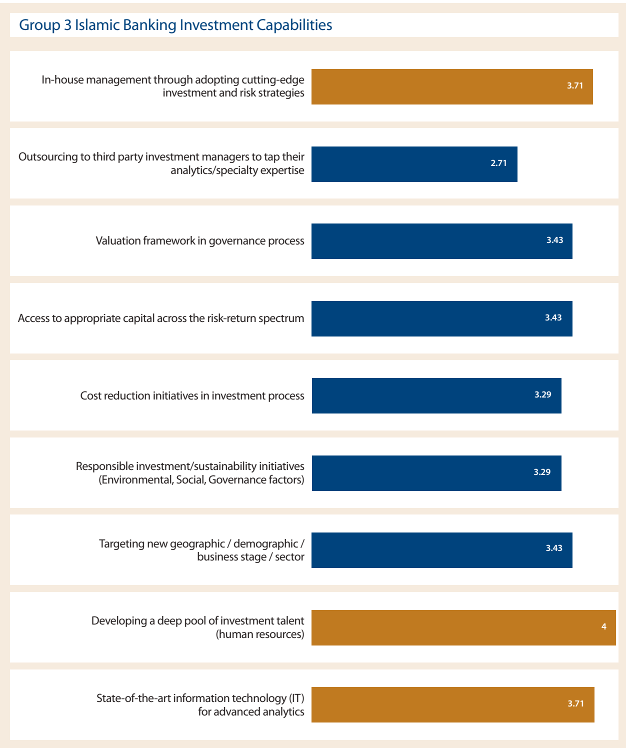


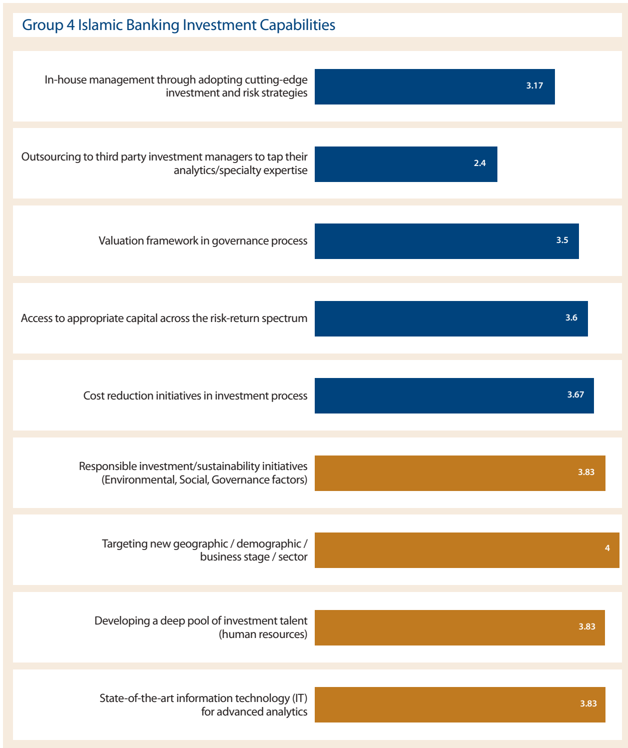
Part III. Islamic Banking Key Drivers of Growth

III.6. Investment capabilities

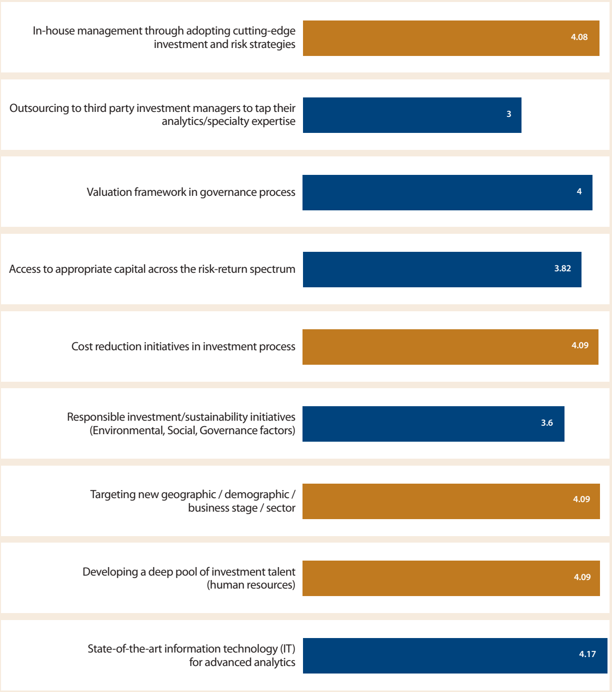




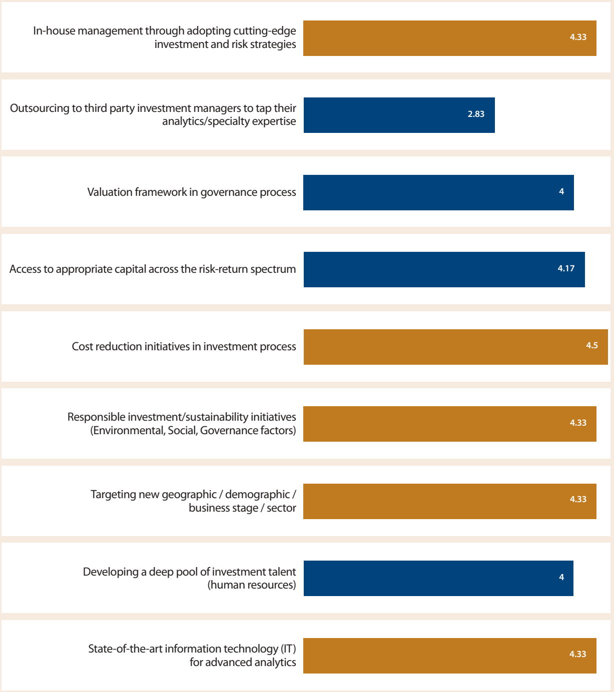




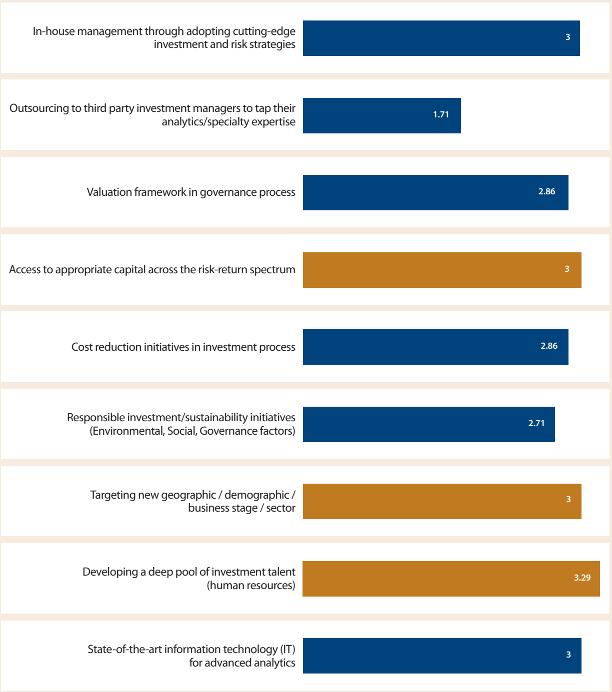
Group 5 Islamic Banking Investment Capabilities



Group 6 Islamic Banking Investment Capabilities



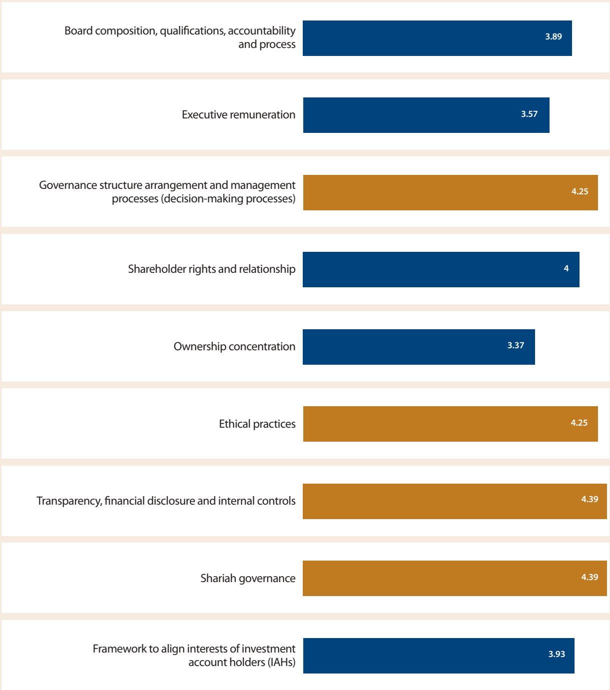
Group 7 Islamic Banking Investment Capabilities



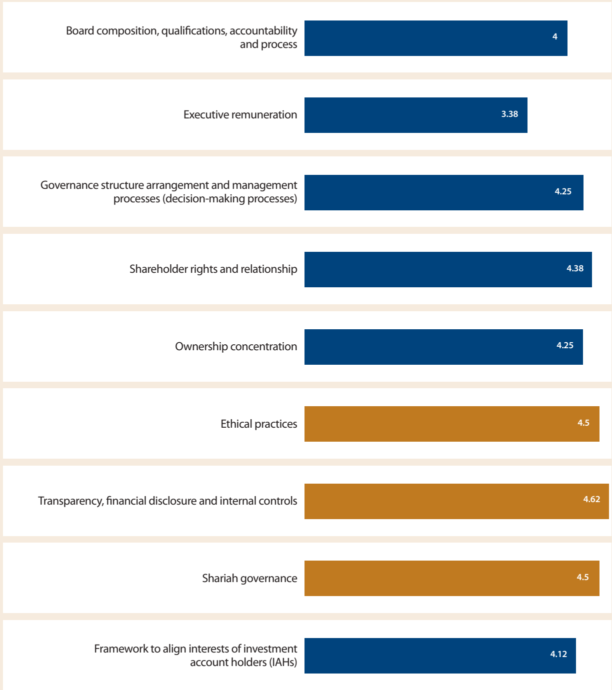
Part III. Islamic Banking Key Drivers of Growth

III.7. Corporate governance

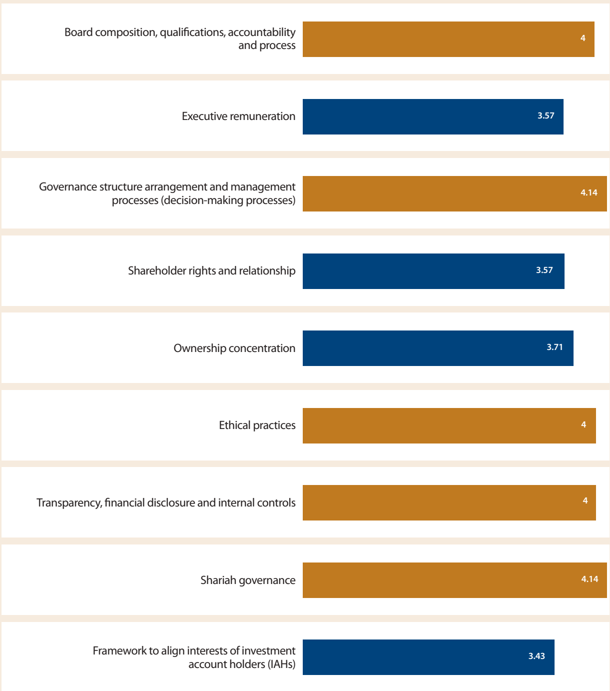
Group 1 Islamic Banking Corporate Goverance



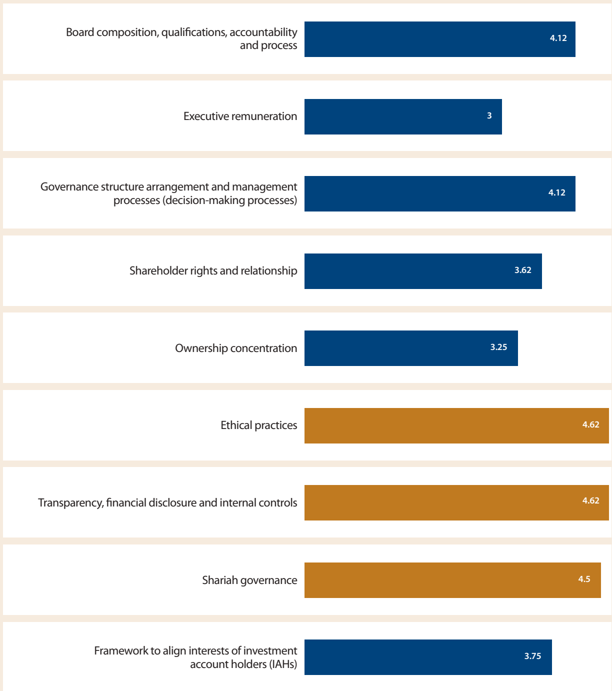
Group 2 Islamic Banking Corporate Goverance



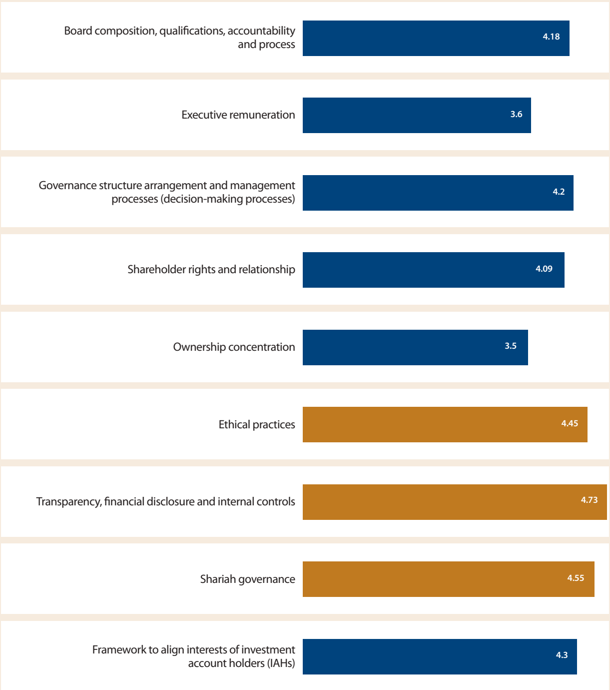
Group 3 Islamic Banking Corporate Goverance



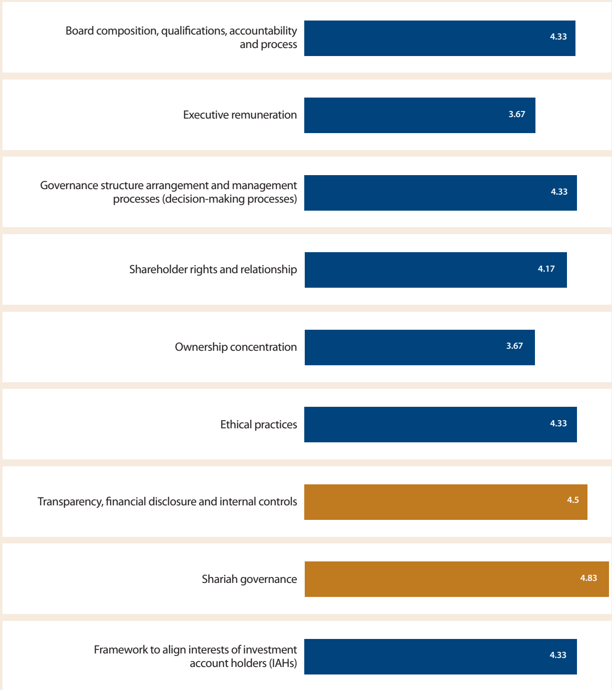
Group 4 Islamic Banking Corporate Goverance



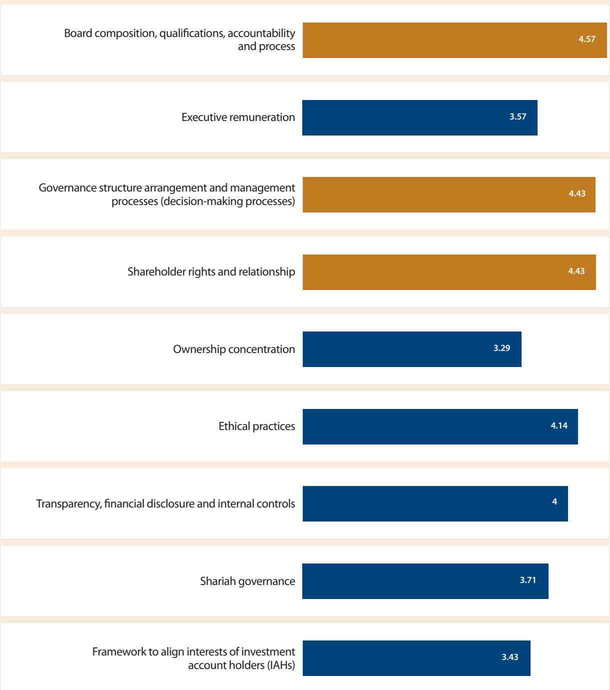
Group 5 Islamic Banking Corporate Goverance



Group 6 Islamic Banking Corporate Goverance

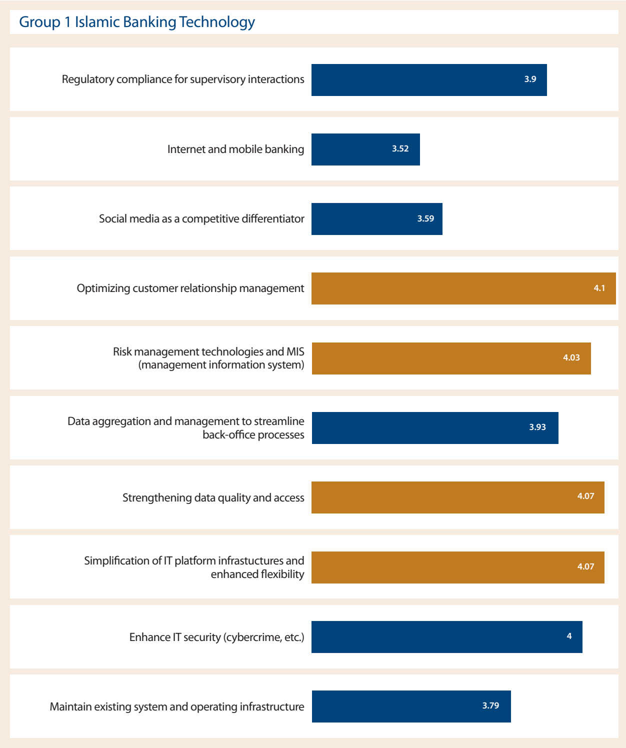


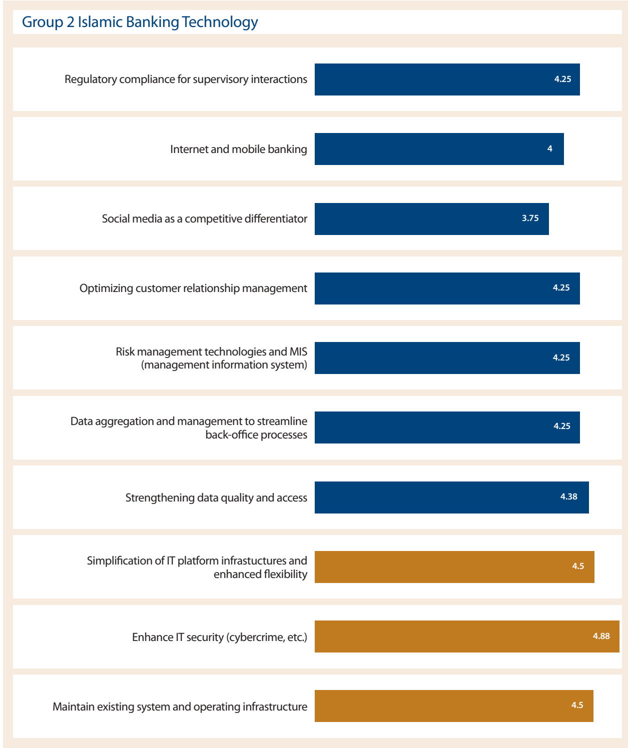
Group 7 Islamic Banking Corporate Goverance

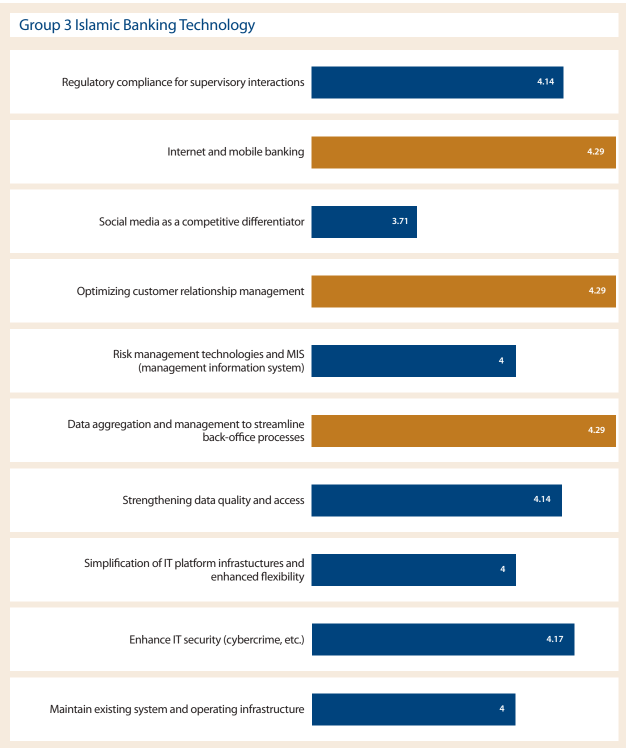


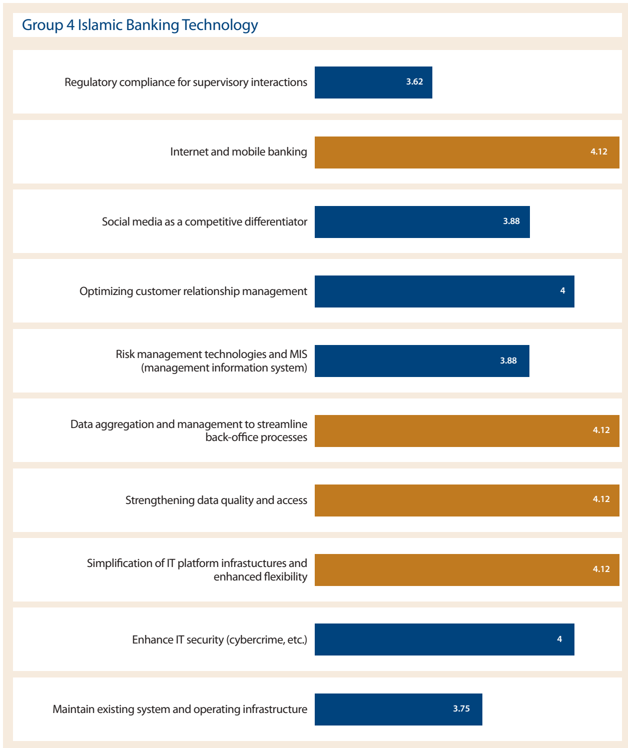
Part III. Islamic Banking Key Drivers of Growth

III.8. Banking technology

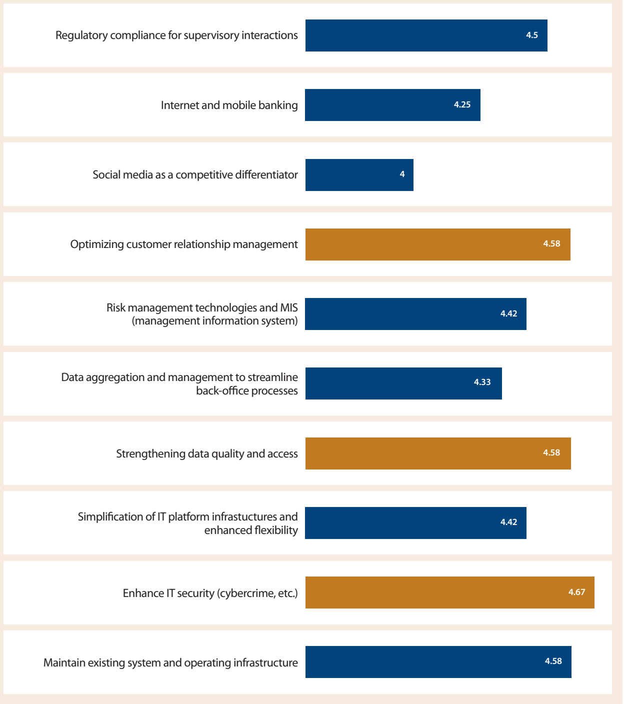




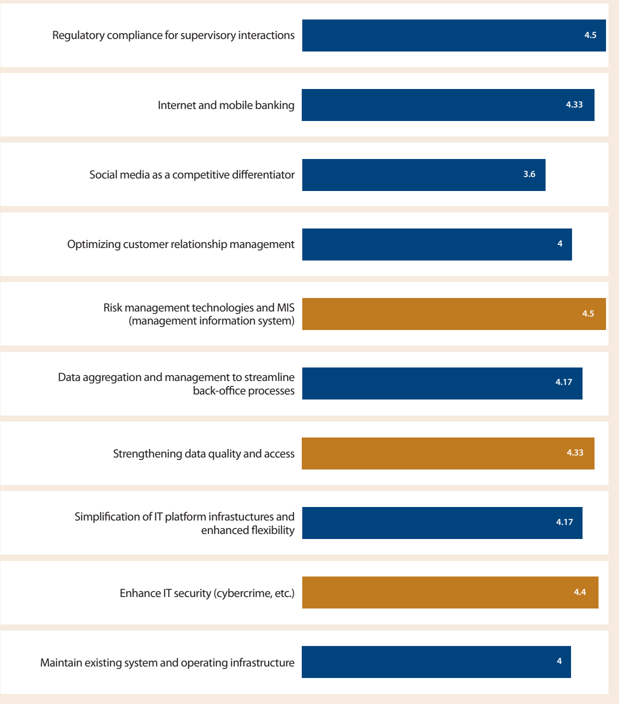




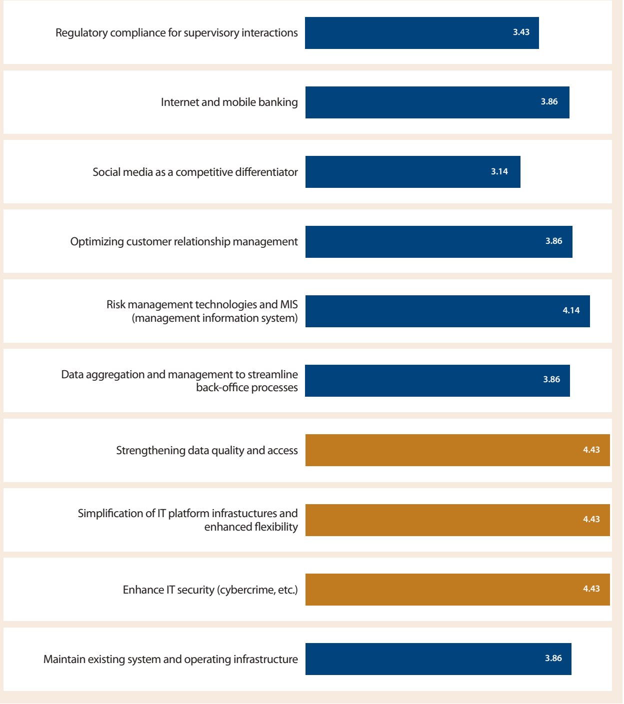
Group 5 Islamic Banking Technology



Group 6 Islamic Banking Technology

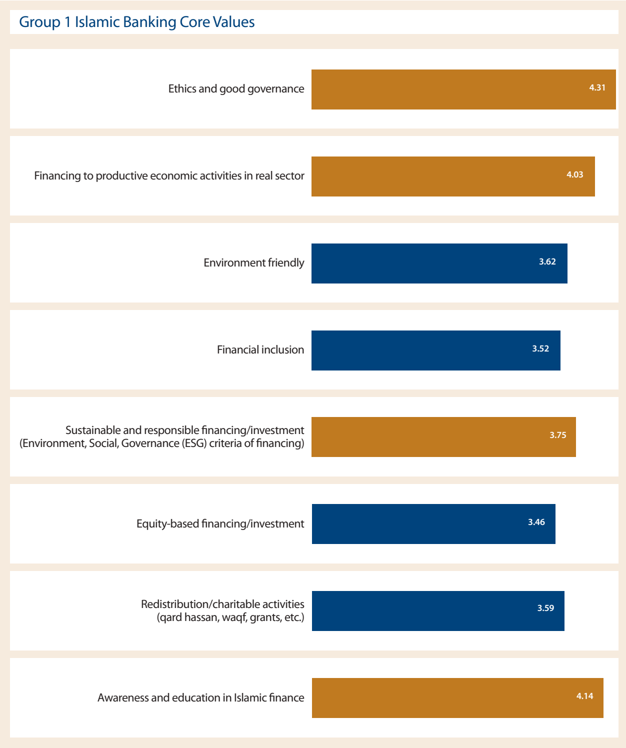


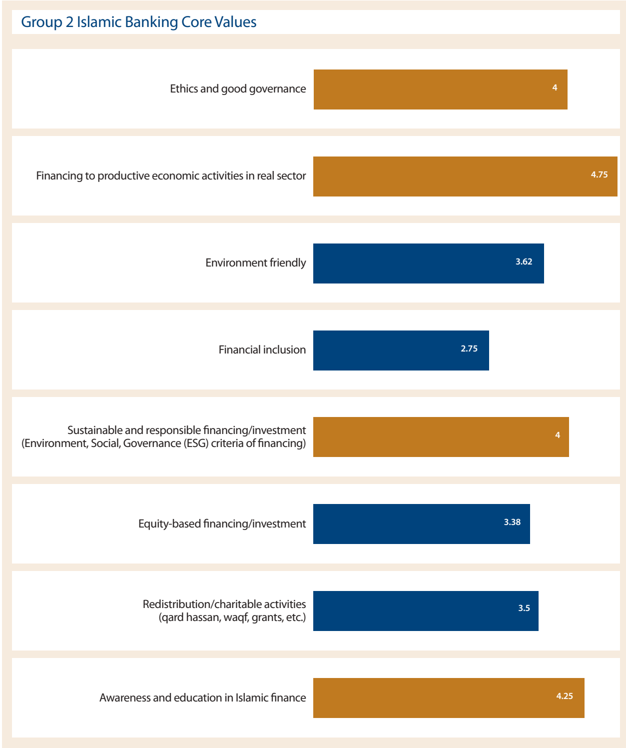
Group 7 Islamic Banking Technology

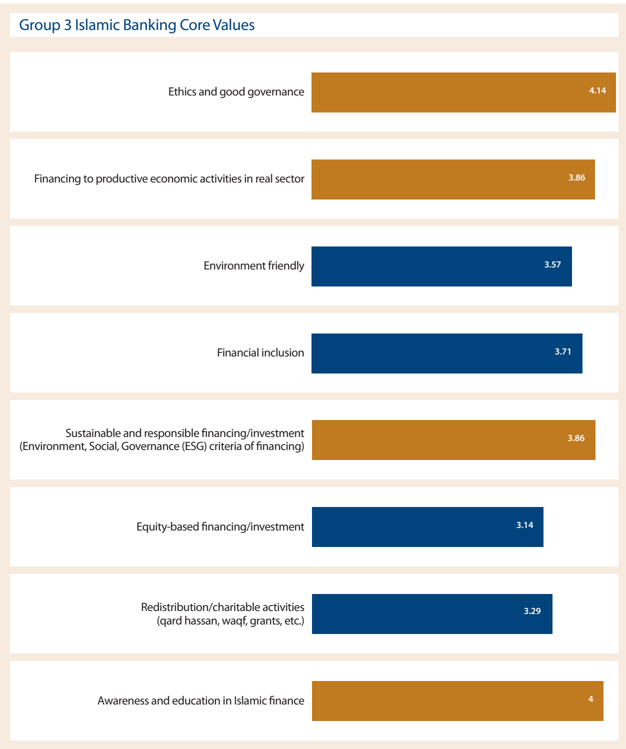


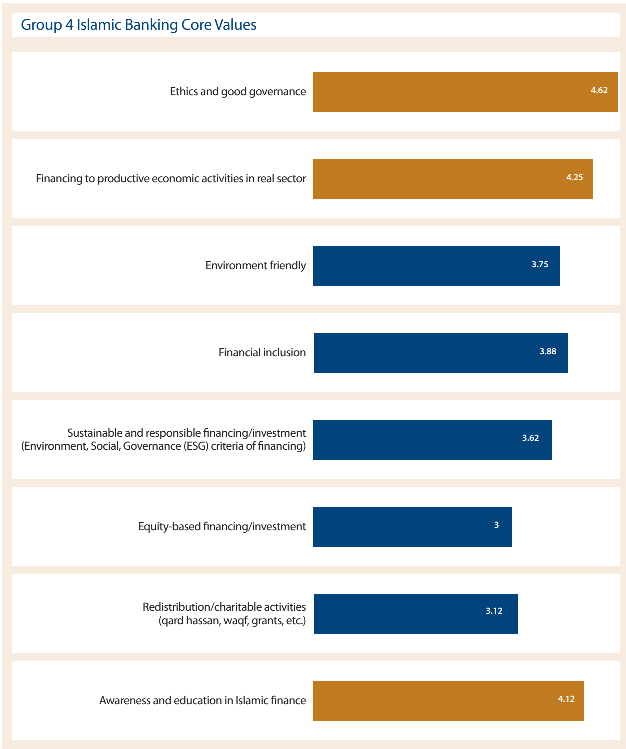
Part III. Islamic Banking Key Drivers of Growth

III.9. Core values

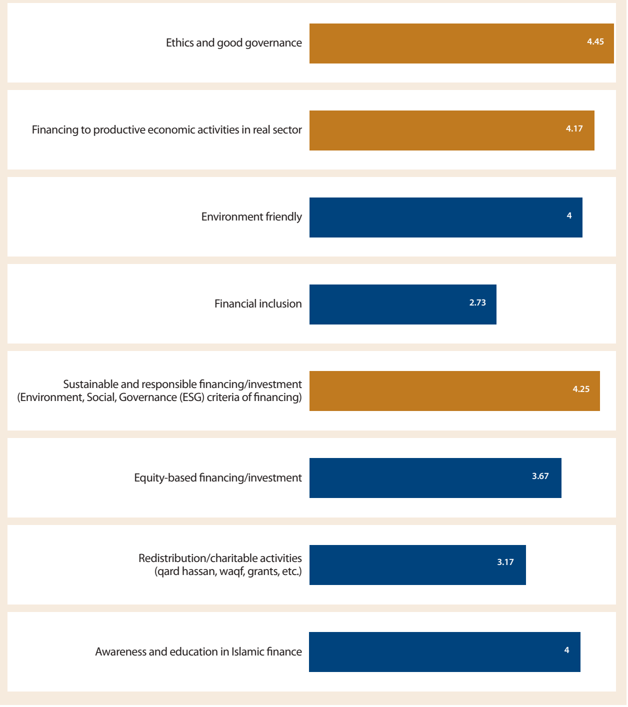






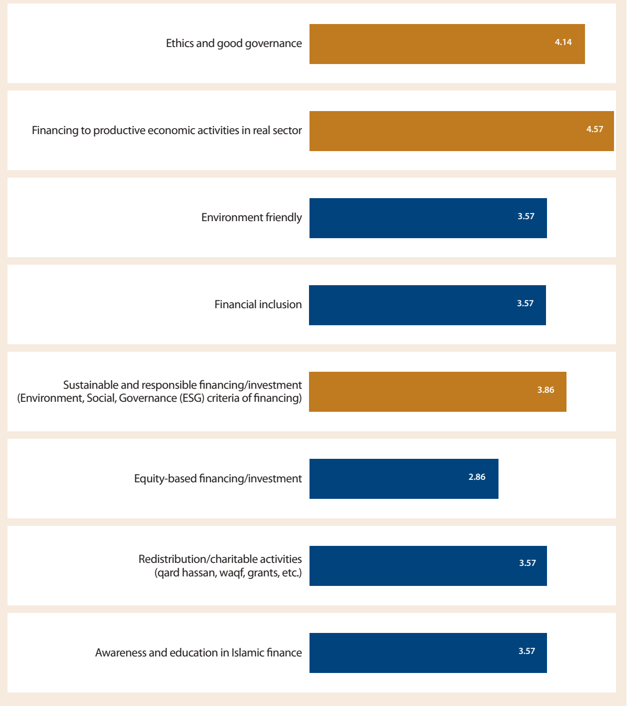


Group 5 Islamic Banking Core Values



Group 6 Islamic Banking Core Values

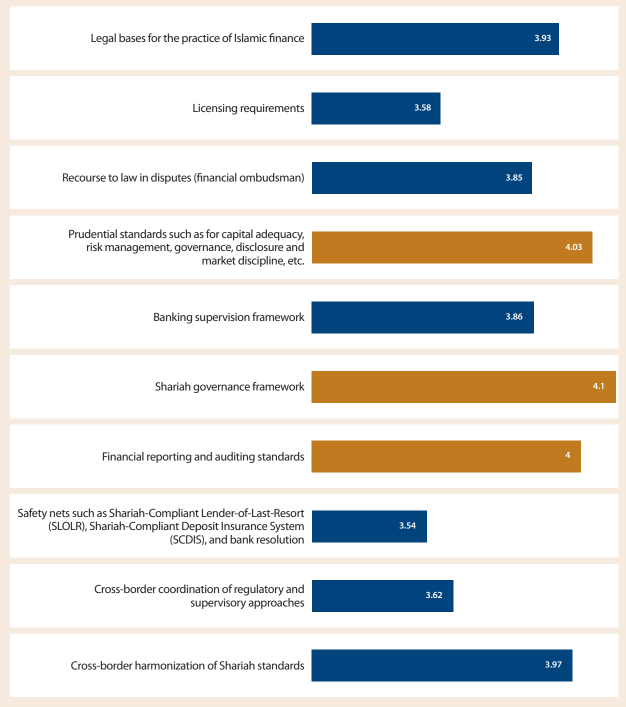
Group 7 Islamic Banking Core Values



Part III. Islamic Banking Key Drivers of Growth

III.10. Banking regulations

Group 1 Islamic Banking Regulation



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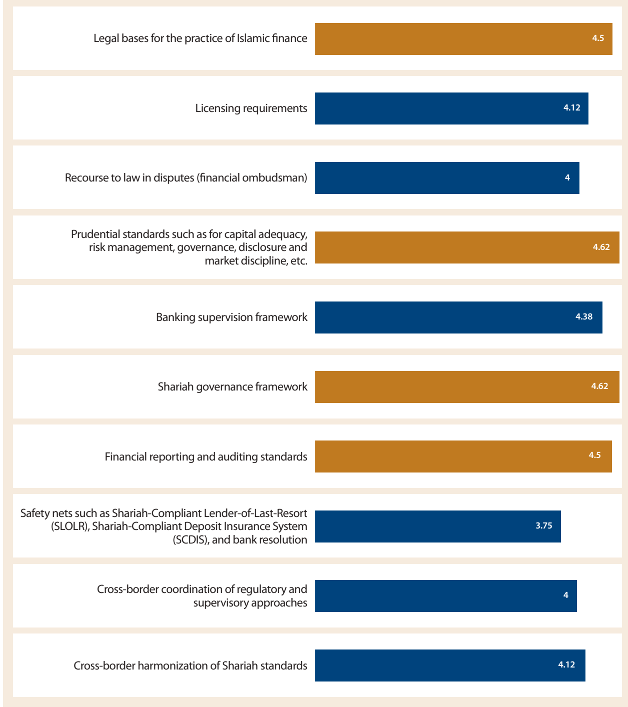

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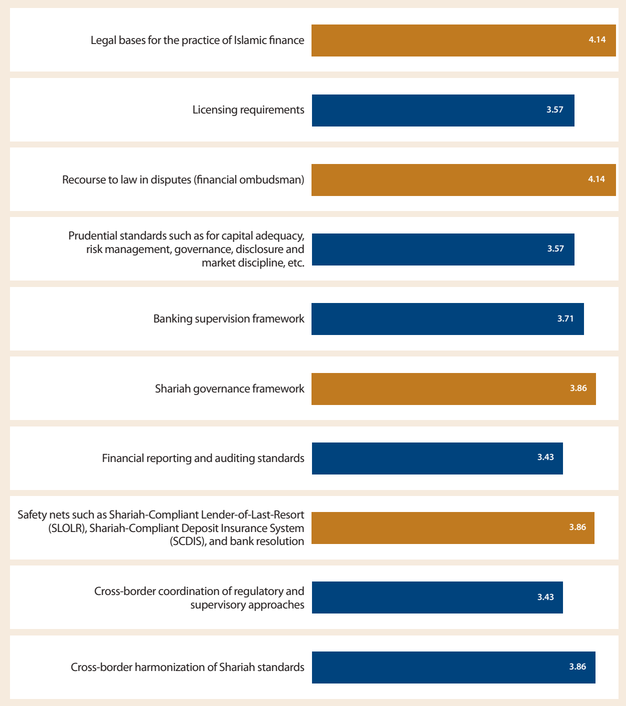

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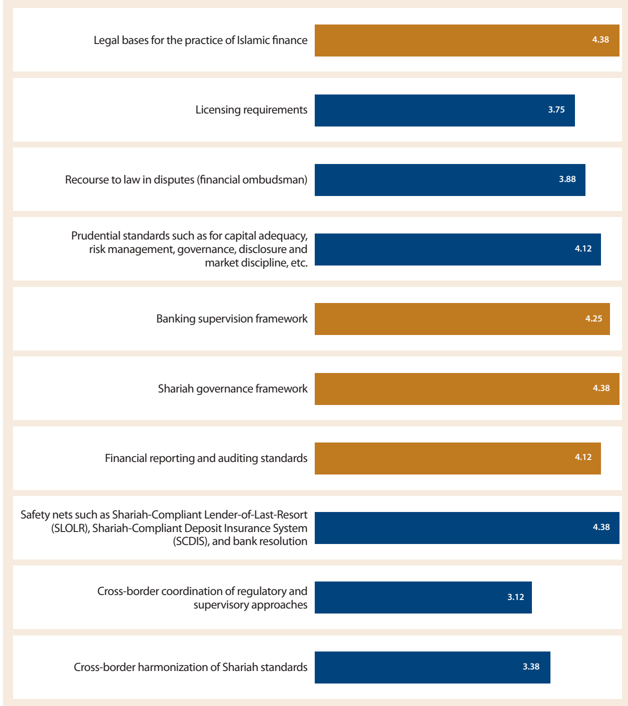
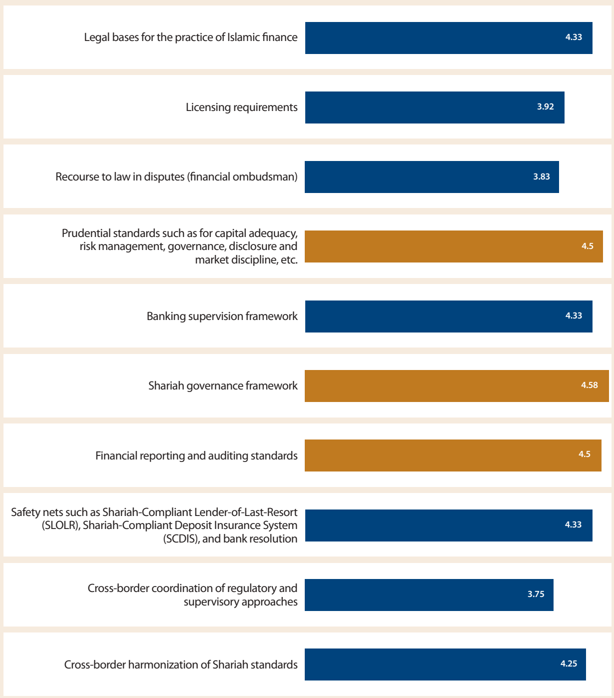


Group 5 Islamic Banking Regulation



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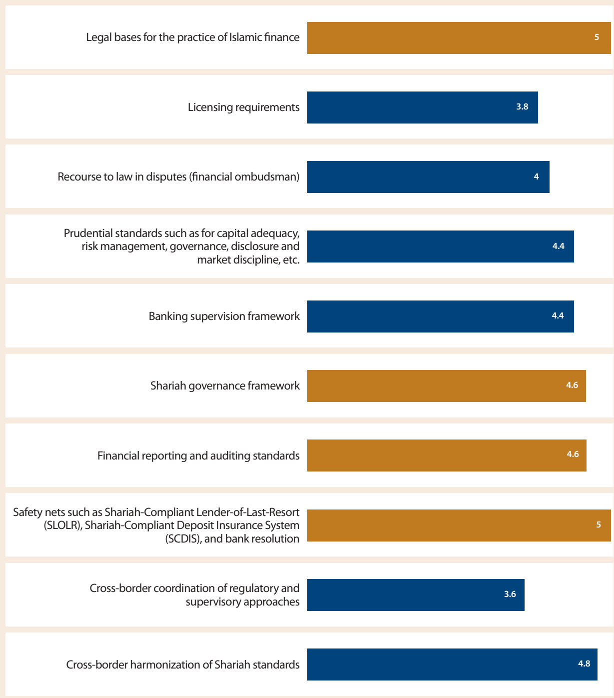
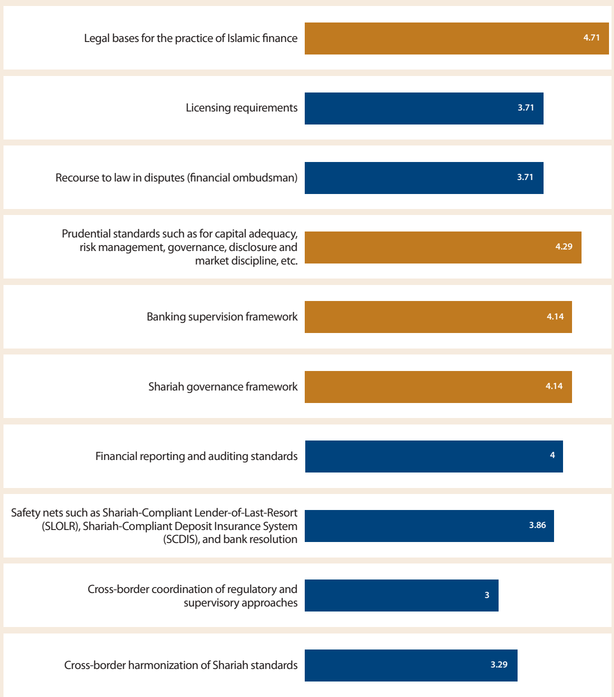


Group 7 Islamic Banking Regulation



Terminologies

No	Terminology	Definition
		I
1	**Ijarah**	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An Ijarah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijarah contract.
2	**Islamic window**	An Islamic window is part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Shariah compliant, with separate funds.
		M
3	**Murabahah**	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed margin profit
4	**Mudarabah**	A Mudarabah is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the Mudarib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudarabah agreement whilst losses are to borne solely by the capital provider unless the losses are due to the Mudarib's misconduct, negligence or breach of contracted terms.
5	**Musharakah**	A Musharakah is a contract between the institution offering Islamic financial services and a customer to contribute capital to an enterprise, whether existing or new, or to own a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharakah agreement whilst losses are shared in proportion to each partner's share of
		S
6	**Shariah**	Divine Islamic law that encompasses all aspects of human life as revealed in the Qur'an and the Sunnah.
7	**Sukuk**	Sukuk (certificates) each of which represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.

No	Terminology	Definition
		T
8	**Takaful**	Takaful is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In a Takaful arrangement, the participants contribute a sum of money as tabarru' (donation) into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
9	**Tanazul**	An act to waive certain rights of claim in favour of another party in a contract. In Islamic finance, applied where the right to share some portion of the profits is given to another party.
		W
10	**Wa'd**	A feature attached to a contract and a unilateral promise made by one party to another, binding on the party that makes the promise. In financing transactions this feature provides assurance that the transaction will be executed as per the specifications of the contract.
11	**Wakalah**	An agency contract where the customer (principal) appoints the IIFS as agent (Wakil) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.
12	**Wakalah fi al-Istithmaar**	A Wakalah investment.