Islamic Finance 2019-2020: One Industry, Three Accelerators

Jun 24, 2019

S&P Global Ratings believes the global Islamic finance industry will continue to expand slowly in 2019-2020. However, inclusive standardization, financial technology (fintech), and opportunities related to the industry's social role could help accelerate growth in the next few years.

In particular, standard Sharia interpretation and legal documentation could simplify sukuk issuance and increase its appeal for issuers, while leaving some room for innovation. Fintech could stimulate growth by making transactions quicker, more secure, and easier to implement. And we believe the social role of Islamic finance could unlock new growth opportunities as core markets implement the U.N. Sustainable Development Goals, and issuers and investors become more sensitive to environmental, social and governance (ESG) issues.

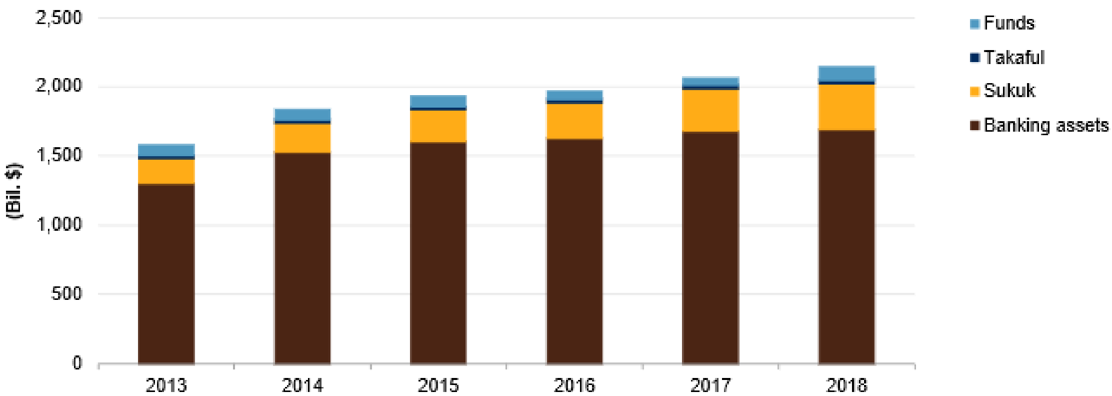
Geopolitical And Other Factors To Hold Back Growth Through 2020

We believe the Islamic finance industry will continue to grow slowly in 2019-2020. It expanded by about 2% in 2018 compared with 10% the previous year, according to our estimates (see chart 1), with strong support from the sukuk market. In 2017, most of the growth stemmed from jumbo sukuk issuances in some Gulf Cooperation Council (GCC) countries, but this was followed by an about 5% reduction in issuances in 2018. In 2019, we do not expect the market to fare much better given the significant volatility in key parameters such as oil prices and geopolitical risk.

The growth of banking assets has also slowed down in almost all core Islamic finance markets. Of specific note, Turkey and Iran lead the decline under a trend that we expect will continue in the next 12-24 months. Malaysia, Indonesia, and the GCC countries were among the few sources of industry growth. As the economic cycle might turn at some stage, we believe a low-single-digit growth rate over the next two years is a fair assumption. However, we see three potential accelerators in the next few years: inclusive standardization, fintech, and the social role of Islamic finance.

Chart 1 | [Download Chart Data]

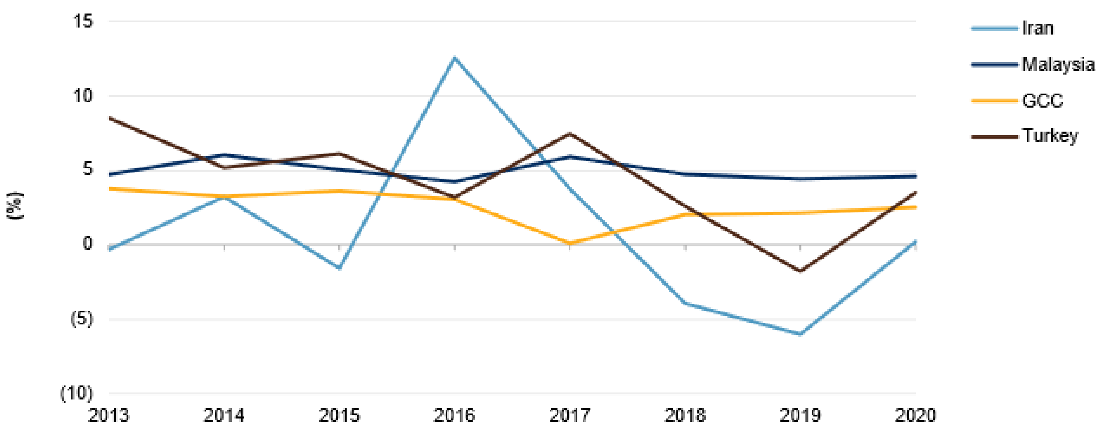
Islamic Finance Is A $2.1 Trillion Industry With Stagnating Growth



Source: Central Banks, Islamic Financial Service Board, Eikon, S&P Global Ratings.

Chart 2 | [Download Chart Data]

Real GDP Growth In The Main Islamic Finance Markets



GCC--Gulf Cooperation Council. Source: S&P Global Ratings, International Monetary Fund.

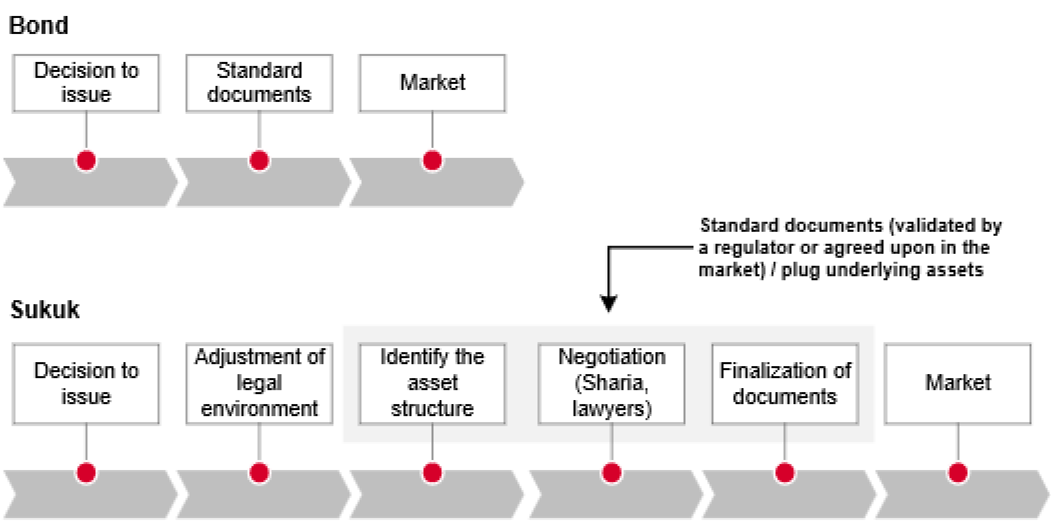
The First Accelerator: Inclusive Standardization

In our view, a prerequisite for faster growth is inclusive standardization. We define this as the standardization of Sharia interpretation and legal documentation that factors in the requirements of all the stakeholders. For issuers, inclusive standardization would mean less complexity and time needed to put together their sukuk and tap the market. Ideally, an issuer would be able to take a set of standard legal documents, plug-in its underlying asset, and go to the market. The process should be equivalent from a time, effort, and price perspective to issuing a conventional bond.

For investors, inclusive standardization means the capacity to understand the risks related to their instruments and avoid situations where they lose money because they, or any other stakeholders, have interpreted the legal provisions of sukuk contracts in a specific way. For Sharia scholars, inclusive standardization means factoring the requirements of the market and creating some room for innovation. The different standard setters of the industry--the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Service Board (IFSB) and the International Islamic Financial Market (IIFM)--are working together to advance this agenda. We believe that regulators, sukuk issuers, and investors should also have their say, and a more inclusive consultative process can help the market move forward more quickly. This process would ultimately lead to the standardization of the full spectrum of sukuk--from fixed-income to equity-like instruments.

Chart 3

Inclusive Standardization And Reduction Of Complexity



Source: S&P Global Ratings.

The Second Accelerator: Fintech Disruption

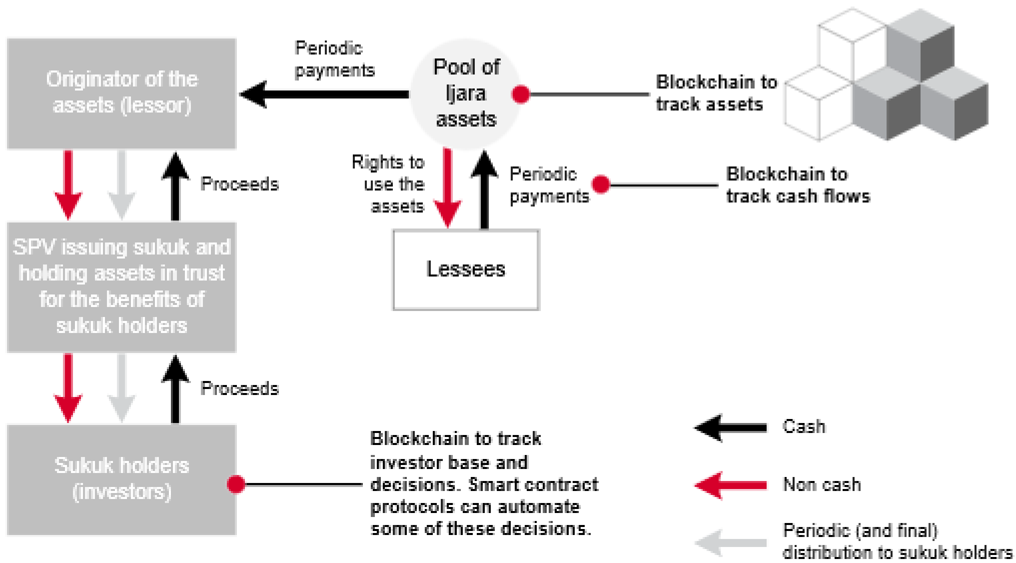
Market participants typically see fintech as a risk for the financial industry, but we think fintech could also help unlock new growth opportunities through the faster execution and better traceability of transactions. We believe that fintech could help the industry in four ways:

Ease and speed of transactions. This is particularly true for payment services and money transfers. Islamic finance industry players can benefit from the possibilities fintech and other innovations offer to enhance their services and attractiveness. Technology could also reduce costs, allowing the redeployment of staff to higher added-value operations.

Traceability of transactions. Using blockchain could help reduce the industry's exposure to risks related to transaction security or identity theft. It could also disrupt the way sukuk are issued and managed. Blockchain could resolve three challenges related to sukuk issuance and management:

- The traceability of underlying assets, which would help investors to better understand the risks related to sukuk in their portfolios.
- The traceability of cash flows, which would help issuers to implement prompt corrective actions if one of the underlying assets underperforms.
- The traceability of investors, which together with smart-contract protocols could create faster, and even out-of-court, resolutions for sukuk disputes.

Sukuk And Blockchain: A Perfect Match?



Source:S&P Global Ratings.

Greater accessibility of Islamic finance services. Fintech could also help the industry broaden its reach and tap new customer segments currently excluded from the banking system. For example, mobile banking for clients in remote areas, or the provision of products such as crowdfunding for affordable housing or small and midsize enterprises (SMEs), could provide new growth prospects. However, this assumes access to a minimum amount of physical and nonphysical infrastructure.

Improved governance. Regulatory technology could help the Islamic finance industry with more robust tools to achieve compliance with regulations and Sharia requirements, assuming agreed Sharia standards are in place. It could also minimize the reputation risk related to a potential breach of Sharia requirements, and free up Sharia scholars to focus on innovation.

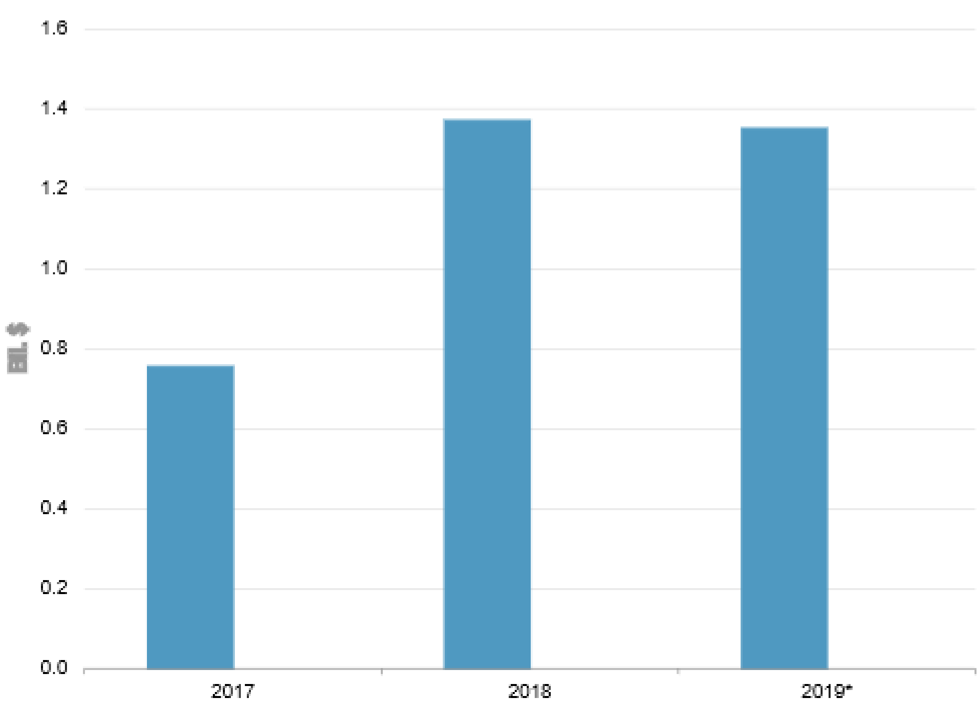
A prerequisite for fintech to enrich the Islamic finance industry is the provision of an adequate physical infrastructure and the implementation of the necessary supervision and regulatory framework. This is why several regulators and authorities in the GCC and elsewhere have launched incubators or specific regulatory "sandboxes"--where fintech companies can test innovations in the real market but in a restricted regulatory environment.

The Third Accelerator: ESG Opportunities

Islamic finance, which must abide by the goals or objectives (maqasid) of Sharia, shares some links with ESG considerations and the broader aim of sustainable finance. As regulators and policymakers around the world seek to establish a more sustainable, stakeholder-focused, and socially responsible financial system, we see areas where Islamic finance and sustainable finance align. For example, Islamic finance's goal to protect life aligns with sustainable finance principles, which emphasize environmental and social protection. These include either refraining from developing or financing operations that could harm the environment or the health or wellbeing of humankind. Green sukuk is an example of instruments that can be used to finance environmentally friendly projects (see chart 5 and Related Research).

Chart 5 | Download Chart Data

Green Sukuk Issuance Has Almost Equaled The 2018 Total So Far This year



*Year to date. Source: S&P Global Ratings.

On the governance side, Islamic banks and instruments are typically subject to an additional layer of governance compared with their conventional counterparts. This typically comes in the form of approval by Sharia boards, which ensure the conformity of these products with Sharia at any point during their life cycle. However, for now, this additional layer of governance has not enhanced market discipline vis-à-vis Islamic financial institutions and instruments. This is because there is currently very limited recourse to external Sharia audits and the publishing of the audit results.

We believe the social aspect has been cast somewhat to the back seat. The underlying principles are socially focused and a number of instruments already exist, but they have not been leveraged in modern Islamic finance in a transparent, systematic manner. This may be because Islamic banks, as issuers themselves, do not appear to focus on their own social performance. From the perspective of financing activities, the lack of visibility of the 'S' factor is underpinned by Islamic banks' commercial interests, including financial performance, and is not because of a lack of instruments or products. Indeed, socially responsible products do exist in Islamic finance and their size is reportedly substantial. These products could make a difference when it comes to socially responsible financing. We think a proper governance framework for their use will be required to reach this objective. Because the amounts are high, users can be tempted to divert these instruments from their original purpose.

How Will These Factors Affect Our Ratings In Islamic Finance

We believe fintech will have only a marginal influence on our Islamic bank and sukuk ratings over the next two years. We consider that Islamic banks will be able to adapt to their changing operating environment through a combination of collaboration with fintech companies and cost-reduction measures. We also believe that regulators across the wider Islamic finance landscape will continue to protect the financial stability of their banking systems. Furthermore, we think that blockchain could help the operational management of sukuk but will not induce any changes in the legal substance of the transactions.

We incorporate ESG considerations into our ratings and analytics of Islamic financial institutions and sukuk, in a similar manner as for conventional issuers and issues (see Related Research). For sukuk ratings, the ESG considerations would generally be reflected in the sponsor rating. For sovereign sukuk, for example, institutional quality and governance effectiveness is a key factor for the rating of the sovereign sponsor. Similarly, for banks, we do take into consideration deficiencies in the overall quality of a banking system's governance and transparency in our Banking Industry Country Risk Assessment. The positive or negative effect could also be reflected in the individual assessment of a bank's management and strategy quality, or through its potential exposure to losses on its financing or investment portfolios because of ESG-related considerations, such as climate change. For takaful companies, risks inherent to the insurance markets in which the company operates, or specific risks undertaken by the insurance company (such as exposure to climate change), are factored in the macro assessment of the insurance company.

Related Research

- The Sukuk Market Starts 2019 Well, But Activity Might Taper Off, June 16, 2019
- IFSB Proposal On Sharia-Compliant Lender Of Last Resort Facilities: Moving In the Right Direction, May 20, 2019

- Islamic Finance And ESG: The Missing 'S', May 20, 2019
- GCC Islamic Banks Will Likely Stay Resilient In 2019-2020, May 6, 2019
- S&P Global Ratings Launches Its ESG Evaluation, April 11, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019
- Countdown To Brexit: Implications Of A No-Deal Brexit For Islamic Finance, Feb. 18, 2019
- AAOIFI's Proposed Standards For Governance Of Sukuk Might Open The Door To Unforeseen Risks, Jan. 21, 2019
- The Rise Of ESG In Fixed Income, Sept. 10, 2018

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