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CIBAFI Global Islamic Bankers' Survey

Confidence, Risk and Responsible Business Practices

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» About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC).

CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives.

With over 120 members from over 30 jurisdictions, representing market players, international intergovernmental organizations, professional firms, andindustry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.

In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of

the Islamic financial services industry and sound industry practice, CIBAFI is guided by its Strategic Objectives, which are 1) Policy, Regulatory Advocacy, 2) Research and Publications, 3) Awareness and Information Sharing and 4) Professional Development.

» Contents

» Acronyms

1	AML	Anti-Money Laundering
2	CSR	Corporate Social Responsibility
3	DIMS	Development Indicators Monitoring System
4	ESG	Environmental, Social and Governance
5	GCC	Gulf Cooperation Council
6	GIBS-	Global Islamic Bankers' Survey
7	GPS	Good Practice Standards
8	ICD	Islamic Corporation for the Development of the Private Sector
9	IDB	Islamic Development Bank
10	KFH	Kuwait Finance House
11	KYC	Know Your Customer
12	M&E	Monitoring and Evaluation
13	MDB	Multilateral Development Banks
14	MSME	Micro, Small and Medium (Sized) Enterprises
15	SDG	Sustainable Development Goals
16	XPSR	Expanded Project Supervision Reports
17	CFT	Combating the Financing of Terrorism

“THIS YEAR, LIKE LAST YEAR, OUR SURVEY GIVES FOCUS TO A SPECIFIC ISSUE THAT IS IMPORTANT TO ISLAMIC BANKS.”

» Statement by the Secretary General

I am delighted to present the second edition of CIBAFI's annual Global Islamic Bankers' Survey. When we launched the Survey last year, we hoped that it would serve as a new reference point for judging the health and development of the Islamic banking industry, but we were already looking ahead to future editions that would enable us to track changes in views and the aspirations of Islamic bankers from year to year.

The inaugural Survey received a very positive response from policy makers, regulators and from banks themselves who welcomed the global nature of the Survey, its statistical rigour, and the light that it shone on what Islamic bankers actually think, and are thinking about.

This second Survey enables us to see how Islamic bankers' views on the prospects for their industry and the risks that they face have changed over the last year.. The news is mixed. Although Islamic bankers remain moderately optimistic about the prospects for banking in their home markets and for Islamic banking in particular, they are less optimistic than last year. They also believe that the risks that they face are increasing. Sixteen out of the 22 risk categories that were included in the survey were scored slightly higher this year than last year.

This year, like last year, our survey gives focus to a specific issue that is important to Islamic banks.

Our focus this year is on Responsible and Sustainable Finance. This is becoming an increasingly important issue for Islamic bankers as they seek to differentiate themselves from the business models of conventional banks. Recognising the importance of this issue, CIBAFI held a conference entitled, "Rethinking Values for Sustainable Growth" in Manama in May 2016.

In this Survey, we investigate Islamic bankers' attitudes towards various aspects of Responsible and Sustainable Finance, provide examples of activities that Islamic banks are currently doing in this field, and offer some recommendations on how the Islamic banking industry as a whole can increase its engagement in this field.

I hope that this year's Survey will receive an even better reception than last year's and that our Annual Survey will be recognised as an invaluable annual fixture of the Islamic banking industry, not only 'taking the pulse' of the industry, but also highlighting key issues that are central to our mission as Islamic bankers.

ABDELILAH BELATIK
Secretary General

» Acknowledgement

The Secretariat would like to express its gratitude to CIBAFI members and non-member banks and financial institutions from around the globe who responded to the survey

We are also grateful to the people and institutions who have contributed to the making of this publication. We would like to extend our special thanks to Syed Siddiq Ahmed, Dr. Abdurrahman Yazici, Aziza Yarlaeva and Mariam Ali Al-Daqqaq from the CIBAFI Secretariat, and Dr. Adam Ng and Andrew Cunningham, CIBAFI consultants, for their contribution and reviews throughout the various stages of this publication. The publication and survey also benefited from the extensive review and comments of Peter Casey, CIBAFI consultant, Mr. Abdullah Haron, International Monetary Fund, as well as Dr. Ginanjar Dewandaru; Mustafa Sancar, Kuveyt Turk Participation Bank; Abdulrazzak M. Elkhraijy, the National Commercial Bank; Mahsuri Mustafa, RHB Islamic Bank; and Zeynep Sagdic, Turkiye Finans Participation Bank.

Appreciation is also due to the CIBAFI Members Consultative Group (MCG) for their valuable inputs while drafting the survey questionnaire and this report: Dr. Sami Ibrahim AlSuwailem, Islamic Development Bank Group; AbdulWahab Al-Roshood, Kuwait Finance House; Mohammed Fawaz Sudqi Sadeq Imam, Jordan Islamic Bank; Abdulkareem Ersan Sukkari, Islamic International Arab Bank, Jordan; Abdul Qadir Khanani, Abu Dhabi Islamic Bank; Khalid Al Qattan, Al Baraka Banking Group; Md. Abdul Jabbar, Islami Bank Bangladesh; Dr. Mohammed Burhan Arbouna, Al Salam Bank, Bahrain.

We would also like to express our gratitude to the representatives of the banks who participated in the interviews conducted by CIBAFI as part of the preparation of the report. CIBAFI would also like to express its appreciation to the Islamic Development Bank.

ABDELILAH BELATIK
Secretary General

“CIBAFI is grateful to the people and institutions who have contributed to the making of this publication.”

» Executive Summary

Our second annual Global Islamic Bankers' Survey (GIBS) is based on responses from 86 banks in 29 countries throughout the world. It includes an update of the Confidence Index and Risk Dashboard that appeared last year, and responses to questions about Islamic banks' work in the field of Responsible and Sustainable Investment.

Islamic banks are 'fairly' optimistic about the future of banking in their home markets, and for the prospects for Islamic banking, but in both cases they are a little less optimistic than they were last year. But Islamic bankers are fairly optimistic that they will be able to outperform their conventional peers in terms of revenue growth.

There are regional differences of opinion. For example, Middle Eastern banks are more optimistic than Asian banks about prospects for banking but there is no clear trend across the three questions posed in the Confidence Index. What is more striking is the moderation of views across all regions – no banks declare themselves to be either 'very optimistic' or 'very pessimistic'.

The macro-economic environment is the biggest concern for Islamic banks, followed by service quality and challenges related to business growth and expansion. Several main concerns relate to common pressures faced by banks in developing and changing business environments. It is an indication of the increasing maturity of Islamic banking industry that banks are now heavily focused on standard banking challenges rather than exclusively on those that are specific to Shariah-compliant financing.

Islamic banks believe that the risks that they face are increasing. Sixteen of the 22 areas identified in the latest CIBAFI questionnaire are deemed to have a higher risk than they did last year.

Regardless of the size, banks broadly face the same risk priorities. Macro-economic risk is seen as the greatest that Islamic banks face, with liquidity risk ranked second and political risk ranked third.

There are regional differences in the principal risks that Islamic banks think they face, but six out of the seven regions rank macro-economic risk as the most important. Banks are confident of their ability to comply with the Shariah principles and rate the risk of non-compliance low.

The Survey on Responsible and Sustainability Business Practices in Part 3 provides findings and analysis that aim to enhance the understanding of the degree of responsible business and sustainability practices in the global Islamic banking industry. Specifically, it considers

11 areas that affect banks' responsible business and sustainability practices: 1) business sector exposure; 2) key stakeholders; 3) economic impacts of Islamic banks; 4) employee relations and development; 5) customer relations; 6) banking product responsibility and financial consumer protection; 7) financial inclusion, social impact and MSME financing; 8) community relations and corporate philanthropy; 9) environmental policy and management system; 10) bank's integration of social and environmental impacts into business strategy; and 11) constraints and benefits in implementing responsible business initiatives, Corporate Social Responsibility (CSR), or sustainability strategy.

Most Islamic banks have moderate to high exposure to three sectors: construction and infrastructure, real estate and mortgages, and trading companies and distributors. Traditional stakeholders (investors, shareholders, board of directors, employees, consumers, governments and financial regulators) are viewed as having the greatest impact on the way Islamic banks contribute to the society, economy and environment.

Among initiatives that could contribute to local economic development, Islamic banks think that strengthening of SMEs and job creation by the banks, banks' clients and banks' suppliers would make the biggest contribution. Over the next one to three years, Islamic banks say they will give more focus to SME financing as well as financing/investing in infrastructures that support micro, small and medium enterprises (MSME).

Among the top challenges that Islamic banks face in promoting high quality employee relations for superior business performance are developing the ability of their employees to innovate, effective career development programmes, mentoring, succession plans, training, as well as maintaining a high level of employee engagement and satisfaction. While high employees' competencies in Islamic finance is fairly challenging, low employee turnover rate is the least challenging.

The Survey shows that there are two key initiatives that have been developed by Islamic banks in customer relations management: a) improvement of the bank's Know Your Customer (KYC) and other client screening mechanisms; and b) resilient client data information security and privacy. In terms of banking product responsibility and financial consumer protection, two key mechanisms developed by the Islamic banking sector stand out: a) service charges, profit rates, and the basis of calculations being transparent to customers; and b) screening of documents (i.e. forms, etc.) by a Shariah supervisory board or its agent to avoid imposition of burdensome terms and conditions to clients. On community relations and corporate philanthropy, the top three philanthropic and social programmes are: a) education; b) empowerment for poor and needy individuals and families; and c) support for and sponsorship of conferences and seminars. Most of the environment-friendly business practices of Islamic banks are in the range of low to moderate development, with a) internal environmental and energy management systems; and b) environment friendly policy or procedures across all operations of the bank being more developed in relation to other practices.

As regards the integration of social and environmental impacts, the top five business practices that Islamic banks wish to improve over the next one to three years are: a) development of the local economy (e.g. creating jobs, enhancing the production level of the local economy, financing the development of infrastructure, financing the broadening of business sectors in the economy, etc.); b) customer relationship management; c) employee relations and human capital development (e.g. talent attraction and retention, employee welfare, etc.); d) financial inclusion and small to medium sized enterprises (SME) financing; and e) business ethics and governance (e.g. codes of conduct, compliance, anti-corruption and anti-bribery, etc.).

Focus will also be given to: a) improvement of employees' responsible business practices on both social and environment factors (awareness, training, and compensation); b) alignment of social and environmental impacts with the overall business strategy of the bank; and c) integration of social risk assessment in financing/investment criteria.

Most of the large banks cited the absence of monitoring social and environmental risks by the bank and by the bank's clients, the high cost for implementing responsible business, as well as complexity in implementing an "integrated, bank-wide approach" as constraints in implementing responsible business initiatives, corporate social responsibility (CSR) and sustainability strategy. Both large and small banks also view the absence of social and environmental regulations as well as the lack of consumer demand for responsible business products and services as significant constraints.

The Survey also provides a detailed account of eight areas where Islamic banks could enhance their work to promote Responsible and Sustainable Finance. This section is based both on survey questions and written-in responses by the banks themselves and takes into account:

1) material issues and indicators of responsible finance and sustainability banking from global standards;

2) good practices of best-in-class responsible and sustainable banks;

3) practices of Islamic banks that have corporate social responsibility / sustainability reports; as well as

4) existing global survey and assessment frameworks on responsible banking and sustainability.

Examples include aligning their work with development goals being promoted by multi-lateral organisations such as the United Nations, deepening their involvement in the local community, and adhering to 'green' policies both in the way that they run their own operations and in the selection of projects to finance.

The eight leading Responsible and Sustainable Business Practices are summarised in Figure 1.

The final section of the Survey provides policy recommendations for policy makers, regulators and individual banks, based on the findings in the previous sections of the report.

Figure 1: Themes of Selected Leading Practices in Responsible and Sustainable Business Practices

» Introduction

» Introduction

OUR SECOND ANNUAL GLOBAL ISLAMIC BANKERS' SURVEY (GIBS 2016) PROVIDES A SNAPSHOT OF HOW THE GLOBAL ISLAMIC BANKING INDUSTRY SAW ITSELF IN THE MIDDLE OF 2016 AND ALSO ENABLES US TO SAY HOW THE INDUSTRY'S VIEW OF ITSELF HAS CHANGED SINCE OUR INAUGURAL SURVEY, LAST YEAR.

This year, our Survey takes attitudes to 'Responsible Business Practices' as its additional area of focus. (Last year, our Survey reviewed attitudes to risk-sharing and participative financial products.)

Part 1 considers the level of confidence and top concerns that Islamic banks have about their industry and its prospects for success.

Part 2 identifies the key risks that Islamic banks believe they are facing.

Part 3 assesses Islamic banks' attitudes towards Responsible Business and Sustainability Practices.

Part 4 considers the opportunities for Islamic banks to enhance their contribution to society – looking beyond narrow measures of financial performance – and uses real examples derived through interview and research. This entailed conducting interviews with senior management of selected Islamic banks.

Finally, the survey offers some recommendations for banks and policy makers that, if implemented, will facilitate greater involvement of Islamic banks in socially responsible business practices.

Our decision to focus on Responsible Business and Sustainability Practices reflects the increased attention that this subject is receiving not only within the Islamic banking industry but also in the wider global financial community.

Responsible business is closely associated with responsible and ethical finance. This has been changing from an approach that screens out sectors that 'do harm' to one that incentivizes and rewards good practices that promote sustainable economic development by balancing the needs of the planet and its people with the ability for companies to make a profit. Sustainability practices acknowledge the relevance to the financial sector of environmental, social and governance (ESG) factors, and of the long-term health and stability of the market as a whole. Within the Islamic banking industry, there is increasing recognition that its ethical dimension resonates widely not only within the community but also beyond it.

Against this background, our Survey provides statistical analysis of Islamic banks' attitudes to Responsible Business and Sustainability Practices and also practical examples of how Islamic banks are putting them into practice.

This year, 86 banks from 29 countries responded to our questionnaire (2015: 83 banks from 35 countries)[1] . Banks in all the major Islamic banking markets responded, as did banks in countries where Islamic banks are still marginal players or where the Islamic banking sector is still in its infancy. We received responses from all seven geographic regions that we identified last year. As a result, we believe that our Survey continues to reflect the views of the global Islamic banking industry.

1 This year we did not receive responses from banks in Afghanistan, Ethiopia, Nigeria, South Africa, Russia, the UK or the US. We received responses from Iran this year. However, with the exception of the additional returns in the "Middle East excluding GCC" group, the sample distribution by region is not very different from last year.

Most of the banks that responded to our questionnaire are fully-fledged Islamic banks (82%). The others are either Islamic banking subsidiaries of conventional banks, or operate as Islamic 'windows'. The respondents are primarily commercial banks, rather than investment banks, and they are engaged in both retail and wholesale banking. About half of the respondents have less than US$1 billion in assets but about a fifth have more than US$10 billion. The figures below provide a more detailed profile of the respondents.

Thirty two of the 86 banks that took part in this year's survey are based in the GCC and another 11 are based in the wider Middle East region. Thirteen banks from North Africa took part in the Survey. Twenty Asian banks responded to the survey, of whom seven are based in Malaysia and Indonesia. The others include banks from Pakistan and Bangladesh, as well as those from Central and Southern Asia.

We are pleased to have received a strong response from areas such as the GCC and Malaysia where Islamic banking is well established but it is important to note that the Survey also includes responses from Islamic banks in countries such as Djibouti, Mauritania, Bosnia and Azerbaijan. Our Survey therefore represents the views of established banks in well-developed financial systems and banks in countries where financial markets are still evolving and where banks are struggling to build sustainable businesses and market shares.

CIBAFI Secretariat sent the questionnaires to the CEO's office of CIBAFI members and to non-member Islamic banks at the end of May 2016, and the final responses were received at the end of August. Our survey therefore reflects the views of the Islamic banking community in the middle of 2016. The questions related to Confidence and to Risk (Part 1 and Part II of the Survey) replicated the questions asked in 2015. This enables us to assess how attitudes have changed from year-to-year, in addition to giving us a snapshot of attitudes at a single point in time.

Questions for Part I and Part II comprised both 'closed' and 'open' questions, where banks were asked to score their attitudes on a scale of 1 to 5 and write their own responses to questions. More details on how specific questions were structured are given in the individual sections of this report.

"This year, 86 banks from 29 countries responded to our questionnaire (2015: 83 banks from 35 countries)"

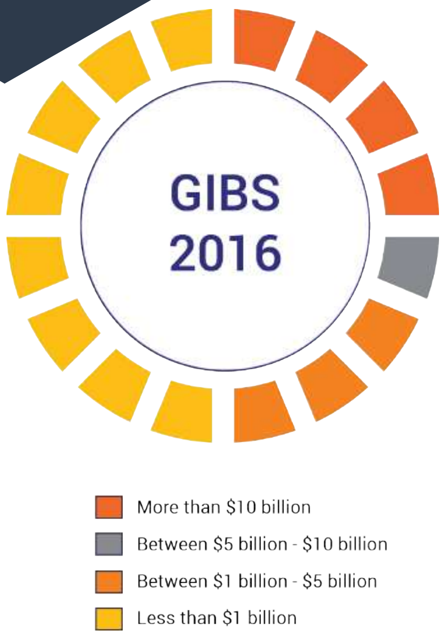


Figure 2: Size of Respondent Banks – GIBS 2016

Figure 3: Size of Respondent Banks – GIBS 2015

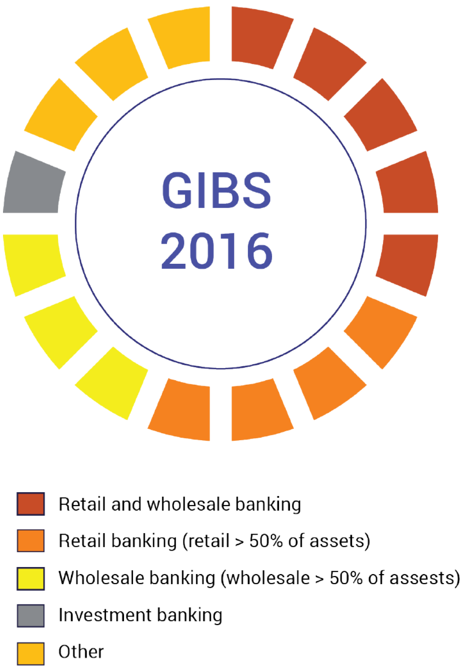


Figure 4: Business Profile of Respondents – GIBS 2016

Figure 5: Business Profile of Respondents – GIBS 2015

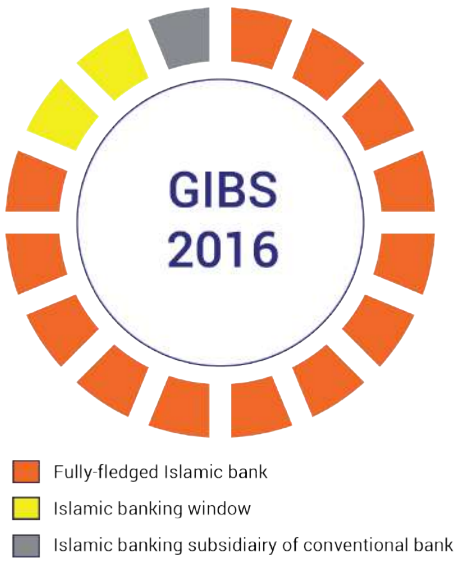


Figure 6: Corporate Profile of Respondents – GIBS 2016

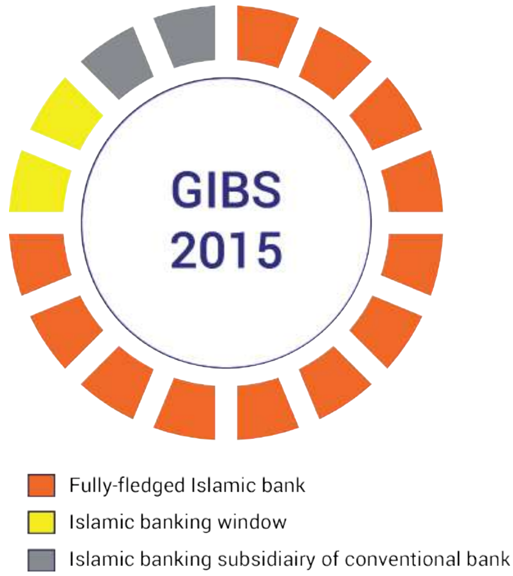
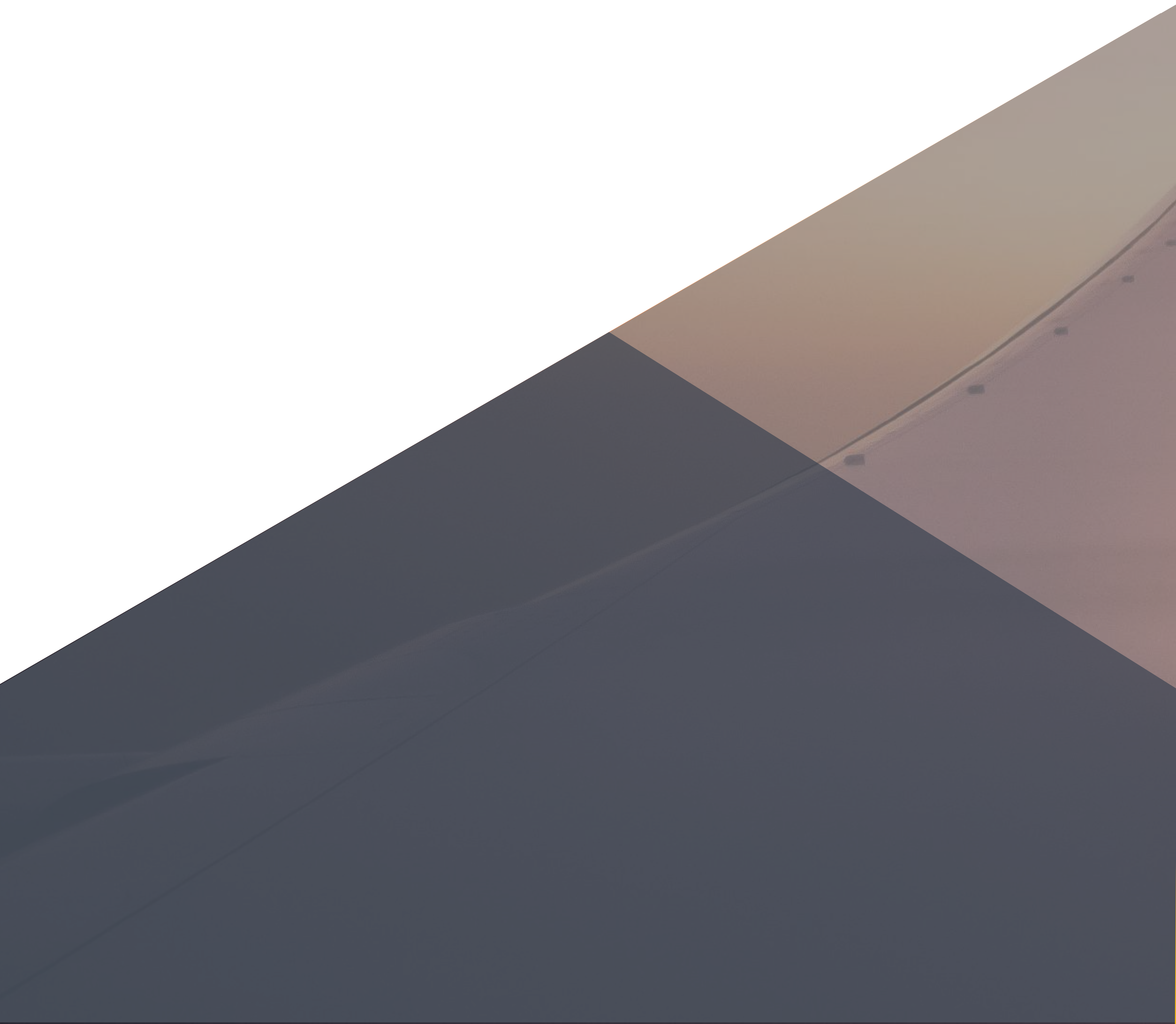


Figure 7: Corporate Profile of Respondents – GIBS 2015

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	32
Group 2	Middle East ex-GCC	Egypt, Iran, Iraq, Jordan, Lebanon, Syria, Yemen	11
Group 3	South East Asia	Malaysia, Indonesia	7
Group 4	West, Central & South Asia	Azerbaijan, Bangladesh, Kazakhstan, Maldives, Pakistan, Sri Lanka	13
Group 5	North Africa	Algeria, Sudan, Tunisia	11
Group 6	Sub-Saharan Africa	Djibouti, Kenya, Mauritania	6
Group 7	Europe, Turkey, US & others	Bosnia, Turkey	6
Total number of countries and banks		**29 countries**	**86 banks**

Figure 8: Respondents by Regions and Countries



» Part 1: CIBAFI Islamic Banking Confidence Index, 2016

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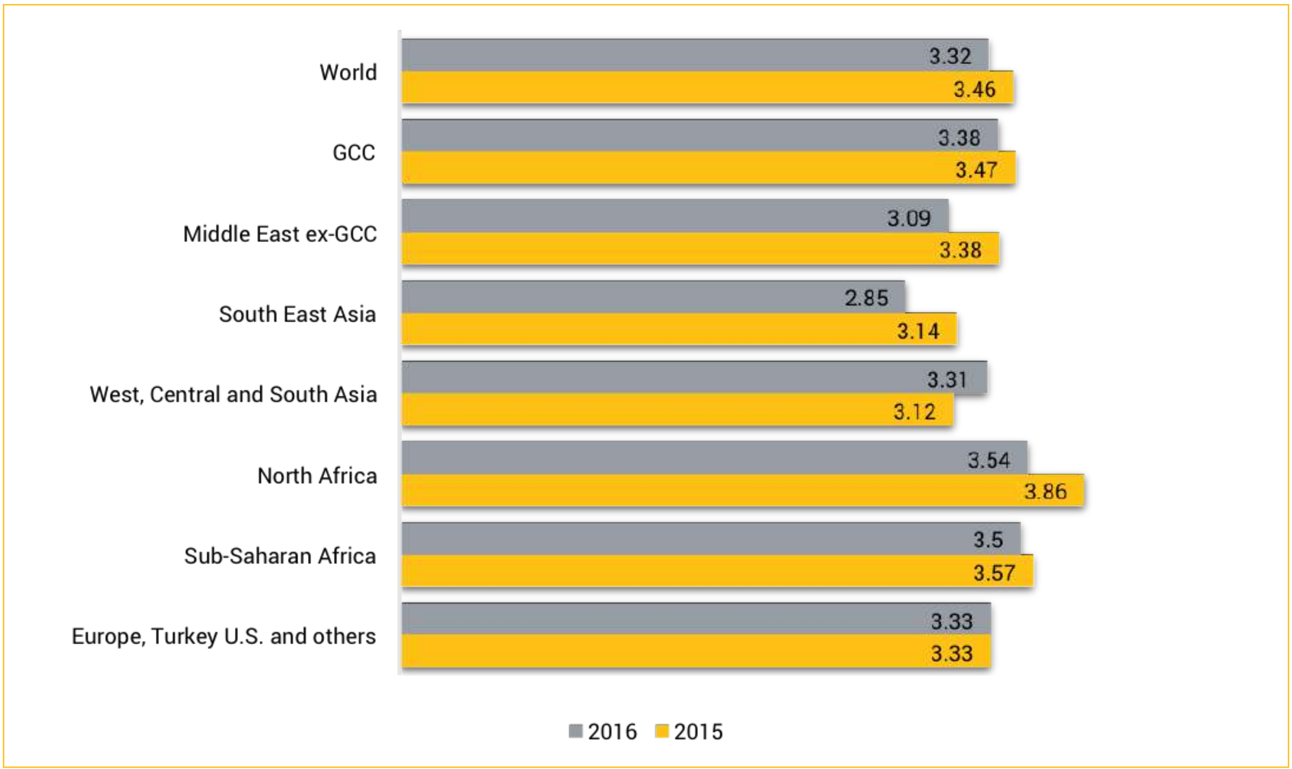
The CIBAFI Islamic Banking Confidence Index articulates the views of the Islamic banking industry on three issues: the future of the banking industry as a whole in the bank's home market, the future of Islamic banking in the bank's home market, and the prospects for revenue growth relative to the previous year.

These were the same three issues that we addressed in our inaugural Global Islamic Bankers' Survey, which was published in November 2015. As a result, this year's survey not only shows the level of optimism in the global Islamic banking industry in absolute terms, based on sentiment in mid-2016, but it also shows whether bankers are more or less optimistic than they were last year.



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

Figure 9: Overall Banking Industry Optimism Level

ISLAMIC BANKS REMAIN 'FAIRLY OPTIMISTIC' ABOUT THE FUTURE OF BANKING IN THEIR HOME MARKETS, BUT LESS SO THAN LAST YEAR

Our first question addressed the level of optimism that Islamic bankers have about the banking market as a whole in the country where they operate. Islamic banks were asked the question:

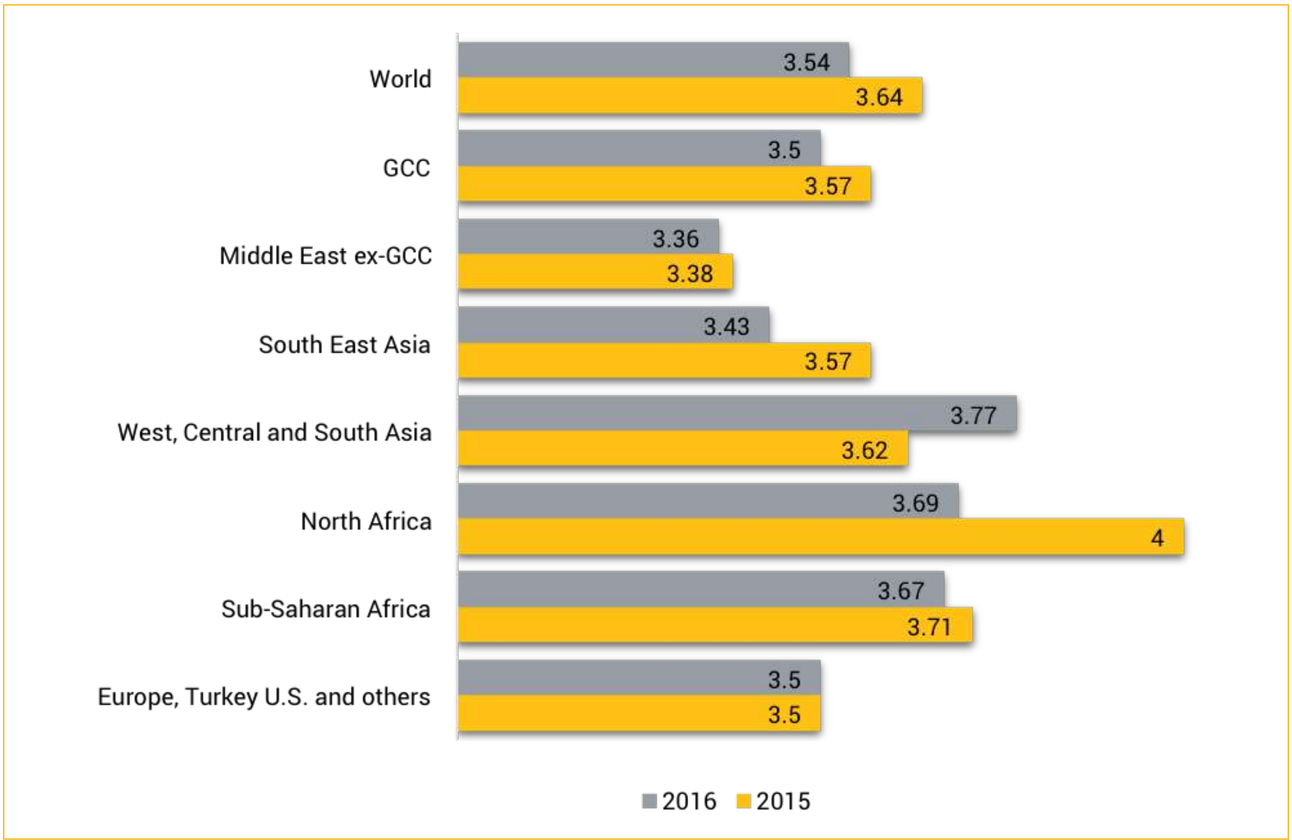
"What is your level of optimism on the state of the banking market in your home jurisdiction this year?"

The combined scores for all banks was 3.32, indicating that they remain 'fairly optimistic'. A score of 3.0 is classed as 'fairly optimistic' while a score of 4.0 ranks as 'very optimistic'.

However, this combined score of 3.32 is less than the 3.46 recorded last year, showing that banks are less optimistic now than they were a year ago. Banks in the Middle East, Africa (both North and Sub-Saharan) and South East Asia declared themselves to be less optimistic now than they were a year ago. Only banks in West, Central and South Asia (who were the least optimistic group last year) declared themselves to be more optimistic this year. Those in Europe, Turkey and elsewhere recorded the same aggregate score as last year.

As was the case last year, banks in North Africa were the most optimistic, with an aggregate score of 3.54. This year, banks in South East Asia are the least optimistic, with a score of 2.85.

The differences between regions are not great – scores range from 2.85 to 3.54 – and no region displays strong sentiments, such as 'very optimistic' or 'very pessimistic.' However, if we look at the two regions where Islamic banking is most active – the Middle East and South East Asia – it is striking that banks in all three regions of the Middle East (GCC, non GCC Middle East, and North Africa) are more optimistic than those in South East Asia.



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

Figure 10: Islamic Banking Industry Optimism Level

ISLAMIC BANKS ALSO REMAIN 'FAIRLY OPTIMISTIC' ABOUT THE PROSPECTS OF ISLAMIC BANKING, BUT AGAIN, THEY ARE LESS OPTIMISTIC THAN LAST YEAR

The Survey's second question addressed banks' level of optimism towards the Islamic banking industry itself in the countries where they operate. Islamic banks were asked the question:

"How optimistic are you about the future of Islamic banking in your jurisdiction compared to your level of optimism last year?"

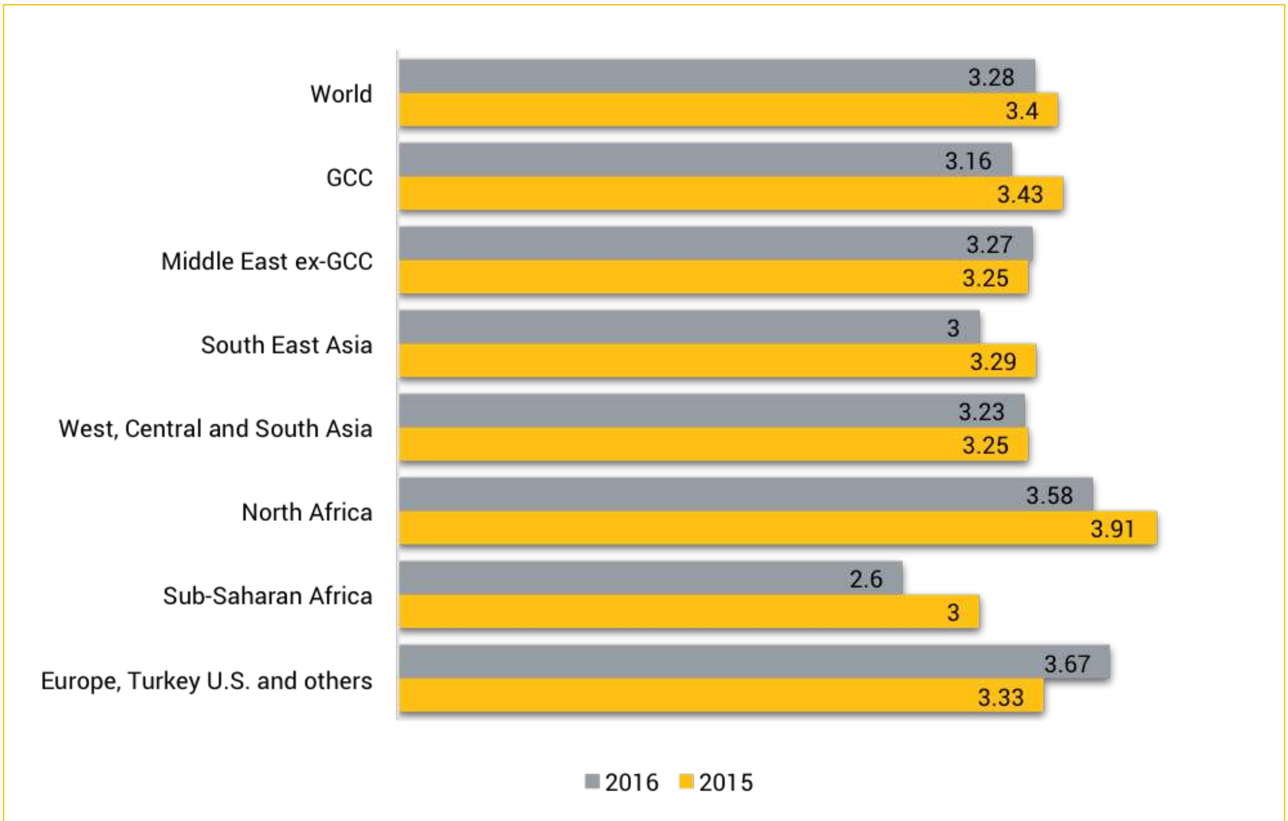
The combined response of all banks was 3.54, again indicating that banks are 'fairly optimistic'. This score is a little less than the 3.64 recorded last year, but not much.

Comparing this result to that of the previous question, we can conclude that Islamic banks are relatively more optimistic about the prospects for Islamic banking than they are about the prospects for conventional banking. Although their levels of optimism have declined, they have declined less in respect of Islamic banking than in respect of conventional banking.

Banks in West, Central and South Asia are more optimistic now than they were a year ago (scoring 3.77 this year, compared to 3.62 last year) but those in North Africa and South East Asia are noticeably less optimistic. The scores for other regions were not materially changed.

Banks in North Africa are the most optimistic though far less so than last year, when they declared themselves to be 'very optimistic'. The least optimistic region is the Middle East, excluding the GCC and North Africa, with a score of 3.36, almost unchanged from last year.

There are no big differences in sentiment between the regions – the scores range from 3.36 to 3.77 – so, again, no region is declaring itself to be either 'very optimistic' or 'very pessimisttic'.



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

Figure 11: Revenue Growth Expectation - Confidence in Outperforming Conventional Peers

ISLAMIC BANKS BELIEVE THEY WILL CONTINUE TO OUTPERFORM CONVENTIONAL BANKS IN TERMS OF REVENUE GROWTH

The Survey's third question asked Islamic banks how they expected their revenues to perform in relation to those of conventional banks in their home market. Islamic banks were asked the question:

"What is your expectation of revenue growth in your institution in 2016 relative to conventional banks in your jurisdiction?"

The aggregate score of all respondents was 3.28. A score of 3.0 would have indicated that Islamic banks thought their revenue growth would be the same as that of conventional banks. A score of 4.0 would have shown expected outperformance; 5.0 would have shown an expectation of extreme outperformance. The score of 3.28 indicates that Islamic banks expect to outperform their conventional counterparts, but the result is not decisive.

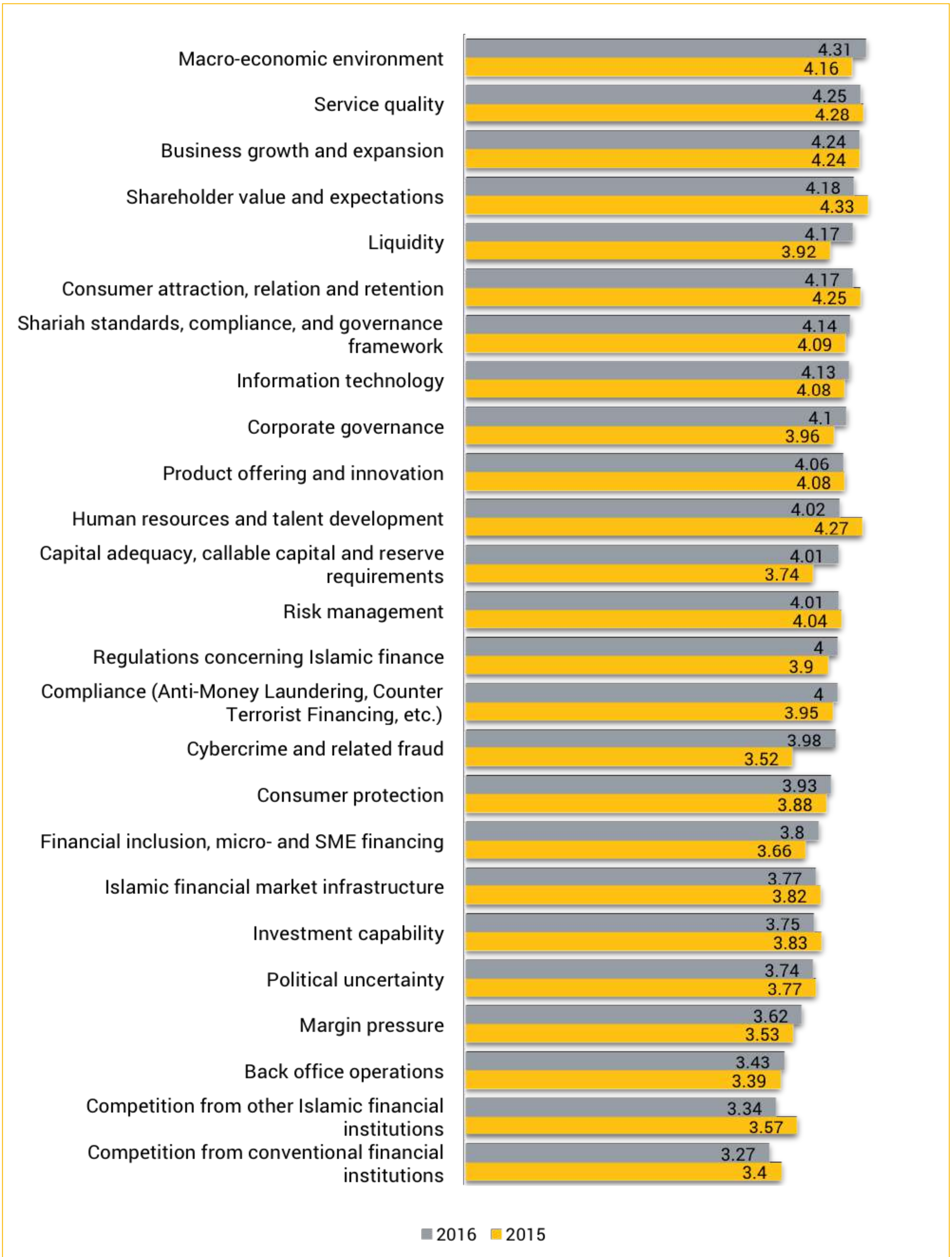
However, banks in some regions do appear confident in their ability to outperform. North African banks score 3.58 and those in Europe, Turkey and elsewhere score 3.67. All except one region –Sub-Saharan Africa, which scores 2.6 – have some degree of confidence that they will be able to outperform their conventional counterparts. Banks in the South East Asia score exactly 3.0, indicating that they see no difference in the likely revenue performance between themselves and conventional banks.

Again, it is striking that in nearly every case, the expectations are lower than last year. The decline is not great, but is spread across nearly all regions.

THE MACRO-ECONOMIC ENVIRONMENT IS THE GREATEST CHALLENGE FOR ISLAMIC BANKS BUT ROUTINE BUSINESS CHALLENGES ALSO FEATURE PROMINENTLY

In the final part of the Confidence Index, we presented Islamic banks with a list of 25 different possible challenges (e.g. Liquidity, Shariah Standards, Compliance) and we asked them to score these challenges on a scale from 1 to 5, with 1 indicating that the bank did not consider the issue important, and 5 indicating that it considered it extremely important. We also asked banks to provide some detail about the two principal challenges that they had identified from the list, and to say how their banks were addressing them.

Figure 12: Global Islamic Banking Top Concerns



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

This year, the macro-economic environment is clearly identified as the most important challenge that Islamic banks face. It scores 4.31, meaning that Islamic banks consider it somewhere between 'very important' and 'extremely important'. Last year, the macro-economic environment came sixth in the ranking of concerns with a score of 4.16.

It is not surprising that the macro-economic environment should rise to the top of Islamic bankers' concerns. Oil prices have remained low and there is little expectation that they will rise significantly in the medium term. As a result, economic growth has slowed in the GCC states. The low oil prices are also depressing economic conditions in other countries with significant Islamic banking activity, such as Indonesia. In some countries, such as Yemen and Sudan, economic performance is being depressed by political events.

CONCERNS RELATED TO ROUTINE BUSINESS PRESSURES ARE PROMINENT

Several of the main challenges identified by Islamic banks relate to routine pressures faced by banks in maturing and changing business environments. 'Service quality', 'business growth' and the need to create shareholder value come second, third and fourth in the ranking of challenges. All ranked highly last year, with the need to create shareholder value which ranked first.

These are challenges that are faced by all types of banks in all markets and regions. It is an indication of the maturity of Islamic banking that it is primarily focused on standard business challenges, rather than particular hurdles that are specific to Shariah-compliant financing.

BUT SHARIAH-SPECIFIC ISSUES ARE ALSO IMPORTANT

Nonetheless, some Shariah-specific challenges remain prominent. Compliance with Shariah standards is ranked as the seventh highest concern, just below liquidity. (It is difficult to tell from the survey results whether concerns over liquidity relate either to the well-publicized problems of creating Shariah-compliant High Quality Liquid Assets or to general issues that also affect conventional banks.) However, the broader picture is that challenges that are specific to Islamic banks (e.g. 'Islamic financial market infrastructure' and 'Regulations concerning Islamic finance') are mingled with concerns that are also being raised by other types of banks all over the world (e.g. 'Corporate governance' or 'risk management').

It is striking that competitive pressures fall at the bottom of the list of challenges. Both competition from conventional banks (scoring 3.27) and from Islamic banks (3.34) are considered 'fairly important' but are clearly relatively less important than all other challenges that were presented. This low score contrasts with some of the 'write in' comments submitted by banks – competitive issues, especially the difficulty of competing against conventional banks – was a big issue for some banks (Figure 12).

In terms of how bankers' concerns are changing, it is noticeable that this year Islamic bankers are scoring liquidity, capital and regulations on Islamic finance higher than they did last year. Financial inclusion has also increased in importance, perhaps due to the raised profile that this issue is receiving not only among Islamic bankers but also in the broader financial community.

The concern over capital is interesting, since high capital levels are generally considered to be one of the strengths of Islamic banks, and many of the largest, GCC-based Islamic banks, boast capital ratios that are far in excess of international standards. Yet in other countries, such as Syria and Yemen, political and economic difficulties, and currency devaluations, are making it very difficult for some banks to maintain strong capital ratios. This is an issue which was illuminated by the responses provided in the 'open ended' questions.

BANKS IN DIFFERENT REGIONS HIGHLIGHT DIFFERENT CONCERNS

This broad assessment of Islamic banks' major concerns needs to be qualified by the differences that occur in different regions.

Four regions, including all three that comprise the Middle East, cite the macro-economic environment as their biggest concern. In contrast, banks in Sub-Saharan Africa – where Islamic finance is somewhat still in an early stage of development – cite the lack of Islamic finance regulations as their biggest challenge.

Both Asian regions rate 'business growth and expansion' as major concerns (top of the list

	2016		2015	
Group 1 GCC	Shareholder value and expectations Macro-economic risk Consumer attraction, relation and retention	4.35 4.31 4.19	Shareholder value and expectations Business growth and expansion Risk management Service quality Human resources and talent development Consumer attraction, relation and retention	4.39 4.25 4.18 4.18 4.18 4.18
Group 2 Middle East ex-GCC	Macro-economic risk Service quality Political uncertainty	4.64 4.55 4.45	Service quality Consumer attraction, relation and retention Macro-economic environment Political uncertainty Investment capability Compliance (AML & CTF etc.) Human resources and talent development Business growth and expansion	4.88 4.88 4.62 4.62 4.62 4.62 4.62 4.62
Group 3 South East Asia	Information technology Business growth and expansion Customer attraction, customer relations and retention	4.57 4.43 4.43	Human resources and talent development Business growth and expansion Regulations concerning Islamic finance Product offering and innovation Information technology	4.14 4.14 4.00 4.00 4.00
Group 4 West, Central and South Asia	Business growth and expansion Service quality Consumer attraction, relation and retention	4.46 4.31 4.15	Service quality Shariah standards, compliance & governance framework Consumer attraction, relation and retention	4.12 4.12 4.12
Group 5 North Africa	Macro-economic environment Shareholder value and expectations Business growth and expansion	4.54 4.38 4.31	Information technology Macro-economic environment Service quality Shariah standards, compliance & governance framework	4.64 4.57 4.57 4.57
Group 6 Sub-Saha- ran Africa	Regulations concerning Islamic finance Human resources and talent development Business growth and expansion Corporate governance	4.67 4.60 4.60 4.60	Business growth and expansion Shareholder value and expectations Islamic financial market infrastructure Service quality Human resources and talent development Consumer attraction, relation and retention	4.57 4.57 4.43 4.43 4.43 4.43
Group 7 Europe, the US and others	Macro-economic environment Shareholder value and expectations Risk management Consumer protection	4.33 4.33 4.17 4.17	Shareholder value and expectations Margin pressure Service quality Compliance (AML & CTF etc.) Human resources and talent development	4.29 4.14 4.14 4.14 4.14
Global	Macro-economic environment Service quality Business growth and expansion	4.31 4.25 4.24	Shareholder value and expectations Service quality Human resources and talent development	4.33 4.28 4.27

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

Figure 13: Geographical Breakdown of Top Three Concerns*

in South East Asia and second in West, Central and South Asia). The other concerns cited by these regions cover business challenges that are common to all developing banking systems, such as service quality and customer relations, although the prominence given to information technology by Group 2 (South East Asia) is striking – no other Group places information technology among its top three concerns.

The GCC region cites shareholder value and expectations as its highest concern, perhaps reflecting the relatively developed nature of GCC financial markets and the scrutiny that banks in the GCC received from investors, brokers and investment bankers. The GCC group cites macro-economic risk as its second highest concern, reflecting the downturn in the GCC economies caused by the continued low price of oil.

THE 'WRITE IN' RESPONSES ILLUMINATE THE CHALLENGES FACED BY BANKS IN DIFFERENT REGIONS

After scoring the 25 areas of possible concern, banks were asked to expand on the top two concerns that they had identified and also to comment on how they were addressing them. The responses shed light on the challenges that banks are facing in particular regions and countries.

For example, a Yemeni bank cited political instability and economic deterioration as its two biggest concerns, adding that further devaluation of the Yemeni Riyal presented the greatest threat to its future. There is little that any bank can do to mitigate such threats, but this Yemeni bank noted that it was trying to keep its business as distant from political issues as possible while also trying to find ways to use its position and resources to improve the economic situation in Yemen – which would in turn benefit the bank itself. A Sudanese bank also cited macro-economic challenges as its greatest concern, but added that external factors such as the US economic embargo and the uncertainty surrounding the enforcement of global rules on combatting money laundering and the financing of terrorism also greatly compromise the bank's opportunities to conduct stable and profitable banking business.

Economic conditions in Djibouti and in Mauritania are challenging, but banks in these countries highlighted the legal and regulatory framework and the current structure of the banking market as major concerns. The Mauritanian bank lamented the lack of an integrated regulatory approach to Islamic banking (that is, an approach that ensures consistency on issues such as taxation, accounting, regulation and the law). The bank in Djibouti cited the lack of a banking law that addresses the particular operating model of Islamic banks. It noted that two conventional banks currently hold 80% of banking assets in Djibouti, even though there is huge demand for Shariah-compliant banking services. The difficulty of competing with the conventional banks was a major issue for this bank (even though 'competition with conventional banks' did not score highly in any of the regional lists or in the aggregate global list).

Comments on bank capital make clear that while many Islamic banks enjoy high capital levels, for others, low capital levels are causing problems. A Sudanese bank that wants to expand micro-finance and social financing throughout the country said that it would not be able to do so without a capital increase. Its response is to take a long-term, patient approach, and look towards full geographic coverage at the end of a 2016-2020 five-year plan. A bank in another economically undeveloped country said that it has decided to retain shareholders' profits every year in order to increase its capital levels. A North African bank also cited lack of capital as a reason why it is unable to expand at the rate it desires.

'Service quality', 'business growth and expansion' and 'customer attraction, retention and relations' score highly in the global aggregated ranking of concerns and in the regional groups. Banks' individual responses provide some perspective on these issues. A Pakistani bank noted that the efficient deployment of its deposits has been a 'massive challenge' as a result of the lack of liquidity products available for the asset side of its balance sheet. Another bank

'Service quality', 'business growth and expansion' and 'customer attraction, retention and relations' score highly in the global aggregated ranking of concerns and in the regional groups.

commented on its efforts to provide a complete range of financial products for its customers, and particularly for those who are currently un-banked and need to be brought into the regulated financial system.

A Jordanian bank made the point that it was difficult to serve SME clients due to the higher risks associated with the sector and the difficulty in identifying suitable collateral for financial facilities. To address these difficulties, the bank was working with the Jordan Loan Guarantee Corporation to develop a scheme whereby the Corporation would guarantee a significant portion of the credit risk associated with lending to SMEs. The bank was also working with the Central Bank of Jordan with a view to developing a funding arrangement that would enable the bank to finance a wide range of industrial projects.

An Asian bank said that, as part of its efforts to improve the skills of its staff, it is trying to close the skills gap between its staff members that have a Shariah-based academic background ('madrassa graduates') and those who have come from conventional financial studies.

A comment from another Asian bank provides an important perspective on the challenges being identified by the Islamic banking industry. This bank has the highest net funding margin (similar to a conventional bank's net interest margin) in its country. Maintaining this margin is the bank's biggest area of concern. The wider point here is that when banks express their concerns, they are not necessarily doing so from a position of weakness but often from a position of strength; though sometimes they are, for example, when they lament the lack of a strong legal/regulatory framework to underpin their activities.

LARGE BANKS AND SMALL BANKS HAVE SIMILAR PERSPECTIVES ON WHAT WILL CHALLENGE THEM IN THE YEARS AHEAD

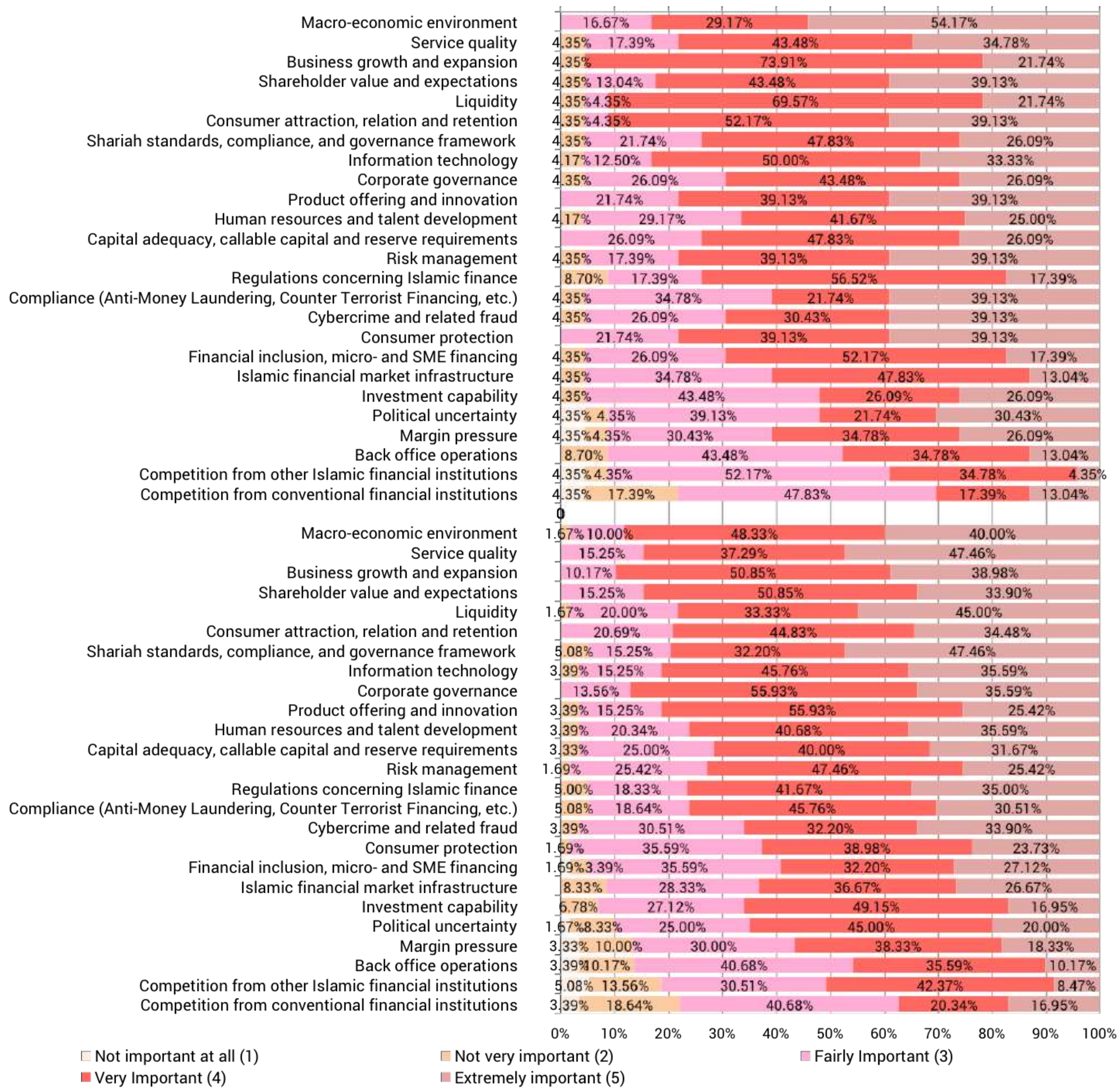
We also asked banks to identify all the areas (from a list of 25) that they thought could be of concern to them in the next 1 - 3 years. Banks could identify as many or as few of the 25 areas as they wished. This year, we additionally divided this part of the Survey between 'large banks' (those with more than US$5 billion in assets) and 'small banks"' (those with fewer than US$5 billion in assets).

Larger Islamic banks tend to be found in the GCC and in South East Asia. Banks in West Central and South Asia, North Africa and in Sub-Saharan Africa tend to be smaller. For example, all Sub-Saharan banks have less than $1billion in assets.

Banks of all sizes identified business growth and expansion as an area of challenge. On the other hand, not many banks, large or small, thought that competition, either from conventional banks or from other Islamic banks would present challenges.

There were differences between large and small banks in the relative ranking of the issues, but it is hard to discern an overall pattern. Large banks are more concerned than small banks about liquidity and risk management but they are less concerned about corporate governance, which ranks second on the small banks' list of challenges. Compliance with regulation on money laundering and terrorist financing does not score highly for larger banks, but it is a significant issue for small banks.

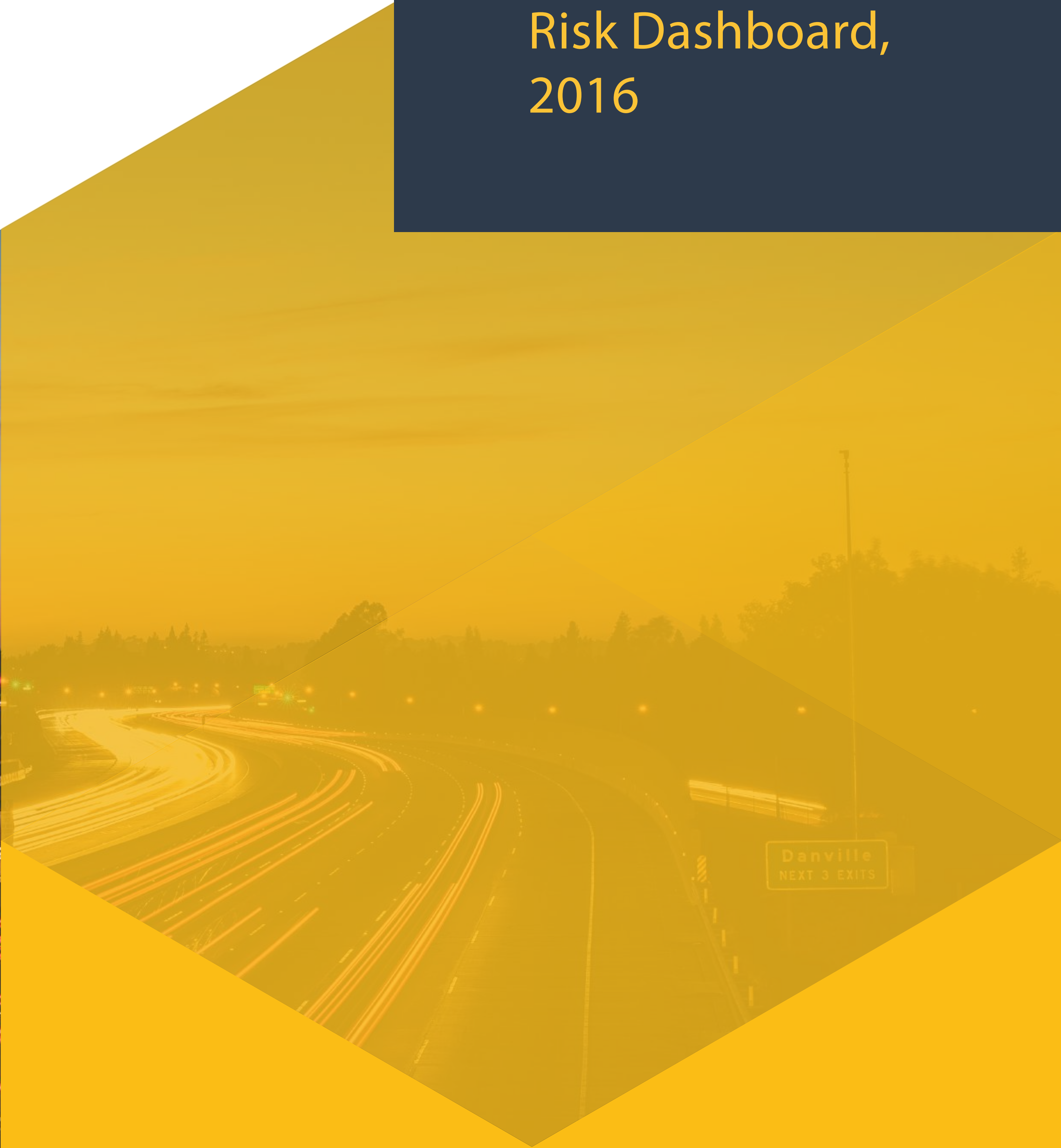
Both large and small banks are concerned about the macro-economic environment, meeting shareholder expectations and Information Technology. They show much less concern about their back-office operations and margin pressure.



Large banks (top set) and small banks (bottom set)

Figure 14:Global Islamic Banking Top Concerns - Large and Small banks

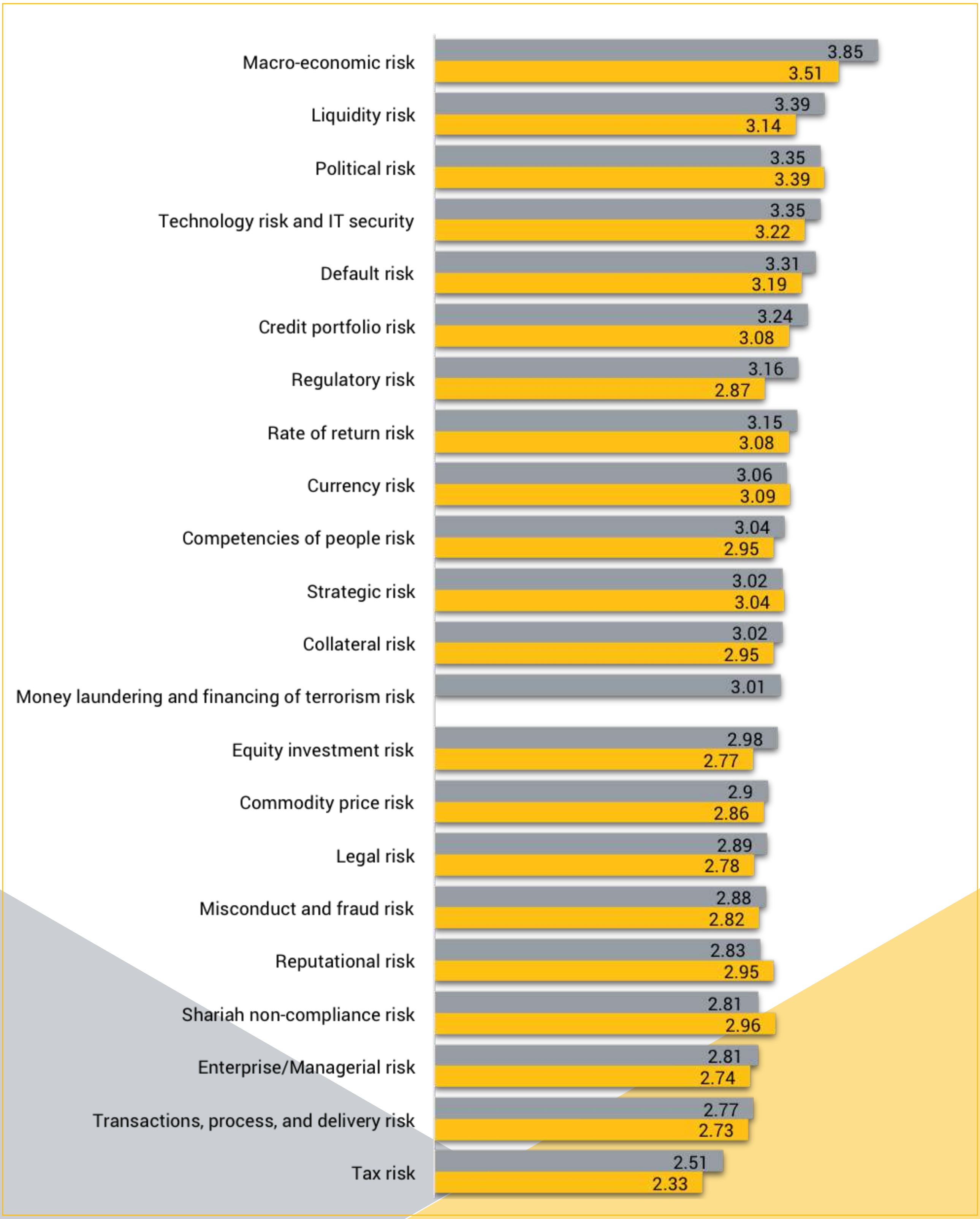
» Part 2: CIBAFI Islamic Banking Risk Dashboard, 2016



» Part 2: CIBAFI Islamic Banking Risk Dashboard, 2016

The CIBAFI Islamic Banking Risk Dashboard presents the views of Islamic Bankers on the biggest risks that they believe their institutions will face over the next 1 - 3 years. Respondents were asked to score each of the risks on a scale from 1 (no risk at all) to 5 (extreme risk). They were also asked to describe in writing the top two risks that they had identified and to describe initiatives that they were taking to mitigate these risks.

Bankers identified macro-economic risk as the biggest risk that they faced, just as they did last year, but this year they scored it higher (3.85 this year compared to 3.51 last year), indicating that they believe the risk has increased. Political risk is the third most highly scored this year. It was second last year.



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

**Money laundering, and financing of terrorism risk added in 2016*

Figure 15: Islamic Banking Risk Dashboard

Liquidity risk is identified as the second biggest risk this year, up from fifth last year. This seems logical, in view of the reduced liquidity in many banking systems in which Islamic banks operate, as a result of continuing low oil prices. Similarly, default and credit portfolio risk remain high, which is hardly surprising in view of the economic slowdown that many countries with Islamic banks are facing.

More significant than the relative ranking of individual risks is the change in risk scores between 2016 and 2015. Sixteen of the 22 areas identified in the CIBAFI questionnaire are deemed to have a higher risk this year than last year. Thirteen risks have a score greater than 3.0, compared to only nine last year. (3.0 denotes 'medium risk').

Risks related to misconduct and fraud fall at the lower end of the risk spectrum. Risks related to employee conduct are receiving a lot of attention from international regulators and standard setters following the exposure of several cases of unacceptable behaviour by groups of employees (for example, in distorting interest rate benchmarks, or in selling inappropriate products to individuals and small businesses). As financial institutions with an explicitly moral mission, Islamic banks should be less vulnerable to risks related to misconduct and fraud, and this may be the reason that Islamic bankers assign a low score to these risks. However, the possibility also exists that Islamic bankers are underestimating the risks they face in this area – the Survey results shed no light on this.

It is also interesting that Shariah non-compliance risk is scored low. It is reassuring to customers and counterparties that Islamic banks are confident of their ability to fulfil their obligations to comply with the Shariah principles.

SIX OUT OF THE SEVEN GEOGRAPHICAL GROUPS IDENTIFY MACRO-ECONOMIC RISK AS THEIR BIGGEST RISK FACTOR

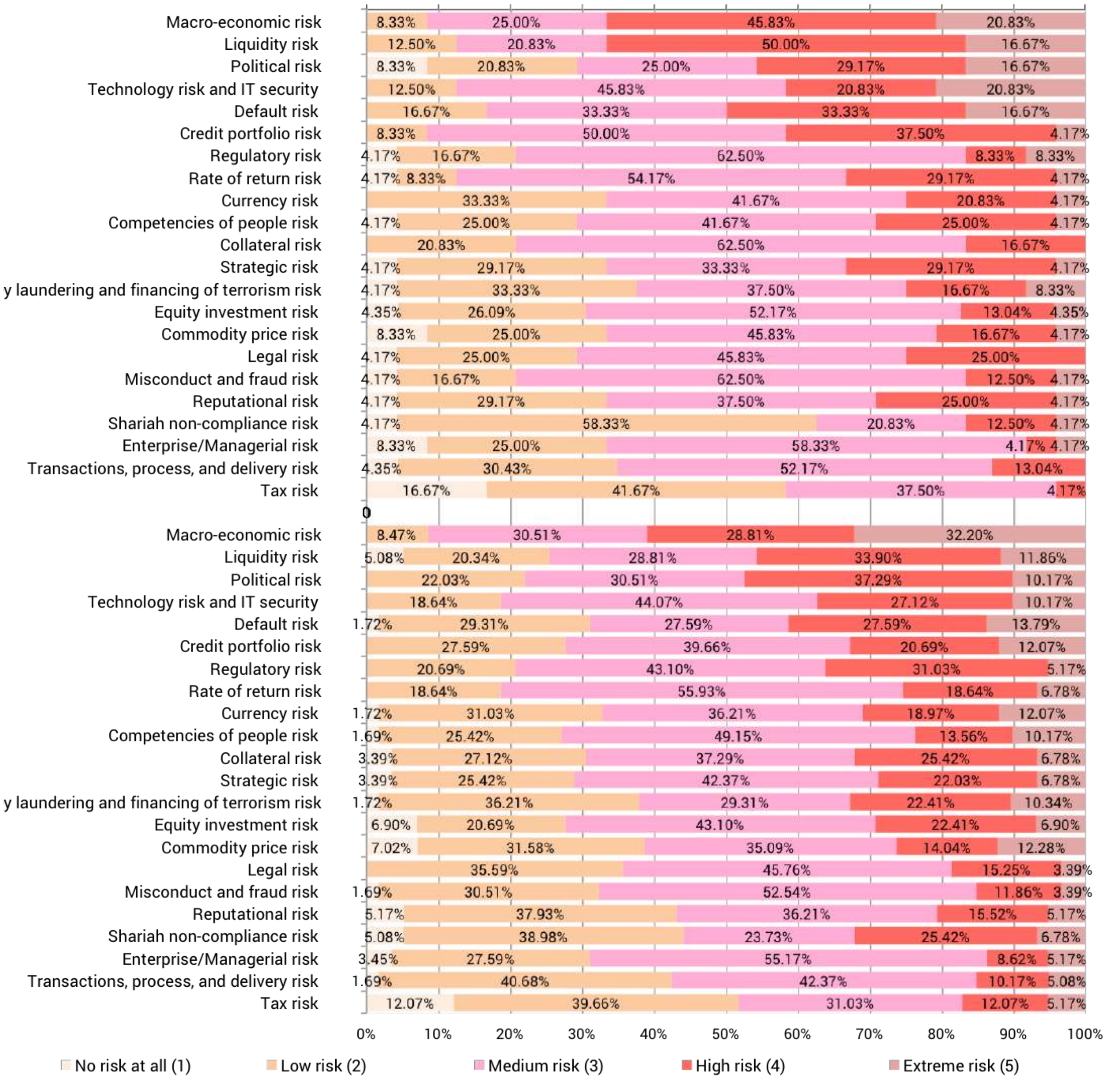
Looking at the seven different geographical groups, it is striking that all except one rank macro-economic risk as the biggest one that they will face over the next three years. The exception is the Sub-Saharan Africa group, where macro-economic risk is ranked second. Four groups have political risk among their top three.

Currency risk ranks highly in both African groups and in West, Central and South Asia. It also scored highly last year. Several emerging market currencies suffered significant devaluations in 2015, and it appears that for some banks devaluation has remained a source of worry. Countries such as Yemen and Syria have suffered particularly steep devaluations due to the military conflicts in their countries, as opposed to other emerging market economies whose devaluations have been caused by macro-economic imbalances.

LARGE AND SMALL BANKS HAVE THE SAME RISK PRIORITIES

The biggest risks that large and small banks identified were remarkably similar. Both groups mentioned that macro-economic risk, political risk, liquidity risk and default risk as their top five categories. Technology risk and IT security was another risk that scored highly with both groups as did credit default risk.

However, there are some differences in the risk outlooks between large and small banks. Larger banks are much more concerned about their ability to attract competent staff, strategic risks and the risks related to their ability to maintain profitability ('rate of return risk'). Smaller banks attach higher priority to risks related to money laundering and terrorist financing, collateral risks and Shariah non-compliance risk.



Large banks (top set) and small banks (bottom set)

Figure 16: Islamic Banking Risk Dashboard - Large Banks and Small Banks

ISLAMIC BANKS FACE THE DILEMMA OF WANTING TO EXPAND THEIR BUSINESS AT A TIME OF DIFFICULT ECONOMIC CONDITIONS

The descriptions that banks gave of their two biggest risks, and actions they were taking to mitigate them, highlight some important developments for Islamic banking.

On one hand, Islamic banks are keen to expand the range of services they offer, and to extend their reach into underserved sectors of society; but on the other hand, difficult economic conditions are pushing them to take a more conservative approach to business development. A GCC bank identifies three areas of commodity finance where it had halted expansion. Another GCC bank says that it is focusing on activities that are likely to offer high profitability and on customers where the bank has reason to believe, from past experience, that there is little risk of default. A South-East Asian bank said that it has been strengthening its underwriting standards and keeping them constantly under review as economic conditions change.

A Middle Eastern bank (Non-GCC) says that it has been tightening its approach to legal actions that it takes against defaulting customers, although it does make adjustments to the level of a customer's indebtedness (i.e. writing off part of the debt) if the circumstances warrant it. A Sub-Saharan bank stressed the needs to secure adequate guarantees from customers at a time when the risk of customer's defaults has increased.

However, an Asian bank said that, in addition to accelerating collections on doubtful debts, it regularly invites customers to informal meetings ('get-togethers') in order to build loyalty between the customers and the bank, and to prevent the customers feeling any sense of alienation or isolation. The amount of time that the bank spends in advising their customers on good business practices, and how to cope during times of economic difficulty, has increased.

A Middle Eastern bank says that liquidity strains have been dampening growth, particularly since the introduction of the Liquidity Coverage Ratio and the Net Stable Funding Ratio in the bank's country. The bank is responding to increased liquidity challenges by re-shaping its asset/liability profile, and diversifying its funding base with a particular focus on retail finance and longer-term deposits.

A Group 7 bank that placed currency risk as one of its greatest risks noted that it hedges all foreign exchange transactions as soon as they are booked and that foreign currency facilities are extended only to the customers who have income in the relevant foreign currency. The bank also said that it has hedged part of its capital, by raising subordinated loans in foreign currency.

An Asian bank noted that is has been upgrading its IT security in order to prevent cyber-attacks and fraud. In addition to technology-based solutions (such as improved hardware) it has been teaching staff about safe IT practices and incentivising them to implement what they have learned. It has also improved the security of customer-facing technology such as ATMs, and it has advised customers on password security. Two North African banks highlight the need to upgrade their IT to reflect the changing IT use in a broader society, such as the use of smart phones. While this may be costly, it may prevent the banks from being exposed to greater technology risk from hackers.

Meanwhile, another Asia bank commented on the difficulty of budgeting for IT improvements at a time when spreads are shrinking and profitability is under pressure.

	2016		2015	
Group 1 GCC	Macro-economic risk Liquidity risk Credit portfolio risk	3.81 3.35 3.25	Political risk Reputational risk Macro-economic risk	3.48 3.38 3.34
Group 2 Middle East ex-GCC	Macro-economic risk Political risk Default risk	4.36 4.18 3.70	Macro-economic risk Political risk Default risk Technology risk and IT security	4.12 4.12 3.62 3.62
Group 3 South East Asia	Macro-economic risk Technology risk and IT security Equity investment risk	3.86 3.57 3.43	Regulatory risk Default risk Rate of return risk Liquidity risk Competencies of people risk Strategic risk	3.14 3.14 3.14 3.14 3.14 3.14
Group 4 West, Central and South Asia	Macro-economic risk Political risk Currency risk	3.38 3.38 3.17	Macro-economic risk Political risk Default risk Rate of return risk	3.25 3.12 3.12 3.12
Group 5 North Africa	Macro-economic risk Currency risk Political risk	4.23 3.69 3.62	Macro-economic risk Currency risk Liquidity risk	4.23 3.85 3.77
Group 6 Sub-Saha- ran Africa	Default risk Liquidity risk Macro-economic risk Collateral risk Currency risk	4.40 4.00 3.80 3.80 3.80	Liquidity risk Technology risk and IT security Default risk Collateral risk Currency risk Competencies of people risk	3.14 3.14 3.00 3.00 3.00 3.00
Group 7 Europe, the US and others	Macro-economic risk Rate of return risk Liquidity risk	3.33 3.17 3.17	Macro-economic risk Political risk Technology risk and IT security	3.71 3.71 3.43
Global	Macro-economic risk Liquidity risk Political risk	3.85 3.39 3.35	Macro-economic risk Political risk Technology risk and IT security	3.51 3.39 3.22

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

Figure 17: Geographical Breakdown of Top 3 Risks*

» Part 3: Demostrating True Value: Survey on Responsible Business and Sustainability Practices

» Part 3: Demonstrating True Value: Survey on Responsible Business and Sustainability Practices

This Section of our Survey presents the results of a questionnaire about attitudes to responsible business and sustainability practices in the Islamic banking industry.

1. BUSINESS SECTOR EXPOSURE AND IMPLICATIONS FOR SUSTAINABILITY

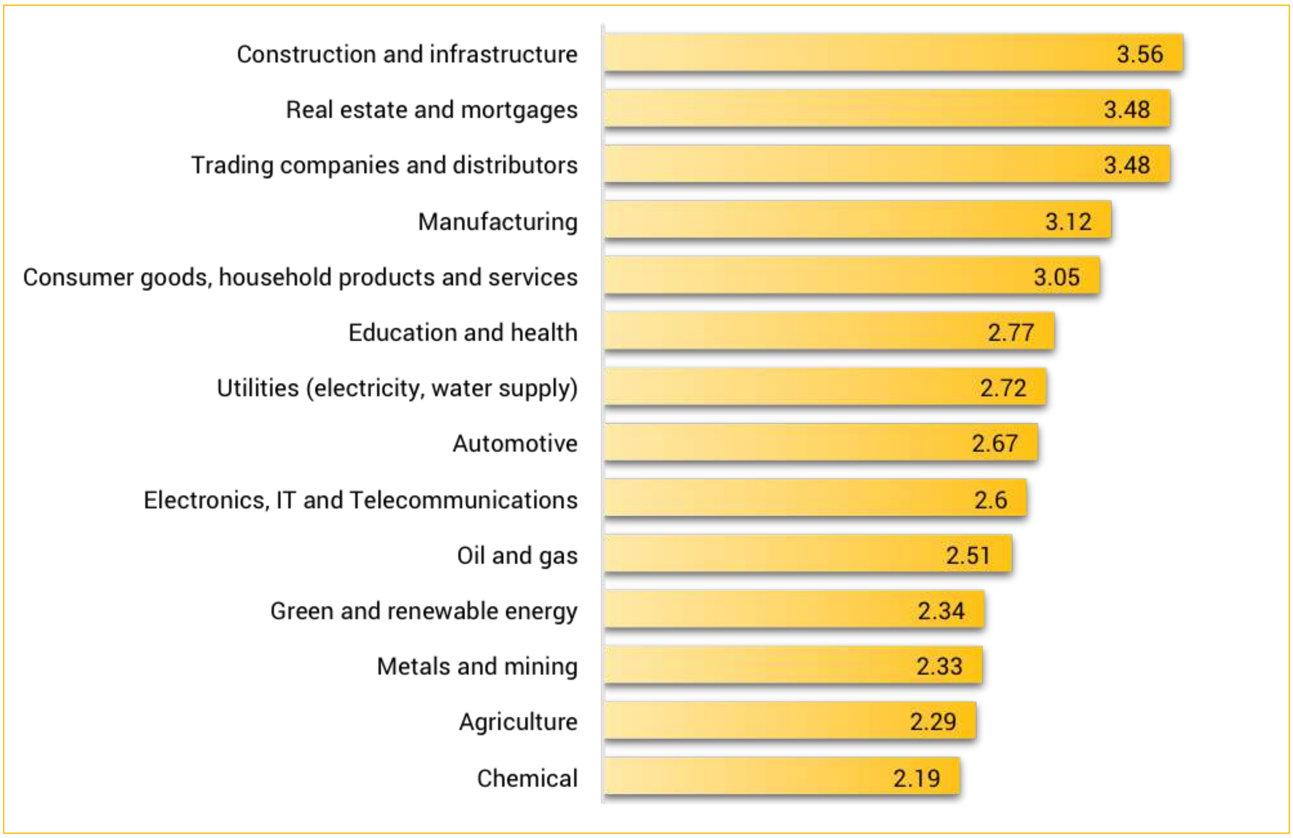
Islamic banks were asked about the extent to which they were exposed to various business sectors, with a score of 1 representing no exposure and a score of 5 representing very high exposure.

Most Islamic banks, regardless of size, have moderate to high exposure to three sectors: construction and infrastructure, real estate and mortgages, and trading companies and distributors (Figure 18).

The construction and infrastructure sector plays an important role in economic growth, development, poverty reduction, and environmental sustainability. Over the next 15 years, the world will need to invest approximately US$ 90 trillion in sustainable infrastructure assets, more than double the present stock of global public capital. The bulk of these investment needs will be in the developing world – the area where Islamic banks are mostly active[2]. In view of such an essential need and the opportunities it presents, Islamic banks, particularly the large ones, can increase their long-term financing for public-private partnerships in infrastructure that are environmentally sensitive and fulfil the needs of low-income users, women and other marginalized groups. While the exposure to the green and renewable energy sector is currently low, Islamic banks can build on their infrastructure financing experience to explore new sustainable infrastructure financing opportunities such as distributed renewable power generation in un-electrified rural areas.

The Survey shows that small banks have proportionally greater exposure to the green and renewable energy sector than large banks. This is possibly because smaller renewable energy projects can be viable from a commercial

[2]Bhattacharya, Amar, Jeremy Oppenheim, and Nicholas Stern. 2015. "Driving Sustainable Development Through Better Infrastructure: Key Elements of a Transformation Programme." Global Economy and Development. Working Paper 91.



1.No exposure; 2.Low exposure; 3.Moderate exposure; 4.High exposure; 5.Very high exposure

Figure 18: Key Business Sectors Islamic banks are exposed to

Islamic banks, particularly the large ones, can increase their long-term financing for public-private partnerships in infrastructure that are environmentally sensitive and fulfil the needs of low-income users, women and other marginalized groups perspective in many developing countries, and they attract the involvement of smaller banks and that larger banks may be taking strategic decisions; they either go into the area on a larger scale or not at all (Figure 19). Banks from Sub-Saharan Africa (Group 6) and North Africa (Group 5) are exposed to the construction and infrastructure sectors and to trading companies and distribution sectors more than other regions. Banks in the Middle East ex-GCC (Group 2) region have higher exposure to real estate and mortgages (Figure 20).

2. KEY STAKEHOLDERS THAT WILL HAVE THE GREATEST IMPACT ON THE WAY BANKS CONTRIBUTE TO THE SOCIETY, ECONOMY AND ENVIRONMENT

Islamic banks were asked which stakeholder groups would have the greatest impact on the way they contribute to society, the economy and the environment over the next five years, with 1 representing no impact and 5 representing very high impact.

The rise of modern communication technologies and social media has increased the availability of information and its accessibility. This trend is enhancing awareness of the impact that banks' activities can have on societies at large. Banks' stakeholders are more able to connect and coordinate their thoughts, ideas and activities, and this is a amplifying the impact of stakeholders on banks.

While traditional stakeholders (investors, shareholders, board of directors, employees, consumers, governments and financial regulators) are viewed as having the greatest impact on the way Islamic banks contribute to the society, economy and environment (Figure 21), these new developments necessitate the implementation of effective management strategies with a particular focus upon the identification and management of relationships with stakeholders beyond the traditional boundaries of stakeholders. By engaging with other relevant stakeholders, banks can further reduce reputational risks, enhance operational efficiency via collaboration with local communities and authorities, attract and retain talented people who share their values, and strengthen the social license to operate by gaining better respectability and credibility.

The significance of traditional stakeholders is similar across banks, with investors/shareholders and board directors having the highest impact on small and large

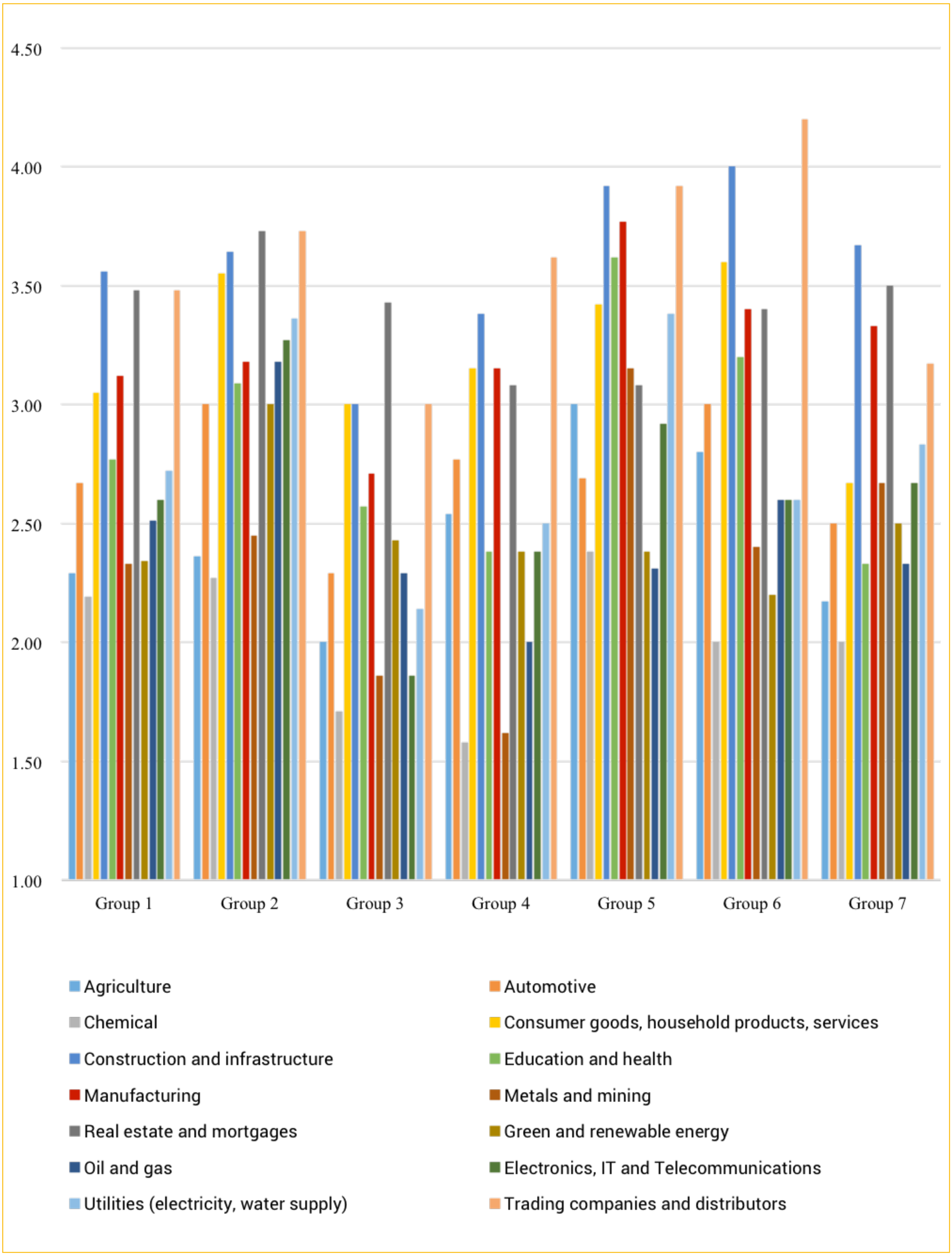
By engaging with other relevant stakeholders, banks can further reduce reputational risks, enhance operational efficiency via collaboration with local communities and authorities, attract and retain talented people who share their values, and strengthen the social license to operate by gaining better respectability and credibility

banks respectively (Figure 22). SMEs, communities, civil societies, NGOs, industry associations, trade unions and employer associations have greater stakeholder impact in the opinion of small banks, while global policy bodies for responsible business (e.g. United Nations Principles for Responsible Investment), the poor, disabled, youth and women entrepreneurs are considered by large banks as having greater impact.

Participation in global initiatives such as the United Nations Global Compact by large Islamic banks can be

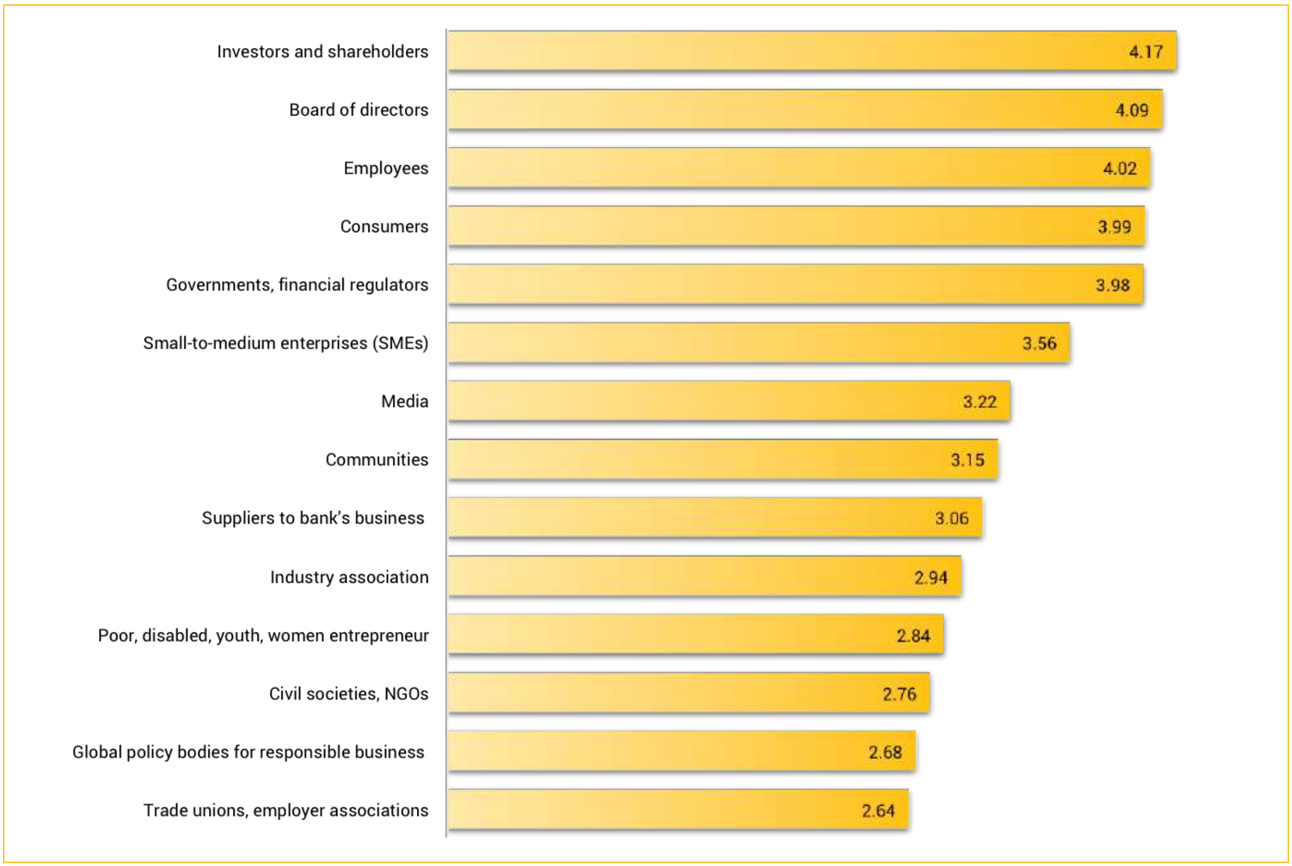
Large banks (top set) and small banks (bottom set)

Figure 19:Extent to which banks are exposed to business sectors (Large Banks and Small Banks)



1.No exposure; 2.Low exposure; 3.Moderate exposure; 4.High exposure; 5.Very high exposure

Figure 20: Key Business Exposures (Group-wise)



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

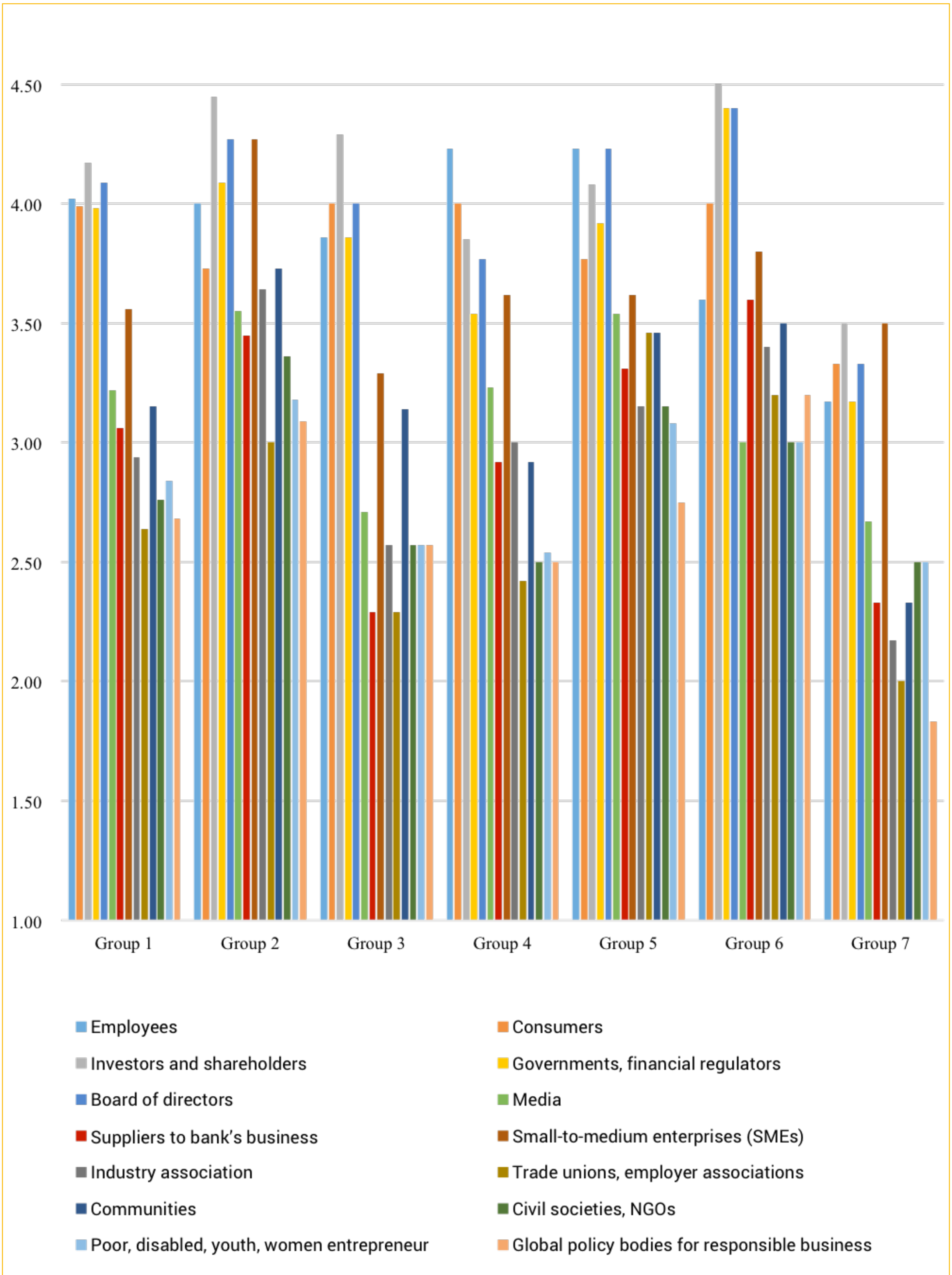
Figure 21: Key Stakeholder groups banks believe will have the greatest impact on the way they contribute to society, economy and environment over the next 5 years

a gradual move towards a more transparent process of corporate sustainability and social responsibility reporting, making Islamic financial institutions accountable in their obligations to promote social well-being.

The importance of stakeholders is broadly similar across regions. Investors and shareholders are considered to have the greatest impact on the way banks contribute to society, the economy and the environment in most of the regions, and particularly in Sub-Saharan Africa (Group 6), Middle East ex-GCC (Group 2) and South East Asia (Group 3) (Figure 23).

Large banks (top set) and small banks (bottom set)

Figure 22: Key Stakeholder groups banks believe will have greatest impact on the way they contribute to society, economy and environment over the next 5 years (Large and Small banks)

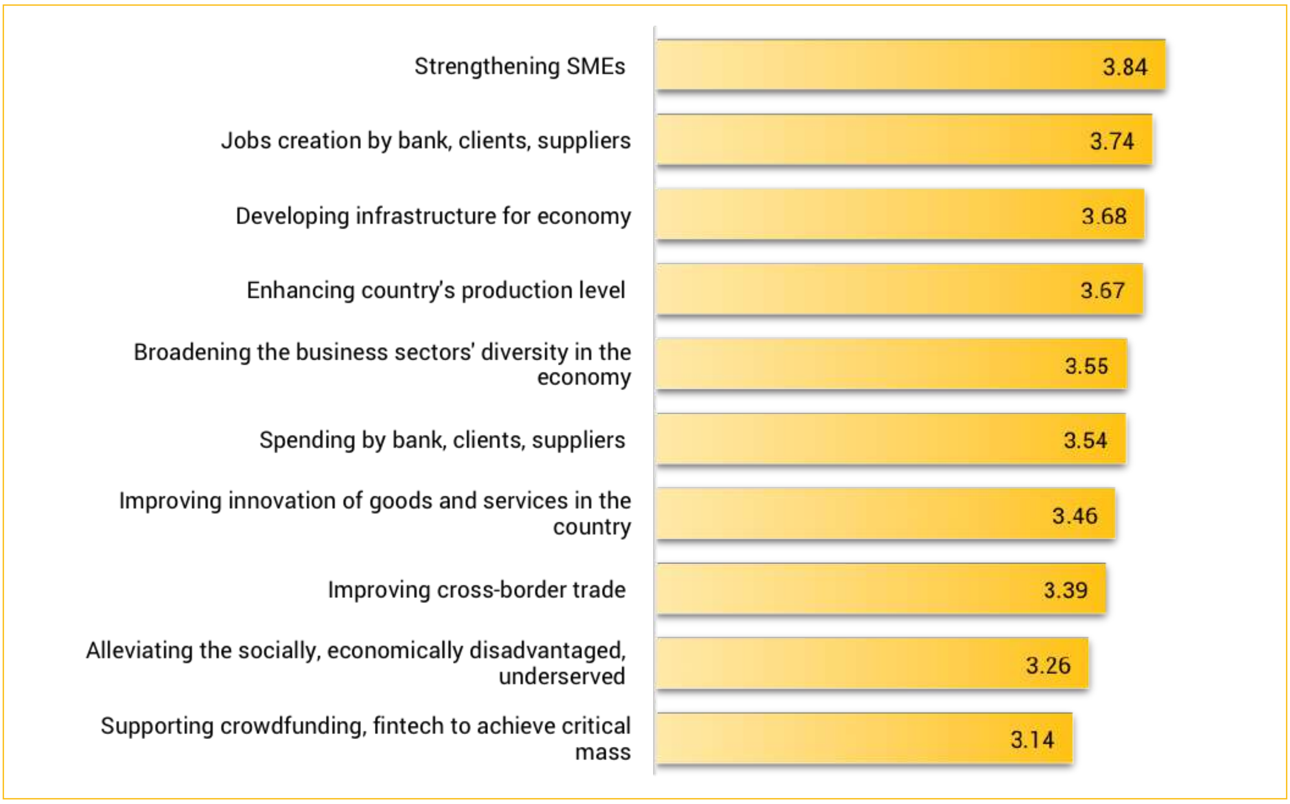


1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 23: Key Stakeholder Groups (Group-wise)

3. CONTRIBUTION TO LOCAL ECONOMIC DEVELOPMENT

Banks were asked through which channels and to what extent their current programmes/initiatives can increase their contributions to local economic development over the next 2-3 years. The scores reflect the expected level of contribution for each channel.



1.No increase; 2.Low increase; 3.Moderate increase; 4.High increase; 5.Very high increase

Figure 24: Channels through which banks' programmes/initiatives increase their contribution to local economic development

Most of the programmes/initiatives (Figure 24) are likely to be able to increase Islamic banks' contribution to local economic development to some extent. Among these initiatives, strengthening SMEs and job creation by the banks, banks' clients and banks' suppliers are believed to make the highest contribution to economic development. Of particular significance is the role of small Islamic banks in harnessing these programmes/initiatives in creating economic impact (Figure 25). Relative to large banks, there are significantly more small banks that consider the following as contributors to the economy: a) job creation; b) spending by bank, clients, suppliers (e.g. purchasing goods and services from the local economy etc.); c) enhancing the production level of the local economy; d) developing infrastructure in the country (e.g. transport, electricity, etc.); e) strengthening SMEs; f) alleviating the socially and economically disadvantaged and underserved (e.g. poor, disabled, youth, women, etc.); g) broadening the diversity of business sectors in the economy; and h) improving innovation of goods and services in the country. There are, therefore, ample opportunities for the Islamic banking industry to enhance its economic impact as it expands its asset size and market reach. From a regional perspective, strengthening SMEs and job creation are viewed by Islamic banks from Middle East ex-GCC (Group 2) and Sub-Saharan Africa (Group 6) to make a significant contribution to the local economic development (Figure 26).

For example, a bank in North Africa believed that job creation can be improved by infrastructure projects funded through Sukuk, while another bank in the European region is launching innovative projects and products through its R&D Centre with 300 engineers. Another example is that through concessionary loans to the SME sector, both directly through its network and indirectly in its capacity as an apex bank for participating financial institutions, a bank in West, Central and South Asia has been providing trade financing services, channel financing, overdrafts, packing credit, bills discounting in addition to the traditional long term financing to SMEs in the infrastructure, tourism, agriculture, transportation and health care sectors.

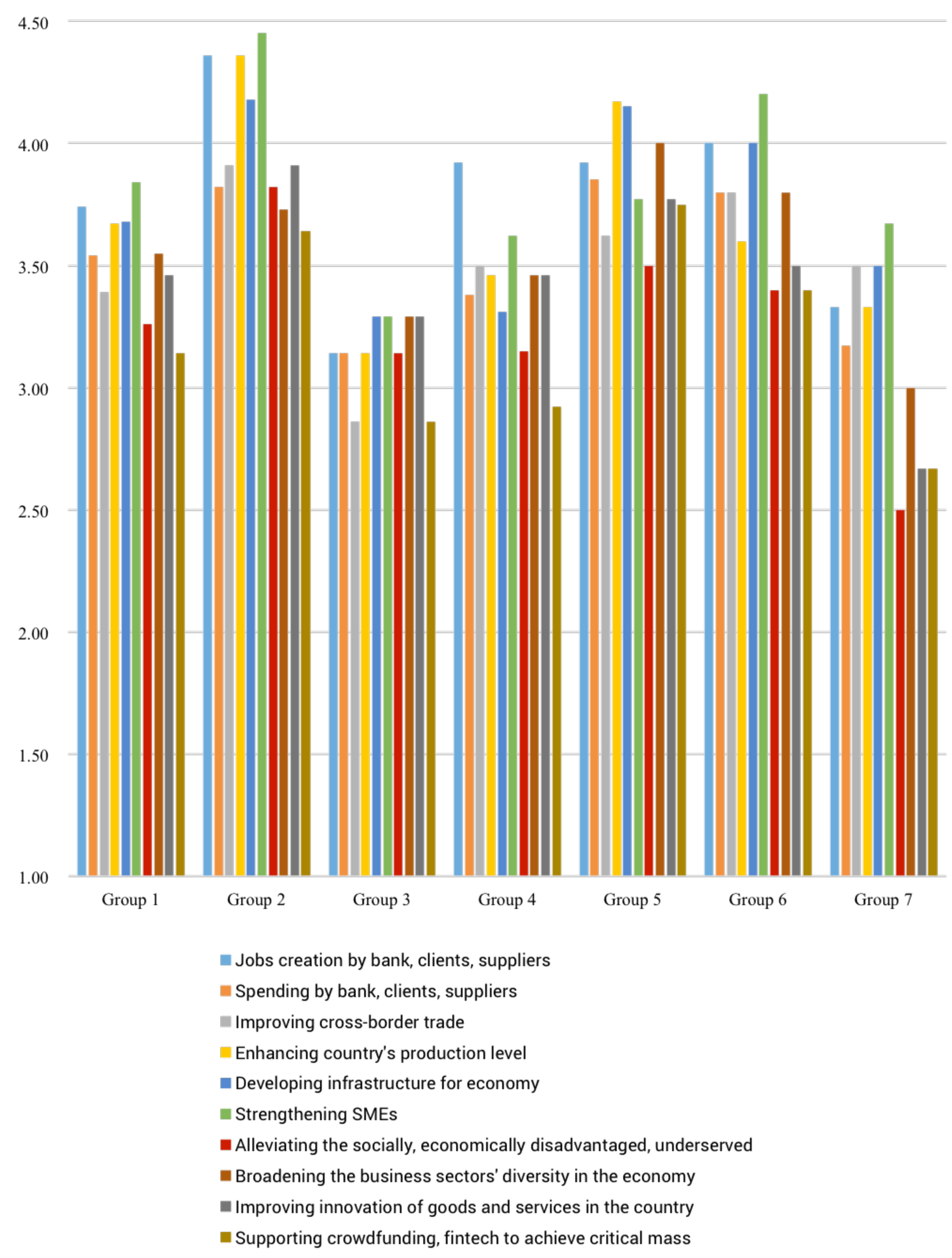
While supporting crowdfunding, financial technology (Fintech) and mobile technology to achieve critical mass is considered by Islamic banks, especially the smaller banks, to have the least economic impact in the short-to-medium term. One should note the potential synergy and creative disruption that innovative Fintech and alternative financial platforms can have in the mainstream banking sector over time. While crowdfunding threatens banks with disintermediation, it also presents them with a new business model for financing and investing. Real estate equity platforms, for example, seek to depart from the single-investor/single-owner model of housing where the homeowner is highly leveraged with a large mortgage. Investors inject capital into a property to supplement the homeowner's equity, thus lowering the amount of debt on each property, which is in accordance with the principles of Islamic finance. First-time housing developers who would not usually qualify for bank financing have the opportunity to establish their track records via crowdfunding, so that banks can take into consideration when assessing them for financing at a later stage. Partnering with Shariah compliant peer-to-peer platforms to provide cash management services to SMEs is another example of how traditional and alternative finance can help SMEs to prosper[3].

Strengthening SMEs and job creation by the banks, banks' clients and banks' suppliers are believed to make the highest contribution to economic development. Of particular significance is the role of small Islamic banks in harnessing these programmes/initiatives in creating economic impact.

[3]Cooper, Jane. 2015. "Playing the numbers game: how banks are facing up to the crowd-funding threat." The Banker.

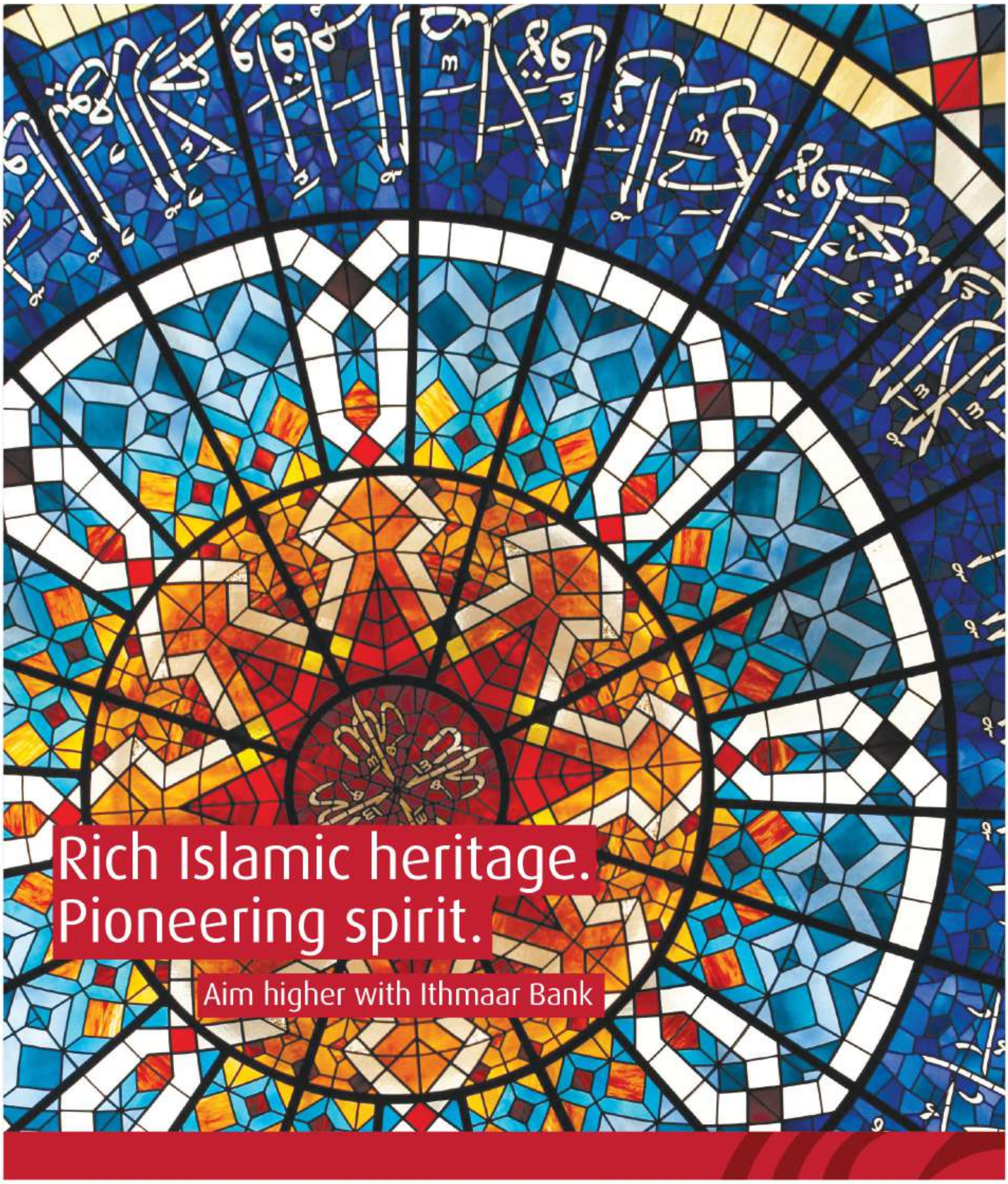
Large banks (top set) and small banks (bottom set)

Figure 25: Channels through which banks' current programmes/initiatives increase their contribution to local economic development over the next 2-3 years (Large and Small Banks)



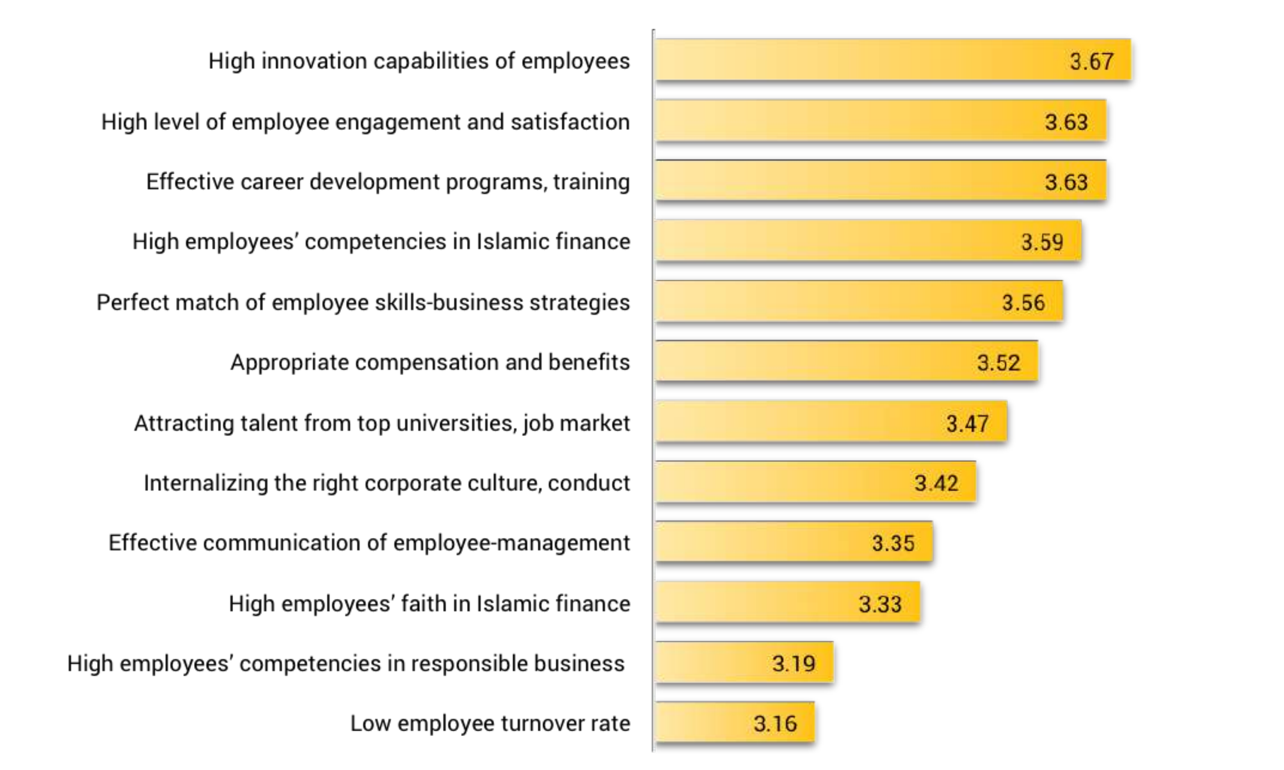
1.No increase; 2.Low increase; 3.Moderate increase; 4.High increase; 5.Very high increase

Figure 26: Economic Impact Channels (Group-wise)


Rich Islamic heritage.
Pioneering spirit.
Aim higher with Ithmaar Bank

4. PROMOTING HIGH QUALITY EMPLOYEE RELATIONS AND DEVELOPMENT

Islamic banks were asked to indicate the extent to which they face challenges in promoting high quality employee relations for superior business performance, with 1 representing not challenging and 5 representing very challenging.



1.Not challenging; 2.Less challenging; 3.Fairly challenging; 4.Challenging; 5.Very challenging

Figure 27: Degree of challenges banks face in promoting high quality employee relations

In increasingly knowledge-based industries, intellectual capital is an essential part of a financial institution's intangible assets. Since human capital represents the most significant operating cost of many organizations, the ability to manage human capital and relations effectively has a significant impact on the competitive advantage or disadvantage of banks. In the overall analysis (Figure 27), developing high innovation capabilities of employees, effective career development programmes, mentoring, succession plans, training, as well as maintaining high levels of employee engagement and satisfaction are among the top challenges that Islamic banks face in promoting high quality employee relations for superior business performance.

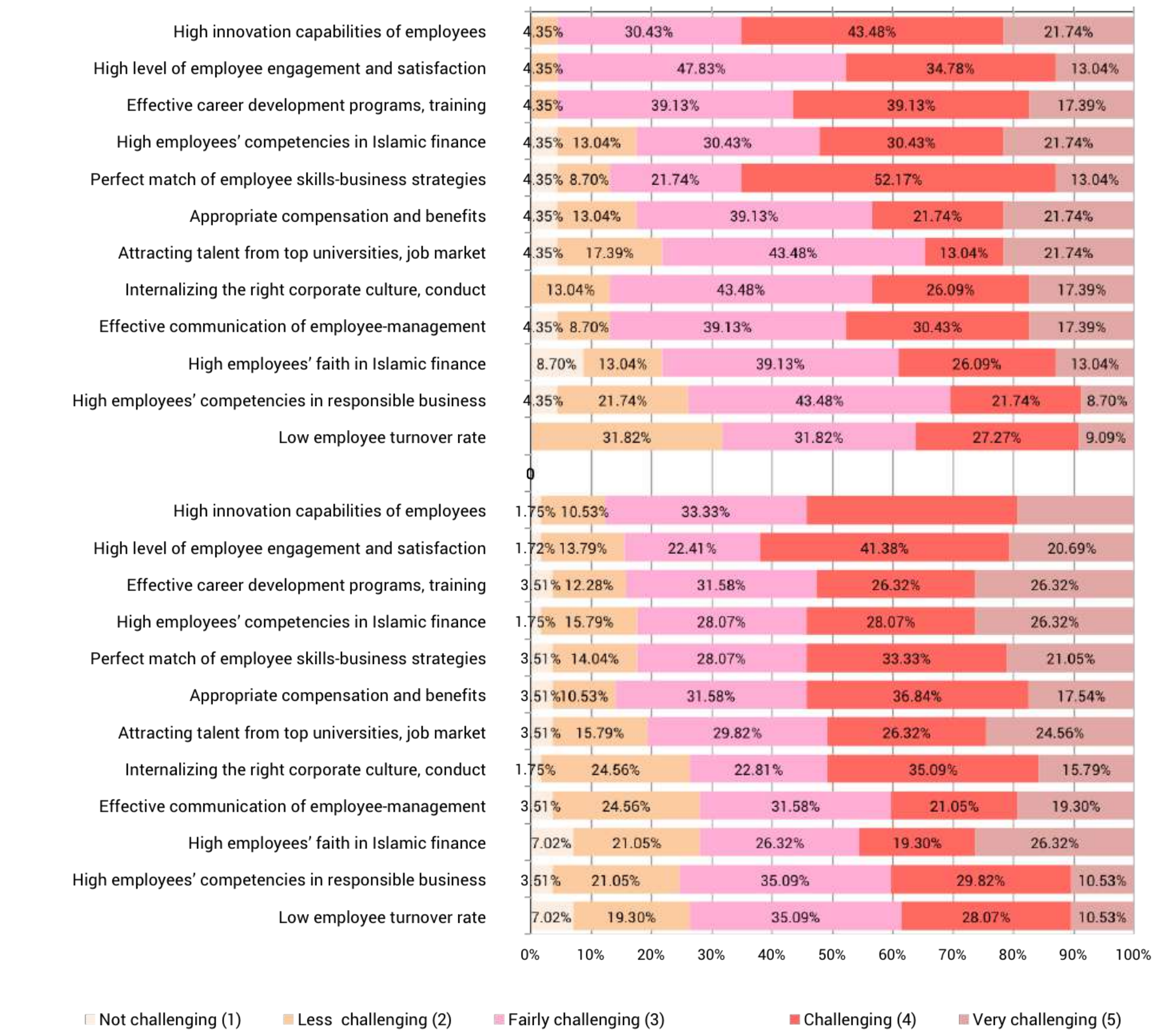
Obtaining a high degree of employees' competencies in Islamic finance is fairly challenging, while low employee turnover rate is least challenging. Small banks faced more challenges in maintaining high level of employee engagement and satisfaction, while large banks think that developing high innovation capabilities of employees and a perfect match between employee skills and overall business strategies are the most challenging aspects in promoting high quality employee relations (Figure 28). The

Developing high innovation capabilities of employees, effective career development programmes, mentoring, succession plans, training, as well as maintaining high levels of employee engagement and satisfaction are among the top challenges that Islamic banks face in promoting high quality employee relations for superior business performance.

degree of challenges in promoting high quality employee relations and development varies across regions. Banks in West, Central and South Asia (Group 4) and Europe and others (Group 7) faced the fewest challenges compared to other regions.

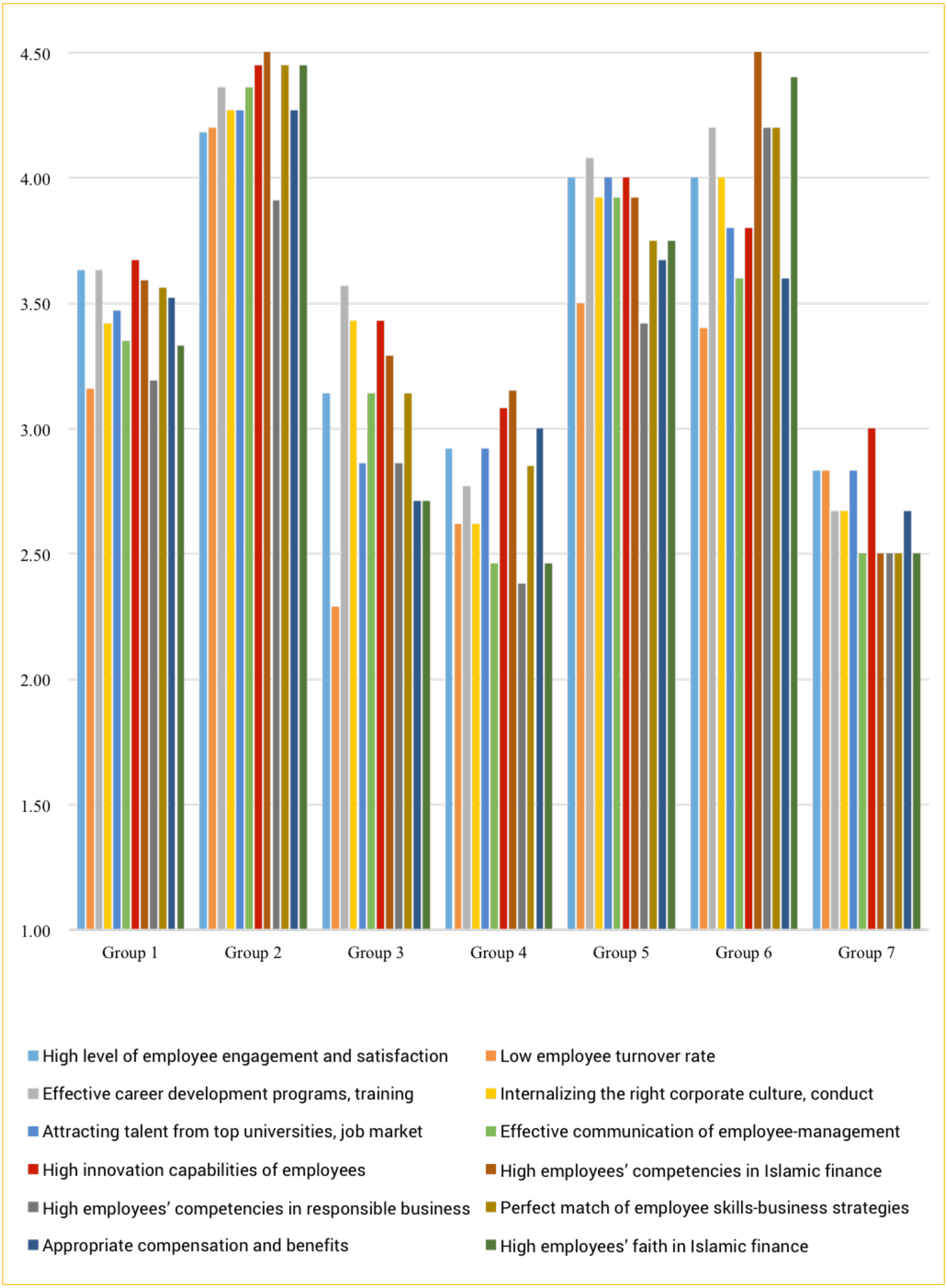
Banks from the Middle East ex-GCC (Group 2) and to a large extent, North Africa (Group 5) and Sub-Saharan Africa (Group 6) are among those that have the highest challenges in this area (Figure 29).

By understanding the economic benefits of human capital investments, Islamic banks can effectively devote resources on employee development in ways that are supportive of their strategy and ability to succeed. Appropriate human capital development strategies in the Islamic banking sector can not only ensure that a bank's employees have the right skill set to execute its business strategy, but also increase its ability to attract and retain talent, and maximize its employees' motivation. This, in turn, maximizes its productivity and potential for innovation. Islamic banks should invest in enhanced training of employees and implement an appropriate, well-balanced compensation framework for all of their employees, adopting compensation plans that are oriented toward long-term incentives.



Large banks (top set) and small banks (bottom set)

Figure 28: Degree of challenges banks face in promoting high quality employee relations (Large and Small Banks)

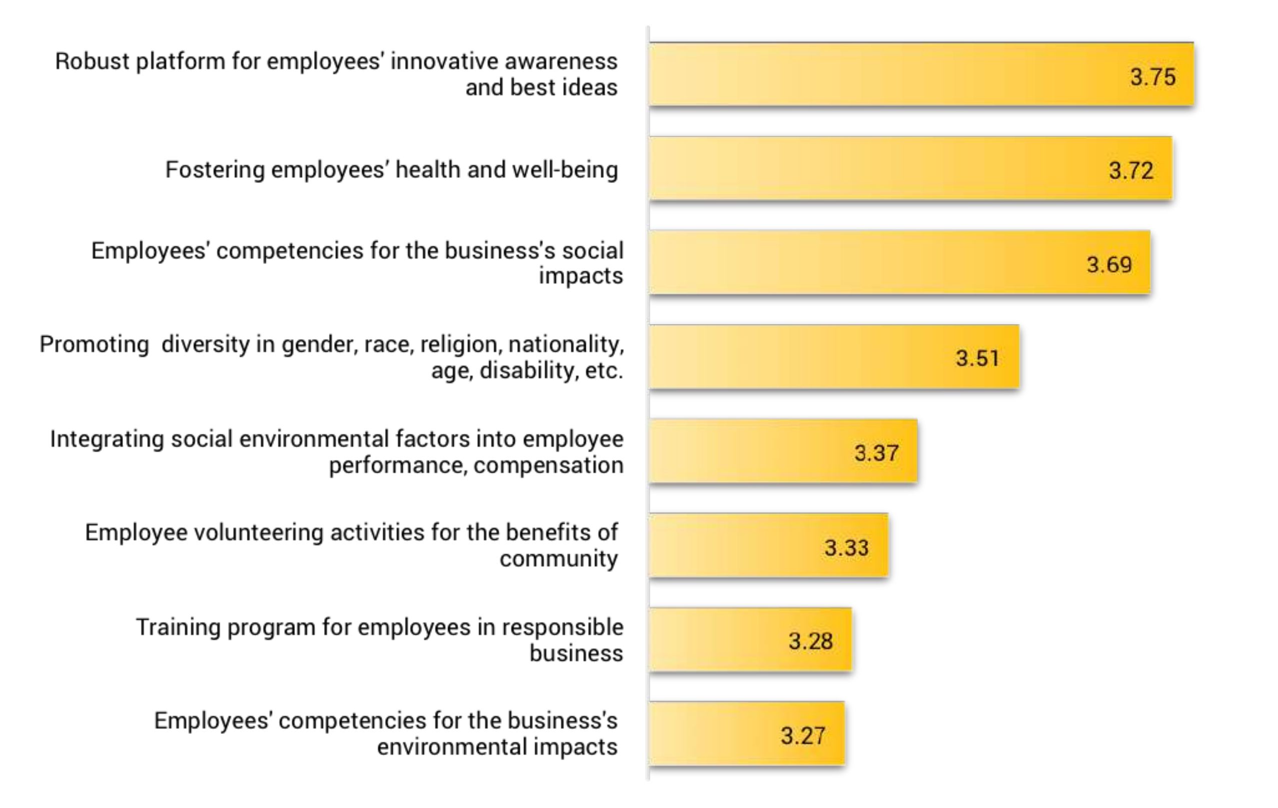


1.Not challenging; 2.Less challenging; 3.Fairly challenging; 4.Challenging; 5.Very challenging

Figure 29: Degree of challenges banks face in promoting high quality employee relations (Group-wise)

Islamic banks were asked to indicate the initiatives relating to employee well-being and employee performance in responsible business that they will take over the next 1-3 years to enhance their overall business performance. A score of 1 represents no implementation and 5 represents very high level of implementation or improvement.

The top three initiatives as shown in Figure 30 are a) a robust platform that raises innovative awareness and recognizes the best ideas among employees at the bank; b) fostering employees' health and well-being (e.g. stress management, ergonomical workplace, child care, health programmes, etc.); and c) competencies of employees across departments to manage the social impacts of the bank's business. This pattern is also applicable in the case of small banks, with an additional key initiative of promoting diversity in gender, race, religion, nationality, age, disability, etc. (Figure 30). Smaller banks expect to improve employees' competencies for the banks' social and environmental impacts, while larger banks will implement robust platforms for employees' innovative awareness and best ideas in the next few years. There are similar degrees of implementation across all banks, regardless of size, in the integration of social and environmental factors in employee performance and compensation packages as well as in employee volunteering activities for the benefits of community (education for entrepreneurs, sports, community outreach, fundraising, etc.) (See Figure 31). There is a wide difference of approach across the regions. Competencies of employees across departments to manage social impacts of banks' business is viewed as important to enhance the overall business performance



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 30: Employee Performance in Responsible Business

of banks from the Middle East ex-GCC (Group 2) and Sub-Saharan Africa (Group 6). It is considered as the least important aspect by banks in Europe and other regions (Group 7). A robust platform that raises innovative awareness and recognizes the best ideas among employees is also an important agenda across most regions especially in South East Asia (Group 3), West, Central and South Asia (Group 4), and Europe and other regions (Group 7) (Figure 32).

Employee engagement and communication are key aspects of corporate sustainability. Studies show that employees who participate in social or environmental activities are twice as satisfied with their jobs as those who do not. An opportunity to give back to society without having to forgo a promising business career can be a major incentive for valuable employees to stay. Empowering employees to take time off to contribute to a social issue they care about can also enhance connectedness to their employers.

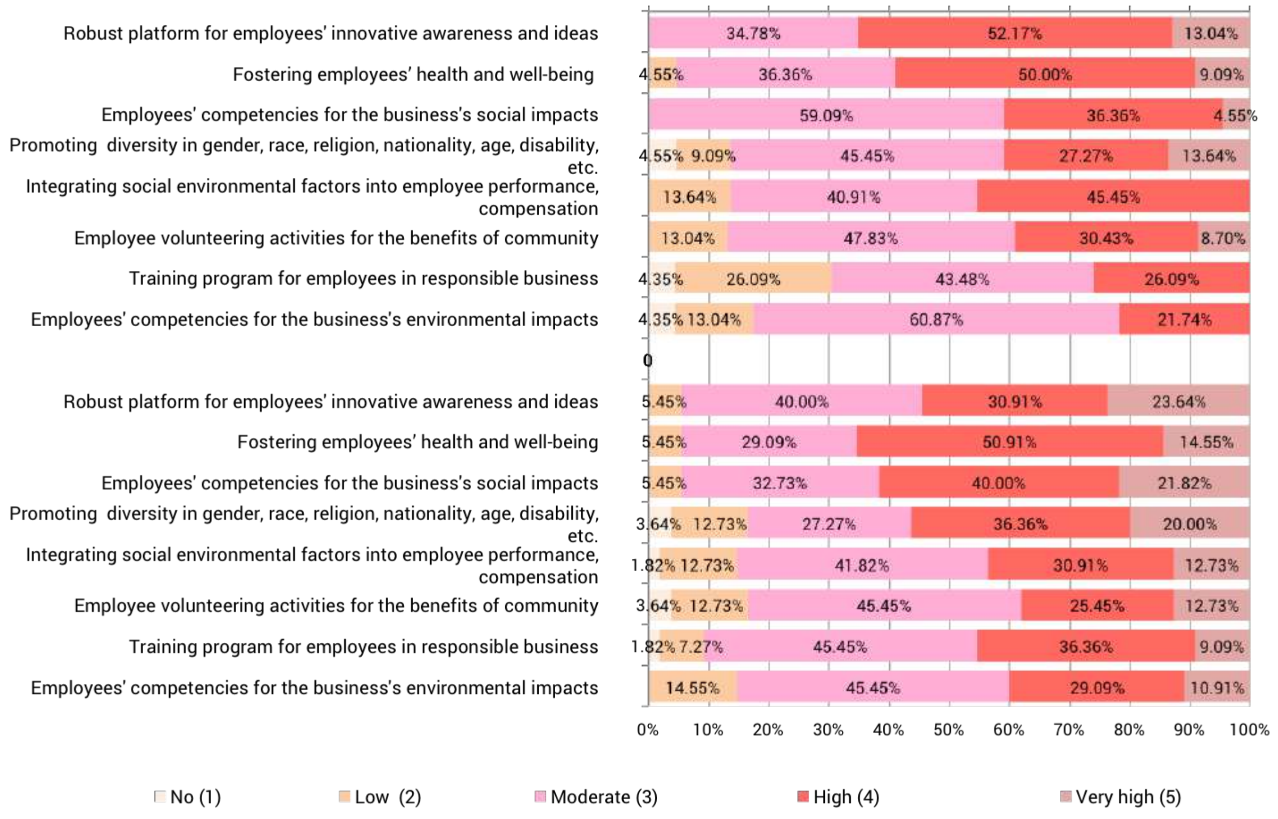
Islamic banks should capitalize on the new form of social engagement – one that recognizes that social impact might be larger if employees apply their existing skills from their commercial activities to social issues.

These projects can also offer the opportunity for

> “Islamic banks should capitalize on the new form of social engagement – one that recognizes that social impact might be larger if employees apply their existing skills from their commercial activities to social issues .”

extending these skills in ways that might be commercially viable. [4]

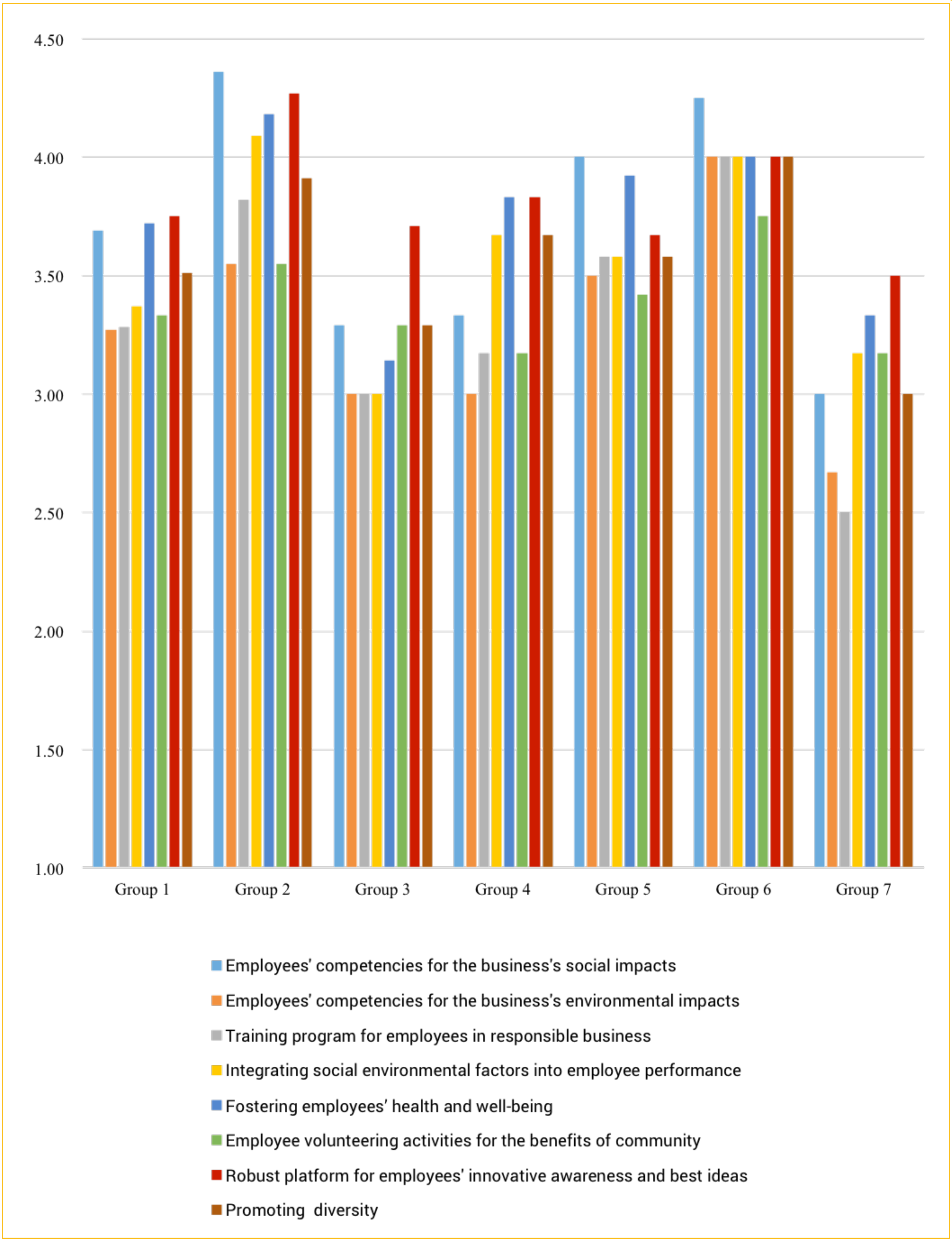
Workplace wellness programmes are emerging as a common employer-sponsored benefit that seeks to contain health care costs, reduce health risk factors, and increase healthy behaviour. As a result, companies are realizing that their societal agenda has to be integrated with their core business in order to have a sustained and large-scale social impact. Given the long latency between health risks and development of manifest diseases, a much longer follow-up period will be required to fully capture the effect of worksite wellness programmes on health outcomes and cost. Islamic banks should assess the long-term impact of their wellness programmes and design programmes that are most likely to achieve wellness goals. Contextual factors such as workplace culture and leadership support as well as financial incentives might also modify programme impacts.



Large banks (top set) and small banks (bottom set)

Figure 31: Employee performance in responsible business and employee well-being initiatives banks implement /will improve over the next 1-3 years (Large and Small Banks)

[4] Singh, Jasjit. 2015. "Corporate Social Impact Initiatives Make Employees More Loyal." INSEAD. 27 August



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 32: Employee performance in responsible business and employee well-being initiatives banks implement /will improve over the next 1-3 years (Large and Small Banks)

5. DEVELOPING HIGH QUALITY CUSTOMER RELATIONS

Banks were asked about the extent to which certain high quality customer relations have been developed in achieving superior business performance. Scores represent the perceived level of achievement.

1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 33: Customer Relations

and redress mechanism of customer's satisfaction and complaints through, for example, regular monitoring, quantitative targets, and efficient customer satisfaction improvement (Figure 34). Interestingly, banks from South East Asia (Group 3) consider most of the customer relation initiatives as moderate in terms of development relative to other regions. Improvement of the bank's KYC and other client screening mechanisms is generally the most developed aspect in all regions (Figure 35). This may reflect regulatory pressures.

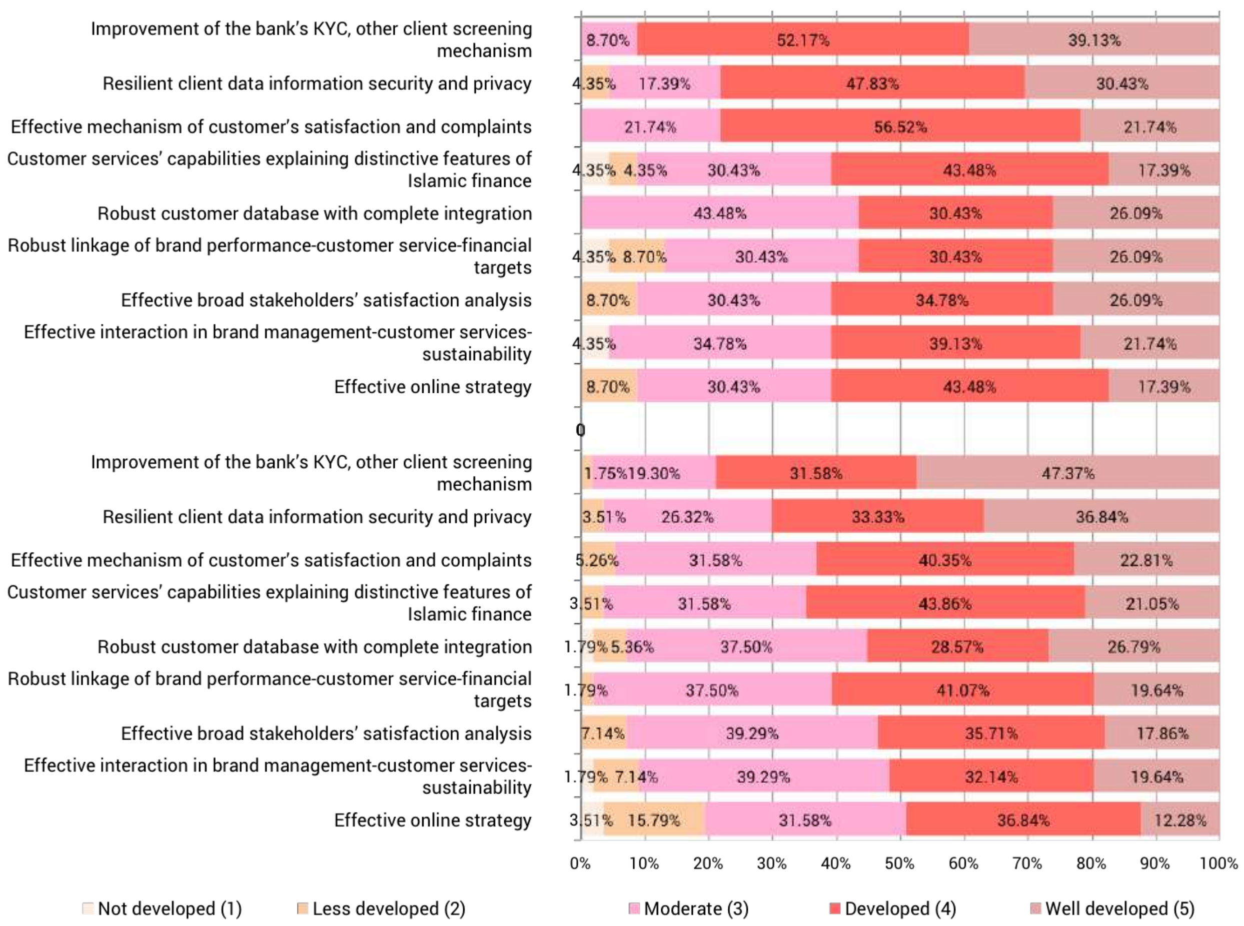
Strong relationships with customers can lead to better customer loyalty. The value of retaining customers makes perfect business sense when one considers that a consumer retained for life is more cost effective, requires less service, provides more business and contributes to new customer acquisition by offering positive referrals. However, in an evolving regulatory environment, processes, inefficient policies and processes in Know Your Customer (KYC) and information security can pose a threat to customer retention.

The Survey shows that there are two key initiatives that have been developed ahead of other initiatives in customer relations management: a) improvement of the bank's KYC and other client screening mechanisms; and b) resilient client data information security and privacy (Figure 33). In addition to these two initiatives, large Islamic banks give more focus on effective evaluation

As the frequency and magnitude of information security risks continues to rise with the proliferation of new technologies and the sophistication of those who pose threats, banks will be required to devote more resources to risk mitigation and regulatory compliance. For Islamic banks to stay ahead of the regulatory curve and to enhance transparency in their operations, it is important that they optimise their KYC policies through proactive and dynamic tracking models that monitor information from the primary source. Seamless system integration and automatic feed with accurate filter and control of information can reduce operational risk and, at the same time, respond to regulatory development. Feedback loops should also be implemented between KYC operations and the rest of the business in the bank.

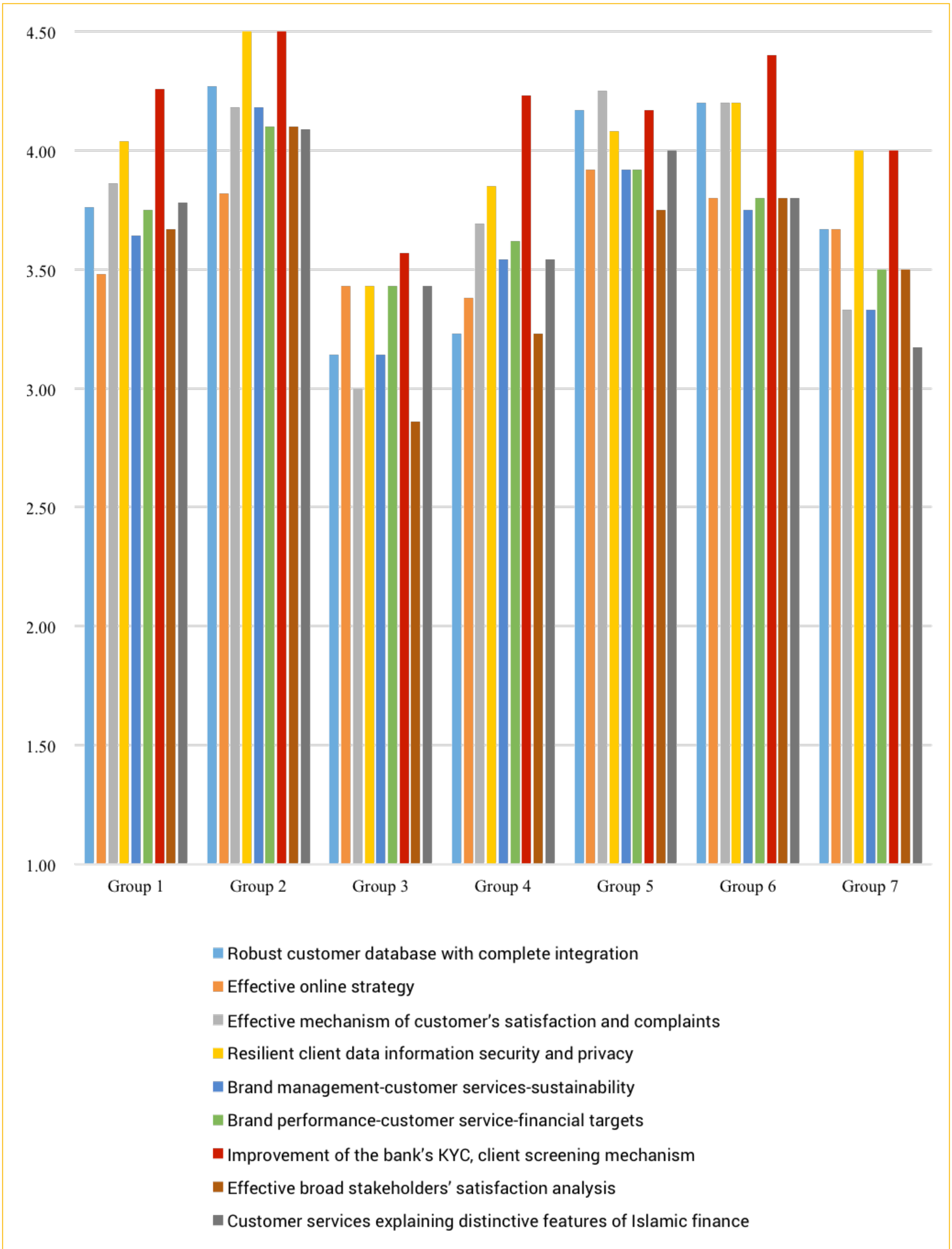
Since online presence and channels have reshaped the customer relationships in the recent years, Islamic banks need to be present on several platforms to reach out to customers. Additionally, improvement in customer relationship management tools can provide important data which allows Islamic banks to target relevant customer groups, develop specific products, and ensure that they have all relevant information to strengthen customer relationships. For example, one bank in the Middle East ex-GCC installed an advanced customer visit management system in order to enhance customer service and experience in parallel with more efficient planning of human resources. Another bank in South East Asia is reviewing its delivery ecosystem by formulating strategies under a branch transformation to increase the efficiency and effectiveness on physical branches, delivery processes, people, and technology. Similarly, a bank in North Africa optimizes the value creation to its customers through customer centric process transformation, products and services simplification, digitalisation, governance and performance management, and delivery model optimisation. Simplification is engineered by rationalising product sets based on what customers value the most and adapting modular product architecture in accordance with tiered, component-based design, shared common components across product lines, and isolated components that drive cost of complexity. In the 'Europe and other' region, a bank launched the 'customer experience and multichannel strategy project' in 2013 to provide customers with the most transparent and comparable information concerning the bank's products and services and to enhance the customer experience at all contact points.

For Islamic banks to stay ahead of the regulatory curve and to enhance transparency in their operations, it is important that they optimise their KYC policies through proactive and dynamic tracking models that monitor information from the primary source.



Large banks (top set) and small banks (bottom set)

Figure 34: Extent to which high-quality customer relations are developed by banks in achieving superior business performance (Large and Small banks)



1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 35: Extent to which high-quality customer relations are developed by banks in achieving superior business performance (Group-wise)

6. BANKING PRODUCT RESPONSIBILITY AND FINANCIAL CONSUMER PROTECTION

Banks were asked about the extent to which they have developed certain policies and mechanisms for equitable and fair treatment of clients. A score of 1 indicates that policies and mechanisms are not developed, while 5 indicates a high level of development.

1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 36: Fair Treatment of Clients

Banking can be both fair and profitable – in fact, fairness can be a source of competitive advantage. As such, banks must be able to demonstrate consistently that fair treatment of customers is at the heart of their business model. Fair treatment of customers can lead to several consumer outcomes: a) consumers can be confident they are dealing with banks where the fair treatment of customers is central to the corporate culture; b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly; c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale; d) where consumers receive advice, the advice is suitable and takes account of their circumstances; e) consumers are provided with products that perform as banks have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect; and f) consumers do not face unreasonable post-sale barriers imposed by banks to change product, switch provider, submit a claim or make a complaint.[5]

Two key mechanisms stand out as developed in the Islamic banking sector (Figure 34): a) service charges, profit rates, and the basis of calculations are transparent to customers; and b) screening of documents (i.e. forms, etc.) by Shariah supervisory board or its agent to avoid imposition of burdensome terms and conditions to clients. This finding is consistent in both small and large banks (Figures 37). As an illustration, one bank from GCC seeks to promote financial education and awareness to help consumers develop knowledge to understand risks and make informed choices. At the same time, the bank ensures that there are no malpractices and mis-selling in marketing and transaction documents, reinforced by the active role of Shariah supervisory board and Shariah department. In the South East Asia region, a bank highlighted its role as a strong advocate of responsible financing, echoing the central bank's macro prudential measures to ensure that the customers do not overstretch their financing commitments. Another bank from West, Central and South Asia mentioned that it provides compensation to customers in case of non-compliance.

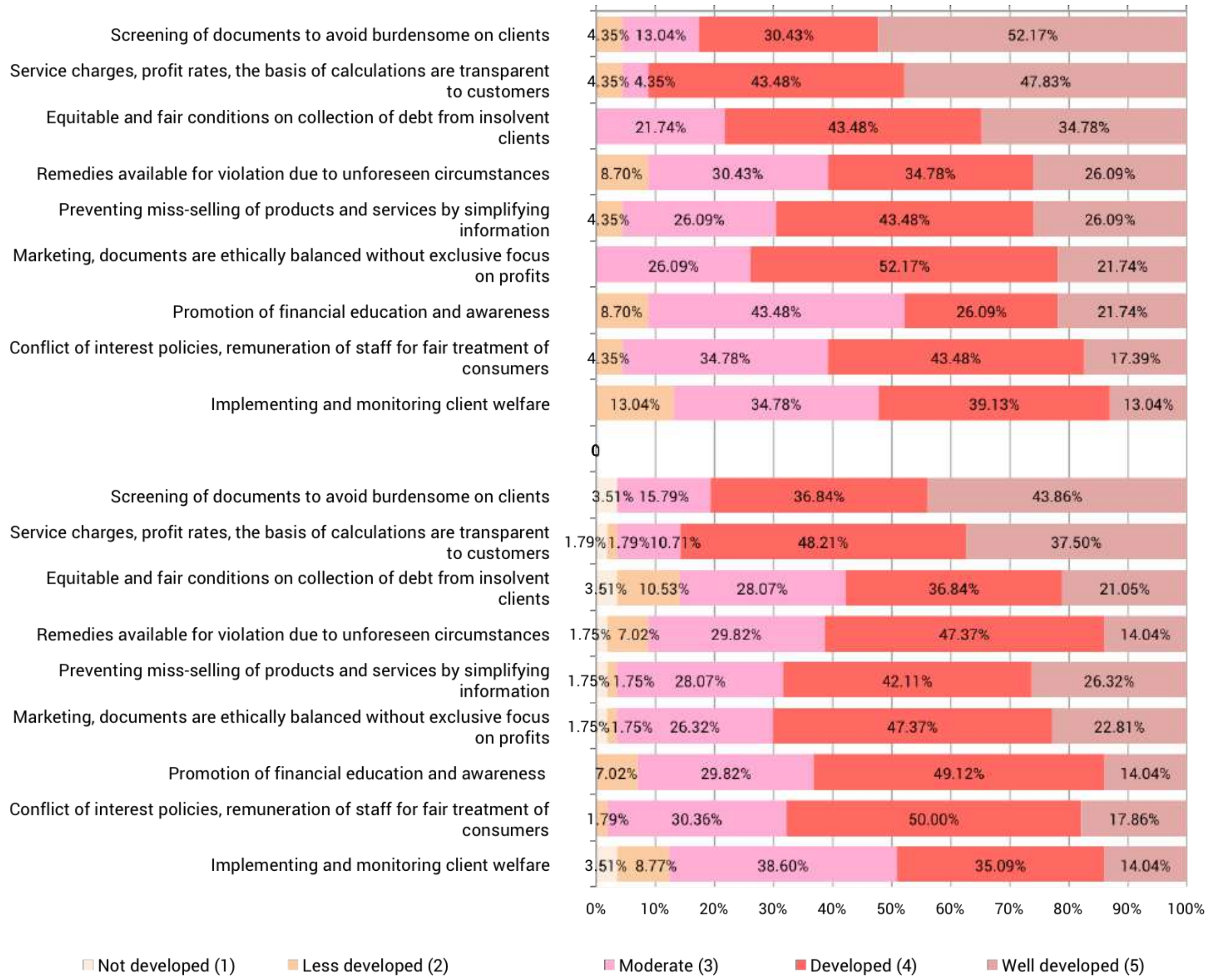
From a regional grouping perspective, the transparency of service charges, profit rates, and the basis of calculations to customers is considered the most developed in relative to other fair treatment initiatives in all region except for West, Central and South Asia (Group 4) and, to some extent, Sub-Saharan Africa (Group 6). Banks from the GCC (Group 1), Middle East ex-GCC (Group 2) and North Africa (Group 5) have relatively more developed policy and mechanism for equitable and fair treatment of clients compared to other regions (Figure 38).

Going forward, Islamic banks should build fairness into the entire business system: in processes, systems, and the culture of the organization. Product responsibility and fair treatment of customers can be enhanced across the whole value chain: product development, financing processing and approval, troubled financing management, termination and enforcement, customer engagement, and public engagement. In terms of product development, IT support can be given for real-time credit advice in the form of "feasible" monthly budgeting and real-time flexible payment modifications. Indebtedness protection can be built into credit card. Islamic banks can also conduct assessments based on individual rather than socioeconomic risk-group scores as well as develop automated approval to ensure efficiency. "Collaborative problem solving" rather than threats and options for delayed or reduced payments according to the customer's circumstance are also aligned with Islamic principles. Islamic banks should actively seek feedback from volunteer customer councils on specific product features and evaluations from customers on how well the banks are living up to their values. Partnership with independently operated non-profit foundation dedicated to improving financial literacy among customers as well as the local community can empower the society and enhance the value propositions of Islamic banks.[6]

Product responsibility and fair treatment of customers can be enhanced across the whole value chain: product development, financing processing and approval, troubled financing management, termination and enforcement, customer engagement, and public engagement.

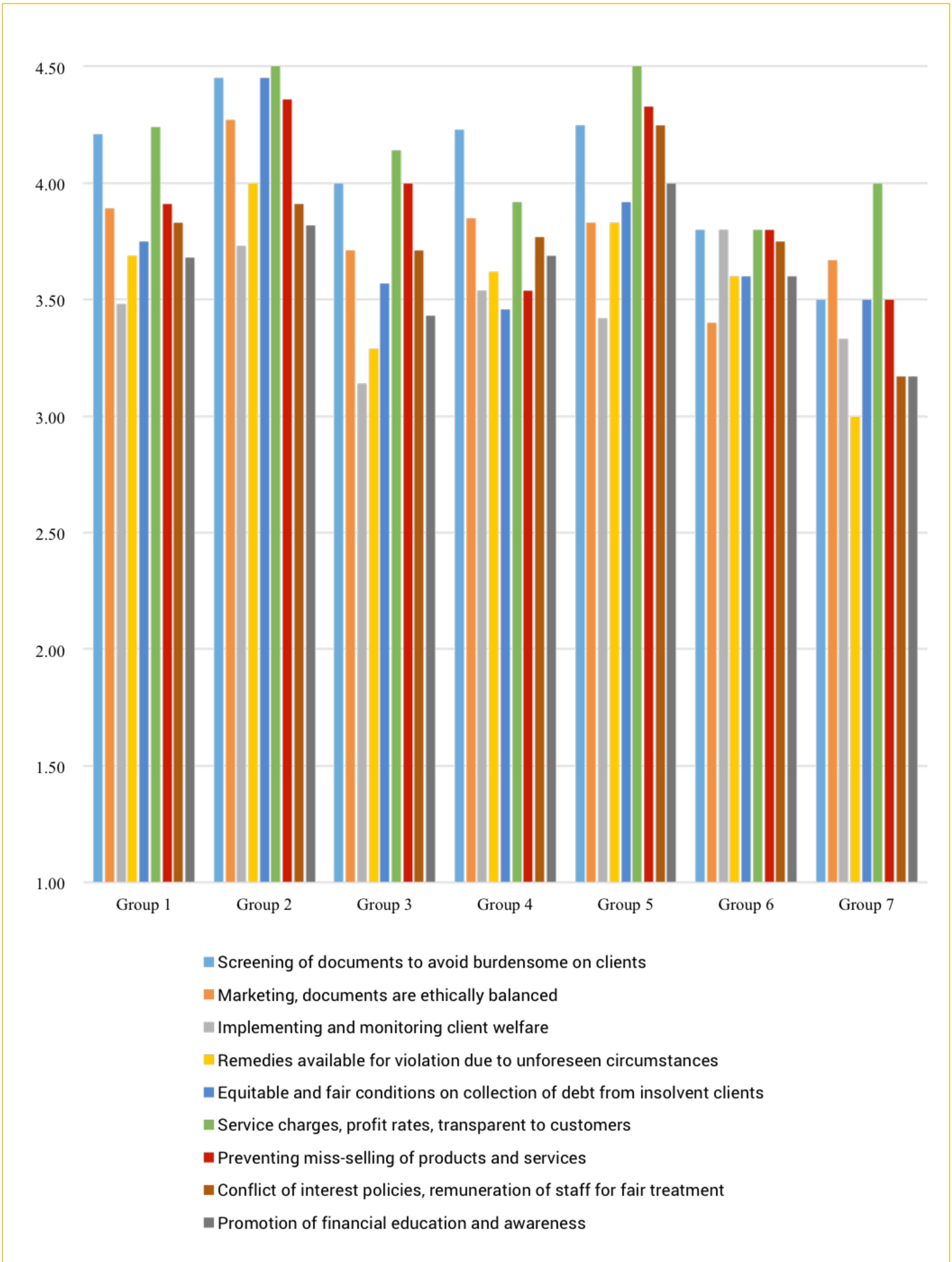
[5]Financial Conduct Authority, United Kingdom.

[6]Christoph H. Loch, Fabian J. Sting, Arnd Huchzermeier, and Christiane Decker. "Finding the Profit in Fairness." Harvard Business Review, September 2012.



Large banks (top set) and small banks (bottom set)

Figure 37: Extent to which policy and mechanism for equitable and fair treatment of clients have been developed by banks (Large and Small banks)

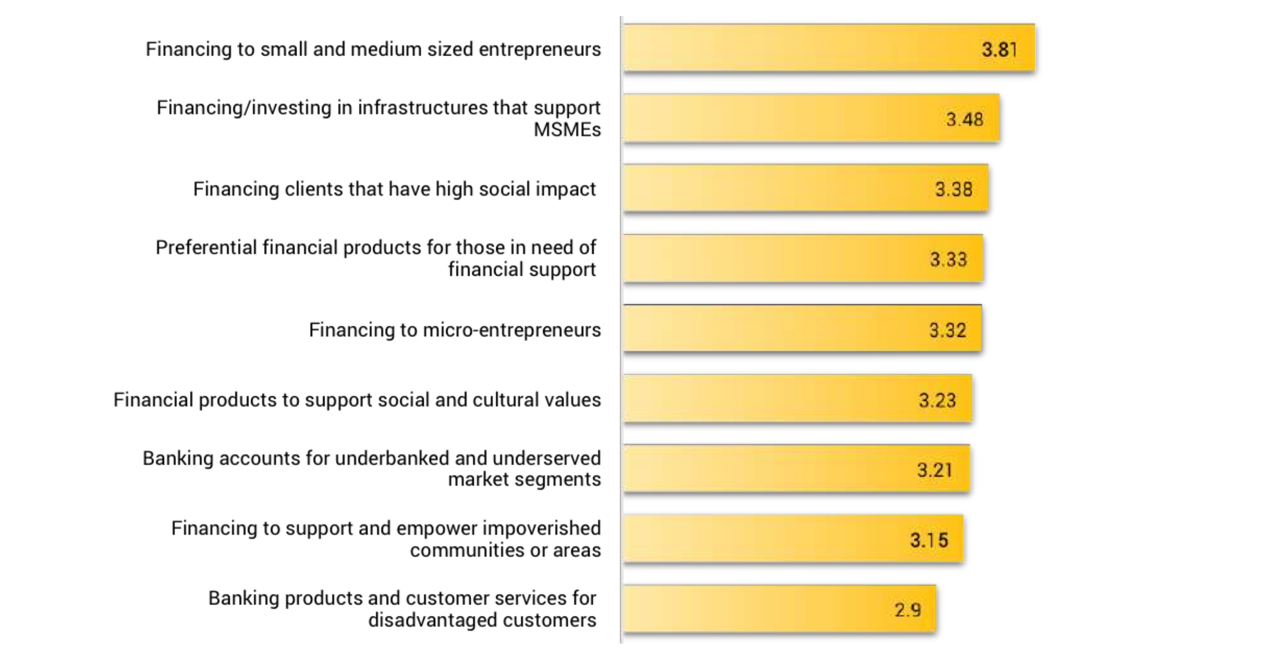


1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 38: Fair Treatment of Clients (Group-wise)

7. FINANCIAL INCLUSION, SOCIAL IMPACT AND MSME FINANCING

Banks were asked about the measures they would focus on to enhance financial inclusion and social impact financing over the next 1-3 years. Score 1 represents no focus while score 5 represents very high level of focus.



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 39: Financial Inclusion and Social Impact Financing

Financial exclusion disproportionately affects the poorest and underserved in society. In many emerging markets, access to financial services for small and medium enterprises (SMEs) remains severely constrained. Over the last several decades, different types of financial services providers have offered new possibilities for the financially excluded. New business models have become viable due to technological breakthroughs, including the global expansion of mobile phones and connectivity.

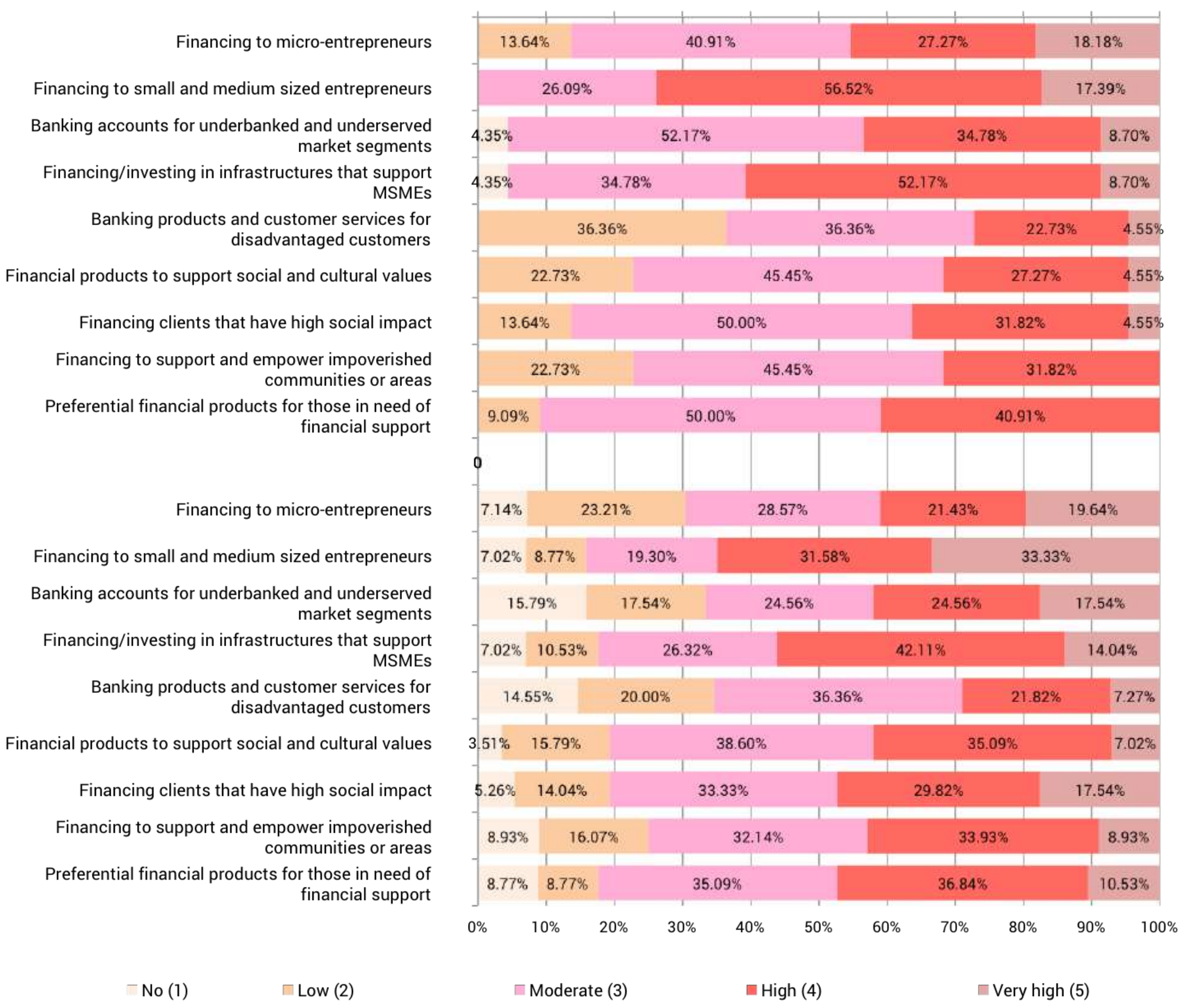
Over the next one to three years, Islamic banks generally will give more focus to SME financing as well as financing/investing in infrastructures that support micro, small and medium enterprises (MSME) (Figure 39). However, there will be low level of focus on banking products and customer services for disadvantaged customers (disability due to physical, sensory, or mental skills, language, cultural, age or gender barriers). These findings are similar in both the cases of small and large banks (Figure 40). Financing SME entrepreneurs is given the highest focus in the GCC (Group 1), Middle East ex-GCC (Group 2), West, Central and South Asia (Group 4), Sub-Saharan Africa (Group 6) and Europe and others (Group 7). Financing clients that have high social impact is particularly given importance by banks in the Middle East ex-GCC (Group 2) (Figure 41).

According to the survey response, one bank operating in the West, Central and South Asian region targets its underserved communities via a) empowerment and capacity building; and b) livelihood development financing. According to the bank, both programmes "inculcate a business orientation that instils a responsible credit culture, devoid of a 'dole out' mind-set that is

> Over the next one to three years, Islamic banks will give more focus to SME financing as well as financing/investing in infrastructures that support micro, small and medium enterprises (MSME)

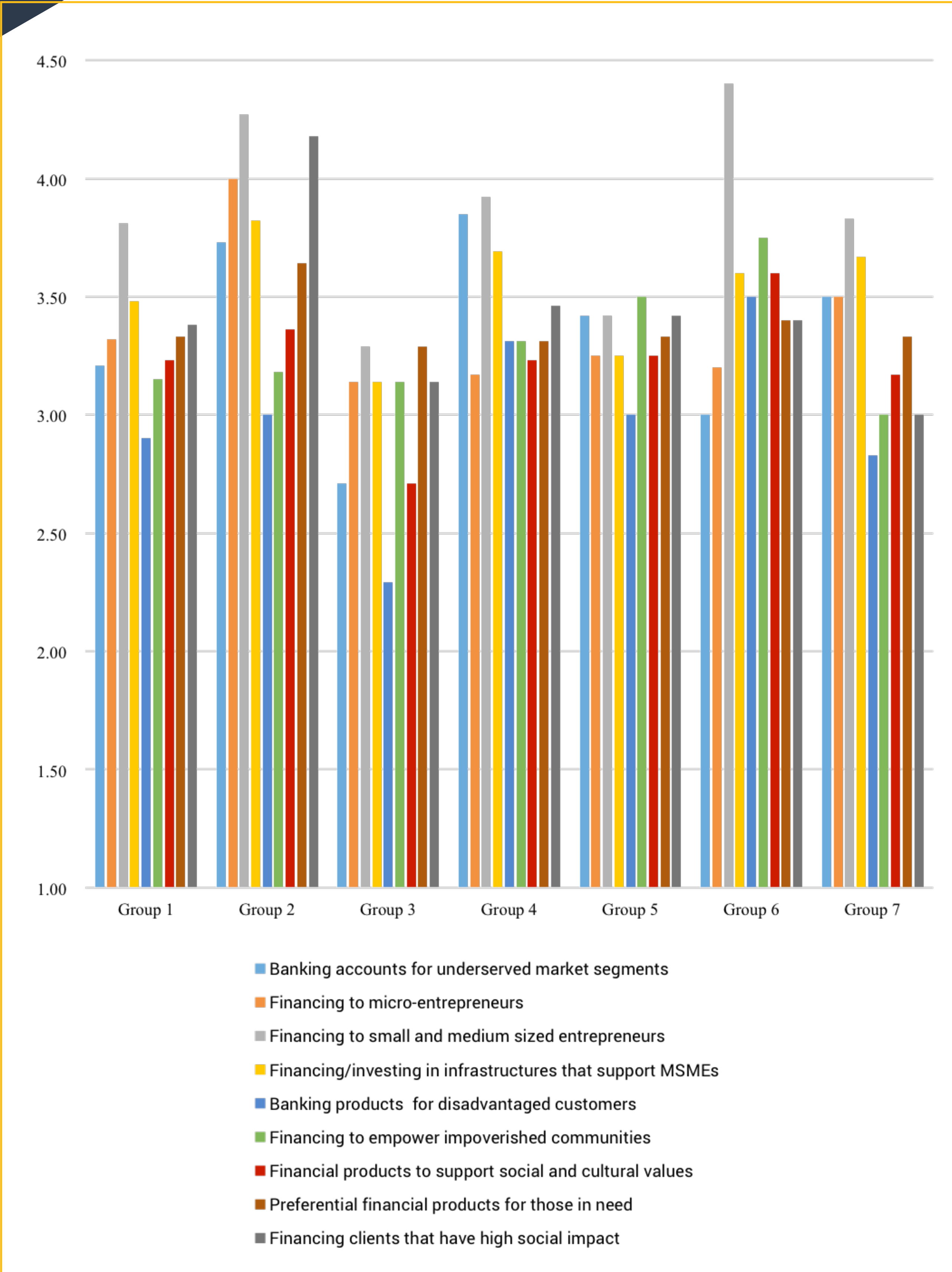
often associated with such initiatives." Promoting self-sufficiency at grass root level, the bank spearheaded the financing of seed paddy farms in 2014, with several tie ups made with corporate and high-end SMEs to finance their grass root level suppliers, particularly small scale tea plantations and suppliers of liquid milk. The bank also financed several small-scale floriculturists and established partnerships between growers and exporters with the collaboration of the country's Export Development Board.

Several financial literacy programmes were conducted for garment factory workers, educating them on the basics of financial management, personal budgeting, investment options and savings. In the South East Asian region, a bank works in partnership with various communities in delivering comprehensive programmes that improve their welfare and livelihoods. The bank's financing scheme includes the rural economy financing scheme, a transformation of sundry shops, modernization of automotive workshops, micro-traders and hawkers scheme fund, a Ramadan bazaar scheme, a micro-financing scheme, as well as the enrichment and enhancement programme.



Large banks (top set) and small banks (bottom set)

Figure 40: Areas banks focus to enhance financial inclusion and social impact financing over the next 1-3 years (Large and Small banks)



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

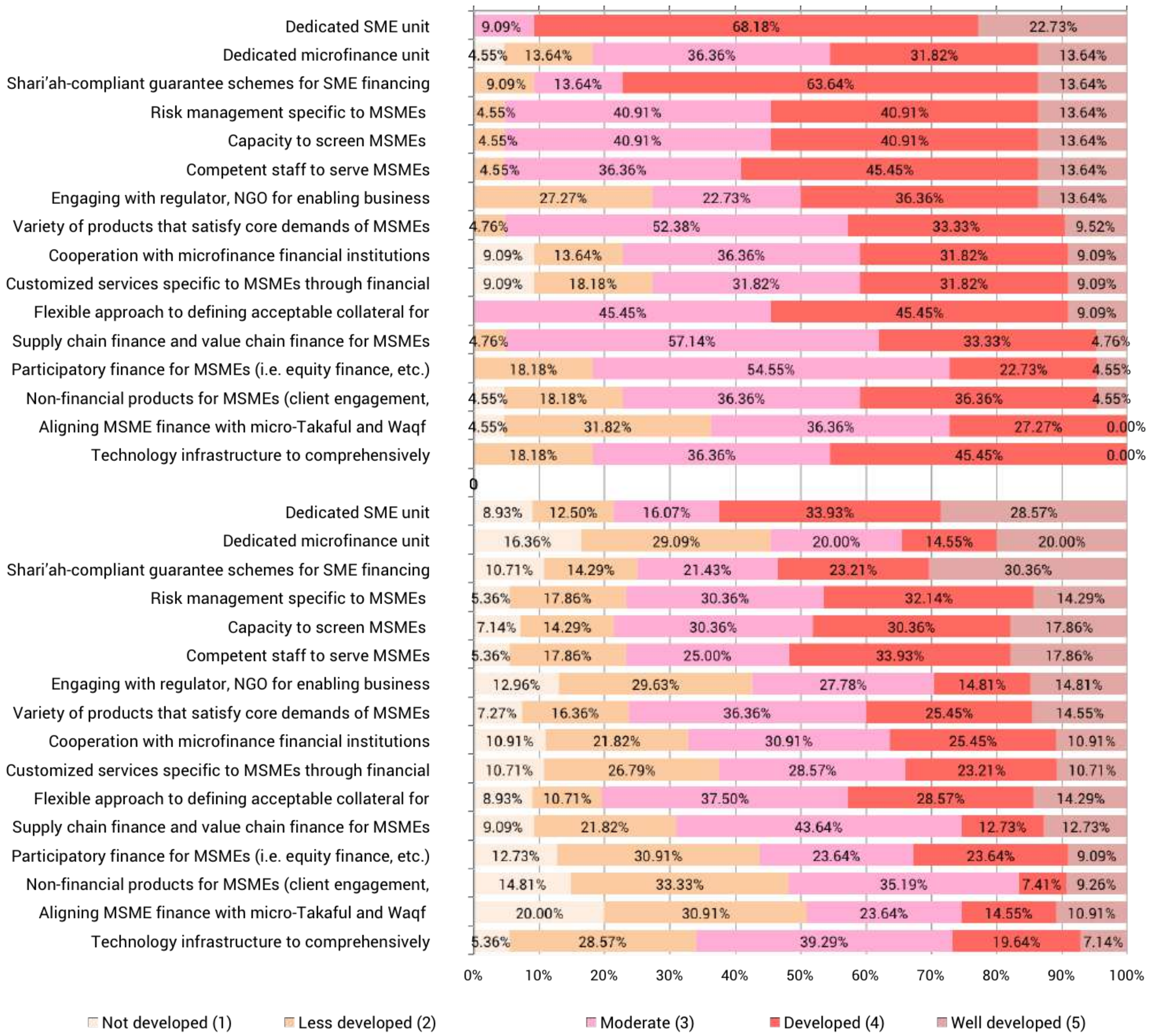
Figure 41: Financial Inclusion and Social Impact Financing (Group-wise)

Banks were asked about the extent to which they had developed a number of possible capabilities to serve the micro, small and medium enterprises (MSME) market. A score of 1 represents no development at all while score 5 signifies well developed capabilities.

1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

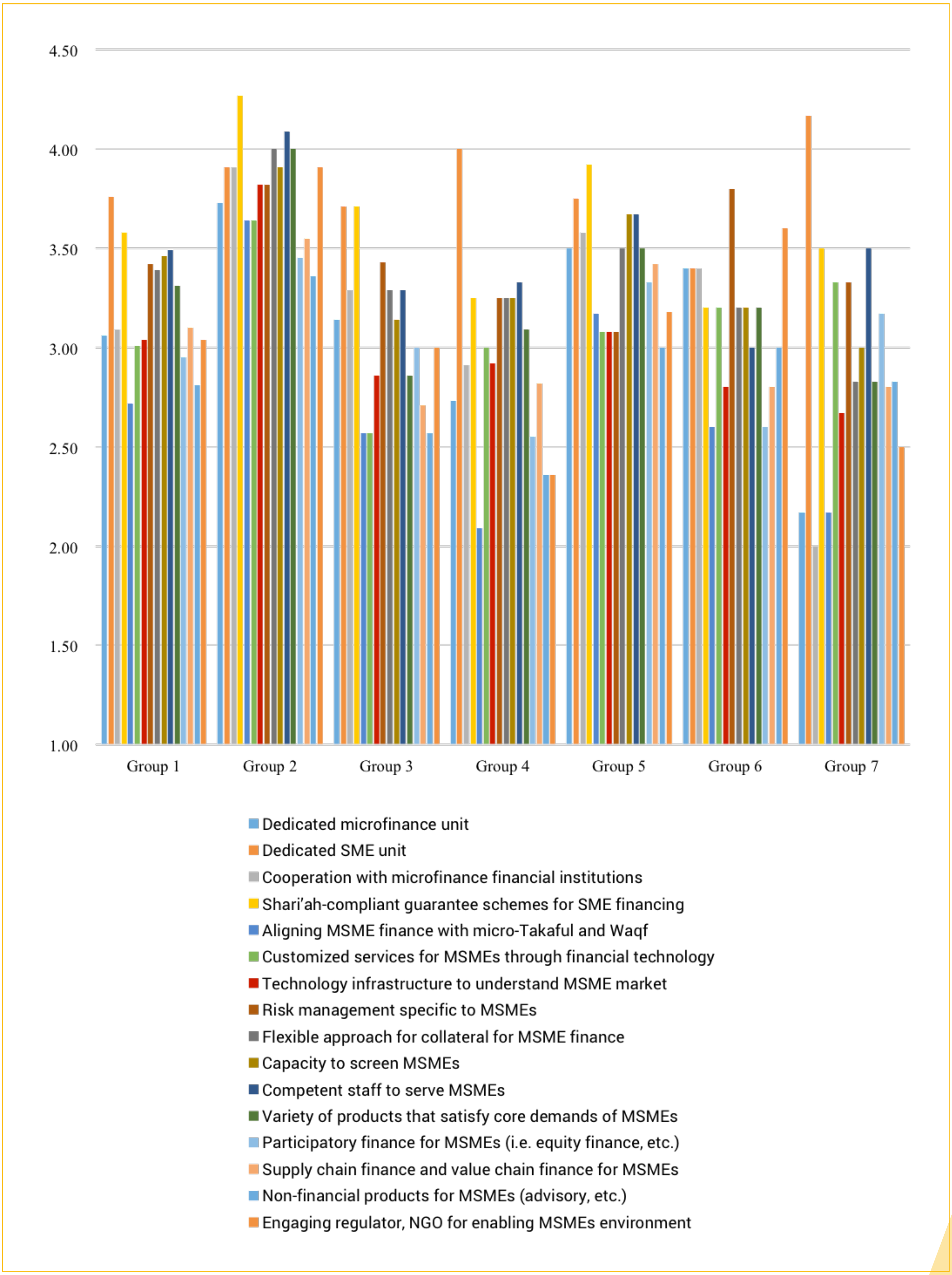
Figure 42: Capabilities in MSME Finance

Despite the increased focus on MSME financing over the next one to three years, most of the capabilities of Islamic banks are at the moderate level of development. In fact, a few capabilities are less developed as shown in Figure 42: a) aligning MSME finance with micro-Takaful and Waqf; b) participatory finance for MSMEs (i.e. equity finance, etc.); and c) non-financial products for MSMEs (client engagement, advisory to empower MSMEs in business and marketing plan and execution, financial skills, etc). Dedicated SME units and Shariah-compliant guarantee schemes for SME financing are featured prominently in most of the large and small banks (Figure 43), though perhaps unsurprisingly it is larger banks that have been able to do more, and have also been able to develop their technology infrastructures more thoroughly. Generally, banks in the GCC (Group 1), West, Central and South Asia (Group 4) and Europe and others (Group 7) consider dedicated SME units as the more developed capability to serve the MSME market compared to other capabilities. Shari'ah-compliant guarantee schemes for SME financing are the most developed in the Middle East ex-GCC (Group 2) (Figure 44).



Large banks (top set) and small banks (bottom set)

Figure 43: Extent to which capabilities to serve MSME market have been developed by banks



1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 44: Capabilities in MSME Finance

8. COMMUNITY RELATIONS AND CORPORATE PHILANTHROPY

Banks were asked to indicate from a list their top five philanthropic and social programmes. The percentage of banks is reported below based on the order of importance accorded to the programmes.

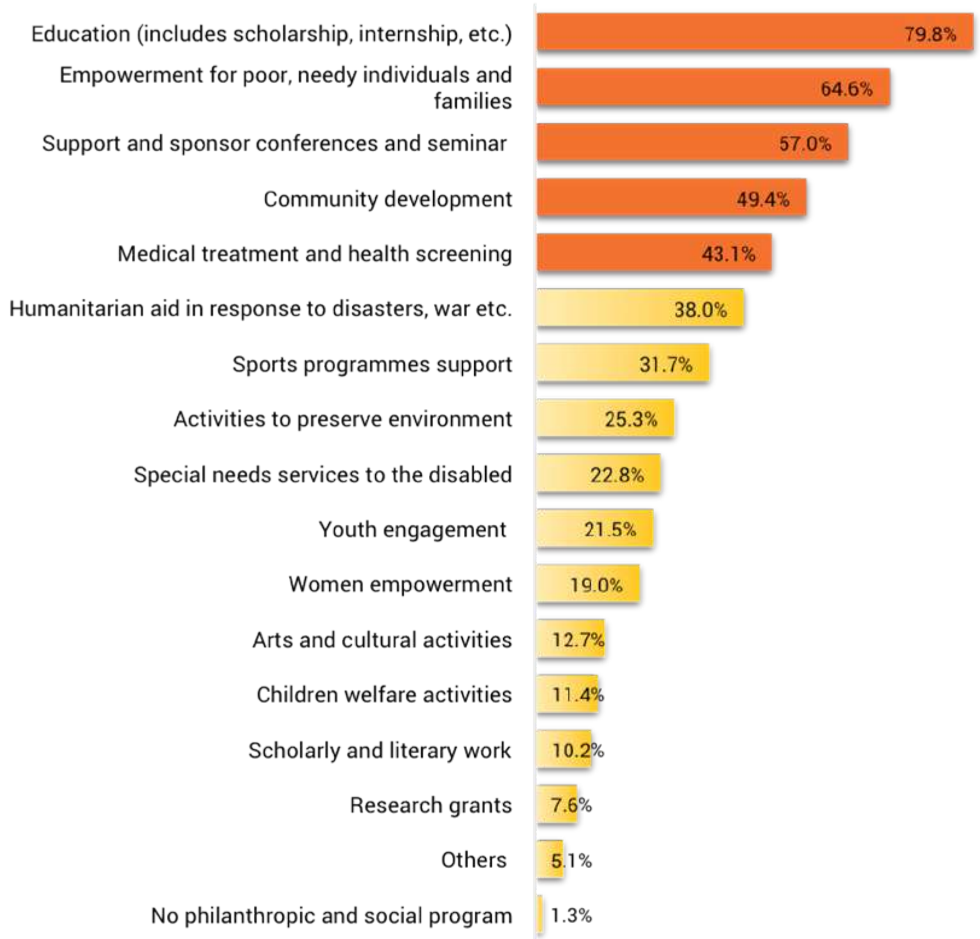


Figure 45: Banks Score "Top Five" Philanthropic and Social Programmes

Banks generally commit themselves to taking philanthropic action to support programmes that help address crucial social issues. In the case of the Islamic banking sector, the top three philanthropic and social programmes are: a) education (includes scholarship, internship, etc.); b) empowerment for poor and needy individuals and families; and c) support and sponsor conferences and seminar (Figure 45), although community development is featured more prominently than c) in the case of large banks (Figure 46). In terms of regional grouping, support for education is prominent across banks in the GCC, South East Asia (Group 3), West, Central and South Asia (Group 4), and Europe and others (Group 7). Empowerment for poor and needy individuals and families commands the highest significance across banks in the Middle East ex-GCC (Group 2), South East Asia (Group 3) and North Africa (Group 5) (Figure 47).

Several examples can be derived from the survey response. One bank from the GCC provides Qard-hasan for educational needs and forges partnership with specialized companies to finance social projects. Another bank from the same region has a mutual benefit and cooperation fund to provide assistance to employees who are unable to meet financial obligations in cases of emergencies and dire needs. In the Middle East ex-GCC, a bank collaborated with the Food and Agriculture Organization of the United

Nations (FAOUN) and a welfare organization to address social issues in the country. A fund was created by a consortium of banks and zakat organizations to alleviate poverty in North Africa. In South East Asia, one particular bank extended financing to the developer of waqf land where houses were built on the land and proceeds were channelled to the Islamic religious authority governing waqf land to further benefit the poor and the needy. Another bank optimizes its impact to the local economic development through a joint venture with a state Islamic institution to collect waqf fund for education and health improvement as well as a debit card facility associated with waqf in which a portion of the fee charges is channelled into the waqf fund.

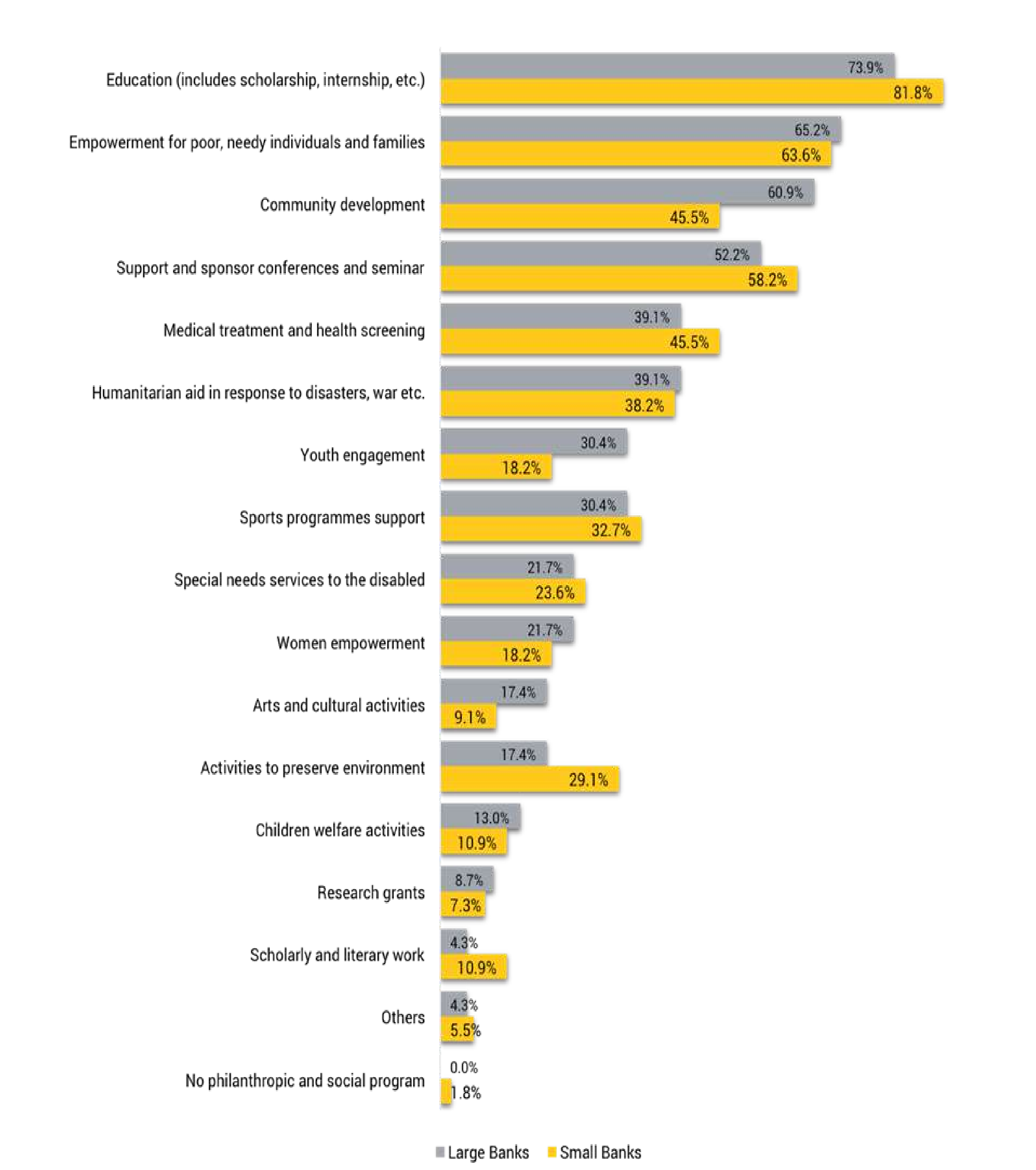


Figure 46: Philanthropic and Social Programs - Large Banks and Small Banks

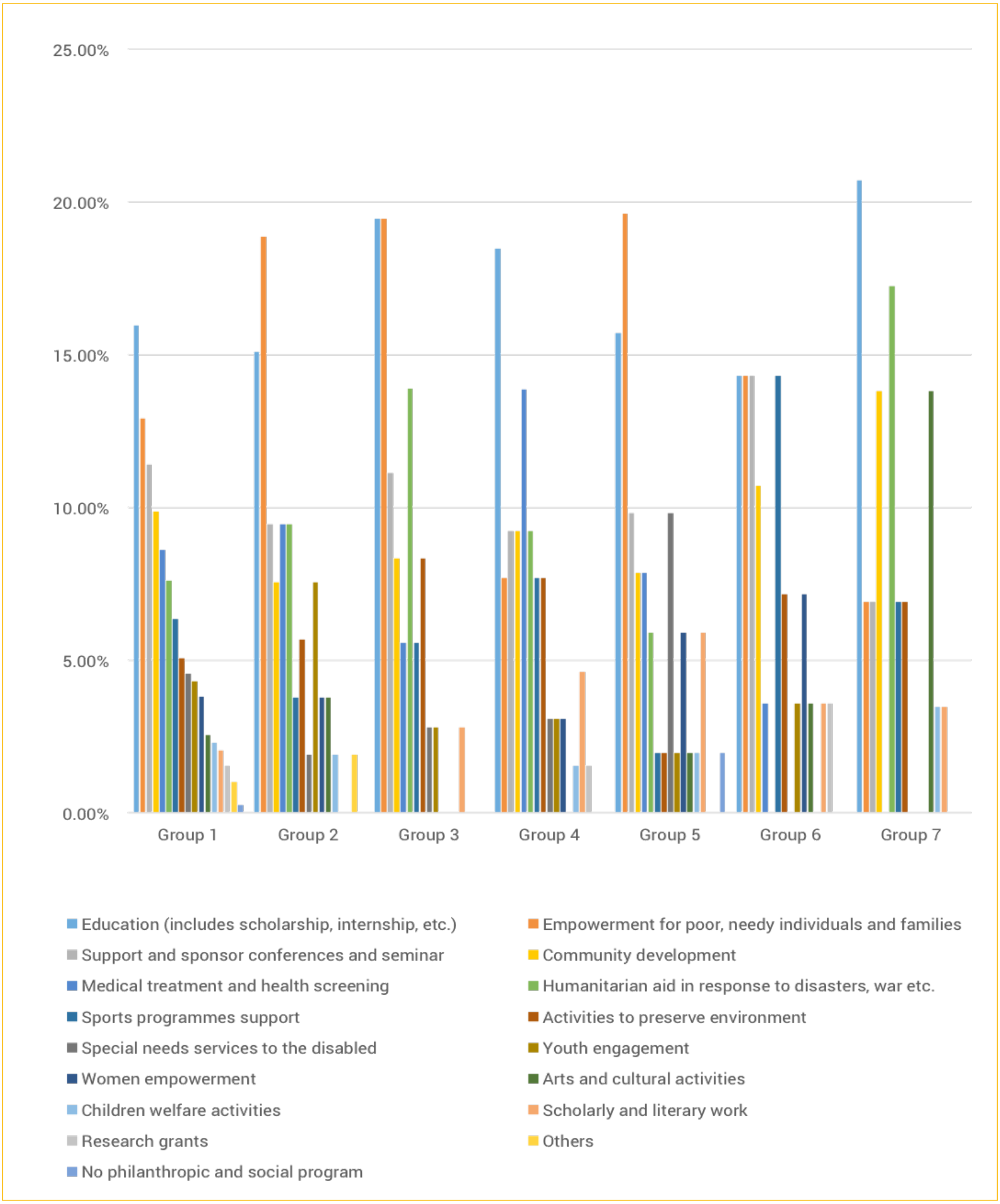


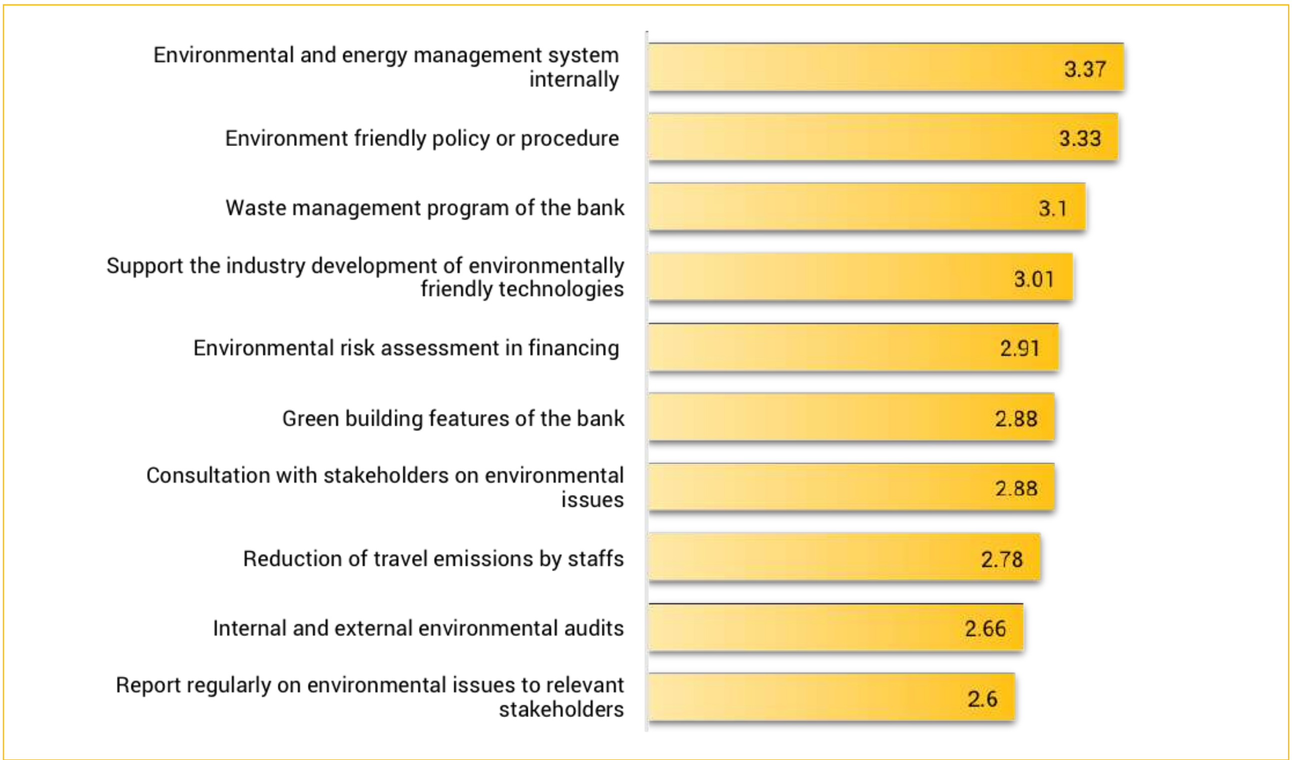
Figure 47: Philanthropic and Social Programs scored by Banks in order of importance accorded by them (Region-wise)

The environmental aspect of sustainability includes the corporate impact on the environment, either through the consumption of non-renewable natural resources or through the production of harmful environmental externalities

9. ENVIRONMENTAL POLICY, ENVIRONMENTAL MANAGEMENT SYSTEM AND PROCEDURES

Banks were asked about the extent to which certain environment-friendly business practices have been developed. Score 1 represents that practices are not developed while 5 represents a high level of development.

and b) environment friendly policy or procedures across all operations of the bank being more developed in relation to other practices. This pattern is similar across small and large banks. Interestingly, there is no significant difference between small and large banks with regard to environmental risk assessment in financing and support given to industry development and diffusion of environmentally friendly technologies (Figure 49). Internal environmental and



1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 48: Environment-friendly Business Practices

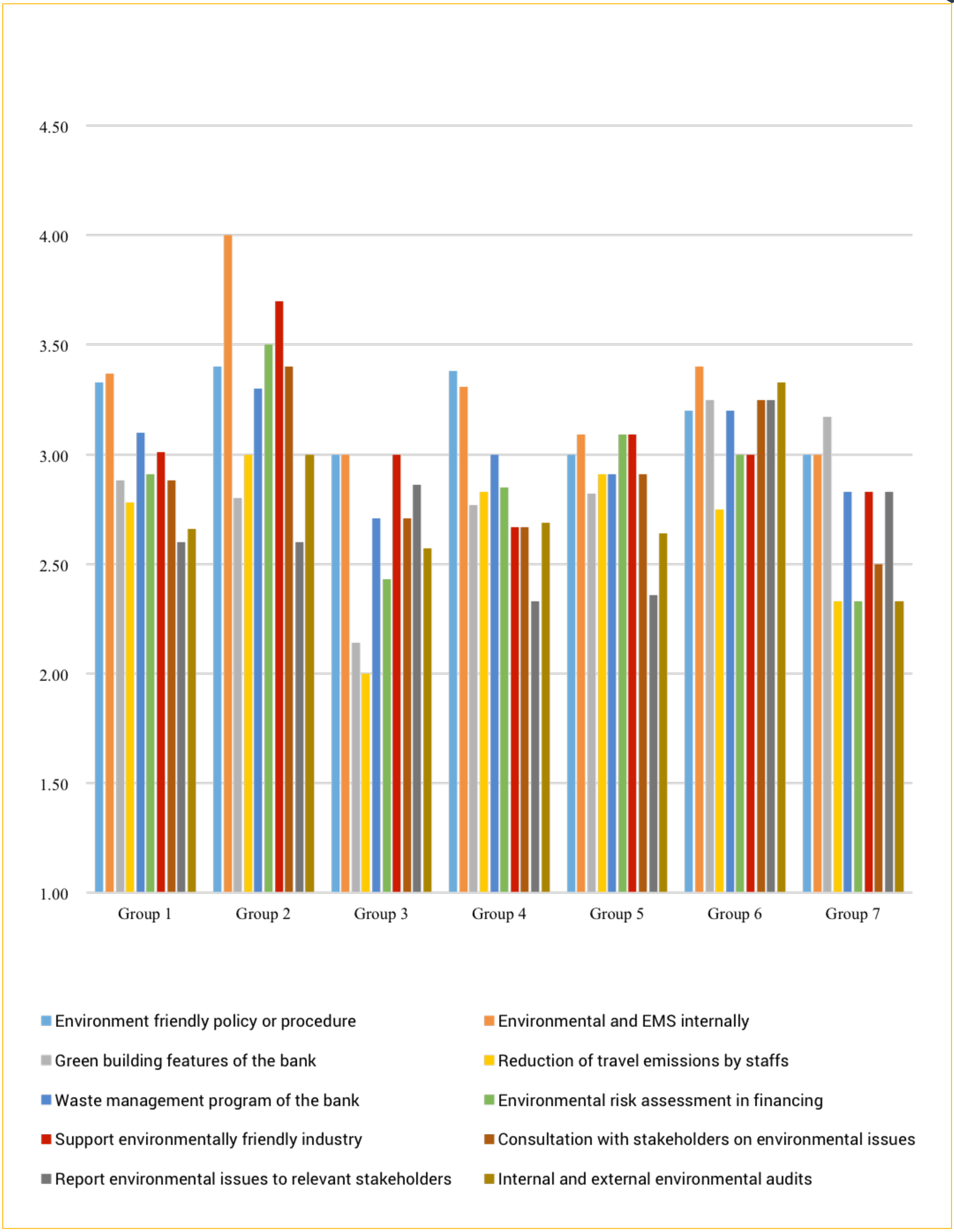
The environmental aspect of sustainability includes the corporate impact on the environment, either through the consumption of non-renewable natural resources or through the production of harmful environmental externalities. As a service industry, the banking sector does not depend directly on natural resources for revenue generation, nor does it have a direct impact on the environment. While the consumption of energy to operate offices, data centres and retail facilities contributes negative externalities, this is not considered a material sustainability issue. As financial intermediaries, banks contribute to positive and negative environmental externalities through financing a range of industries that have substantial impacts on environment. It is therefore necessary for banks to examine environmental sustainability factors in their financing and risk management processes.

From the survey result (Figure 48), most of the environment-friendly business practices of Islamic banks are in the range of low to moderate development, with a) internal environmental and energy management systems; energy management systems as well as environmental friendly policy or procedures are the most developed across banks in the Middle East ex-GCC. Banks in this region generally have more developed environment-friendly business practices relative to other regions (Figure 50).

As an illustration, one bank in the Middle East ex-GCC suggested the setting of standards for preferential financing relating to the protection of the environment. There is a joint project between the bank and the United Nations Development Programme (UNDP) to integrate 'development' and 'banking' where the UNDP is supporting the bank's improvement of its 'green' banking and credit procedures and policies. Another bank in the GCC incorporates environmental goals in its strategic plan and provides financing to environmentally compatible projects. Similarly, in South East Asia, one bank is actively advocating green financing, for example, solar farms, green buildings and hydro power plants. The financing goes through rigorous risk assessment which translates into good quality assets and hence better business performance. In the West, Central and South Asia region, there is a bank that evaluates projects not only in terms of economic risks but also environmental and social risks. The bank has in place an Environmental and Social Management System (ESMS) which is regularly updated to reflect the trends in line with the International Finance Corporation (IFC) Standards. The ESMS, which is an integral part of the Credit Policy and Credit Evaluation Process of the long-term financing of the bank, identifies environment and social risks in the projects it finances and takes actions to minimize such risks at the early stage of the credit evaluation. The bank has also been a participating credit institution (PCI) in the World Bank's Energy Services Delivery (ESD) project and the Renewable Energy for Rural Economic Development (RERED) project.

Large banks (top set) and small banks (bottom set)

Figure 49: Extent to which environment-friendly business practices have been developed at banks (Large and small banks)



1.Not developed; 2.Less developed; 3.Moderate; 4.Developed; 5.Well developed

Figure 50: Environment-friendly Business Practices (Group-wise)

10. INTEGRATION OF SOCIAL AND ENVIRONMENT IMPACTS INTO BUSINESS STRATEGY, RISK AND OPPORTUNITY MANAGEMENT

Banks were asked to indicate in the order of importance the five areas in which they wished to improve responsible business practices over the next 1-3 years. The percentage given in the table below shows the order of importance accorded by banks to the various business practices.

and SME financing in the case of large banks (Figure 52). The development of the local economy is the most important area for improvement across all regions. Employee relations and human capital development as well as customer relationship management are also key areas in most regions except North Africa (Group 5), Sub-Saharan Africa (Group 6). In North Africa, banking product responsibility and financial consumer protection has more prominence in relative terms (Figure 53).

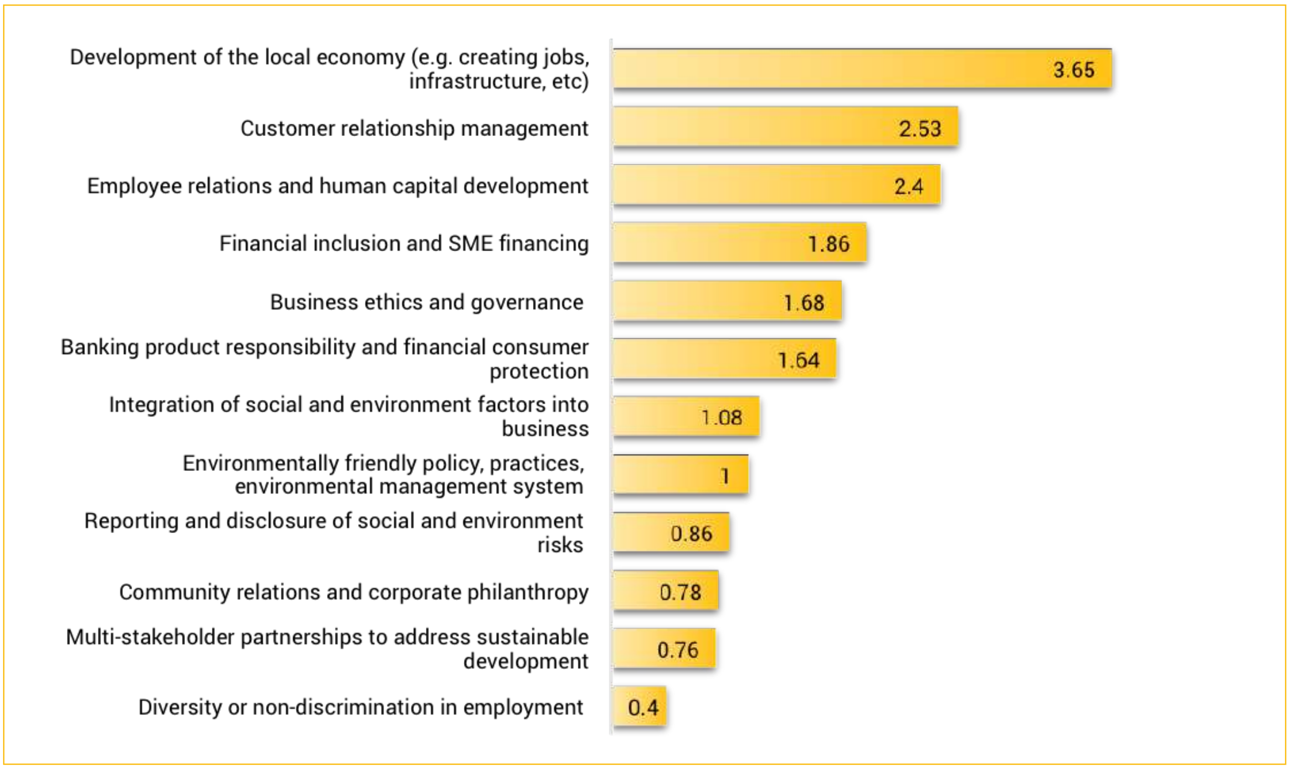
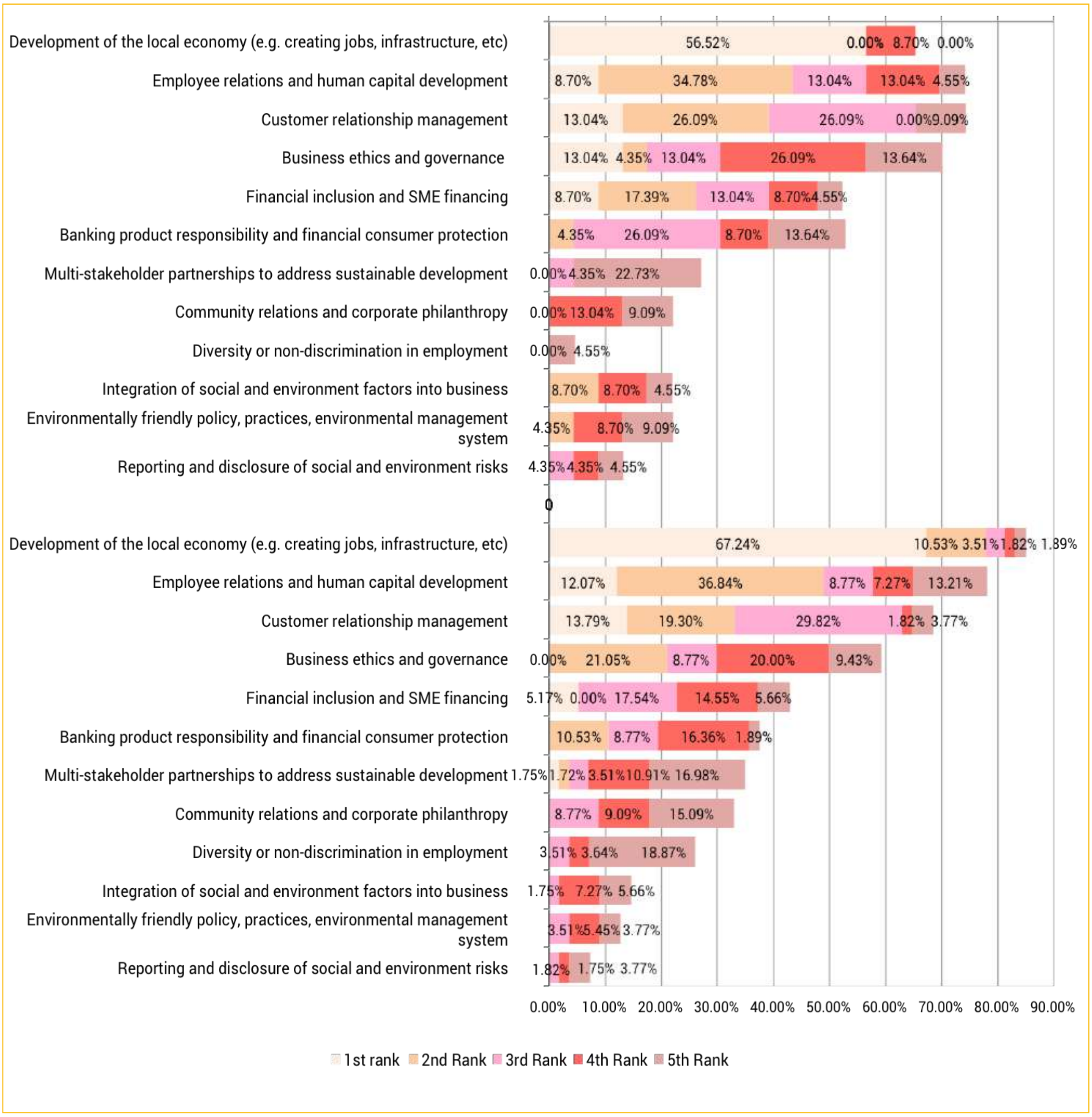


Figure 51: Top Five Areas to Improve Responsible Business Practices

The top five responsible business practices that Islamic banks wish to improve over the next one to three years are: a) the development of the local economy (e.g. creating jobs, enhancing the production level of the local economy, financing the development of infrastructure, financing the broadening of business sectors in the economy, etc.); b) customer relationship management; c) employee relations and human capital development (e.g. talent attraction and retention, employee welfare, etc.); d) financial inclusion and small to medium size enterprises (SME) financing; and e) business ethics and governance (e.g. codes of conduct, compliance, anti-corruption and anti-bribery, etc.) (Figure 51). The development of the local economy is the top agenda item of small banks, while customer relationship management and human capital development rank among the highest for large banks in terms areas of improvement over the next one to three years. Banking product responsibility and financial consumer protection have the same level of importance as financial inclusion

The development of the local economy is the top agenda item of small banks, while customer relationship management and human capital development rank among the highest for large banks in terms areas of improvement over the next one to three years



Large banks (top set) and small banks (bottom set)

Figure 52: Extent to which banks considered and ranked top priorities to improve Responsible Business Practices (Large and Small banks)

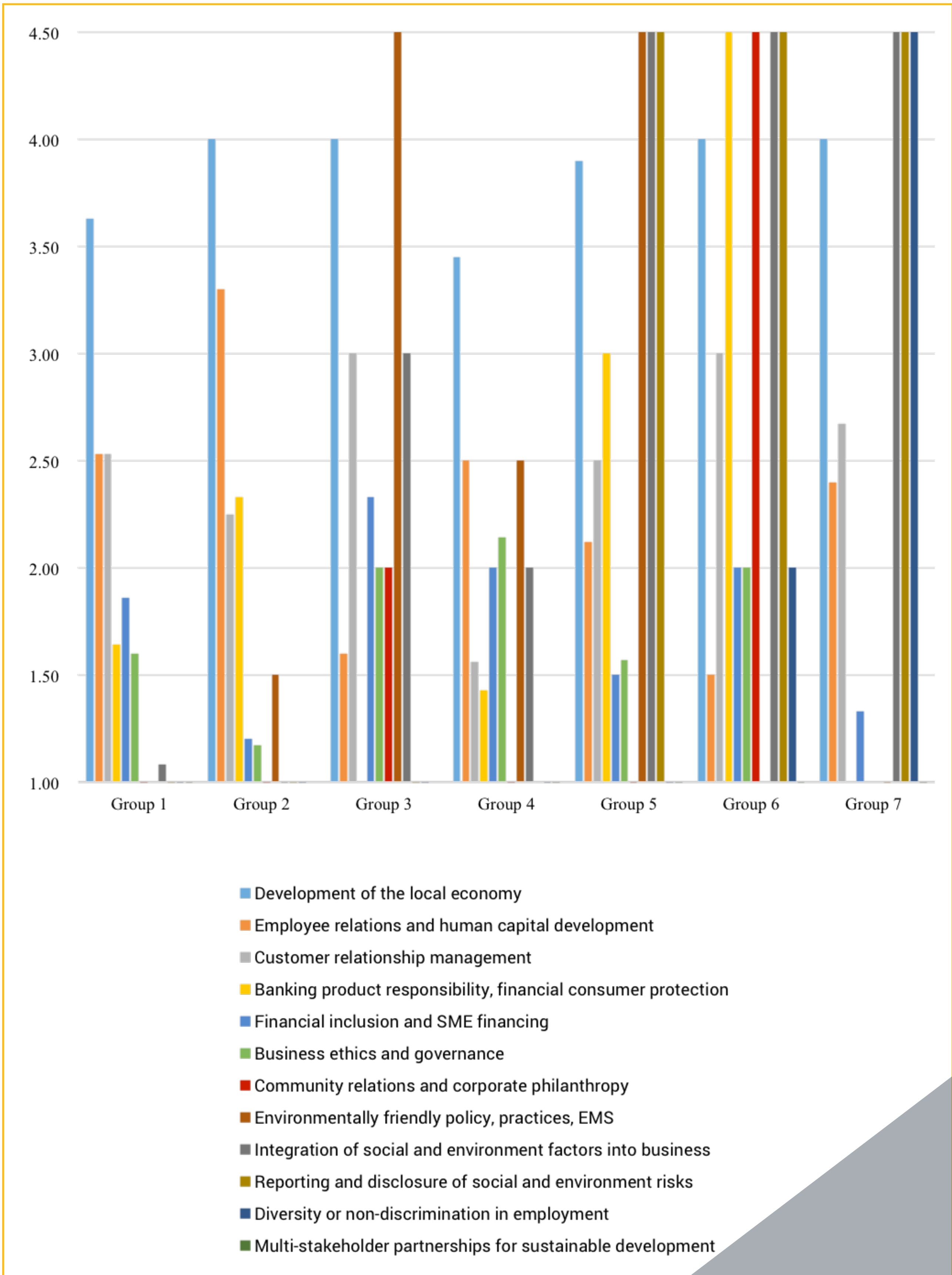
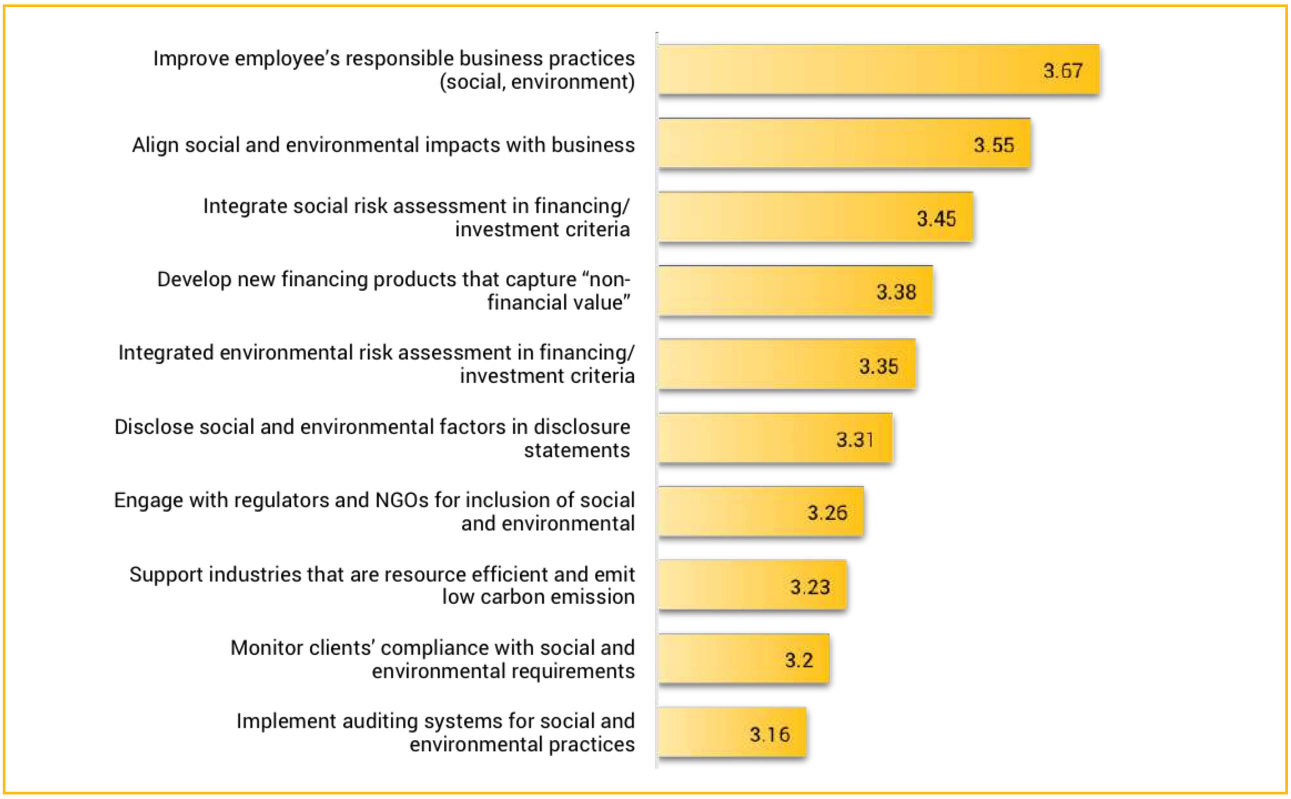


Figure 53: Five Areas to Improve Responsible Business Practices



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

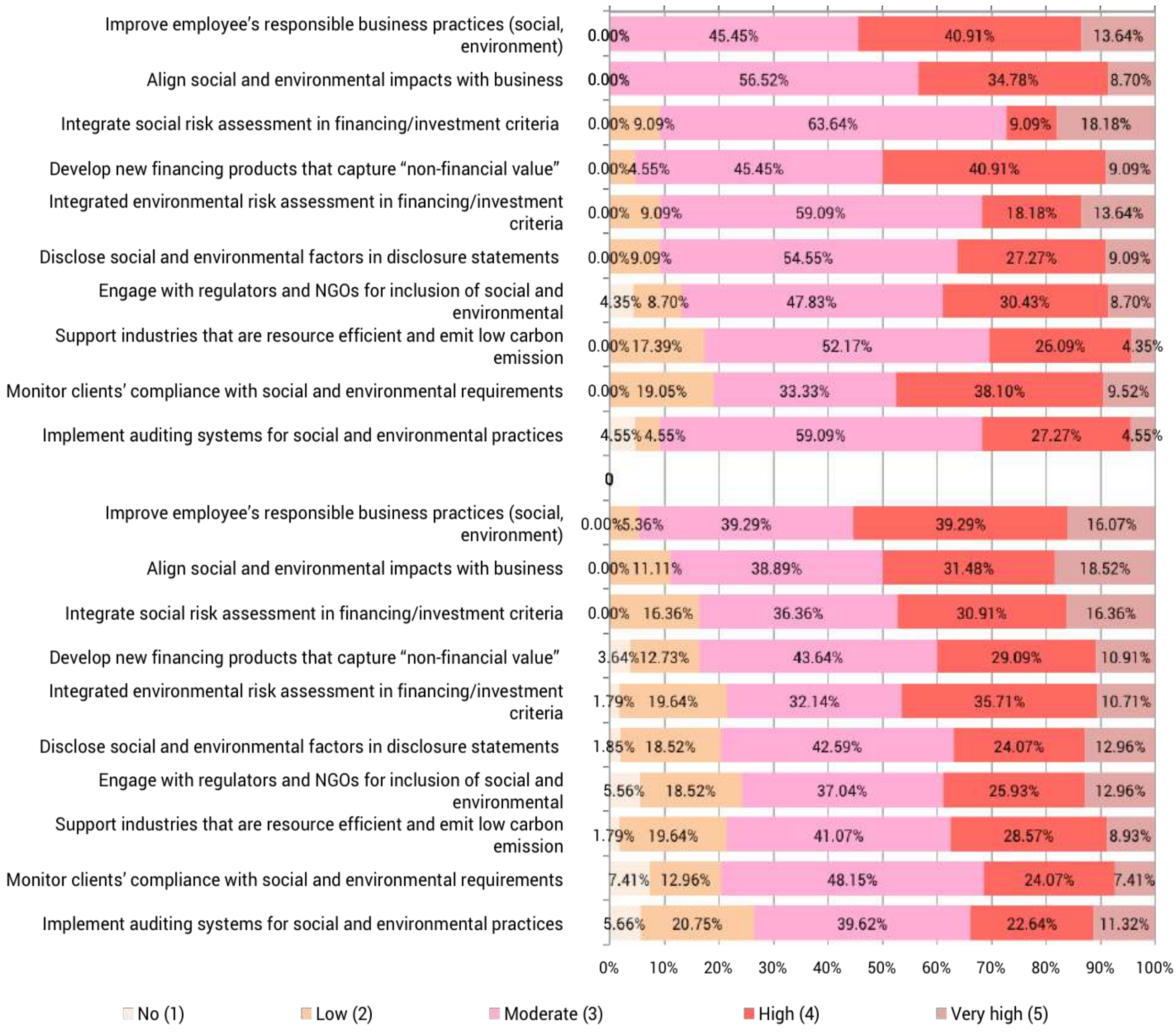
Figure 54: Improvement in Responsible Business Practices in Future

Sustainability changes present opportunities and risks for banks' customers and for banks' own business. Well managed banks should focus on both the risks and opportunities, becoming the key leverage points to shift from business-as-usual to a sustainable future. Banks can do this by engaging with their clients on environmental, social and governance (ESG) matters, moving capital flows to more sustainable activities and creating new products and services which have sustainability-related features. These initiatives are important elements of a responsible business.

In the case of the Islamic banking sector, there will be a moderate level of adoption or improvement of responsible business practices as a top priority in the next five years (Figure 54). Among the practices, three stand out as having relatively higher potential for improvement: a) improvement of employees' responsible business practices on both social and environment factors (awareness, training, and compensation); b) alignment of social and environmental impacts with the overall business strategy of the bank; and c) integration of social risk assessments in financing/ investment criteria. This pattern is applicable to small banks (Figure 55). In the case of large banks, most will be developing new financing products that capture the 'non-financial value' of business transaction as well as monitoring clients' implementation of and compliance with social and environmental impact requirements, in addition to improving employee's responsible business practices on both social and environment factors (Figure 55). The improvement of employee's responsible business practices on both social and environment factors as well as the alignment of social and environmental impacts with the overall business strategy of the bank are generally given priority for improvement across all regions except North Africa (Group 5) (Figure 56).

A vital part of developing an effective social and environmental sustainability strategy and control framework is determining and understanding the social and environmental risk exposure of banks' portfolios as well as the industry-specific issues affecting banks' clients. An initial assessment of Islamic banks' social and environmental risk exposure can be conducted by mapping business line activities to industry sectors, and scoring them in their known social and environmental risk profiles on a portfolio heat map. This should be followed by an assessment of the present status of sustainability integration in order to understand which aspects of internal frameworks and processes require strengthening for more effective sustainability integration. Islamic banks can then decide on their risk appetite, taking into consideration their specific social and environmental sustainability risk profile, corporate strategy and other relevant business objectives. In responding to social and environmental risk, Islamic banks can develop internal systems and controls, and inform client behaviour through, for example, setting basic transaction acceptance parameters in both screening and documentation, client engagement, and products that are geared toward sustainability integration.[7]

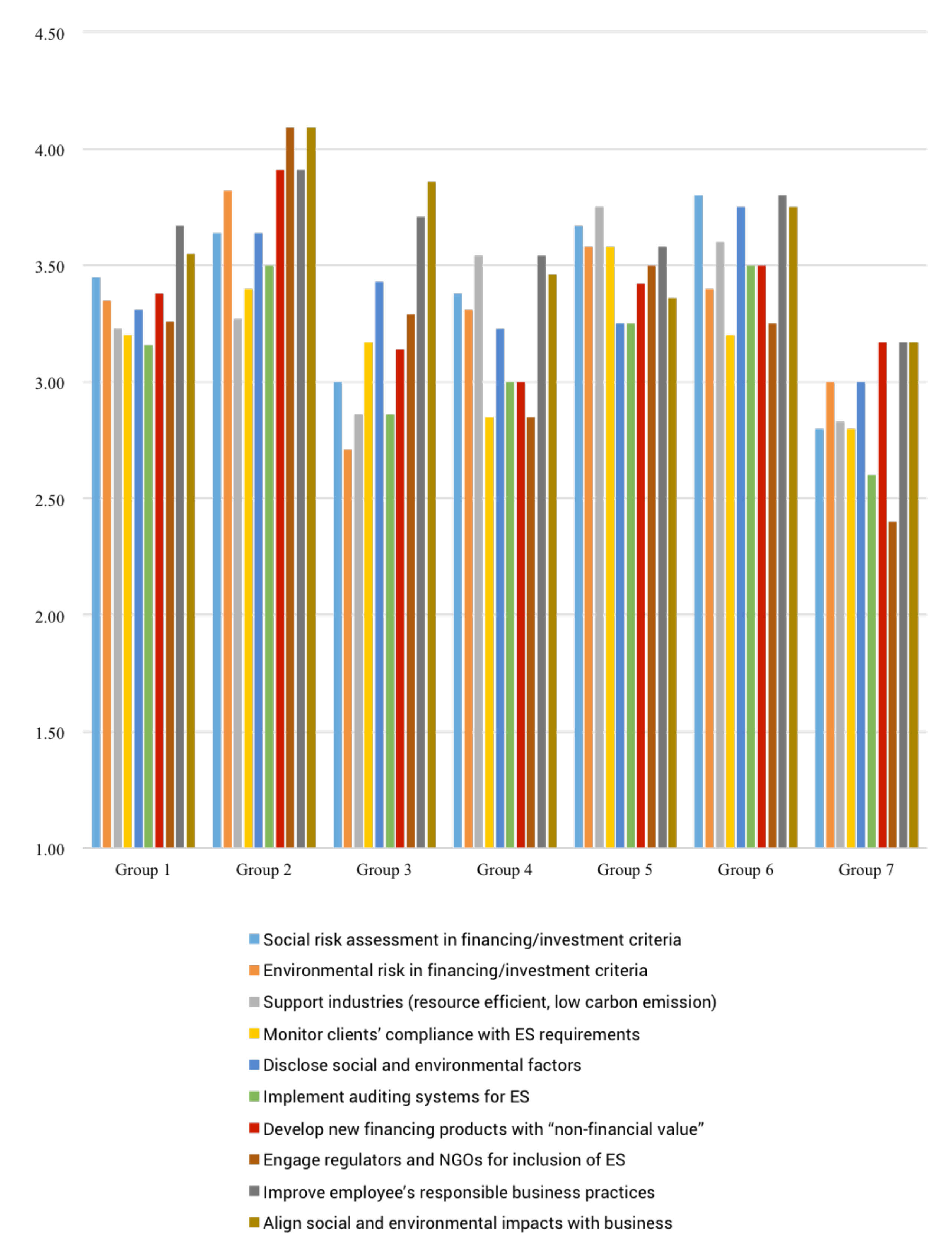
Driving these positive changes requires not just the improvement of employees' responsible business practices but also the creation of an operating model and organizational structure commensurate with the size and complexity of the bank. It is particularly important to develop sustainability-related KPIs in order to create management information about the progress on strategy implementation, to measure performance so that key impact areas can be identified, and to improve transparency for internal and external stakeholders about the bank's progress toward integrating sustainability.



Large banks (top set) and small banks (bottom set)

Figure 55: Aspects of responsible business practices banks will adopt or improve as top priorities in the next five years (Large and Small banks)

[7]WWF Report. 2014. "Environmental, Social and Governance Integration for Banks: A Guide to Starting Implementation."

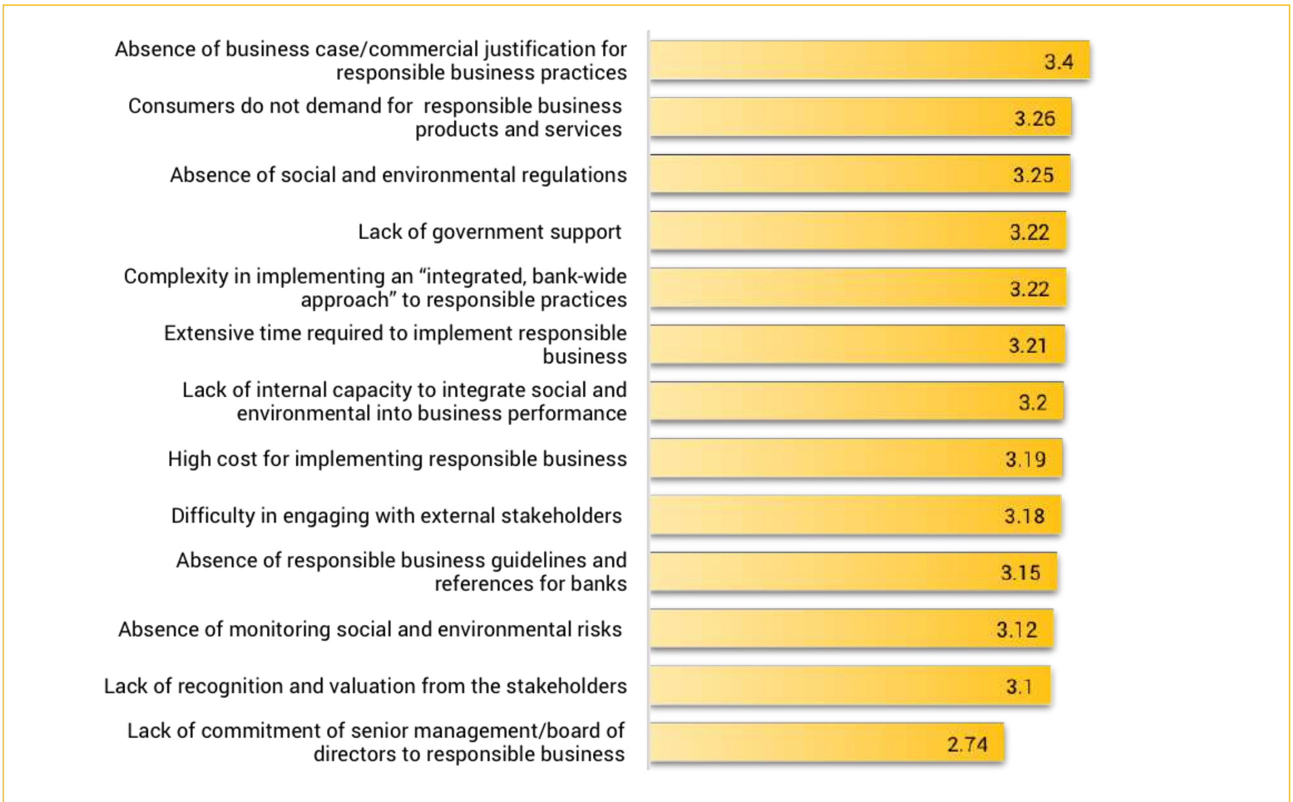


1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 56: Improvement in Responsible Business Practices in Future (region-wise)

11. CONSTRAINTS AND BENEFITS IN IMPLEMENTING RESPONSIBLE BUSINESS INITIATIVES, CORPORATE SOCIAL RESPONSIBILITY (CSR), OR SUSTAINABILITY STRATEGY

Banks were asked about the most significant constraints for implementing responsible business initiatives, Corporate Social Responsibility (CSR), or a sustainability strategy. A score of 1 signifies no constraint while a score of 5 represents a very high level of constraint.



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

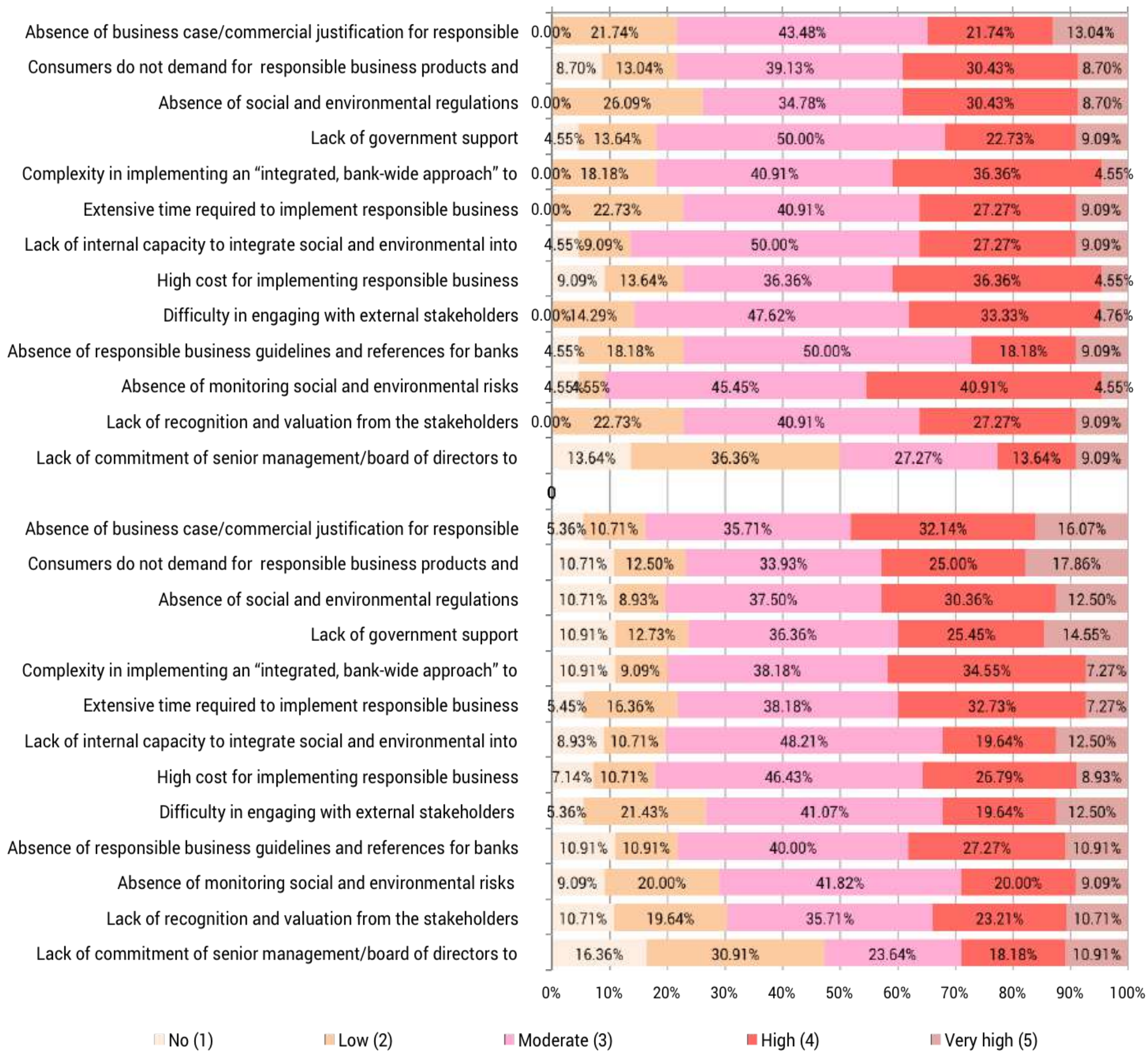
Figure 57: Constraints in Responsible Business Practices

Islamic banks think that almost all the constraints in Figure 57 have a moderate level of importance as constraints on incorporating the consideration of the social and environmental impacts of banking activities into their business strategies, goals and financing choices. While there is commitment of senior management or the board of directors to responsible business, there is a lack of a strong business case or commercial justification for it. This is particularly true for small banks (Figure 58). Most of the large banks cite the following as constraints: the absence of monitoring social and environmental risks by the bank and by the bank's clients, the high cost for implementing responsible business, as well as the complexity of implementing an 'integrated, bank-wide approach' to CSR, responsible and sustainability business practice (Figure 58). Both large and small banks also view the absence of social and environmental regulations as well as the lack of consumer demand for responsible business products and services as significant constraints. Banks in the Middle East ex-GCC (group 2) and North Africa (Group 59) generally faced higher constraints in responsible business practices relative to other regions. Banks in West, Central and South Asia (Group 4) have the least constraints. Among the most challenging aspects are the absence of business case, lack of government support and the absence of social and environmental regulation across most regions (Figure 59).

Despite these constraints, several well-established studies and practices demonstrate that sound sustainability practices can result in lower risk and better financial and operational performance of firms

Despite these constraints, several well-established studies and practices demonstrate that sound sustainability practices can result in lower risk and better financial and operational performance of firms. For example, the rate of correct credit default predictions improved about 7.7% if sustainability criteria were added to conventional credit risk indicators, and alpha for a portfolio of stocks selected on the basis of material sustainability is 3%-8% (annualized) over a 20-year period. Reducing of environmental costs takes at least one or two years in order to enhance firm performance. Almost 76% of CEOs in various sectors said that measuring and reporting the total impact of their company's activities across social, environmental, fiscal and economic dimensions contributes to the long-term success of their organization.[8] Moreover, consumers reward companies that offer fair products even in price-sensitive industries such as consumer banking.

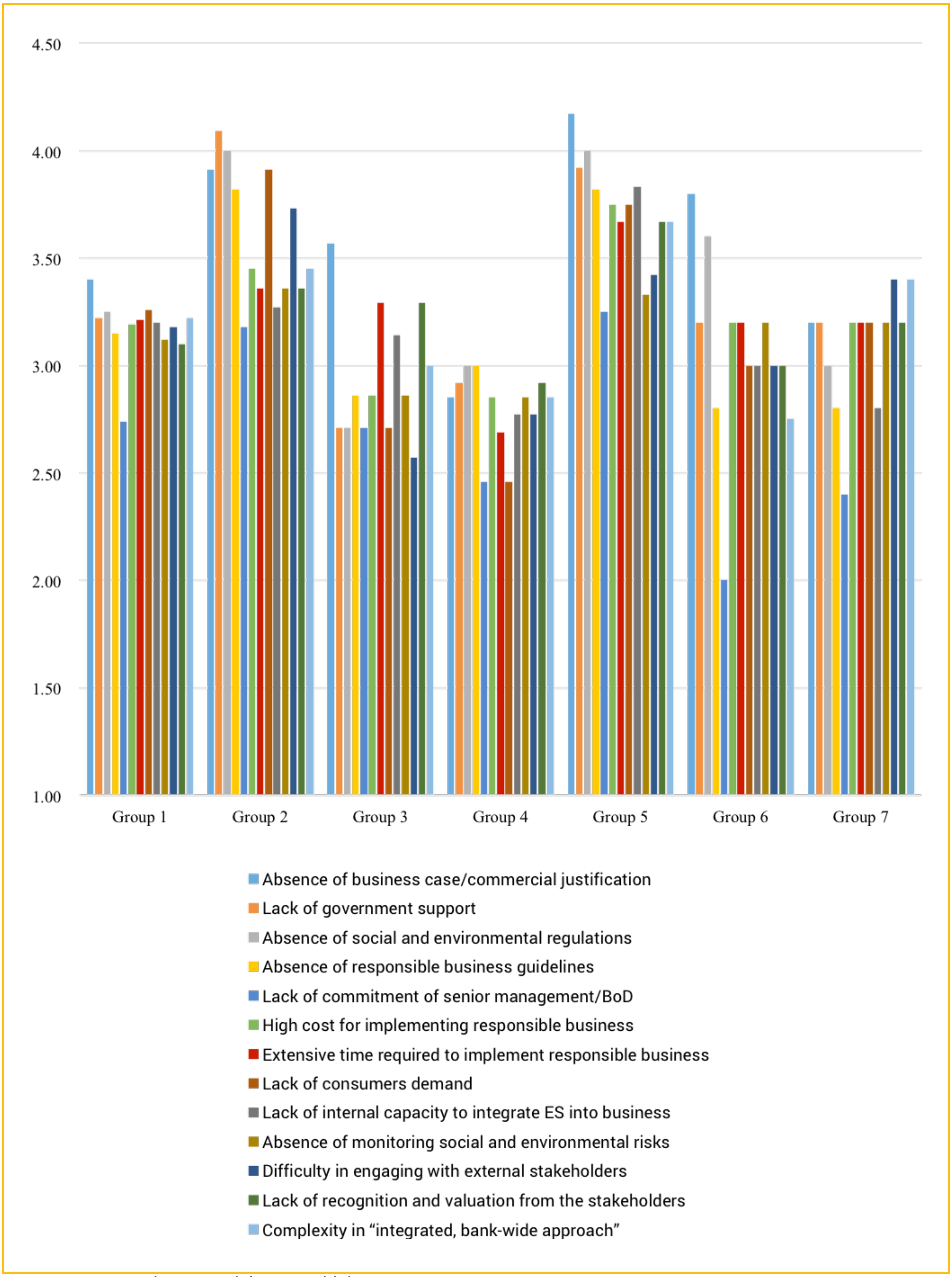
The complexity of implementing an 'integrated, bank-wide approach' remains a valid concern. Such integration requires a focus on value creation across resources or forms of capital (such as financial, manufactured, human, social, intellectual and environmental), accounting for broader stakeholder value and longer-term consideration.



Large banks (top set) and small banks (bottom set)

Figure 58: Constraints banks see in implementing responsible business practices (Large and Small banks)

[8]PwC 19th Annual CEO survey (2016).



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 59: Constraints in Responsible Business Practices (Group-wise)

Banks were asked about the level of benefit they saw from responsible business practices in various areas. A score of 1 represents no benefit at all while a score of 5 indicates very high level of benefit.

resources is viewed as the most significant benefit by banks from all regions except Europe and others (Group 7). It appears that banks in the Middle East ex-GCC (Group 2) generally see more benefits from responsible business practices (Figure 62).

1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

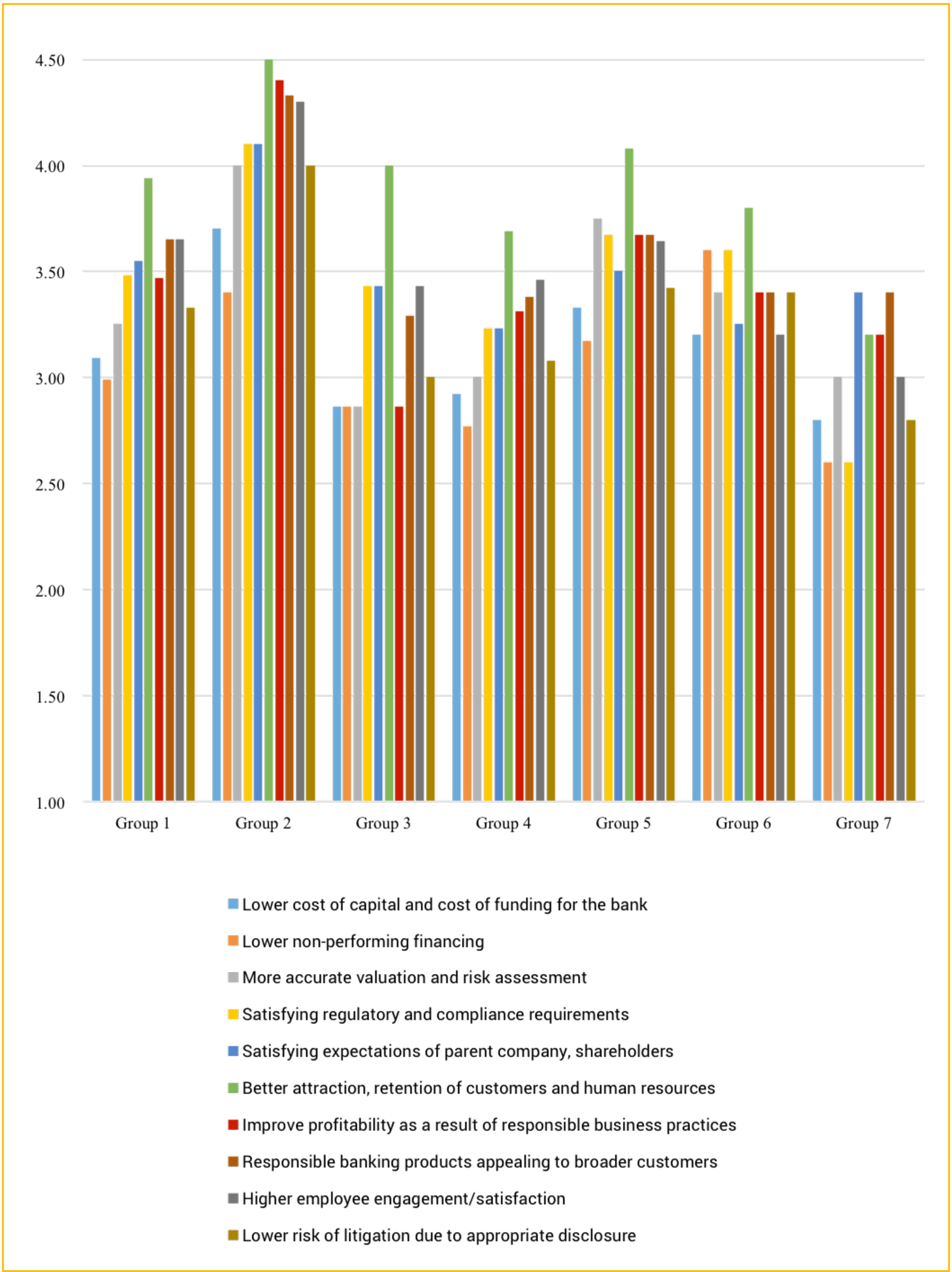
Figure 60: Benefits from Responsible Business Practices

According to the Cambridge Institute for Sustainability Leadership, many companies are using sustainability as a strategic lens, translating it into product and service opportunities, productivity and innovation potential, bottom-line savings, reputational and market growth, and license to operate. From the survey results, it appears that Islamic banks can benefit moderately from implementing responsible business initiatives, CSR, or sustainability strategies. The most prominent benefit in the opinion of Islamic banks is 'enhanced brand, trust and reputation resulting in better attraction and retention of customers and human resources' (Figure 60). This finding, which is applicable to small and large Islamic banks (Figure 61), corresponds with the Sustainability Survey of Financial Institutions conducted by the International Finance Corporation in 2005. Although most banks cited reduced risk and improved access to international financing as among the top benefits, banks consider sustainability issues when enhancing their credibility and reputation. Enhanced brand, trust and reputation resulting in better attraction and retention of customers and human

Using reputation on sustainability as a critical differentiator can help a bank transition to an era in which sustainability will be a core component in attracting the most talented employees and in retaining customers. Creating a business that is both sustainable and profitable demands efforts by people at all levels of the organization; hence, engaging employees in sustainability is key to success. Islamic banks will need to communicate more effectively about their progress on sustainability issues to their employees, and to engage them in developing relevant innovations. Another measure is through crowdsourcing platforms to enable consumers and entrepreneurs to collaborate in solving global sustainability challenges. Some large corporations and global banks have launched a platform where community members are able to submit ideas and build on other peoples' idea through community collaboration and up-voting. Using crowdsourcing as an engine to ignite and drive the initiative, the ideas-creation and innovation process is incentivised, encouraging open collaboration to find solutions to real social challenges.

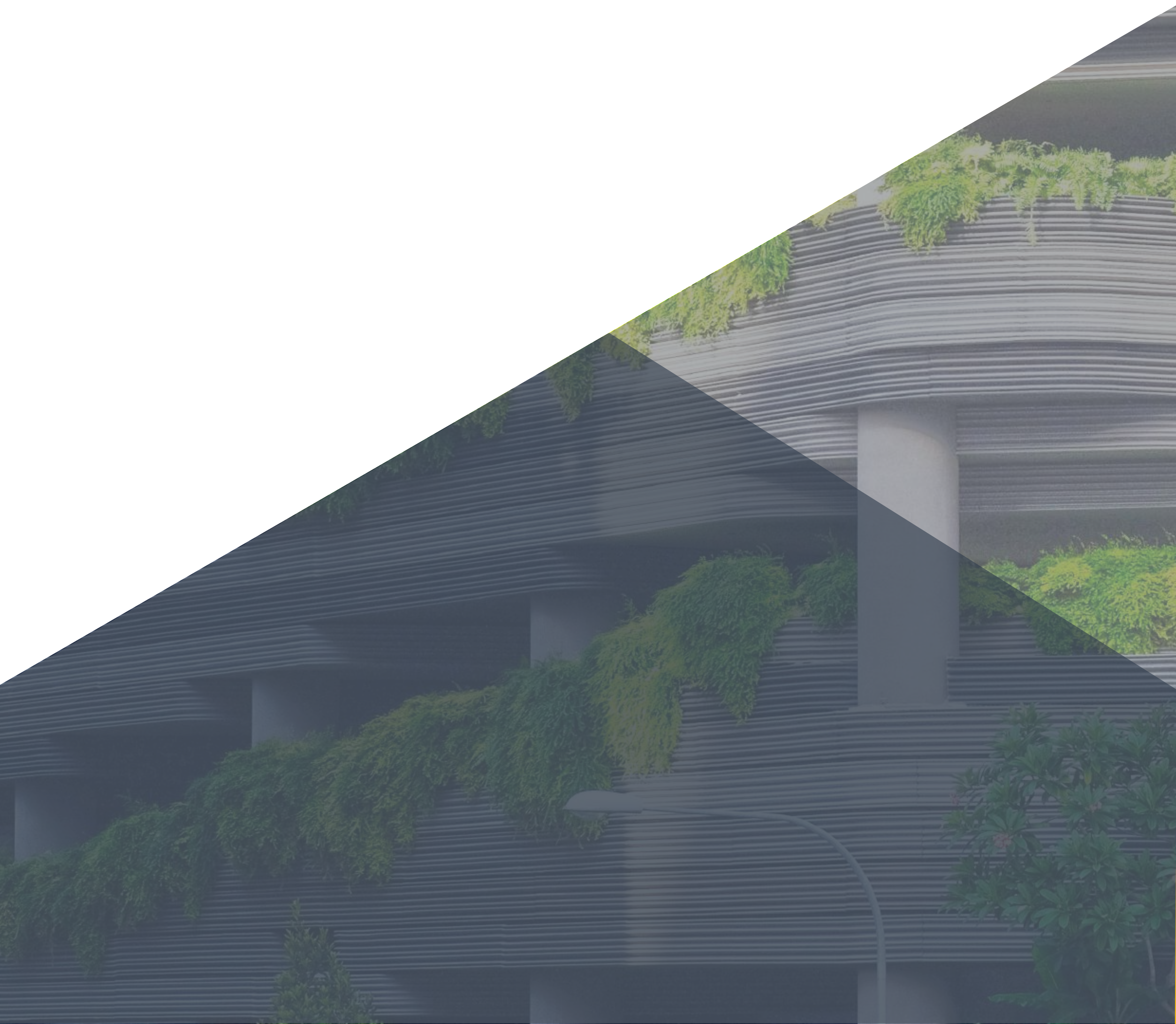
Large banks (top set) and small banks (bottom set)

Figure 61: Extent to which banks say they can benefit from implementing responsible business initiatives, CSR, or Sustainability strategy (Large and Small banks)



1.No; 2.Low; 3.Moderate; 4.High; 5.Very high

Figure 62: Benefits from Responsible Business Practices (Group-wise)



» Part 4: Leading Practices & Opportunities in Responsible & Sustainability Business

» Part 4: Leading Practices & Opportunities in Responsible & Sustainability Business

Part 4 of this report contains eight themes of selected leading practices and opportunities in responsible and sustainable business across the global Islamic banking sector derived through interviews and research. The interviews enhanced the depth of the report by 1) reflecting comprehensive details on the top priorities, business strategy, processes and challenges related to responsible and sustainable business in Islamic banks; 2) identifying leading practices and solutions on a particular aspect of responsible finance and sustainability by Islamic banks; and 3) discussing the opportunities for Islamic banks to finance and invest in corporations that adopt responsible and sustainable business practices.

1. SUSTAINABLE BANKING AS A CATALYST FOR SUSTAINABLE DEVELOPMENT

1. 1.1. Sustainable Development Goals (SDG) and Islamic finance

In September 2015, 193 member States of the United Nations adopted a set of goals to make our world more prosperous, inclusive, sustainable and resilient. Over the next fifteen years, countries will mobilize efforts to end poverty, address inequalities and tackle climate change, while ensuring that no one is left behind. The 17 Sustainable Development Goals (SDGs) of the 2030 Agenda for Sustainable Development, which officially came into force on 1 January 2016, provide the opportunity for governments to take ownership and formulate national frameworks to harmonize economic growth, social inclusion and environmental protection that are crucial for the well-being of societies. The achievement of SDGs depends significantly on the involvement of governments working alongside the private sectors, Parliaments, local authorities, the scientific and academic community, civil society and all people.

The financial services industry, as a key enabler for the real economy, can support the SDGs by the following."[9]

[9] United Nations. "The Sustainable Development Agenda."; United Nations Global Compact and KPMG International. 2015. "SDG Industry Matrix."

Figure 63: Means for the financial services industry to support SDGs

The SDGs offers an opportunity for the Islamic finance industry to optimise its increasing global relevance in a manner that best demonstrates the Islamic values of finance and development. Specifically, Islamic finance can support global efforts in eradicating poverty (SDG-1), achieving food security (SDG-2), ensuring healthy lives (SDG-3), and promoting peaceful and inclusive society (SDG-16). Innovative Islamic financial instruments particularly for infrastructure development could also be used to mobilise resources to finance water and sanitation projects (SDG-6), sustainable and affordable energy (SDG-7), build resilient infrastructure (SDG-9) and shelter (SDG-11). [10]

Islamic banks are supporting global sustainable development efforts by designing targets with measurable and realistic priorities in the next few years. For example, three priorities in the areas of job creation, education and healthcare are highlighted in Al Baraka Banking Group Goals 2016-2020, which is aligned with SDG-1 (no poverty), SDG-3 (good health and wellbeing), SDG-4 (quality education), SDG-5 (gender equality), SDG-7 (affordable and clean energy), SDG-8 (decent work and economic growth) and SDG-9 (industry, innovation and infrastructure). In particular, the strategic goals of Al Baraka Banking Group for the next five years are:

1. Creating 50,000 jobs across the countries where the bank operates by financing new and existing customer operations.

2. Financing, and supporting, a variety of educational institutions. The bank is pledging US$191 million to support and finance educational initiatives and institutions.

3. Improving access to quality education. Financing, and supporting, children hospitals, cancer hospitals, diabetic hospitals, kidney dialysis units. The bank is pledging US$ 434 million to support and finance healthcare projects and initiatives, both public and private.

4. The bank is focused on encouraging customers whose initiatives would result in job creation and job retention, thus creating greater economic opportunities.

Figure 64: UN Sustainable Development Goals
Source: www.undp.org

1.2. THE ROLE OF POLICY MAKERS AND INDUSTRY IMPLEMENTATION

Policymakers and regulators are also playing an important role in facilitating the implementation of sustainable finance. For example, in the case of Indonesia, the Indonesia Financial Services Authority (OJK) launched the Sustainable Financial Roadmap on 5 December 2014, where the banks representing 46% of the total banking asset in Indonesia have committed to become the pioneer for sustainable banking under a pilot project known as “First step to be a sustainable bank”. The pilot project was developed by the OJK and the World Wide Fund for Nature (WWF)-Indonesia to support banks in preparing their competency towards realizing the targets

[10] Ali, Ahmad Mohamed, , at the 3rd International Conference on Financing for Development Addis Ababa, Ethiopia, July 2015.

The SDGs offers an opportunity for the Islamic finance industry to optimise its increasing global relevance in a manner that best demonstrates the Islamic values of finance and development

in the Sustainable Finance Roadmap for the period of 2014-2019. Participating banks will be benefiting from roundtable discussion and series of technical assistance on the identification of bank's Environment, Social, and Governance (ESG) risk profile in various sectors as well as ESG risk mitigation framework. In this respect, the palm oil sector has been selected as the pilot case for the systematic implementation of sustainable finance given the importance of the sector in the Indonesia economy and its association with environmental issues.[11]

With regard to the industry implementation, the leading practices are to implement sustainable financing by integrating ESG concept into the bank's operation and developing green product (financing models) for certain industries. As an illustration, Bank Muamalat Indonesia (BMI)'s implementation of the OJK's Sustainable Finance Roadmap is based on the following four steps:

To put the framework into practice, BMI focuses on certain industries that have significant ESG risk exposures. While financing portfolio in the agriculture sector, including in the palm oil industry, is 2.4% of the bank's total financing portfolio as of December 2015, the bank is keen to continue developing the financing portfolio in the palm oil industry

Figure 65: Steps Sustainable Finance Roadmap based on

[11] WWF. 2015. "Eight Largest Banks in Indonesia Commits to Implement Sustainable Finance," November 23

given its attractive business proposition. It is, therefore, important for the bank to keep up with industry trends related to the implementation of sustainable practices in the production of palm oil.

To address these challenges, the bank cooperates with (a) the public notary to check the land certification in Badan Pertanahan Nasional (BPN), the national land authority of the country; (b) a legal advisor to examine all operational licenses; and (c) an independent consultant to assess the customer's feasibility study of plantation development (new or replanting) and to monitor the progress. In addition, the bank conducts site visits to palm oil plantation to inspect social issues, human resources management, and plantation operation. Customers are required to provide financial a report, which includes a progress report from an independent consultant. These policy and industry measures are supportive of the implementation of sustainable finance.

2. ENHANCING ECONOMIC IMPACT OF ISLAMIC BANKS

As a key agent in stimulating economic development, banks can add value to local economies in many ways through their policies, operations, products and services. Banks enable businesses to establish, to expand and to trade globally. Banks also help economies to prosper, to build infrastructure and to bring people out of poverty. By doing these things in the right way, banks can be a powerful catalyst for good throughout the economy. Through economic impact assessments, some banks are assessing how their corporate clients contribute to the

Figure 66: Areas identified in managing the quality of a financing portfolio

GDP, employment generation, salaries and wages, and government tax revenues in the country they operate. In this regard, a social accounting matrix has been used to assess the direct, indirect and induced impacts on employment and value-added (also known as the multiplier effect) of banking activities.[12] This approach has particular relevance for stakeholders to understand bank's socio-economic impact or footprint as well as the productivity of various sectors in the economy.

2.1. Incorporating economic impact into banks' policy and operation.

In the Islamic banking industry, an example in which economic impact is translated into economic value creation for customers is the Privilege Partners programme of Al Baraka Banking Group. This programme entails, at the grass root level, clear focus on the economic empowerment of each and every customer. The Banking Group has taken certain steps to implement and measure the impact of this programme. For example, one of the bank's customers, an owner of a single pharmacy in Jordan, progressively expanded his business to form a chain of pharmacies, and is now successfully running a manufacturing facility for medicines which employs around 150 people. In addition, the bank's social responsibility programme encompasses the following features related to the generation of economic impact: assessing the social impact of its business at the local and transactional levels; supporting local economies, and supervising and monitoring the development in the bank's microfinance programme. These initiatives have resulted in positive and direct economic impact.

"The growth objectives of the customers, which are long run in nature, ought to have ingredients of societal impact such as creation of jobs, enhancing the customers' own employees' quality of life, and/or meeting developmental objectives of the country, such as building hospitals, factories, large farms, etc. Preference is given to working with customers that are adding, and retaining jobs, creating greater economic opportunities, and conducting their business in a way that advances the SDGs."

[12] A SAM describes inter-industry linkages in an economy, presenting how the output of one industry goes to another, where it serves as an input. It therefore makes one industry dependent on another, both as customer of outputs and as supplier of inputs.

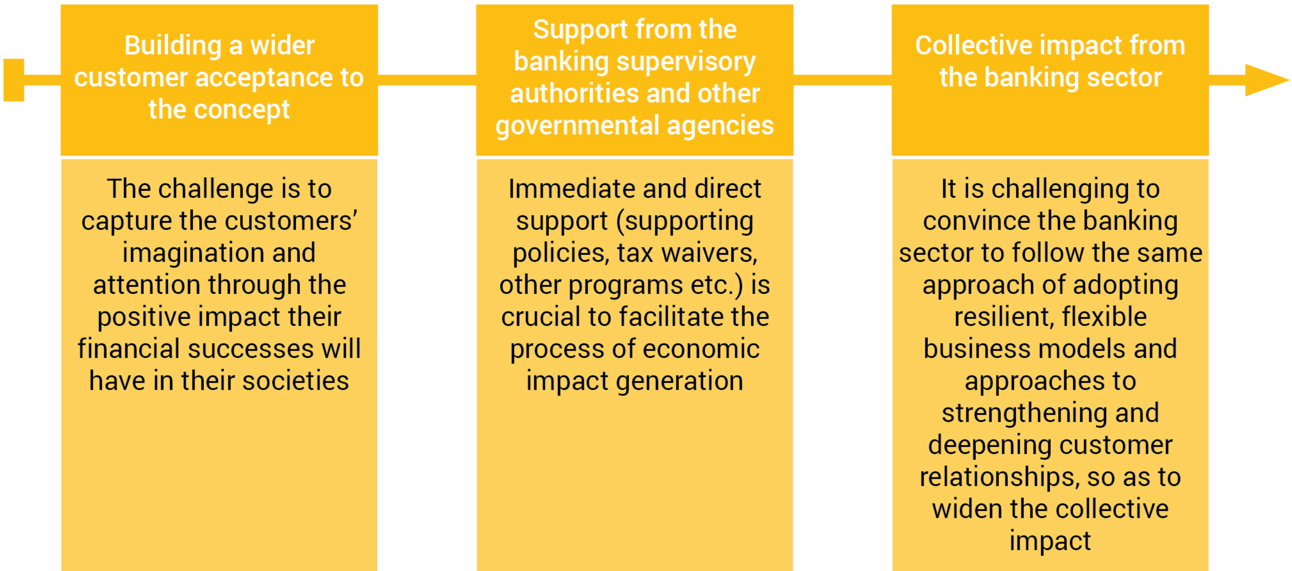


Figure 67: Challenges in incorporating the economic impact into the bank's policies and operations

Going forward, comprehensive assessment of indirect and induced impacts on employment and value-added of Islamic banks' activities would provide a macro-perspective on the operations of a single enterprise, including the understanding of the potential economic vulnerabilities of economic sectors that would have effect on the sustainability of Islamic banks in the country.

2.2. Innovative marketplace to improve economic impact

Through the diverse range of Shariah contracts, Islamic finance is well positioned to meet the dynamic needs of the real economy and address the prevailing gaps in the investment intermediation activities. In this connection, investment accounts have been mobilized by Islamic banks to cater to a spectrum of investor risk-return preferences, with the objective of promoting a stronger linkage of finance and the real economy, as well as stimulating entrepreneurship and productivity.

To improve the role of investment accounts in enhancing economic impacts, Malaysia initiated an innovative solution through establishing a unique marketplace. The introduction of Islamic Financial Services Act 2013 (IFSA 2013) in Malaysia is a step forward that provides the Islamic finance industry with the foundation to transition into its next level of growth and development. The distinction between investment and deposit accounts under IFSA 2013 offers the opportunity for Islamic banks to meet various customers' risk appetite, i.e. from low-sustained growth to medium-high growth returns. At the same time, it offers an avenue for customers to fund feasible ventures under a wider set of criteria aligned with the risk-absorbing characteristics of investment accounts.[13] Despite its possible implications and impacts, this initiative is hoped to enable banks in Malaysia to reap several benefits, such as cost savings from capital management.

[13] Bank Negara Malaysia. 2014. "Investment Accounts under IFSA." Financial Stability and Payment Systems Report, 72–76.

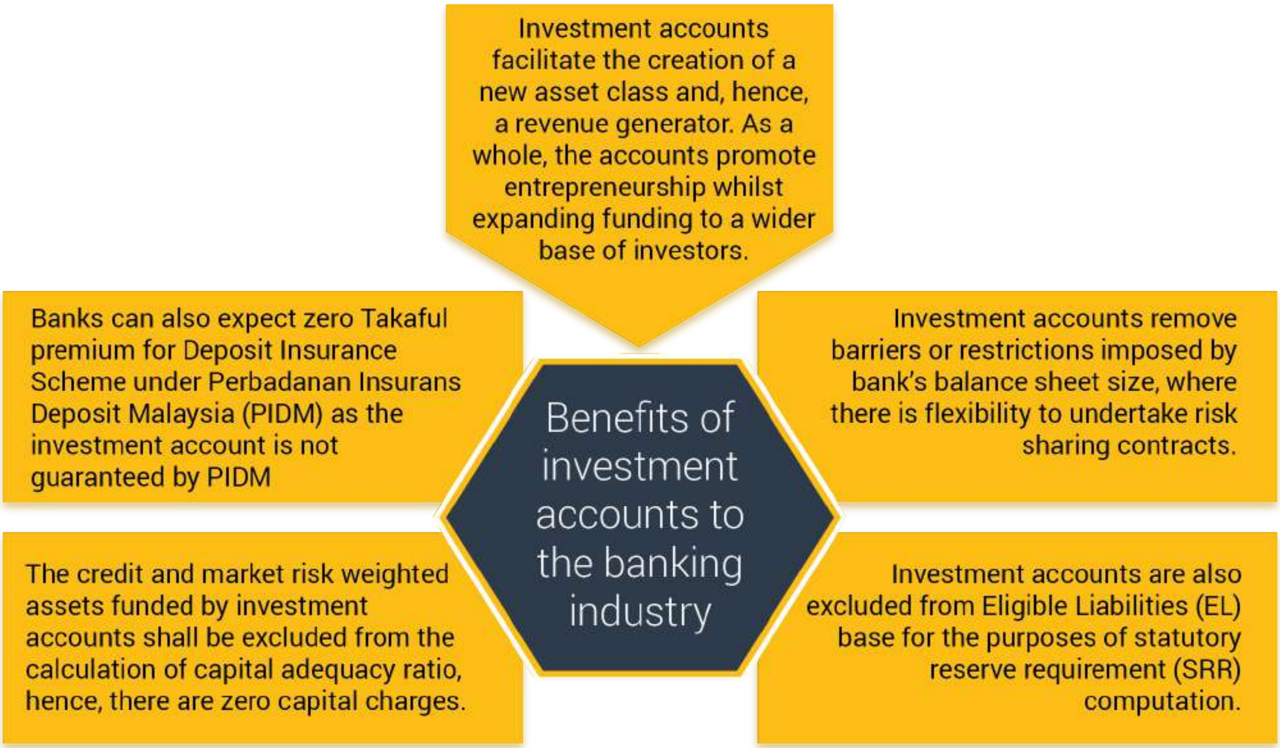


Figure 68: Benefits of investment accounts to the banking industry

Given the important need to achieve critical mass and to reach the widest possible coverage of prospective investment ventures, the Investment Account Platform (IAP) was launched in February 2016 to enable the efficient delivery of investment account offerings via an internet based and centralized multi-bank platform. Incorporated on 13 May 2015, the IAP, a brainchild of Bank Negara Malaysia, is supported by four Islamic Banks in Malaysia as well as two development financial institutions. The portal will facilitate efficient intermediation by the Sponsoring Banks to match financing requirement of ventures (corporate, SME and non-SME companies requiring financing) with investment from retail and institutional investors via the IAP.

Figure 69: Investment Account Platform
Source: IAP Integrated Sdn Bhd

Figure 70: Key features of Investment Account Platform

The key to the success of this platform is the enhanced governance to safeguard ventures' interest and banks' reputations including compliance with minimum disclosure standards, as well as a separate fund management to facilitate accurate distribution of returns and resolution on winding-up. Investors shall also be kept updated by Sponsoring Banks particularly on matters material to the investors such as a venture defaulting and the performance of the ventures. As a new marketplace leveraging on shared infrastructure and financial technology, the IAP is expected to widen opportunities for investors, ventures and banks to participate on a risk-sharing basis capitalizing on the proactive role played by Islamic banks within a conducive regulatory environment.

3. BOLSTERING QUALITY OF LIFE WITH SHELTER: THE CASE OF SOCIAL AND AFFORDABLE HOUSING FINANCING

Access to adequate and affordable housing is an instrumental condition of thriving and equitable communities. It also serves an important economic function by supporting a productive workforce and lowing social service costs. The provision of affordable housing is increasingly becoming an impactful policy and business agenda, as demonstrated by governments' multimillion-dollar social housing development initiatives in countries with significant middle- and low-income population. Financing the construction affordable and social housing can be a strategy to improve standards of living, while financing sustainable construction incorporates elements of economic efficiency, environmental performance and social responsibility, contributing to architectural quality, technical innovation and transferability.

The issue of housing affordability is particularly apparent in countries with housing backlogs of tens of thousands of units, and land allocation constraints such as Bahrain. Since 2012, the Government of Bahrain has been actively pushing ahead with state-funded housing projects that are expected to have long-term impact on the social economic development of the kingdom. The BD 750 million (US$ 1.99 billion) Social Housing Finance Fund launched in 2013 to provide subsidized mortgages is one of such key initiatives. Development projects including housing and infrastructure in the kingdom are also supported by the GCC Marshall Fund over 10 years.

One of the leading practices for Islamic financial institutions is to engage with relevant stakeholders to achieve the targeted impact. For example, through a joint venture between the Ministry of Housing and a group of commercial banks, including Eskan Bank, Ahli United Bank, Bahrain Islamic Bank, Kuwait Finance House and Al Salam Bank, the scheme provides up to BD 90,000 (US$ 238,500) in financing for eligible Bahraini nationals, with the house purchaser contributing 10% of the house price as deposit and the remaining 90% funded by participating financial institutions. Monthly payments are capped at 25% of the purchaser's total monthly income, while the government provides the remaining of the balance.[14]

Islamic banks are also leveraging on their market and institutional network to achieve efficiency. For example, Al Salam Bank collaborated with state-owned Eskan Bank to facilitate a joint property financing programme as part of tter's quest to meet the housing needs of Bahraini citizens.

The programme seeks to provide access to financial institutions to support the beneficiaries of government housing financial services without requiring the beneficiary to provide additional mortgage guarantee. The fact that Al Salam Bank has ownership of land and access to a property development company is useful to the success of the programme. Such public-private partnership is

> To assist the social housing sector to grow in a sustainable, replicable and commercially viable manner, it is important to reduce the yield gap on social and affordable housing investments in order to remove the barrier to private sector and institutional investment in the sector

aimed to bolster the quality of life of the underprivileged, and at the same time, drive real estate and infrastructure development in the country.

There are several material sustainability issues that Islamic banks can address to drive competitiveness within the mortgage finance industry. These include: a) incorporating the increased frequency of extreme weather events associated with climate change into financing practices and risk analysis; b) ensuring that consumers receive fair and transparent information; c) incorporating responsible financing practices and working to prevent defaults; and d) ensuring compliance with an increasingly stringent regulatory framework. Islamic banks have the potential to leverage its position to assist consumers lower their environmental footprints through energy efficiency improvements. Energy-efficient mortgages allow customers to qualify for larger amount of financing that account for energy performance improvements, and the related cost savings, while reducing the risk of default. Banks also have the opportunity to collaborate with developers to increase the supply of energy-efficient housing.[15]

The provision of social housing is not without challenge as the provision for the majority of the population will exert financial pressures on government spending. Measures to lower pressures leading to rapid house-price escalation and planning for a steady supply of housing at affordable prices are therefore important to strengthening the market efficiency of the sector. For example, a moratorium of a certain period can be applied to buffer new housing units' supply. The creation of integrated database for housing would give information required for efficient planning of housing supply based on demand and socio-economic dynamics of the locality.[16] Other banking solutions for social and affordable housing can include cash flow financing solutions for community housing providers, Shariah compliant securitization, and direct financing to community housing providers. Social impact Sukuk can also be issued by banks to finance affordable and social housing through the sharing of risks with domestic and international capital providers of sustainable investments.

Policy should consider enhancement to the regulatory and/or governance framework for community housing providers to more closely align their structure and capabilities with institutional investor requirements over the longer term

4. FOSTERING PRODUCTIVE COMMUNITY AND SOCIAL DEVELOPMENT

4.1. Community development for social empowerment

To be a catalyst for development, corporate philanthropy and community development programmes need to be well managed. Creating value for the beneficiaries of these programmes and shareholders alike requires Islamic banks to have a clear direction and focus to guide their philanthropic activities and to measure their effectiveness from a cost / benefit perspective. The key focus of this criterion is on how Islamic banks assess the value of their corporate citizenship, community development and philanthropy programmes for social empowerment.

Dedicated efforts and commitments in fostering productive communities have been strategically incorporated by Islamic banks across regions. For example, in Saudi Arabia, The National Commercial Bank (NCB) has put an emphasis on the importance of introducing creative, innovative, and non-profit programmes that contribute to community development. The initiatives are broad in scope and look to cater to a number of areas related to community development (Figure 71).

The first step is to put the core value into practices under its CSR programme, "Ahalina", in order to create

[14] Oxford Business Group. 2015. "Bahrain's Retail and Housing Segments Grow as the Real Estate Sector Begins to Bounce Back." and "Bahrain Plans Construction of Social and Affordable Housing." The Report: Bahrain 2015.

[15] Sustainability Accounting Standards Board. 2014. "Mortgage Finance: Research Brief."

[16] Khazanah Nasional. 2015. "Making Housing Affordable"

Figure 71: Areas related to community development

the bank's relations with the community at the same level as its relations with its own families. It implements a multifaceted strategy to empower the community under three main programmes for community empowerment:

a. the productive families programme to empower women;
b. the entrepreneurs programme to empower the youth; and
c. the orphans programme to empower the children.

All these three programmes are designed to provide the targeted beneficiaries with opportunities for education and training along with other supporting means that help them to realize their aspirations in life. Through productive families programme, the objective is to arrange professional trainings to help women acquire craft and skills in order to create job opportunities that enable them to improve their standards of their living, thereby leading a decent life, such as weaving, manufacturing carpets, rosary industries, pottery etc.

In the case of Al Baraka Banking Group, the organization seeks to improve access to quality education, and pledge to fund public and private educational institutions. As access to high quality healthcare is a fundamental human right, Al Baraka Goals 2016-2020 pledge to fund various healthcare providers including specialist hospitals including specialist Cancer, Diabetes and Children's hospitals. Driven by four pillars (Philanthropic Programme, Economic Opportunities and Socia Investments Programme, Qard-Hasan Programme, and Time Commitment Programme), the bank has been contributing and supporting people with special needs as well as youth, women, and children. The bank has provided special need services with an equal distribution to both genders through a number of its subsidiary units, and has supported youth engagement, sports, women empowerment and children welfare activities.

4.2. Social business practices to satisfy community needs

Islamic banks have adopted some social business practices to address social needs that enable societies to function more efficiently. For example, the preliminary step taken by Jordan Islamic Bank is to set its value in serving the society and its provision of a legitimate alternative to the banking needs rather than the maximization of returns. The bank aims to strengthen Islamic values in business transactions and to consolidate the ties of social unity and compassion and solidarity. The bank has undertaken to grant Qard-Hasan to citizens to help them meet their social needs such as medical treatment, education, and marriage. The bank also engages other stakeholders to achieve the objective while collaborating with partners that have shared interest. Moreover, financial support has been provided to support publication of research and training opportunities to university students. For example, among these benevolent loans are those that the bank granted to youth wishing to marry, in cooperation with Al-Afaf Charitable Society; and those granted to teachers, as per the bank's agreement with the Jordan Teachers' Syndicate.

Apart from this practice, the bank has also initiated the mutual insurance fund inasmuch as the bank's debtors sharing in the fund are jointly liable for mitigating the harm that may befall any one of them, by paying the balance of his debt obligation in case of death, permanent disability or continuing financial hardships. The fund alleviates the risks exposures and is approved by the Central Bank of Jordan. To boost community impact, the bank has expanded its Takaful coverage in order to include everyone whose debt obligation reached 100 thousand dinars or less, instead of 75 thousand dinars or less.

In Kuwait, banks have been actively addressing social needs related to religious activities. For example, Kuwait Finance House (KFH) set the practice where it donates 0.5% of the value spent by customers using Al-Kheir prepaid cards into a special fund account throughout the year. This fund is used to sponsor a large number of needy people for Hajj and Umrah as part of the bank's social and moral responsibility. The strategy to serve its clients in all occasions is evidenced by special services during national holidays, when KFH takes the responsibility of delivering Eid money to client relatives' homes.

For the case of Malaysia, Bank Rakyat implemented the school adoption programme to support the educational activities such as examination workshop and provide rewards for excellence students. The bank has also designed a special service known as "Bank Bergerak" to access the outskirt and remote area in order to meet effectively the needs of the community.

4.3. The role of technology in addressing social issues

Leveraging advanced technology to achieve efficiency while providing customization to the society is becoming a recent practice in the financial industry. The distinctiveness in utilizing such technology is for banks to cater to specific needs of society, which cannot be satisfied by traditional infrastructure.

As an example, Kuwait is ranked 6th highest in the world to have the highest occurrence rates of diabetes. According to the International Diabetes Federation, there were nearly 410,000 cases of diabetes in Kuwait in 2014. Diabetes has grave social and economic dimensions for the patients, such as hampering the capabilities of those suffering from the disease along with high treatment and prevention costs. To respond to such structural problem, Kuwait Finance House (KFH) sponsored many government events and activities held by the Ministry of Health and Dasman diabetes institute in Kuwait to increase the awareness of diabetes and show the disease can be treated and reduced in the society.

In Malaysia, Bank Rakyat has launched a financial application known as "TouchStyle" for smartphone users, which is the first Shariah application for financial literacy developed in Malaysia. Customers can download it for free to access into the bank's latest products and services information. The apps also enable users to keep track their savings and expenditure, empowering them to practise sound financial management.

To maximize Islamic banks' positive impact on the social and environmental systems in which they operate, Islamic banks should develop coherent corporate social responsibility (CSR) strategies. The existing programme can be pruned by considering the following guiding principles: a) align with Islamic banks' purpose and values; b) align with Islamic banks' core business by focusing on economic growth and community development; c) form networks of nonprofit and educational partner who have world-class expertise and experience; d) track and measure results to ensure maximum impact; e) engage the time and talent of the people at all levels of the bank; f) coordinate programme across philanthropy, operational effectiveness and new business model to create shared value; and g) create an interdisciplinary management team to drive CSR strategy.[17] Banks' foundations should be exploring how venture philanthropy and social investment strategies can be used to maximize their income and asset base. Even within a competitive banking industry, Islamic banks should be open to collaboration and knowledge-sharing.

> To boost community impact, the bank has expanded its Takaful coverage in order to include everyone whose debt obligation reached 100 thousand dinars or less, instead of 75 thousand dinars or less

[17] Rangan, Kasturi, Lisa Chase, and Sohel Karim. "The Truth CSR." Harvard Business Review. January-February 2015.

5. EMPOWERING ENTREPRENEURSHIP AND SOCIAL VENTURE

Small and medium-sized enterprises (SMEs) constitute the backbone of economic systems and are the key drivers of long-term economic growth. With an estimated contribution of 43.5% to global employment, SMEs command the largest share of job creation in many developed and developing countries. The 2015 CIBAFI Global Islamic Bankers' Survey on 'Risk Perception, Growth Drivers, and Beyond' highlighted that "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" and that many Islamic banks are turning to building SME lines of business. Financing SMEs is viewed as an important aspect of Islamic banks' moral obligation to intermediate funds for the good of the society.

At the microenterprise level, several Islamic microfinance institutions have been serving poor Muslim clients who demand financial products, leading to the development of Islamic microfinance as a market niche. However, Islamic microfinance institutions have not yet established a strong footprint in many Muslim countries as commercial Islamic banks have. Islamic microfinance is presently concentrated in Afghanistan, Bangladesh, Indonesia, Malaysia and Sudan which account for 80% of the global outreach. There is therefore great potential for Islamic micro-financing to fill the gap and to help microenterprises become SMEs[18].

> While the SMEs segment has been considered to have huge potential to enhance economic development and generate returns for Islamic banks, special treatment should be tailored to the distinctive features and needs of this market. In other words, SMEs require non-financial support combined with innovative financial products to ensure their sustainable operation

5.1. Product innovation to empower SMEs

Various initiatives have been introduced and implemented by Islamic banks in this area. In Turkey, efforts in fostering SME development have been commended by international bodies, and could serve as an example for countries seeking to strengthen their SME sector. However, access to finance is not the main concern for Turkish SMEs compared to the high costs of production, sourcing for customers and skilled staf[19]. Responding to this problem, banks like Al Baraka Turk emphasize product development offering different financial solutions for different business sectors in the SME market. Several packages like the SME service package, dentist package and foreign commerce package have been offered by the bank to the market. This is mainly to empower small business and entrepreneurs, as well as to support SMEs to become part of the global value chain.

In terms of technical assistance, the accounting integration systems for SMEs also present opportunities for new business solutions. Focusing on the SME customers segment can enable a bank to diversify credit risk and improve its profit margin. As the bank's credit portfolio is currently dominated by corporate credits, it takes time to decrease corporate credits' share while trying to increase share of SME credits. The challenge is that a broader scale and branch network is required to face the stiff competition in SME banking in Turkey going forward.

Profitably and effectively serving the MSME segment requires a tailored customer management approach. For example, offering non-financial advice to customers has proven to be a winning strategy to deepen relationships especially in emerging markets. A SME client is profitable only when it purchases three or more products. Hence, Islamic banks can increase cross-sell and up-sell through specialized processes and bundles that optimize pricing strategies (e.g. micro-Takaful, waqf, advisory to empower SME in business and marketing plan). A dedicated SME customer management group can be formed to conduct analysis, builds tools, and serves as an effective advocate of the needs of SME clients within the bank.

One of the most reliable growth stimuli for SMEs is

[18] Karim Nimrah, Michael Tarazi and Xavier Reille. 2008. "Islamic Microfinance: An Emerging Market Niche," CGAP, Focus Note

[19] Aysan, Ahmet F., Mustafa Disli, Adam Ng, and Huseyin Ozturk. 2016. "Is Small the New Big? Islamic Banking for SMEs in Turkey." Economic Modelling 54: 187- 194; World Bank, Islamic Development Bank, Islamic Research and Training Institute. 2015. "Leveraging Islamic Finance for SMEs". Joint WB-IDB Policy Report.

value chain financing. Given the sizeable credit gap linked to value chains globally, targeting value chains can offer Islamic banks the opportunity to target SMEs in a scalable and risk mitigated way. For value chain financing to work, it is important that Islamic banks obtain the buy-in and partnership of large corporations (anchors which purchase products and services from SMEs. There must also be alignment between the finance/treasury and sourcing/procurement departments of the anchor to ensure that both business units benefit from the new product to be introduced. In conducting due diligence on suppliers, Islamic banks should segment the suppliers and, through deep market knowledge, tailor the financing rate depending on the supplier's segment. To enhance the scalability of the value chain financing process, Islamic banks can automate the process through a) an on-boarding programme with the anchor, suppliers, and/or distributors; b) internal IT platform or partnership with IT service providers; c) dedicated sales force with proper incentive mechanisms; and d) cannibalization tests to ensure that the value chain financing programme will not cannibalize important revenues stemming from other product offerings. Strengthening governance and legal compliance is also key to ensure that no collusion agreements have been made to defraud Islamic banks.[20]

5.2. SERVING UNDERSERVED AND PROMOTING ENTREPRENEURSHIP

In Saudi Arabia, banks like NCB enable women, who have problems in obtaining funding, to run small enterprises through micro finance programmes. The bank's objective is to transform women from charity-seekers into working, self-sustaining businesswomen. In this regard, the bank provides financing without any charge, returns or guarantees with convenient repayment periods. The financing is given on the basis of group approach with each group consisting of 5 persons wherein the group leader will ensure that the group members repay the financing obtained from the bank. The age range for the programme is from 18 to 60 years, with the condition that such group of women be located within the same district. As for supporting entrepreneurship, the bank introduced two Entrepreneur Support schemes: the NCB Start-Up Award and the Financing Small tProjects scheme, where graduates can apply for interest-free finance for their new endeavours. These financial support and advice are enabling SMEs to mature into established, sustainable organizations that can compete in broader markets, thereby intensifying their impact on local economies.

Another approach is taken through collaborating with relevant stakeholders while leveraging the strong business presence in SMEs market. For example, banks that are active in the SME sector such as Kuwait Finance House (KFH) are expanding financing to SMEs in collaboration with government agencies. The bank takes great interest in this vital sector as SMEs contribute in reducing the unemployment rates while motivating the youth to further contribute to the economy. Similarly, Al Baraka Banking Group believes that SME sector plays a pivotal role in the growth of economy and believes in encouraging entrepreneurship to promote the prosperity of societies and communities. The bank is also establishing specialized units, forging agreements with development funds, which is fuelled through its corporate social responsibility goals.

> Underserved markets caused by limited access to finance remains a key issue in the global financial industry. Proactive approach is required to serve this segment by promoting diversity as the target market

To further strengthen SME banking, it is important for Islamic banks to develop robust strategies and implementation plans based on sound understanding of the specific opportunity in the SME sector and the competitive landscape.[21]

[20] International Finance Corporation. 2010. "The SME Banking Knowledge Guide".
[21] IFC. 2015. "Raise the Anchor".

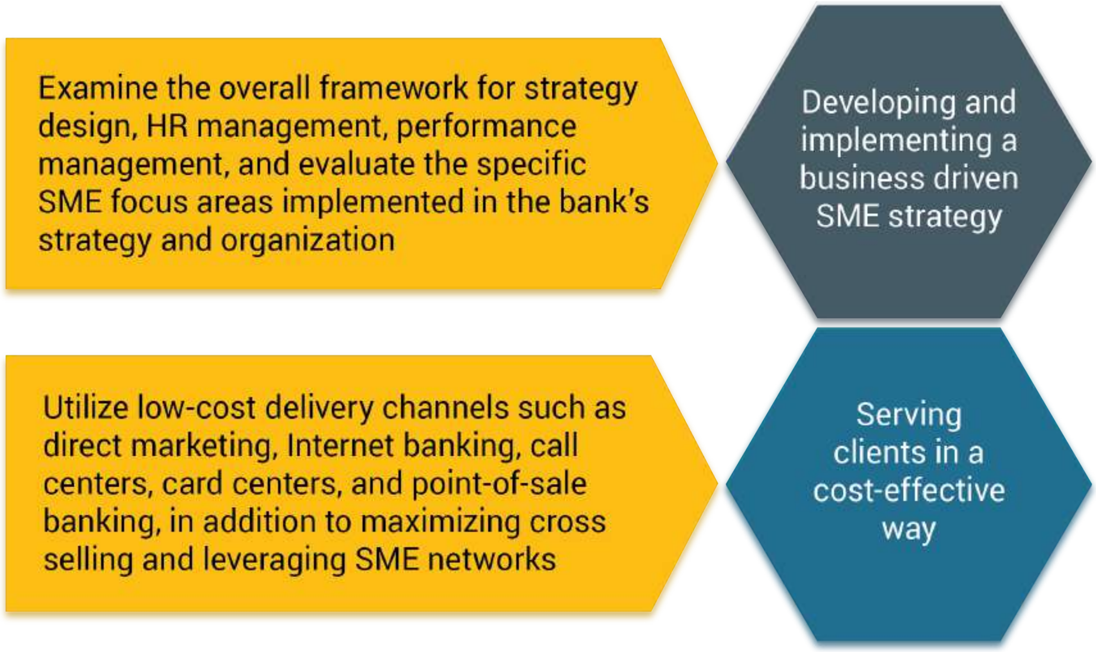


Figure 72: Strengthening SME banking

While SME financing is vital in developing a vibrant SME sector in any economy, it is equally important to enhance financial inclusion of the under-banked and under-served market segments, including disadvantaged customers, impoverished communities and those who are in need of financial support. Emerging evidence demonstrates that access to financial services through formal banking accounts can enable individuals and firms to smooth consumption, manage risk, and invest in education, health and enterprises. Islamic banks can forge partnerships with specialised organizations such as development institutions and social organizations to leverage on their expertise and outreach in order to create wider social impacts.

5.3. SCALING UP MICROFINANCE FOR TRANSFORMATIONAL CHANGE

Bangladesh, an agrarian economy with vast rural population, has been the bedrock of microfinance that has contributed to poverty alleviation, women empowerment and rural development. However, while there are over 20,000 NGOs and microfinance institutions registered with the Bangladeshi Department of Social Affairs, the degree of success in poverty alleviation has been debatable. Commercial banks' outreach to the rural poor has been low due to weaknesses in the design, planning and management of microfinance programme including the inadequate accountability and credit administration system.

Recognizing that the majority of the population is below the poverty line in the rural area, a "Rural Development Scheme" (RDS) was developed by the Islami Bank Bangladesh Limited (IBBL), a commercial bank, in 1995 to reduce the rural-urban disparity and to ensure equitable distribution of income through the creation of employment opportunities. The RDS was initially introduced as a corporate social responsibility of the bank, and it is now one of its main financing channels. The scheme has five main objectives:

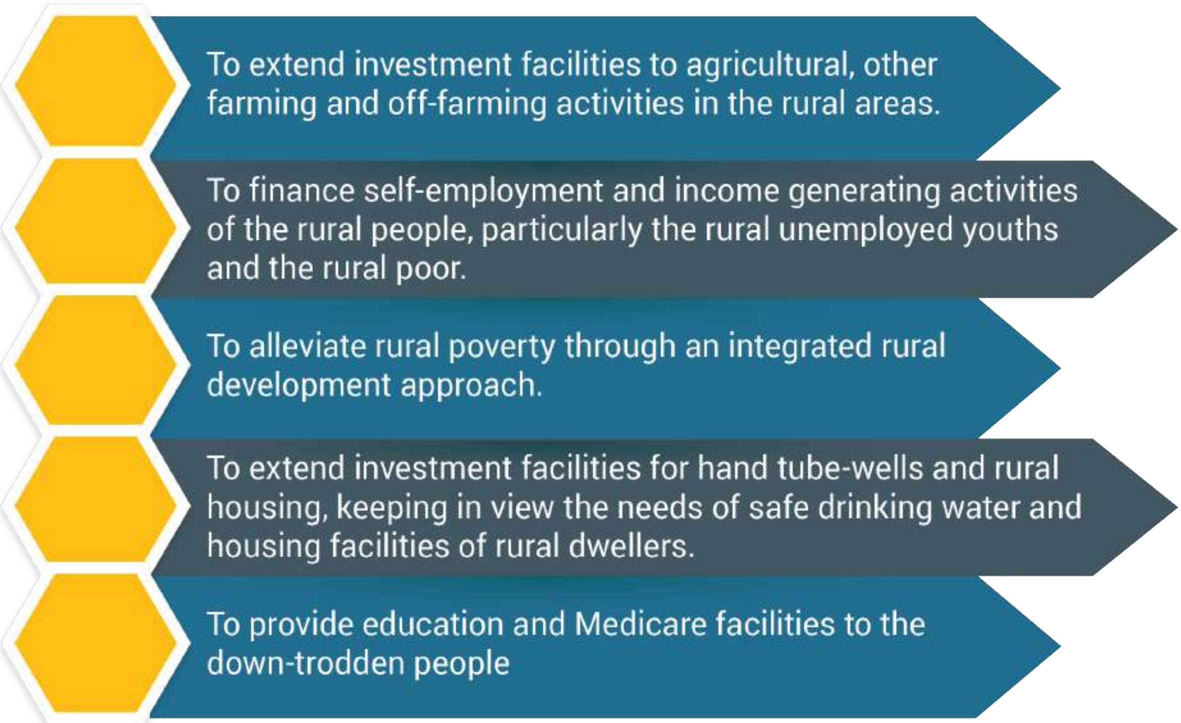


Figure 73: Objectives of Rural Development Scheme (RDS)

The RDS is funded through the general investment fund of the bank without financial support from the government or external donors. Instead of issuing the financing amount to customers in cash, the bank delivers goods to the customers to ensure that the financing is channeled to income generating activities

Robust risk management and close customer engagement through close supervision, follow-up and monitoring are crucial to the sustainability of the RDS. The bank branch has to take the responsibility for the investment as well as recovery. To ensure 100% recovery, the field officers make very close and intensive supervision over the clients. Moreover, the group approach is very helpful in this process whereby clients are motivated, induced and pressed by the fellow members in recovering the investment.

1. One Field Officer is appointed for 400 investment clients, and one or more Assistant Officer/Officer is engaged in the Branch as Project Officer to supervise the activities of the Field Officers
2. An Assistant Project Officer (APO) is also engaged where more than 10 Field Officers are working in the Branches.
3. At the zone level, one or more officials in each zone are assigned as RDS Zone Officer to supervise the RDS activities of the Branches under the Zone.

4. The Zone Officers visit the Branches under their respective Zone at least twice in a year.

5. At the head office level, Head Office Officials also visit the activities in the Branch level once in a year.

6. Weekly, monthly, quarterly and annual statement of RDS of the Branches are prepared and sent to the higher authority to monitor and evaluate the activities regularly. [22]

The scaling up process of the RDS was enabled by a conducive cultural and policy environment, institutional and organizational capacity, as well as dedicated management and capacity building of its employees. The bank has been developing microfinance products that are responsive to market demands and cultural needs of the poor, many of which claimed a preference for Islamic products over conventional products even if the former is more expensive. The Government of Bangladesh has been actively providing an enabling environment for the private sector to be involved in the country's poverty reduction agenda. The Islami Bank Training and Research Academy (IBTRA) was formed to train employees on Islamic financial practices in a structured learning process. There is also a Micro Enterprise Investment Scheme to meet the needs of graduated clients who are already availed the highest limit of investment under the Scheme. Going forward, the bank will be promoting the use of the more extensive use of biogas and solar panel in rural households, clean drinking water and sanitation as well as ensuring zero drop-out from primary education in its RDS programme.

However, there are several challenges to the growth of Islamic microfinance especially for the non-commercial microfinance institution. These challenges include the inadequate funding, lack of expertise and limited staff capacities, insufficient economies of scale, operational inefficiency and unfavourable rules and regulation. Scaling up local innovations in microfinance will hopefully contribute to more effective achievement of sustainable and equitable development at the broader level.[23]

Islamic banks can further align its SMEs financing initiatives to ensure inclusive and quality education and promote lifelong learning opportunities for all (United Nations Sustainable Development Goal 4). This can be achieved by providing SMEs with accounting, customer service and business management training to progress their lifelong learning, thereby building loyalty and success of SME customers and helping to identify and attract new ones. Moreover, Islamic banks can consider opportunities for social enterprise and impact investment ventures particularly in post conflict countries where SMEs and micro-enterprises play a critical role in providing jobs (UNSD Goal 16).[24]

Islamic banks can also contribute to the promotion of inclusive and sustainable economic growth, full and productive employment and decent work for all (UNSD Goal 8) in the following ways: a) expand microfinance (savings, credit and insurance) for small business owners; b) collaborate with partners to expand finance for 'the missing middle' i.e. small enterprises graduating from microfinance which are not yet able to access credit from the formal banking system; c) leverage new business models and technologies to raise diversified sources of capital including impact investment, crowd funding, peer-to-peer lending and catastrophe bonds; d) provide targeted internships for young people from disadvantaged backgrounds in order to promote social mobility whilst also enhancing enterprise performance through increased workforce diversity; and e) create opportunities for lower paid workers to develop their skills and gain access to improved professional opportunities, both within and outside of the Islamic financial services sector.[25]

[22] Target group includes farmers, sharecroppers, persons engaged in off-farm activities, fishermen, women and people in distress. Qard for one year is provided to distressed members and the ultra-poor on a revolving basis.

[23] UNDP. 2012. "Scaling up Islamic Microfinance in Bangladesh through the Private Sector: Experience of Islami Bank Bangladesh Limited (IBBL)".

[24] United Nations Global Compact and KPMG International. 2015. "SDG Industry Matrix: Financial Services."

[25] Ibid.

6. SEIZING OPPORTUNITIES IN GREEN FINANCING

6.1. Financing renewable energy

About 1.2 billion people – 17% of the global population - did not have access to electricity in 2013 according to the International Energy Agency. More than 95% of those living without electricity are in countries in Sub-Saharan Africa and developing Asia, and they are mostly in rural areas (around 80% of the world total). The lack of access to energy services limits the ability of the population to benefit from opportunities for economic development and an increase in living standards. At the same time, the problem of human-induced climate change has been high on the global policy agenda and will continue to be so given the devastating trend of global warming. Global warming is on course to reach 4-6 degrees Celsius by the end of the century, which can disrupt global food production and increase the frequency of extreme weather incidents.[26] On a positive note, the global market for green technology has grown by an average of 12% yearly since 2007, and is currently valued at over EUR2 trillion.[27] By 2025, the market is expected to more than double to EUR4.4 trillion. In particular, the global market for renewable energy namely wind, solar photovoltaic (PV) and biofuels is forecasted to reach US$400 billion by 2021.[28]

In the case of Indonesia, with around 70 million people not having access to electricity, the country's rate of electrification is only about 60%, one of the lowest in the region. Given the soaring demand driven by population growth, economic growth and the limited availability of Indonesia's fossil fuel reserves, there is an urgent need for renewable energy such as hydro, biomass, solar, wind, geothermal, bioenergy. The need for renewable energy is also important to reduce greenhouse gas emissions, which are expected to double from 165 million tons in 2013 to 335 million tons in 2022 with 86% of the emissions coming from coal emission. However, despite the potential of sustainable energy resources of the country, the development and utilization of renewable energy is still lagging behind the target of 17% by 2025 in the National Energy Policy.[29]

Responding to this issue, in the last five years, more commercial banks have provided funding to renewable energy projects, with development agencies' assistance and encouragement by the Green Banking Regulation of Bank Indonesia, the country's central bank. Islamic banks are also emerging as active financiers. At present, Bank Muamalat Indonesia (BMI) manages the financing of the electricity, gas and water sectors, including a mini hydro power plant, with total outstandings accounting for 6.1% of total financing as of December 2015. From the experience of the bank, there are some factors to be considered in the management of the quality of financing portfolios, such as Environment Impact Analysis (Analisis Dampak Lingkungan), feasibility study, Power Purchase Agreement (PPA) with the state-owned enterprise in electricity sector (PLN), and financial support from shareholders or sponsors. The challenges in financing mini hydro power plants in a sustainable way include analysing power plants' location topography and water capacity in a particular location in order to produce adequate electricity power. To address above challenges, the bank cooperates with independent experts in reviewing a project's feasibility study and a location's topography. While financing sustainable energy remains a daunting task for Indonesia, there is a promising prospect for Islamic banks to develop financing channels and instruments that can support the liquidity needs of green infrastructure development projects going forward.

> Access to finance remains a challenge for companies, project developers and investors because domestic financial institutions perceive renewable energy project as a risky venture, creating a dependency on foreign funding

Unlike some of its oil-rich MENA neighbours, Jordan requires a significant level of renewable energy supply due to its limited fossil fuel resources and the volatilities of the price of imported fuel. Jordan has taken active steps to promote the development of renewables in the last decade, taking advantage of its rich wind energy resources and vast solar supply. Since 2005, the Jordanian government has launched a gradual removal of subsidies for gasoline,

[26] Sachs, J. D. "The year of sustainable development." Project Syndicate. 9 December 2014.
[27] Green Tech made in Germany 3.0- Environmental Technology Atlas for Germany, 2012.
[28] Clean Edge. "Clean Energy Trends Report" 2012.
[29] WWF. "Sustainable Energy Finance in Indonesia." 2014.

diesel, fuel oil and kerosene. A target to obtain 1,800 MWs or 10% of the country's energy supply from renewable sources by 2020 has been set in the Master Strategy of the Energy Sector in Jordan. Several regulatory measures have been introduced as part of its Nationally Appropriate Mitigation Action plan to reduce carbon emissions. There is also a legislation known as Renewable Energy & Energy Efficiency Law that sets out measures for the use of renewable energy in Jordan. The Jordan Renewable Energy and Efficiency Fund, financed by the Jordanian government and international donor agencies such as the World Bank, is open for domestic and international investors.

Building on these initiatives, the Islamic International Arab Bank (IIAB) signed an agreement with the Central Bank of Jordan in 2015 to develop Shariah compliant alternatives for mid-term loans based on Wakalat al-Istithmar for financing of energy efficient and renewable energy projects. Under this arrangement, the maximum amount of financing is US$ 6 million and the maximum tenor is up to 120 months, with a fixed pricing based on the central bank's rediscount rate. There is also a finance guarantee scheme based on Kafala that can be used as appropriate collateral in the transaction. Among the challenges faced by the IIAB are the impacts of oil price volatility on payback periods, cost of finance and feasibility impact of renewable energy projects, as well as the awareness of energy efficient and renewable energy solution. In this regard, the Wakala agreement with the central bank seeks to reduce to the cost of finance and to increase the financing tenor in line with the payback period to overcome oil price volatility. IIAB also collaborates with specialized entities to enhance the awareness of the benefits of energy efficient and renewable energy. The bank has launched a special product for the instalment of home solar energy systems without any profits or returns. This product aims to provide clients with the assistance to reduce the electricity bill and lower the pressure on the national electricity grid company.

Challenges remain in the adoption of environmental, economic and social impact guidelines, uncertainty of renewable energy laws and regulations, as well as qualified consulting engineers and energy audit parties. In this regard, the bank has an internal engineering department to conduct the following:

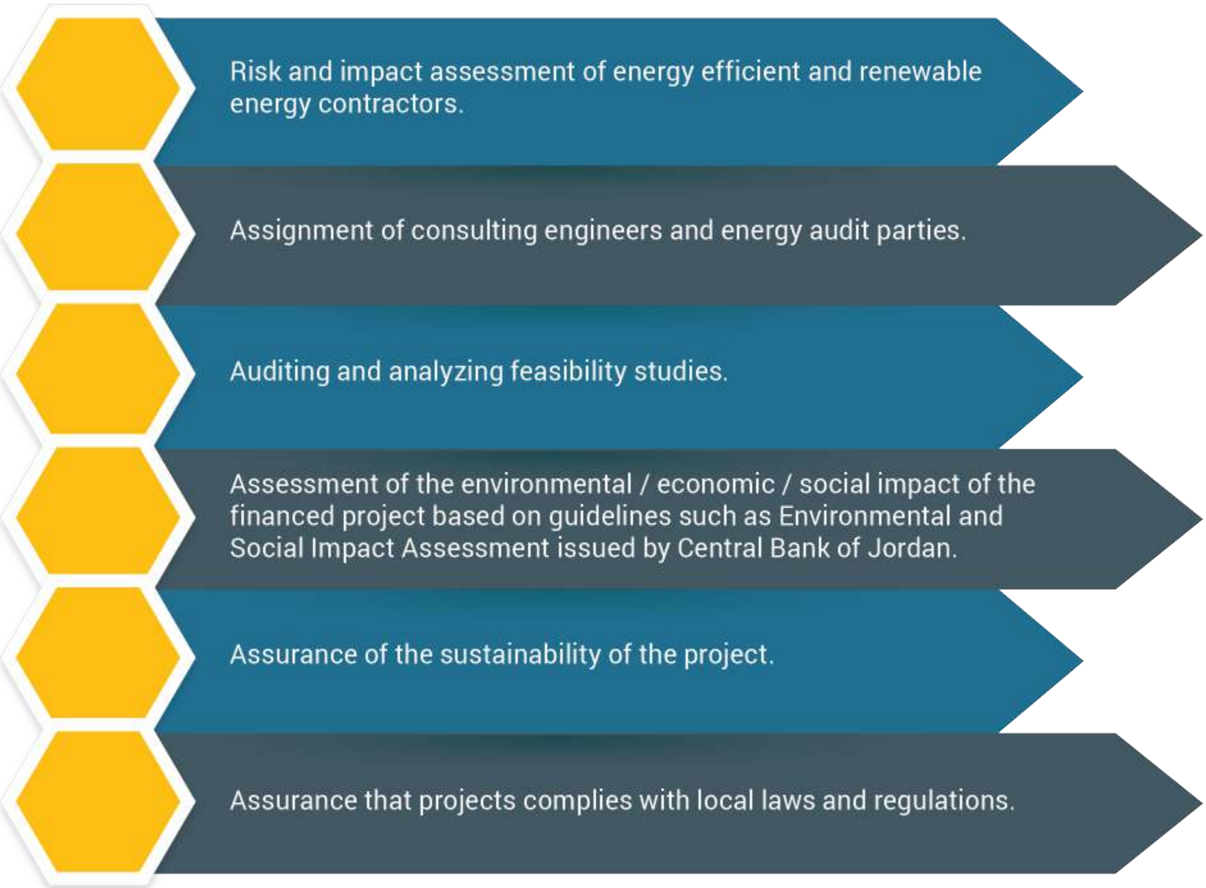


Figure 74: Checks banks conduct in adopting environmental, economic and social impact guidelines

In Malaysia, the importance of green technology as a driver of sustainable energy growth for the future and the sustainable development of the country is well recognized by policymakers and regulators. This has been spelled out in the National Green Technology Policy in July 2009 and identified as a Key Strategic Reform Initiative under the New Economic Model. Malaysia made a commitment in Copenhagen to reduce up to 40% of carbon emission intensity of GDP by the year 2020. In the solar energy sector, Malaysia is one of the top producers in PV manufacturing, generating direct foreign investment of over RM12 billion (US$3 billion) and creating over 10,000 skilled jobs.[30] In 2010, the Green Technology Financing Scheme (GTFS) was established by Bank Negara Malaysia, the Ministry of Finance, and the Ministry of Energy, Green Technology and Water in order to accelerate the expansion of green investments by providing easier access to financing from financial institutions.[31] With an initial allocation of RM1.5 billion (US$375 million) and an increment of an additional RM2.0 billion (US$500 million), the GTFS offers a 60% guarantee of the financing amount via the Credit Guarantee Corporation Malaysia Berhad (CGC) and a rebate of 2% on the profit rate charged by the financial institutions. Since the introduction of the GTFS, green technology financing has been gaining traction among Islamic banks. To date, a total of 36 projects have been financed by Islamic banks.

Advances have also been made in retail green financing. A green mortgage to facilitate installation of solar systems for home owners to benefit from the country's Feed-in Tariff plan was introduced by a local Islamic bank in Malaysia. Such financing offers home owners the opportunity to participate in the renewable energy initiatives as well as enhancing the awareness of green technology in the country. Efforts are also undertaken to strengthen the advisory capacity of financial institutions to support businesses, including a certification process that verifies the businesses which qualify for the GTFS. These initiatives and progress are crucial to the further unleashing of the growth potential of green technology in Malaysia given the largely untapped opportunities in this niche market. Islamic banks can mobilize resources to build their capacity and capabilities in order to contribute towards a sustainable financing ecosystem and a high value-added economy.[32]

Going forward, Islamic banks can consider adopting the Equator Principles – a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in project financing. In addition, some trading companies have stakes in or operate large-scale projects such as exploration activities that have a higher exposure to environmental and human right issues. Islamic banks can manage these risks by integrating social and environmental impact assessments into their financing and supply chain management.

6.2. Integrating environmental friendliness into banking operation

The GCC countries are considered among the highest energy consuming countries in the world on a per capita basis. The per capita usage of water in the Middle East region is much higher than the global average. Kuwait ranks third in the world in Kilowatt Hours consumed per capita. The principal reason behind the high consumption rates is the heavily subsidized price of energy whereby Kuwaiti consumers pay approximately 5% of the cost to generate electricity.

Kuwait Finance House (KFH) discovered that one of the most material issues to its external stakeholders is its environmental impact. While financial institutions are not typically considered by society to be among the big polluters relative to other industries, nearly 40% of energy consumed in the world goes to power buildings. In view of this, the bank has taken a conscious decision in environmental responsibility in the banking sector by regularly monitoring, managing, and reducing its energy footprint in all of its branches. By reducing water consumption in its regional operations, the bank believes that it will prevent environmental degradation, and see financial benefits as a result of lower operational costs. The bank is involved in the Tarsheed conservation campaign organized by the Ministry of Electricity and Water, which takes place during the summer months. Some of the bank's efforts to conserve water and energy during the peak summer months include: replacing building lighting with energy saver compact fluorescent lamp (CFL) bulbs, using the latest technology for electrical appliances, and conducting regular check-ups for water leakages. Since the bank's energy consumption occurs through its offices, the bank uses a global methodology, developed by the International Energy Agency (IEA) to estimate its CO2 emissions using a grid emission factor multiple. The grid factor is determined by a country's sources or fuels used in the power plants.[33] KFH has also embarked on an

30 Data from Malaysian Green Technology Corporation. 8 Oct 2013 http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech_all&ac=481

31 The GTFS is available until 31 December 2017 or upon reaching a total financing approval amount of RM3.5 billion whichever is earlier.

32 Ibrahim, Muhammad bin. 2013. "Role of the Islamic Financial System in Supporting Green Technology." Keynote Address at The Green Financing: Discover Green Technology Industry in Malaysia.

33 Countries that use cleaner fuels such as natural gas and renewable energy have lower grid emission factors, and countries using more polluting fuels, such as coal, have higher grid emission factors.

initiative to commit all of its operations to the Zero-Waste Strategy. Work is progressing on the most efficient ways to implement this strategy. The initiative aims to recycle and re-use all the waste from banking operations, potentially including paper, plastic and e-waste.

In the case of Turkey, some banks are actively promoting environmental-friendly buildings from their conception to the construction stage in line with the spirit and guidance of environmental awareness. For example, Kuveyt Turk Participation Bank's Banking Operation and Life Centre is an environmental-friendly building that satisfies global certification bodies in environmentally sustainable building. In addition to mitigating the life cycle impacts of buildings on the environment, the use of the "Building Research Establishment Environmental Assessment Method (BREEAM) in sustainable buildings help to reduce operational costs, limit investor and developer risk, enable buildings to be recognized according to their environmental benefits, as well as creating a more productive and healthy workplace.

In Jordan, Jordan Islamic Bank continues to furnish its branches with alternative energy sources, through the use of solar cells – installed on the roof to generate electricity. This development has decreased electricity bills, contributed to lower electricity burdens on Jordan, and, subsequently, helped to support the national economy and protect the environment. It is worth noting that this programme encompassed three branches as its first step. This system is currently applied in 18 branches. Jordan Islamic Bank also operated renewed energy system units for Al Rawdah District Mosque in Amman and for other units for two schools in remote areas to meet their need of electricity. Similar practices can be seen in Al Baraka Banking Group's Headquarters where the building has adopted automatic lighting systems among the technologies that save energy, and is making conscious efforts with its infrastructure projects, schools and hospitals development, to ensure that the initiatives are sustainable and environment friendly. Its headquarters building in Turkey also has an environmental management

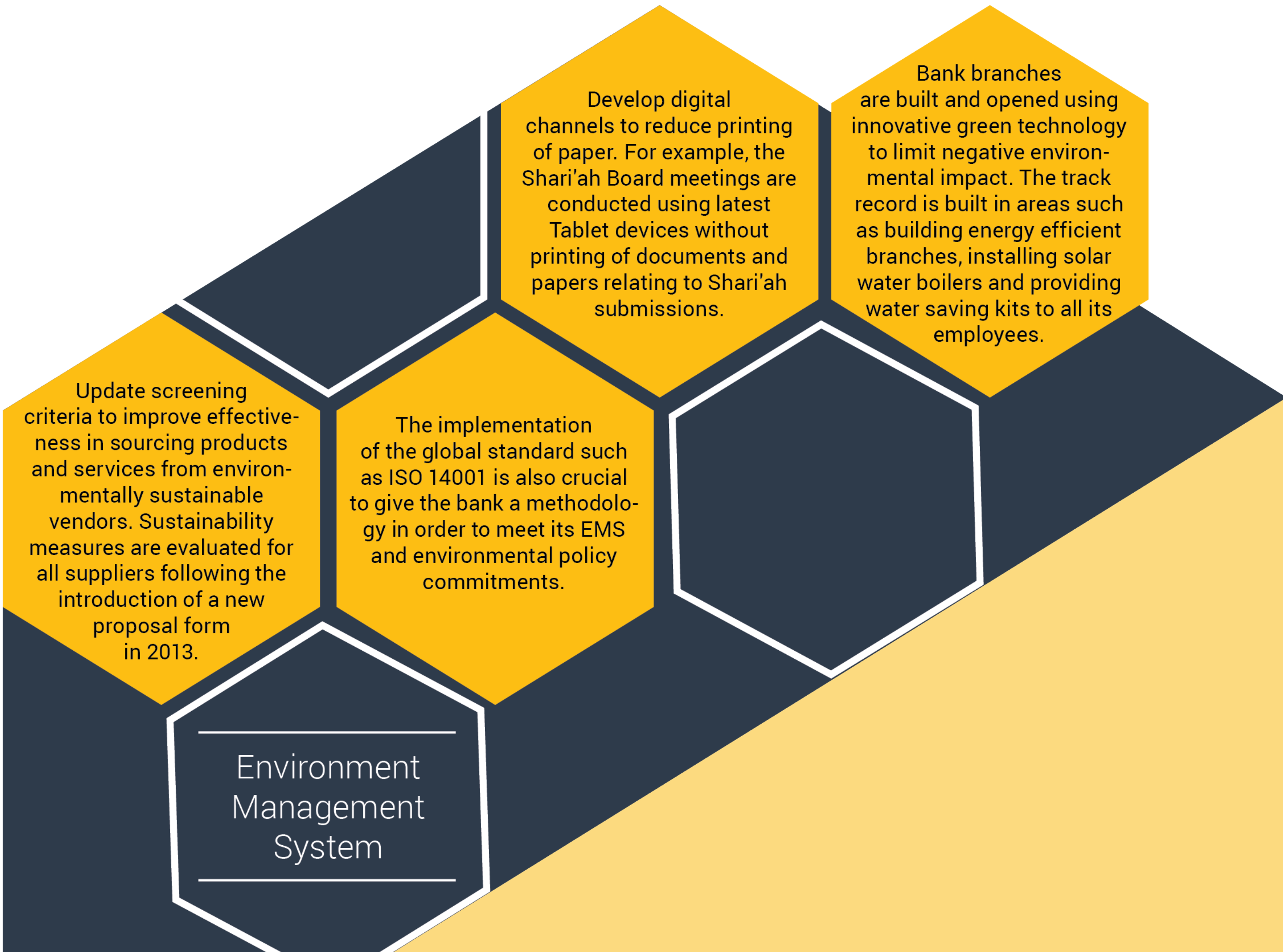


Figure 75: Environment Management System

system that tracks the usage of paper, vehicle, building energy audits, among others. In addition, the banking group has pledged to support the environment-friendly initiatives of the United Nations' Global Goals for Sustainable Development.

In Saudi Arabia, NCB put into practice good corporate citizenship which encourages every staff member within the bank to act responsibly and sustainably towards the community and environment. This is implemented through the Environment Management System (EMS).

7. INSTITUTING AND COMMUNICATING SUSTAINABILITY: THE SIGNIFICANCE OF SISTAINABILITY REPORT AND CULTURE

7.1. Significance of sustainability report

Sustainability reporting is an important platform that enables organizations to measure, comprehend and communicate their impacts on a wide range of sustainability issues to their stakeholders – whether positive or negative. Sustainability reporting also presents the organization's values and governance model, enabling them to be more transparent about the risks and opportunities they face in their commitments to a sustainable global economy. This helps to build and maintain trust in businesses particularly in this era of trust deficit. The significance of sustainability reporting has called for the development of global guidance. Global Reporting Initiative (GRI) has been a pioneer in this field since the late 1990s, transforming it from a niche practice into one that is becoming a mainstream. To date, thousands of companies across all sectors have published reports that reference to GRI's Sustainability Reporting Guidelines. Of the world's largest 250 corporations, 92% report on their sustainability performance and 74% of these use GRI's Standards to do so .[34]

Figure 76: Benefits of sustainability reporting for organizations

[34] KFH has produced its sixth Corporate Sustainability Report to date.

7.2. Implementation of sustainability reporting in Islamic banks

Islamic banks can track and assess key long and short-term issues based on materiality to their business and actual stakeholder expectations and interests on a regular basis. Having a stakeholder engagement policy helps to set out the banks' rules of engagement with external stakeholders that may affect, or be affected, by the banks' activities, products or services, or performance. More constructive engagement with external stakeholders such as small-to-medium enterprises, communities, civil societies, industry association, the poor, disabled, youth and women entrepreneur may include topics related to a) financial inclusion, including debt and access to affordable credit; b) issues that the banks should prioritize to become the industry leader for customer service and trust (e.g. security, stability and privacy of financial transactions, consumer protection); c) the increasing availability of alternative sources of finance and how banks should collaborate with these providers; and d) eco-efficiency through the banks' own operational footprint and the financing that they provide. Through engagement with customers during project due diligence and consumers during day-to-day operation, Islamic banks can also contribute to customers' to social and environmental risk management capacity building as well as increase awareness on the impact of sustainability issues in the business world.

Saudi Arabia has been actively promoting "Responsible Competitiveness" - competitiveness that accounts for the relevance of sustainable development in global markets and strengthens the competitiveness of companies and nations. Leading corporations in the Kingdom have published sustainability reports, adopting new global benchmarks and demonstrating commitment to support performance transparency in the course of assessing collective progress in achieving sustainable development for the Saudi business community. The National Commercial Bank (NCB) has been publishing a GRI checked sustainability report since 2008. The reasons for the bank to publicly share its performance on economic, environmental and social impacts were four-fold:

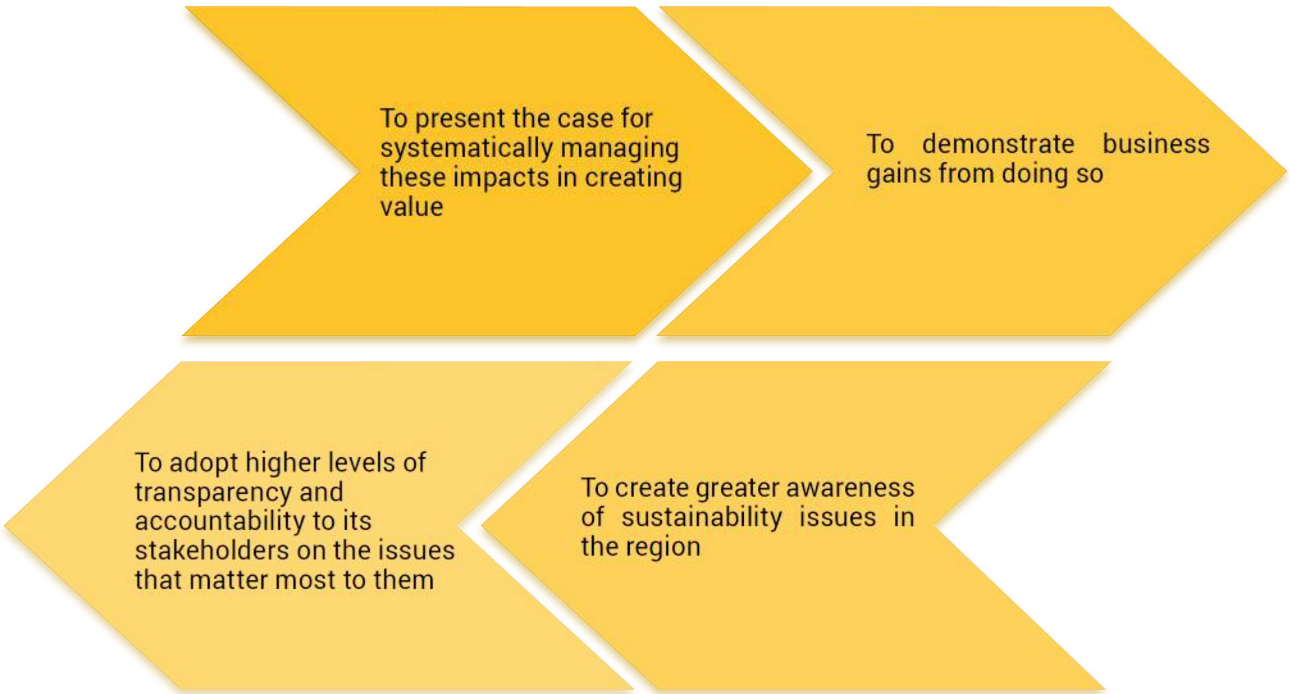


Figure 77: Reasons for the bank to publicly share performance on economic, environmental and social impacts

These reasons have been a strong driver for the bank to address challenges in preparing the sustainability report. One of the key challenges was compiling and checking data from various departments within the bank, for example power and water consumption measures, which were not tracked prior to 2008. Another challenge was establishing the relevance between sustainability principles and business objectives, as well as selecting the relevant content and key messages.

Since sustainability reporting is a journey, the bank has taken a strategically focused and tactically phased approach by identifying strategic priorities with the aim of improving year on year, and establishing the relevance of sustainability issues within the bank and with key stakeholders. Initially, the bank defined how sustainability relates to the bank, and then identified stakeholders and their priorities. Through a process of internal analysis and external verification, the bank identified six stakeholder groups: customers, employees, business partners, shareholders, the environment and the community at large. Such identification was important for the bank to understand and respond effectively to the priorities of each of the stakeholder groups, which enabled the bank to better manage and enhance its economic, social and environmental performance via stakeholder engagement. The next stage of development entailed forming strategies, targets, and action plans for the bank's highest priority issues. By 2010, the bank began to focus on resource-use and on broader environmental issues, in order to enhance awareness of conservation matters. 2011 marked the start of structured engagement with business partners, customers and employees, through which the bank was able to share its sustainability experiences and achievements, and promote sustainable practices. Each year the goals featured in the sustainability report demonstrate greater commitment and increased depth.[35]

Apart from the above, a sustainability policy is in place to set out the principles for applying sustainability management and allocating responsibility for sustainability performance in the bank. Effective implementation of this policy will benefit numerous areas within and outside the bank (Figure 78).

Figure 78: Efforts to effectively implement a sustainability policy

[35] "Why we need sustainability reporting" (26 October 2011) and "GRI Report Services: Spotlight on The National Commercial Bank" (4 April 2013)

While a strategic plan incorporates all necessary plans and actions to ensure the achievement of continuously improving sustainability performance, implementation is the responsibility of all managers and employees. Hence, the bank's Sustainability Steering Committee has been formed to guide all the bank's future sustainability strategies and initiatives. It is also responsible for applying performance indicators and other measures to monitor the achievement of objectives. The committee's membership is drawn from the bank's senior management, with an objective to ensure that sustainability efforts are aligned with the bank's overall strategy and goals, while adhering to its sustainability framework. These commitments are predicated on how the bank defines sustainability management – the integrated management of economic, environmental, and social performance with the goal of creating value for all stakeholders and pursue business excellence.

Going forward, Islamic banks may strengthen their policies, procedures and systems by producing more formal positioning statements that reflect a range of positions as part of the banks' public commitment to future environmental goals:

a) Limitations and reduction of impacts of environment factors based on banks' own activities (direct exposure);
b) Limitations and mitigation of impacts of environmental factors based on the activities of banks' clients (indirect exposure);
c) Development of proactive systems of advanced risk management and opportunity identification;
d) Use of environmental sustainability as a strategic/competitive initiative (for example, developing new or enhanced business products, deeper client relationships, leadership in certain sectors or on certain sustainability themes);
e) Contribution to the transition to a more sustainable economy through environmental sustainability leadership.

The positioning statement can also include Islamic banks' positions on the extent of monitoring and transparent reporting to which they aspire.[36]

8. MEASURING THE DEVELOPMENTAL IMPACTS OF FINANCING AND INVESTMENT: THE CASE OF ISLAMIC DEVELOPMENT INSTITUTIONS

The Sustainable Development Goals (SDGs) will be setting the goals for development institutions around the world over the next decade. In the context of Muslim countries, they will also be an important policy guidance for Islamic development institutions such as the Islamic Corporation for the Development of the Private Sector (ICD), under the Islamic Development Bank Group (IDBG).

8.1. Practices of development institutions to support Micro, Small and Medium Enterprises (MSMEs)

The ICD views MSMEs as the backbone of economic development in many developing member countries given their contribution in providing employment opportunities for young people and sustainable solution for poverty alleviation. As a development institution that focuses on Muslim-majority countries, particular consideration has been given to the challenges of achieving the SDGs in low-to-middle income member countries in an era characterized by rising income disparity, fast pace of globalization and social insecurity.

To achieve its objectives, the institution has adopted four strategic pillars, through which it aims to make its developmental impact in its member countries.

As a distinctive feature of an Islamic development institution, it aims to support the economic development of its member countries through the provision of Shariah compliant financial services to private sector participants. The institution has developed different tools and means to serve MSMEs. First is the development of partnerships with local financial institutions in financing SMEs through Lines of Finance, SME funds established in a number of member countries and microfinance initiatives. Secondly, through its Advisory Services the institution also promotes and encourages entrepreneurship and sustainable competition among small and medium enterprises (SMEs), advises governments on Islamic finance enabling environment and encourages cross-border investments.

By promoting Islamic finance, the institution attempts to enhance financial inclusion of the Muslim population which has limited access to Islamic finance. This target can be achieved through the establishment of Islamic financial institutions (Islamic banks, Ijara companies, etc.) or in partnership by local banks (both Islamic and conventional) in channelling Shariah compliant financing to private sector businesses, especially SMEs. The institution's working environment has been framed around core Islamic values with the aim of serving the Muslim population.

Through these pillars and practices, the institution attempts to address issues such as SMEs' access to finance and competitiveness, economic development of the country through nurturing of the private sector, job creation and empowerment of women, encouragement and creation of value to end customers, particularly through the Islamic banks where the institution has a strategic shareholder or founding shareholder role.

[36] "WWF Report. 2014. "Environmental, Social and Governance Integration for Banks: A Guide to Starting Implementation."

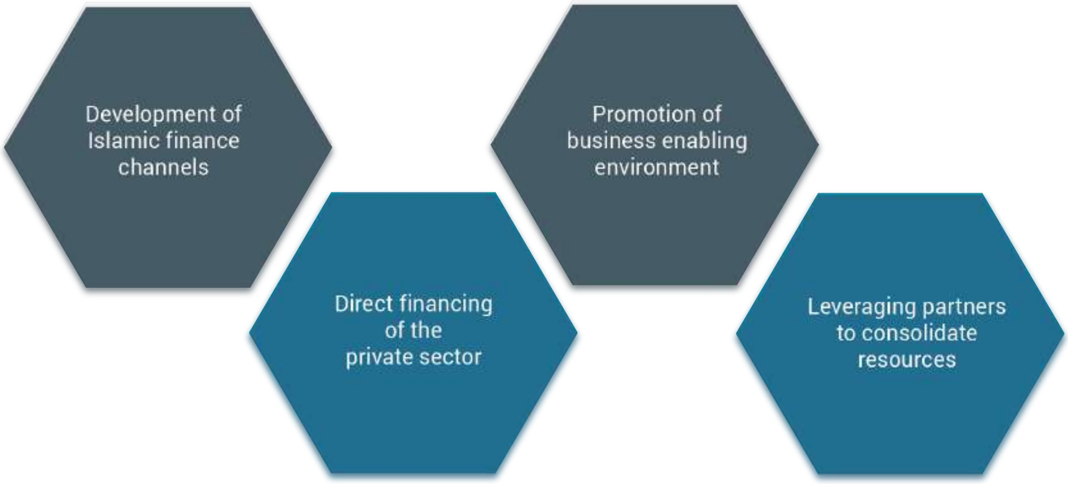


Figure 79: Four Strategic Pillars to develop MSMEs

8.2. Promoting diversity and environmental friendliness in project appraisals

Sustainable financing/investment avoids negative externalities to the environment and the society. Social and environmental aspects of the projects are taken into consideration for any investment or financing transaction. For example, the number of women employed is one of the indicators used in the assessment of developmental/ social impacts of the projects financed through local banks under ICD's Lines of Finance. Also, the development institution's financing agreements include environmental covenants and predefined indicators related to the environmental impact of projects. The agreed environmental steps to be taken are followed up during the project execution via supervision missions (both from operations and Monitoring and Evaluation (M&E)) and project implementation reports. During the evaluation throughout the project cycle, the overall status is assessed in line with the specificities of its member countries, local regulations as well as best practices of MDBs. For the institution's clients, with evolving local regulation and pressures of multilateral financial institutions, tools such as social and environmental profit and loss accounts will progressively be resorted to.

8.3. INVESTMENT PRACTICES TO BOOST ECONOMIC IMPACTS

One of the main criteria driving investment decisions of development institutions is the need to boost economic impact. This can be in the form of direct job creation though indirect and induced investments. In terms of tools to assess the multiplier effect, the ICD, like other multilateral financial institutions uses specific sector metrics derived from experience and studies conducted by MDBs. For example, the effect on private sector development is measured by the institution through, for example:

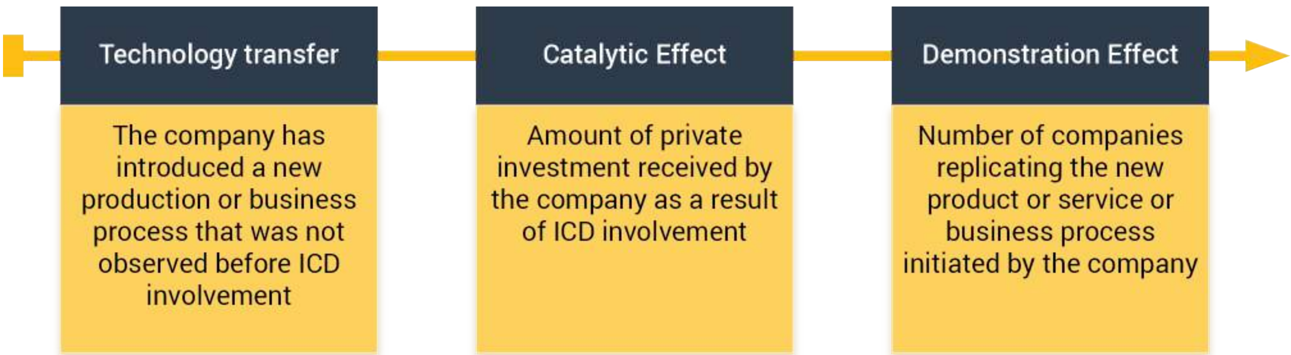


Figure 80: Measuring the effect of Private Sector Development

8.4. Building blocks and strategies

In general, a development institution needs to enhance its business processes particularly in risk management in order to achieve its financial and development targets within sound risk parameters. This is because a development institution is neither a charitable organization, nor a solely profit-driven institution, and as such it requires specific strategies and practices that aim to strike a balance between sometimes contradictory goals of development and profitability. Such 'complementary-balance' leads to the contribution of better business performance.

To ensure the proper and effective delivery of the above mentioned developmental results, the development institution has implemented several responsible business practices and strategies. Among them, the following are the key three practices.

The establishment and full integration of an M&E Department into daily operations can systematize the institution's developmental goals, establish a mechanism to evaluate the developmental impact of projects implemented, and assess the developmental effectiveness of the institution's operations in its member countries. Specifically, the institution is implementing a proper mechanism to evaluate its developmental effectives of its mandate and properly report it to its multi-stakeholders, including member countries, partners etc. Enhancing operational efficiency is a key to achieve notable development results, despite working in often uncertain and fragile operating conditions in many member countries, as a result of falling oil prices and ongoing political instability.

In addition, setting up the building blocks is essential to becoming a more effective development institution. This includes the Development Indicators Monitoring System (DIMS) developed internally and an Information Management Platform as well as Supervision and Expanded Project Supervision reports (PSR and XPSR). The key strategy is also to adopt the private sector development measurement framework endorsed by the Multilateral Development Banks (MDB) Evaluation Cooperation Group's Good Practice Standards (GPS) for Private Sector Operations, which focuses on four criteria: a) financial performance; b) economic performance; c) private sector development; and d) environmental, social, health and safety. The institution has an additional indicator, which is Islamic finance. The way forward would be to integrate the design delivery and assessment components of the institution, building on the existing strong base towards achieving sustainable development in Muslim countries.[37]

Figure 81: Responsible business practices and strategies implemented by the development institution

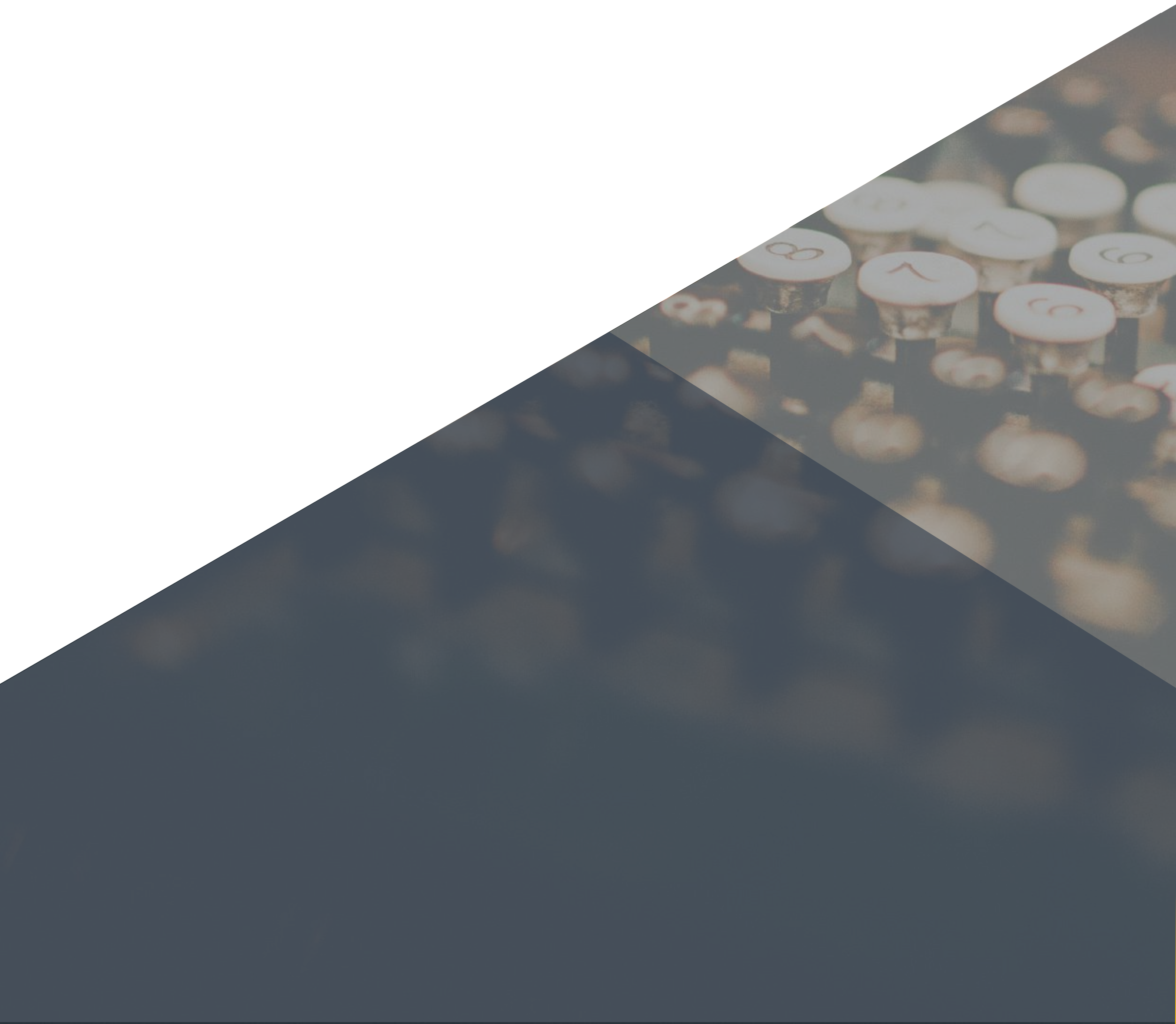
[37] Islamic Corporation for the Development of the Private Sector. "Annual Development Effectiveness Report (ADER): Featuring a Special Report on Lines of Finance 2015."

8.5. CHALLENGES FOR A DEVELOPMENT INSTITUTION TO BOOST IMPACT

There are key challenges facing development institutions like the ICD. Firstly, among the challenges is the fact that impacts occur long after project completion and the necessity to define an initial baseline of developmental situation at the project design. To address this challenge, the institution's existing framework will be reinforced both with new tools and complementary steps to be taken throughout the project cycle such as specific sectoral logical frameworks that enable the definition and monitoring of developmental impact.

Secondly, considering the fact that the institution has member countries with different economies, jurisdictions, and level of flexibility to accommodate Islamic finance agreements and assure their enforceability, including countries with different needs and challenges, it is always challenging to deliver on its mandate and to implement effectively any initiative. A flexible approach is required when it comes to implementing projects in member countries to make sure that its intervention addresses needs, contributes towards economic development and has a sustainable impact. Finally, there is a lack of awareness on requisites and requirements of Islamic finance in many member countries (lack of required regulations and policies, lack of practical knowledge among the bankers and lack of awareness among the public). This requires the role of multi-stakeholders of Islamic finance industry to enhance the awareness and knowledge of Islamic finance.

Figure 82: Challenges for a development institution



» Conclusion and Recommendations

This Global Islamic Bankers' Survey provides a clear account of how Islamic banks view the prospects for their industry and most important challenges they are facing. It also provides a detailed analysis of Islamic banks' attitudes towards Responsible Business and Sustainability Practices including examples of initiatives in this field taken by regulators and banks. The Survey's findings also point towards steps that various stakeholders can take to strengthen the Islamic banking industry and, specifically, to enhance its work in the field of Responsible Business and Sustainability Practices.

The recommendations below follow the format of the Survey and are divided into recommendations emerging from the confidence index, the risk monitor and the two sections on Responsible Business and Sustainability Practices.

ISLAMIC BANKERS CONFIDENCE INDEX AND RISK PERCEPTION

Islamic banks need support in dealing with the effects of difficult macro-economic conditions

Many Islamic banks operate in countries whose economies are facing varying degrees of difficulty. Banks in the GCC are troubled by the economic effects of low oil prices, while those in Syria and Yemen are trying to maintain services in economies that are ravaged by civil war. Yet it is important that banks in these countries are able to continue operating and emerge from the current difficult conditions ready to take advantage of the opportunities that will be offered by political stability.

The development of legal and regulatory infrastructures for Islamic finance industry needs to be accelerated in countries where Islamic Finance is in its early stages of development.

The demand for Islamic finance in regions such as Sub-Saharan Africa and Central Asia is increasing and banks cited the lack of laws and regulations underpinning Islamic financial transactions as an important impediment to their future growth.

Islamic banks and regulatory authorities should give greater attention to risk management.

The risks facing Islamic banks have increased in severity compared to last year. Macro-economic risk tops the list – as it did last year – and this is unsurprising, given the difficulties faced – for a variety of reasons – by in economies in which Islamic banks are operating. Banks have also scored high in a wide range of others risks including liquidity, IT, default and credit, and regulatory risks.

Islamic banks say that they are keen to offer their services, especially to underserved or currently-excluded sections of society. Yet doing this during times of macro-economic uncertainty is difficult and risky. Only by upgrading risk management capabilities will banks be able to maintain or expand their operations during a time when the perception of risk is increasing.

ENHANCING RESPONSIBLE BUSINESS AND SUSTAINABILITY PRACTICES

Islamic banks need to promote sustainable economic growth through their everyday activities

Promoting sustainable economic growth lies at the heart of the mission of Islamic finance. One avenue for achieving this is through facilitating the growth of SMEs. Islamic banks need to think more broadly about the way their financing activities can create jobs throughout the corporate sector, improve countries' industrial and social infrastructure, and enhance economic efficiencies and production levels.

Enhancing the skills and motivation of bank staff is an important element in promoting responsible and sustainable financing

Without properly-qualified staff, who are committed to the banks' objectives, it will be challenging for Islamic banks to achieve much in the field of responsible business and sustainability practices. Islamic banks need to ensure that their employees understand that responsible business and sustainability practices are important to the industry and the economy, and that they must have the technical skills to promote them. This is a particularly important issue for small Islamic banks, which may have diffilty in attracting staff with relevant skills and experience.

Islamic banks need to ensure that their customers share their commitment to responsible and sustainable financing

Islamic banks need to ensure their customers are not engaging in activities that contravene a commitment to responsible business and sustainability practices. At the same time, Islamic banks also need to treat their clients fairly, for example by being transparent about the charges they apply for financing and services, and by avoiding terms and conditions of their products that are over-bureaucratic.

Islamic banks need to bring currently-unbanked citizens into the regulated banking system.

Financial inclusion is a core value of Islamic finance. Islamic banks need to prioritise financing for entrepreneurs, small businesses that are not using a wide range of financial services, and, in particular, individuals who do not have bank accounts. In their responses to the Survey, 91% of large banks stated that they had a dedicated SME unit. Sixty three per cent of small banks had an SME unit. But a smaller percentage of both big and small banks believed that they had the right capabilities to serve this market.
Islamic banks should enhance both the capability of their staff and also their product offerings so that all aspects of financial inclusion become a core part of day-to-day activities.

Islamic banks need to become integral parts of their local communities

The role of Islamic banks in Responsible Business and Sustainability Practices goes beyond the services and products that they provide to their customers. They need to use their expertise to enhance their local communities. Many Islamic banks are already doing this, for example, by funding education programmes and providing charitable services to the poor. However, this work needs to continue, so that banks become significant contributors within society.

Islamic banks need to demonstrate a business case for corporate social responsibility (CSR)

Islamic banks stated that they are committed to corporate social responsibility programmes but that they are held back from doing more due to a lack of customer support and an inability to make a strong business case for CSR activities. However, they would be able to do more if they could articulate the reasons that CSR would make a bank stronger and more profitable over the long-term.

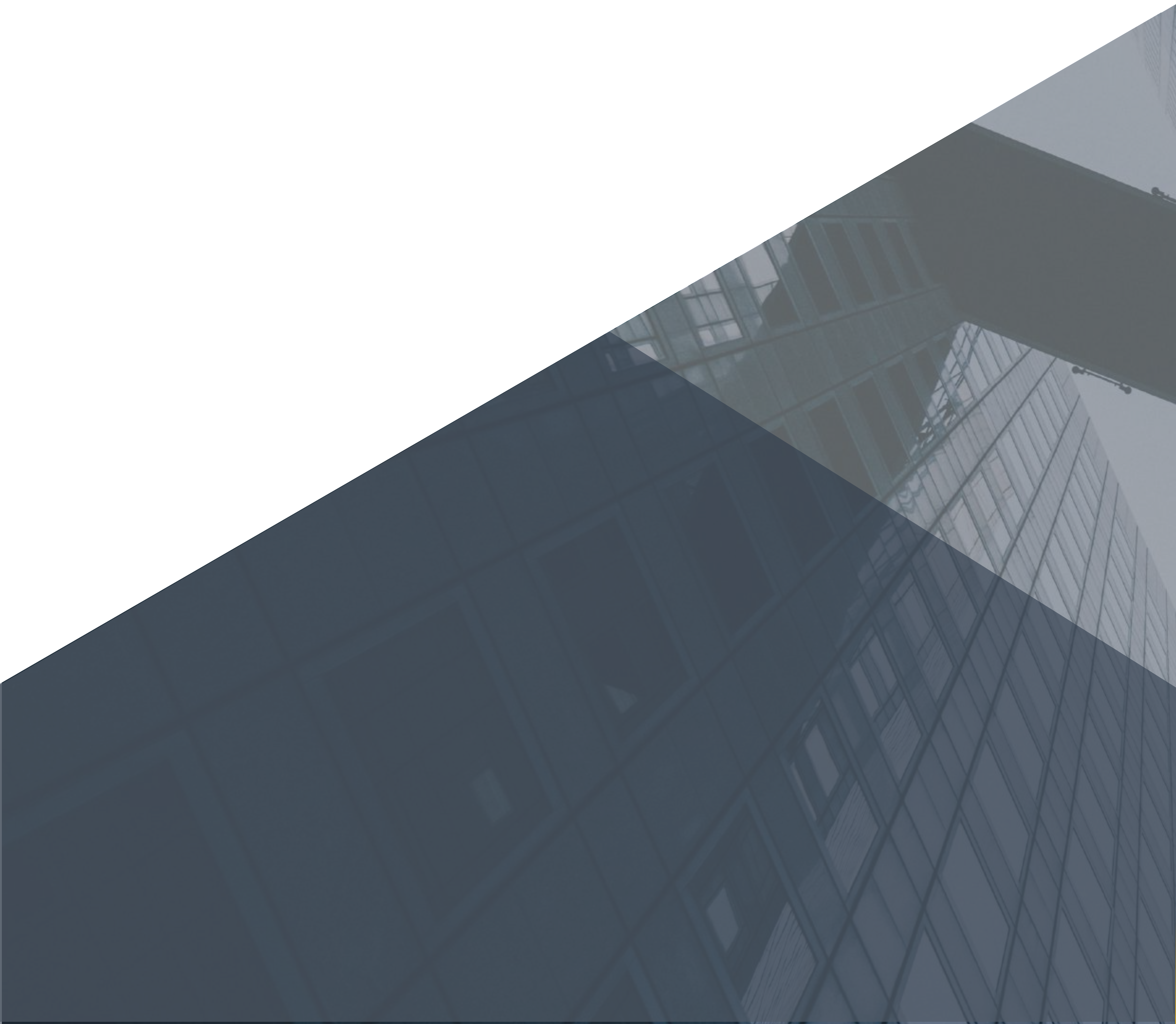
Islamic banks should further support global development agendas and, where such activities are already in place, they should create awareness for others that can be followed.

Islamic banks should play a significant role in promoting global development agendas. Some are already doing this, by aligning their own social and development goals with those of multinational bodies such as the United Nations. Some financial regulators are also aligning their banking development programmes with broader development goals.

This trend should be encouraged by urging Islamic banks to show how their programmes will contribute to the broader development goals of the international community.

Examples of areas where Islamic banks could be encouraged to promote sustainable development include, affordable housing, empowering entrepreneurship, 'green' financing and 'green' operating practices, and contributing to a culture of sustainability by publishing reports on their actions in this field. The Islamic banking industry should share examples of the practical contributions that they are making to economic and social development. One of the best ways to do this is to publish an annual 'Sustainability Report' on their work in this field.

» Table of Figures



» Appendix 1: Overview of CIBAFI

» Appendix 1: Overview of CIBAFI

1. Policy, Regulatory Advocacy
2. Research and Publications
3. Awareness and Information Sharing
4. Professional Development

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 over 120 members from over 30 countries and is proud to say that membership is increasing.

The Council is governed by a Board of Directors that is chaired by H.E. 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 produces documentation for Shariah-compliant financial instruments). CIBAFI also works closely with global organisations such as the World Bank and the IMF, the Basel Committee on Banking Supervision, the International Accounting Standards Board (IASB) and the Institute of International Finance (IIF). It has a close relationship with the Islamic Development Bank and shares its objectives to promote and strengthen the Islamic Financial Industry.

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

1. **Policy, 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 is founding member of the IMF's External Advisory Group on Islamic Finance and a member of the International Accounting Standards Board's Consultative Group on Shariah-compliant instruments and transactions. It solicited the views of its members on the Liquidity Standard being prepared by the Islamic Financial Services Board and made representations to the IFSB on behalf of its members. It also submitted the collective feedback of its members to the Basel Committee on Banking Supervision (BCBS) on the Consultative Document on Standardised Measurement Approach for Operational Risk, among others.

2. **Research and Publications**

CIBAFI conducts research and produces publications on issues of interest to its members and which are relevant to the development of the Islamic finance industry. Its annual flagship report is this Survey, which is part of an initiative to increase the output of publications and research. It also publishes a newsletter ("InFocus") to keep members and others informed about CIBAFI activities and about significant developments in Islamic finance. CIBAFI also publishes a need-based periodical "Briefing", which are short and concise papers addressing emerging issues of the industry. In addition to this, CIBAFI publishes a series of market related research that is conducted by CIBAFI or/ and with its strategic partners.

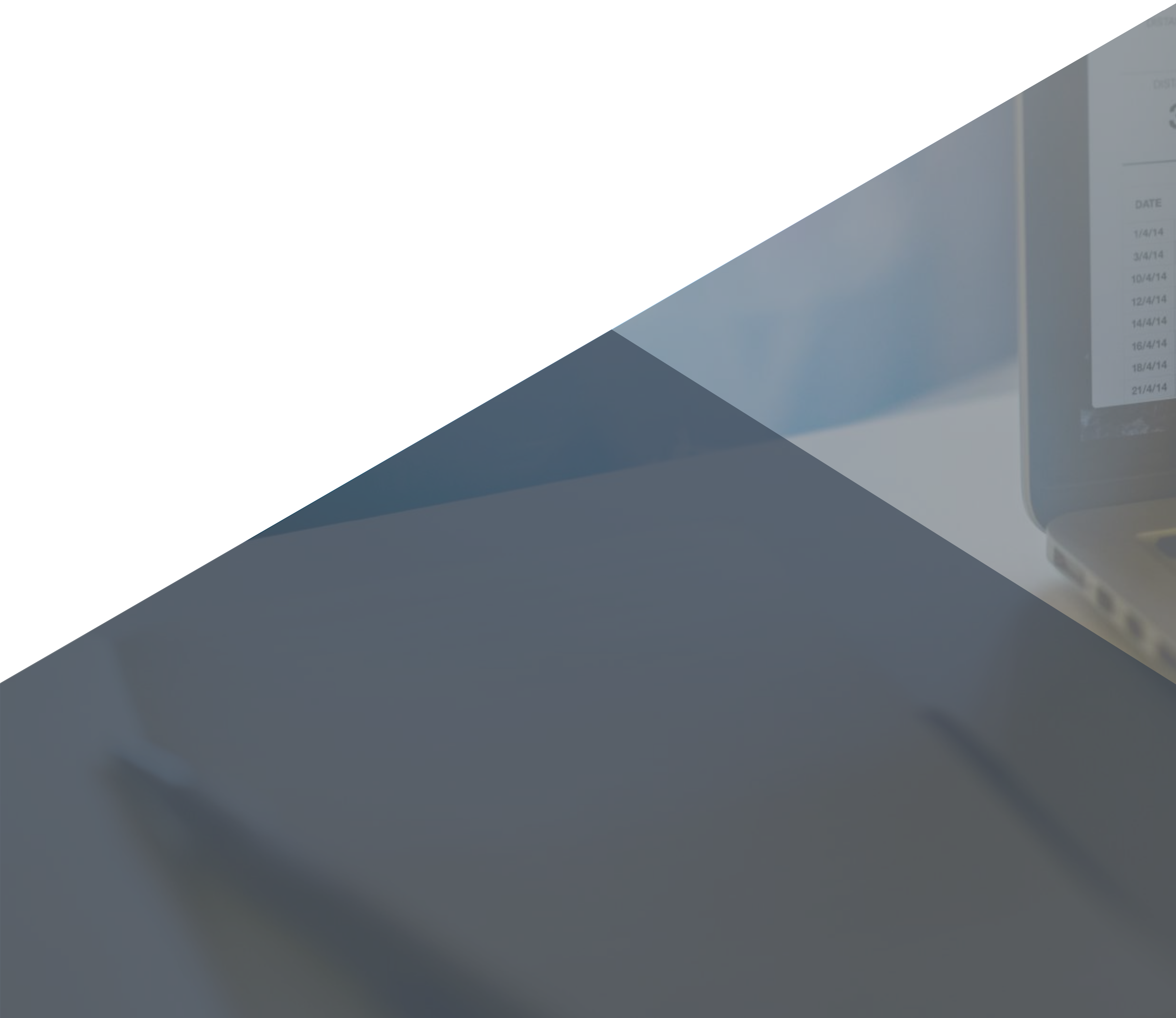
3. **Awareness and Information Sharing**

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. It has an annual gathering "Global Forum", where it addresses key themes of the year, and it also organises various regional events on its own and/or with our partners such as the Islamic Development Bank, World Bank, Union of Arab Banks and others. These events are usually hosted by a local regulator.

4. **Professional Development**

CIBAFI members have identified as one of their priorities the need to strengthen the talent pool within the Islamic finance industry. In response, CIBAFI offers 3 categories of professional development programmes: Executive Programmes for senior management and board level; Technical Workshops for mid-level staff of Islamic banks that are usually hosted by a regulator; and 14 professional certifications.

CIBAFI welcomes suggestions from members and non-members for ways in which it can strengthen the work that it does.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» Appendix 2: Survey Findings: Region-focussed

Group 1

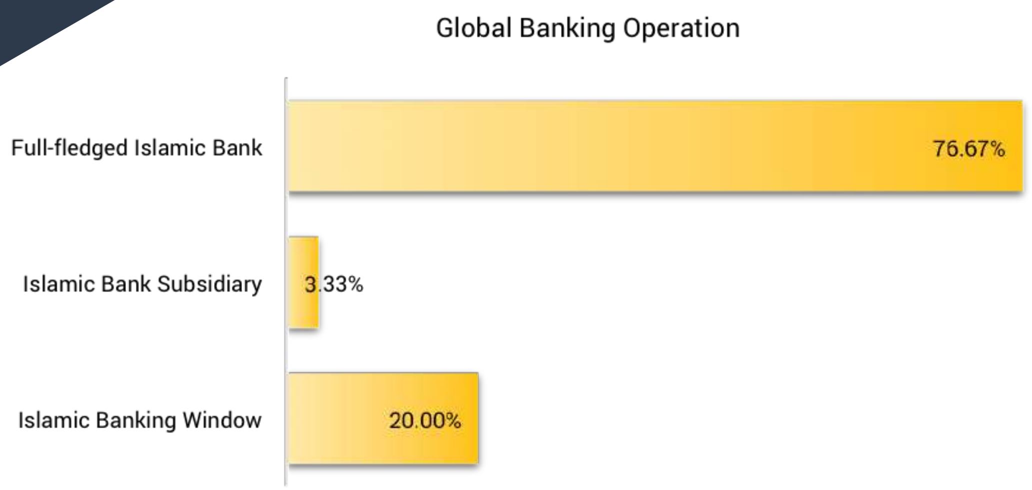

Figure 1: Corporate Profile of Respondents

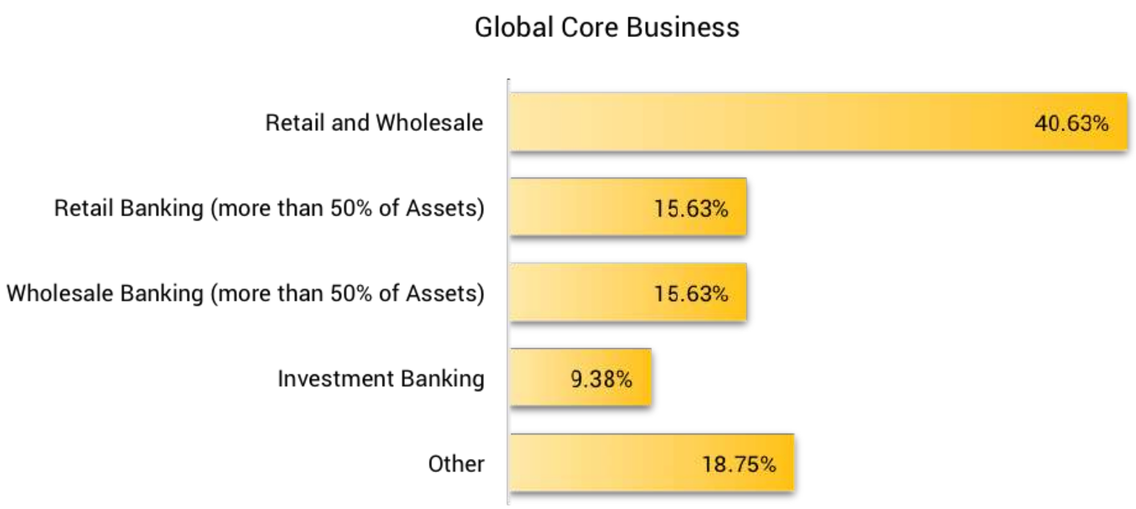

Figure 2: Business Profile of Respondents

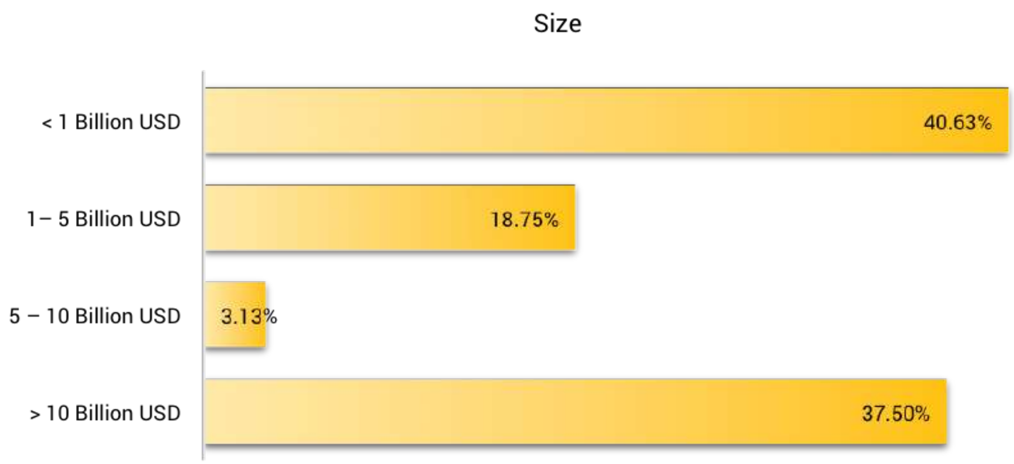

Figure 3: Size of Respondent Banks

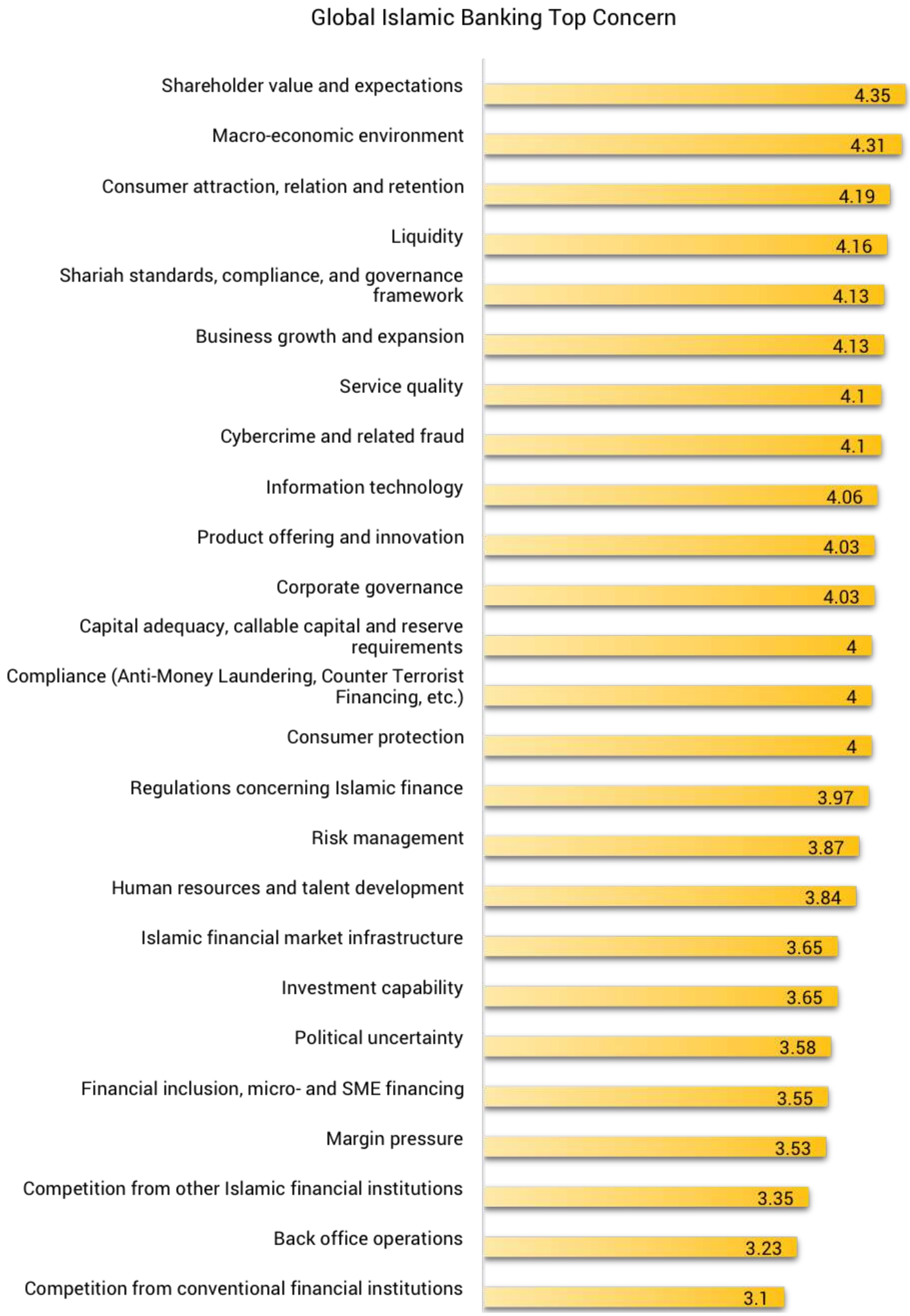

Figure 4: Islamic Banking Top Concerns

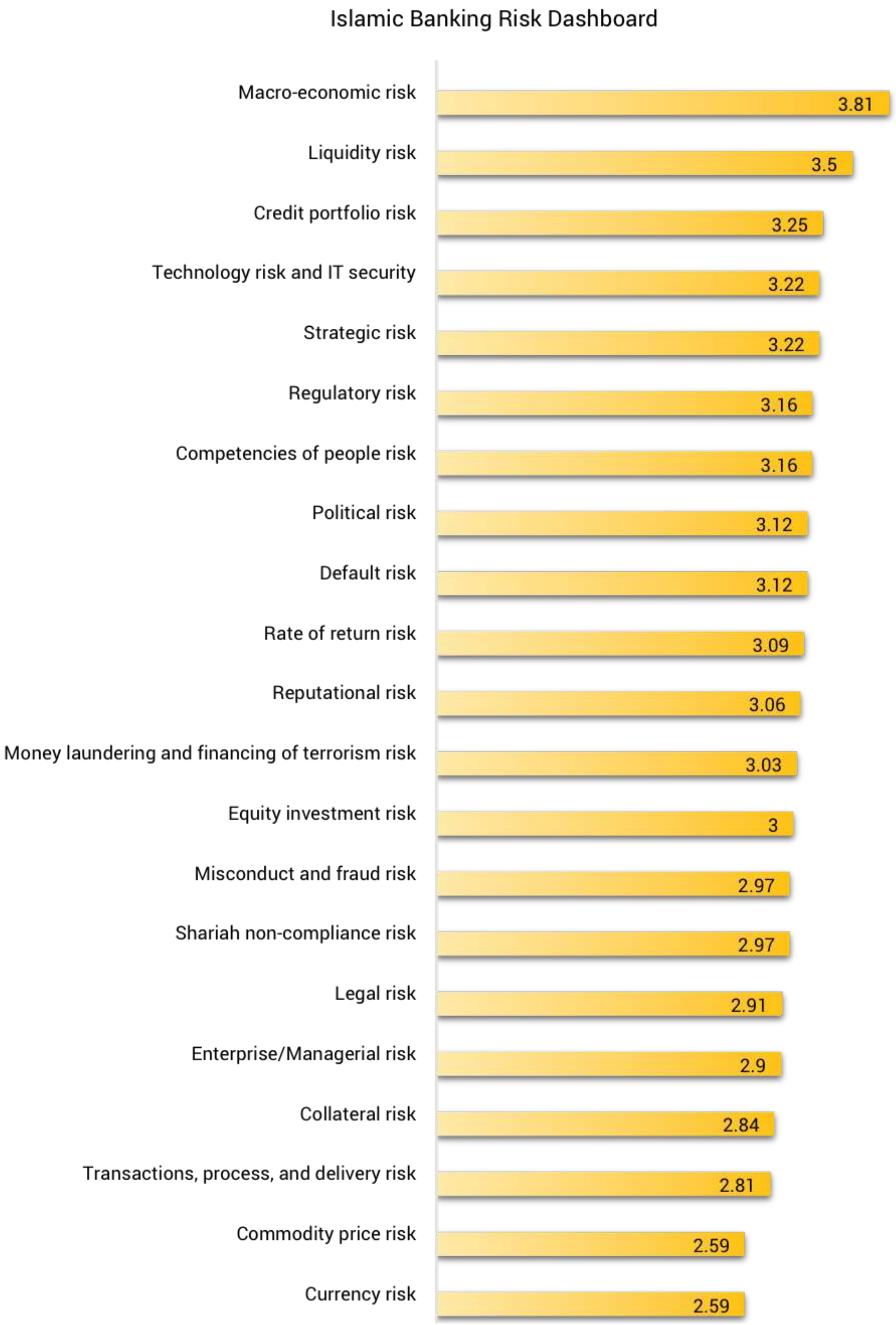

Figure 5: Islamic Banking Risk Dashboard

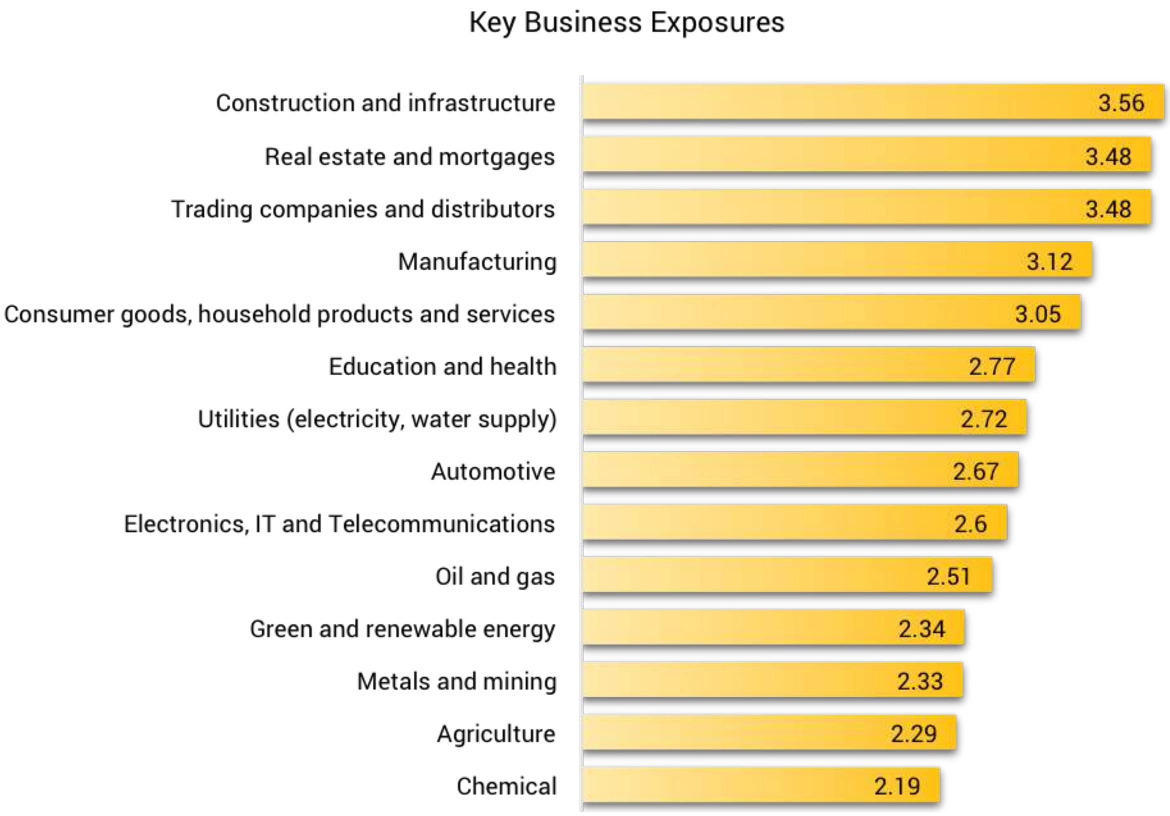

Figure 6: Key Business Sectors Islamic banks are exposed to

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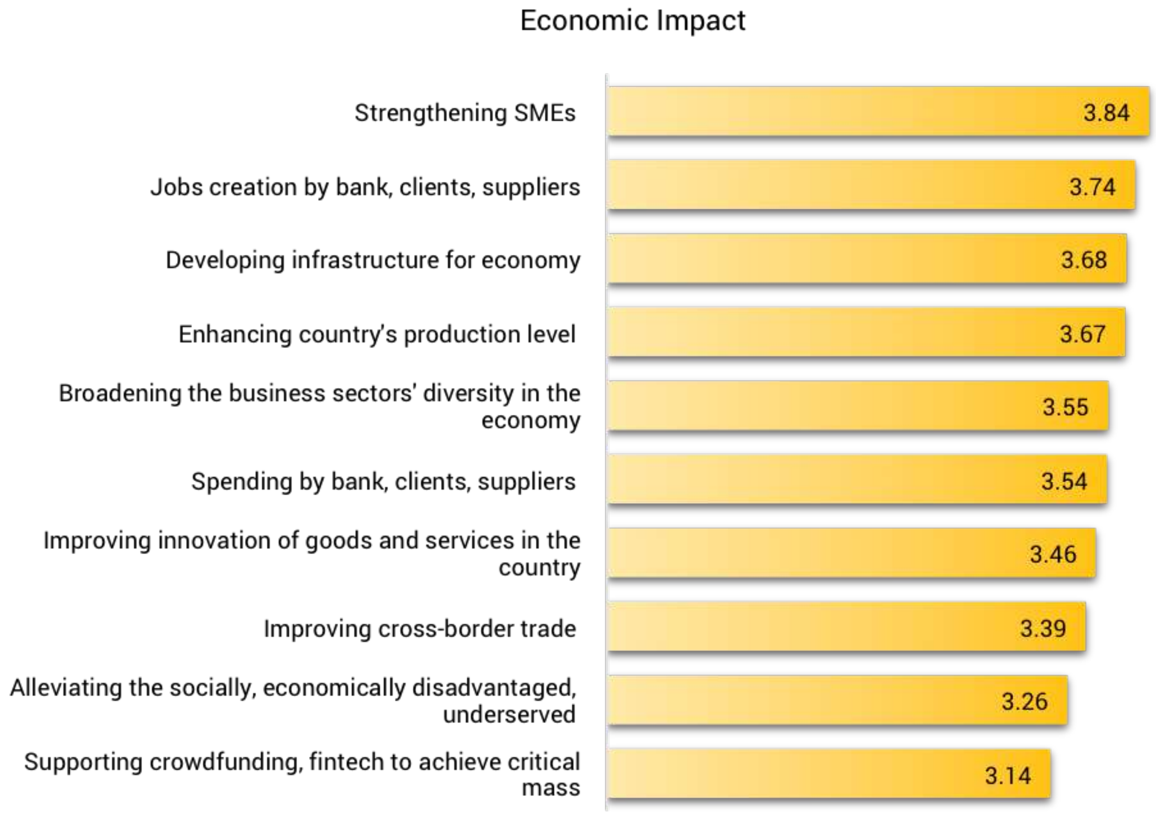

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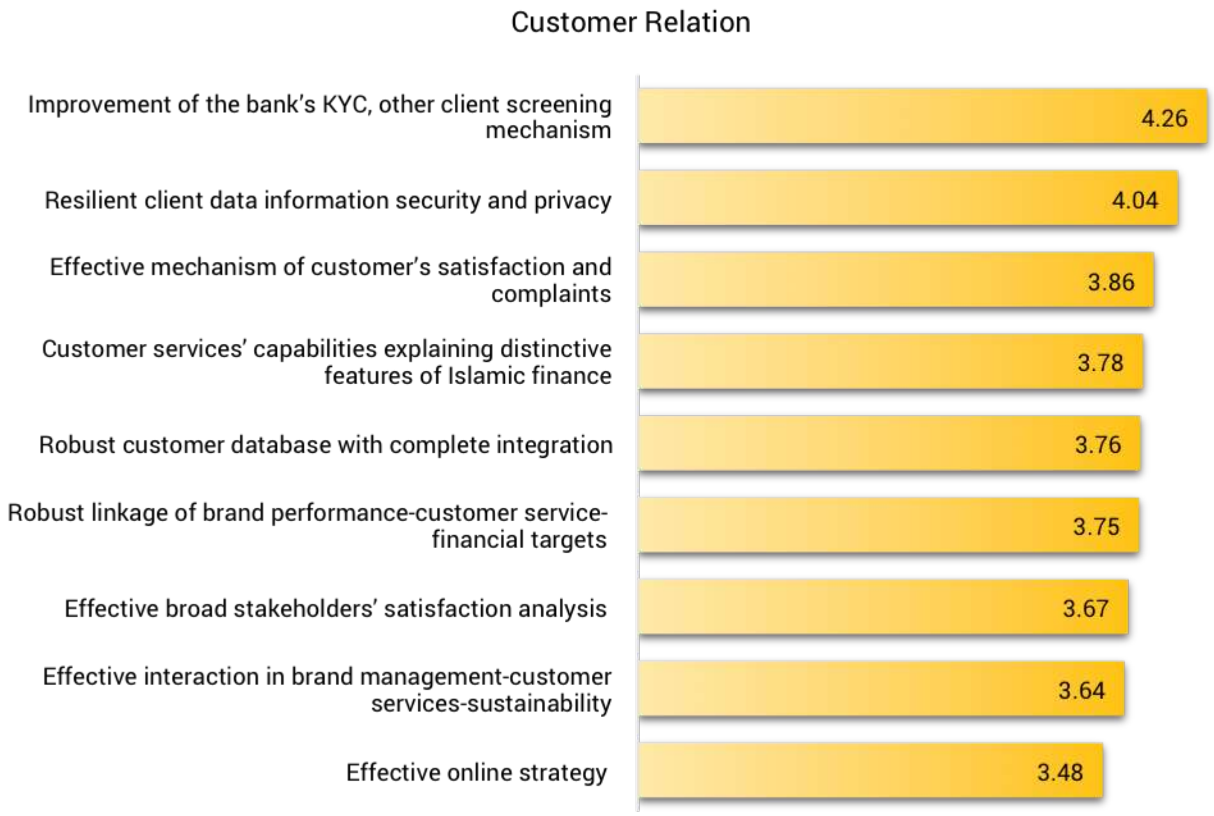

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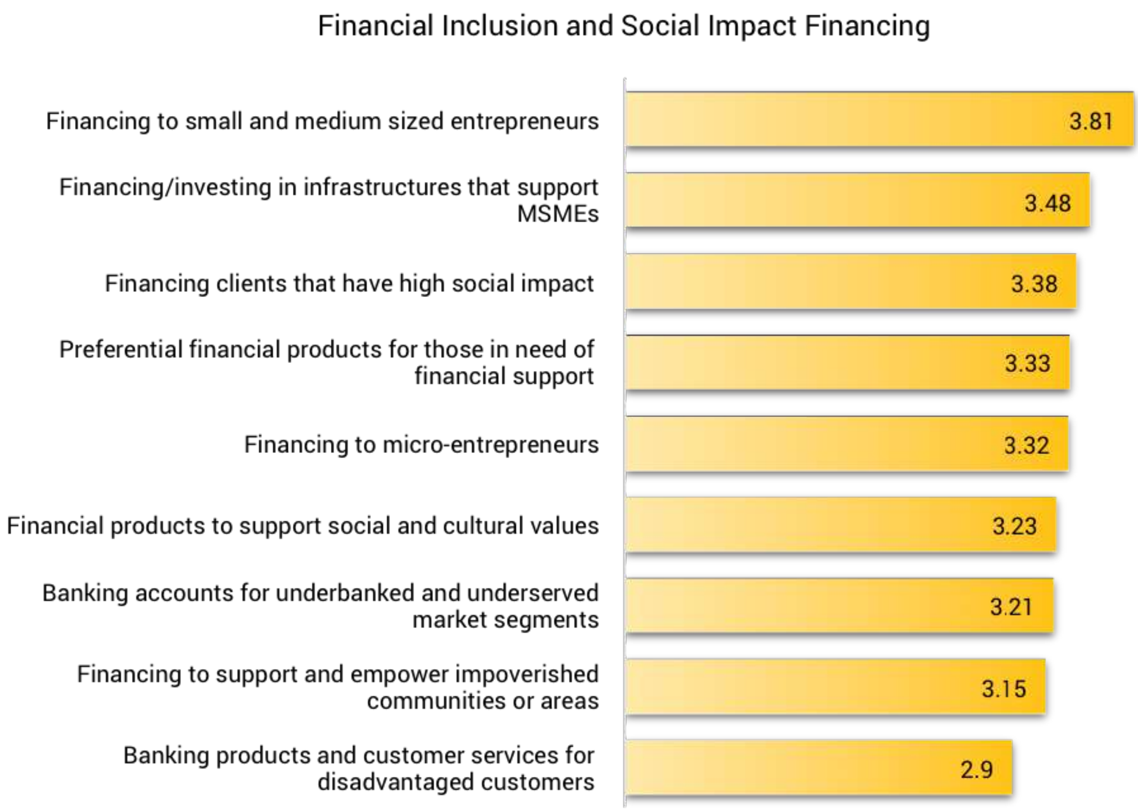

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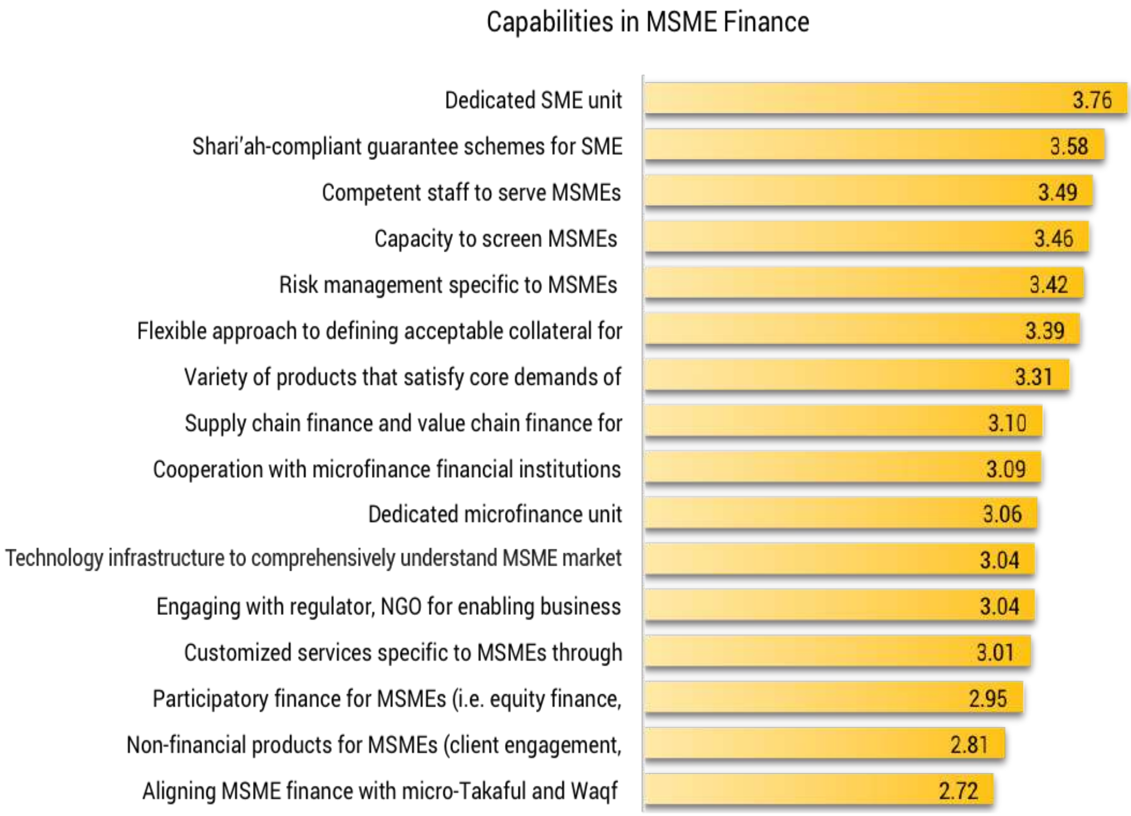
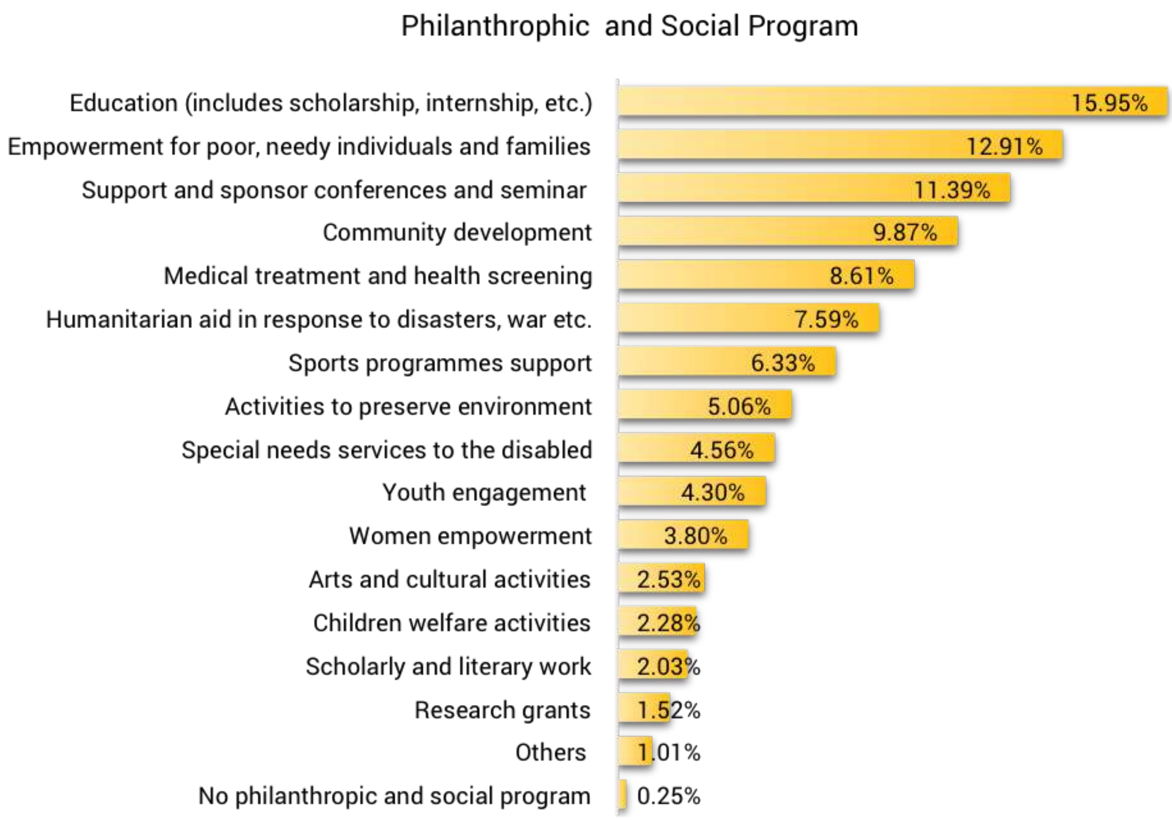


Figure 14: Capabilities in MSME Finance



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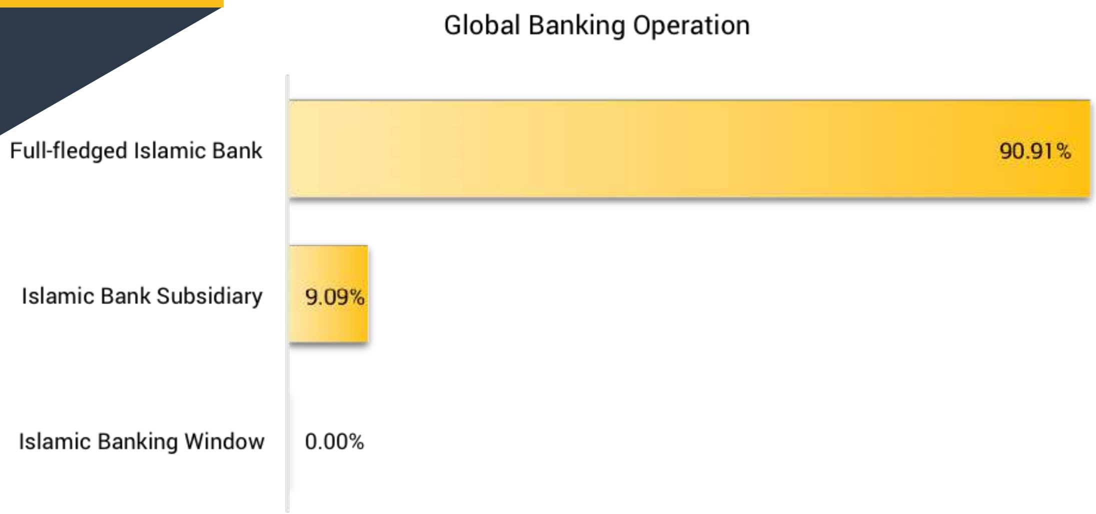
Group 2



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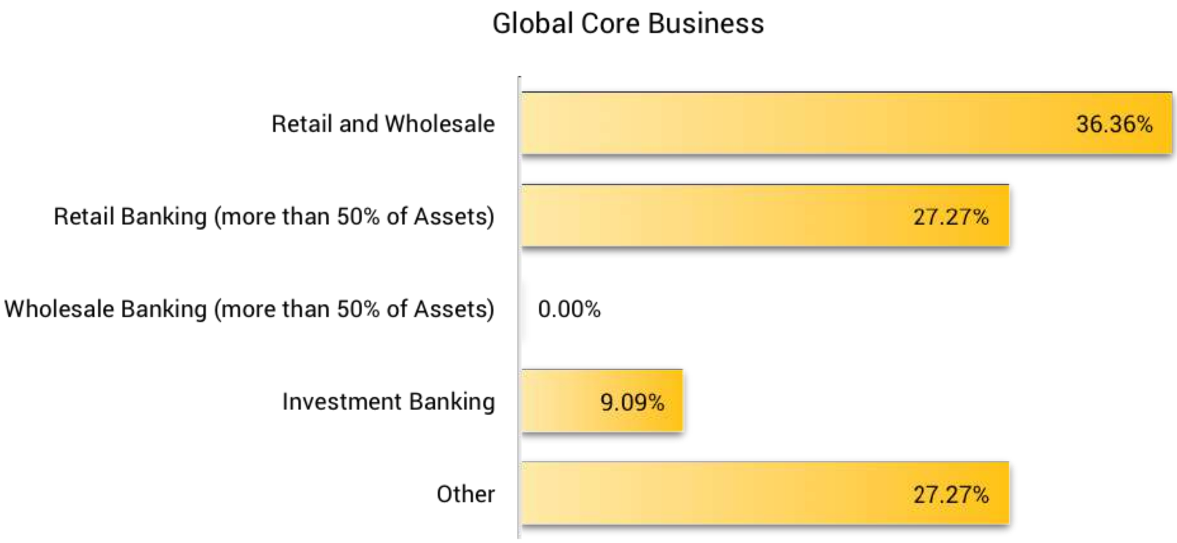

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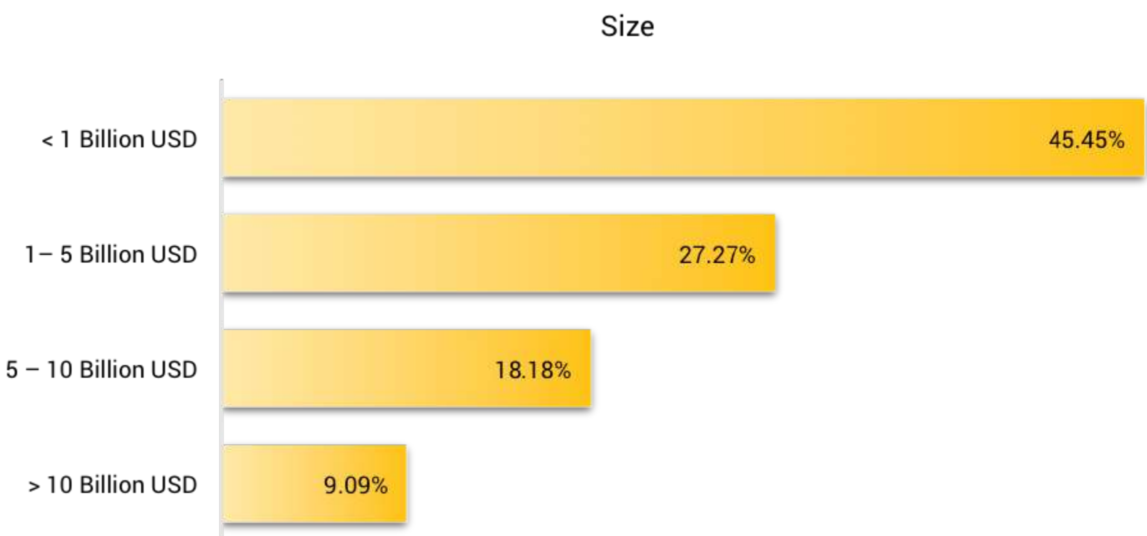
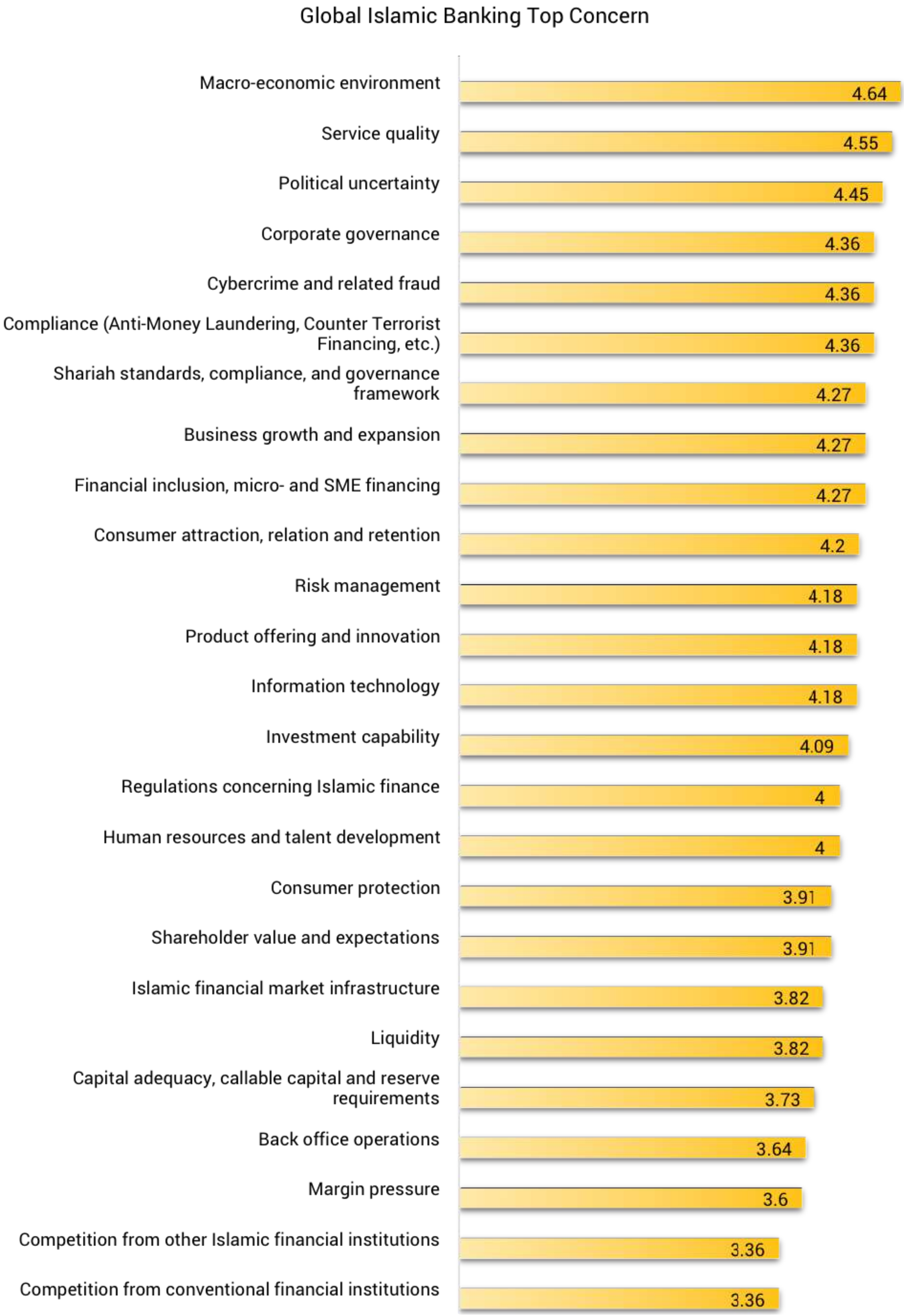


Figure 3: Size of Respondent Banks



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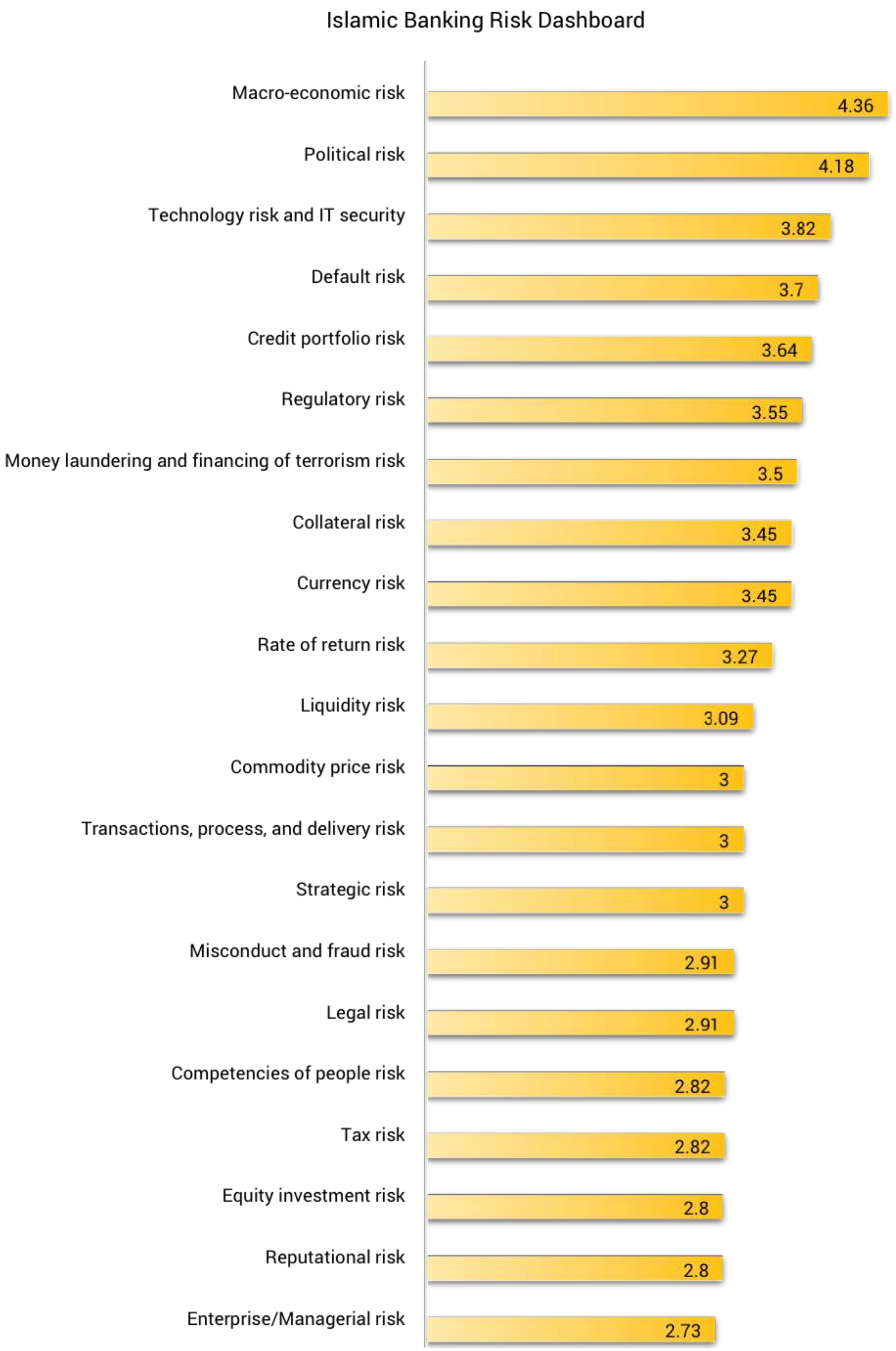

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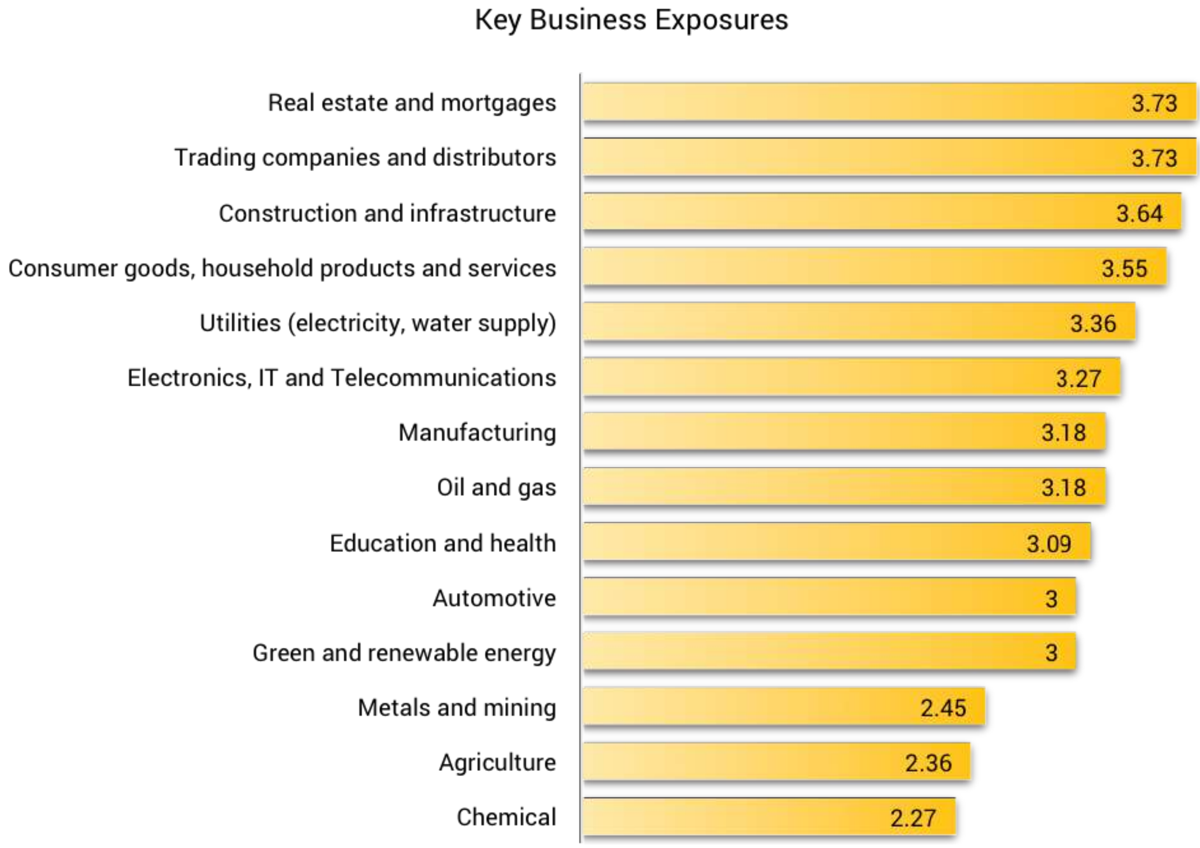

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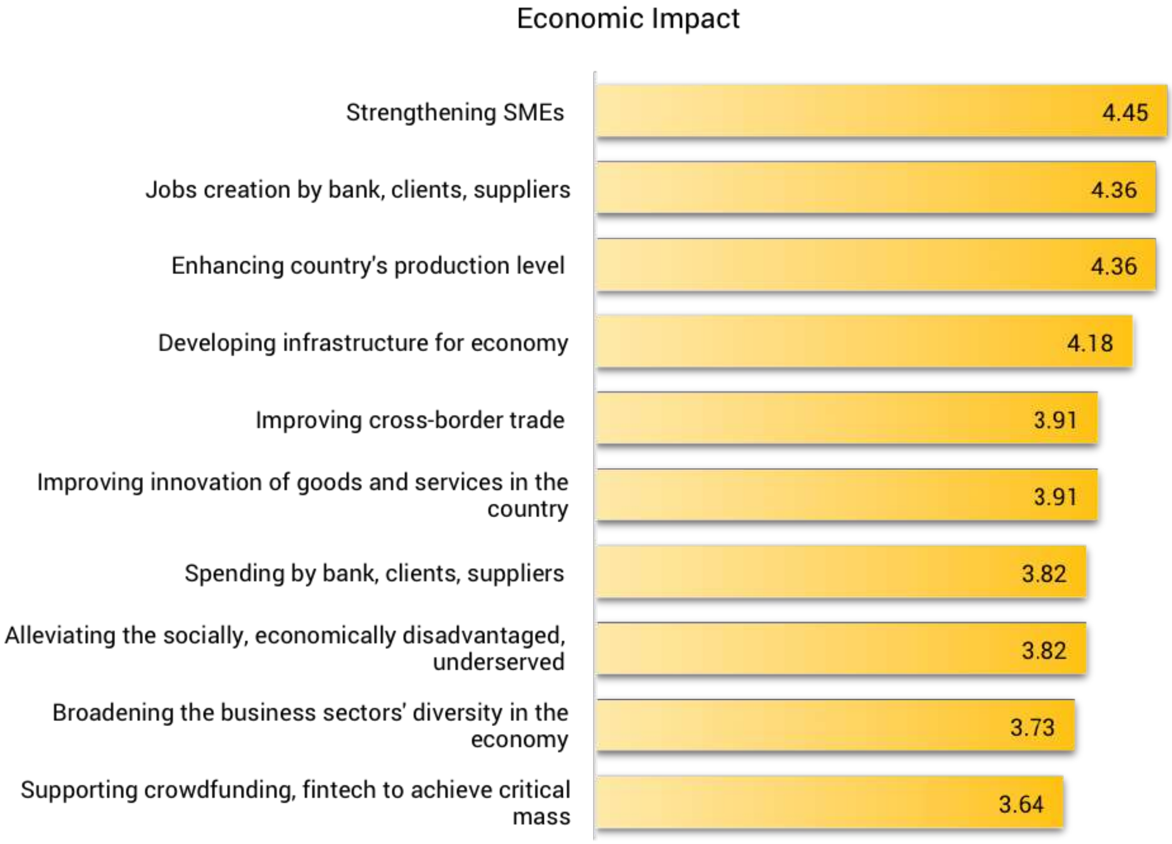

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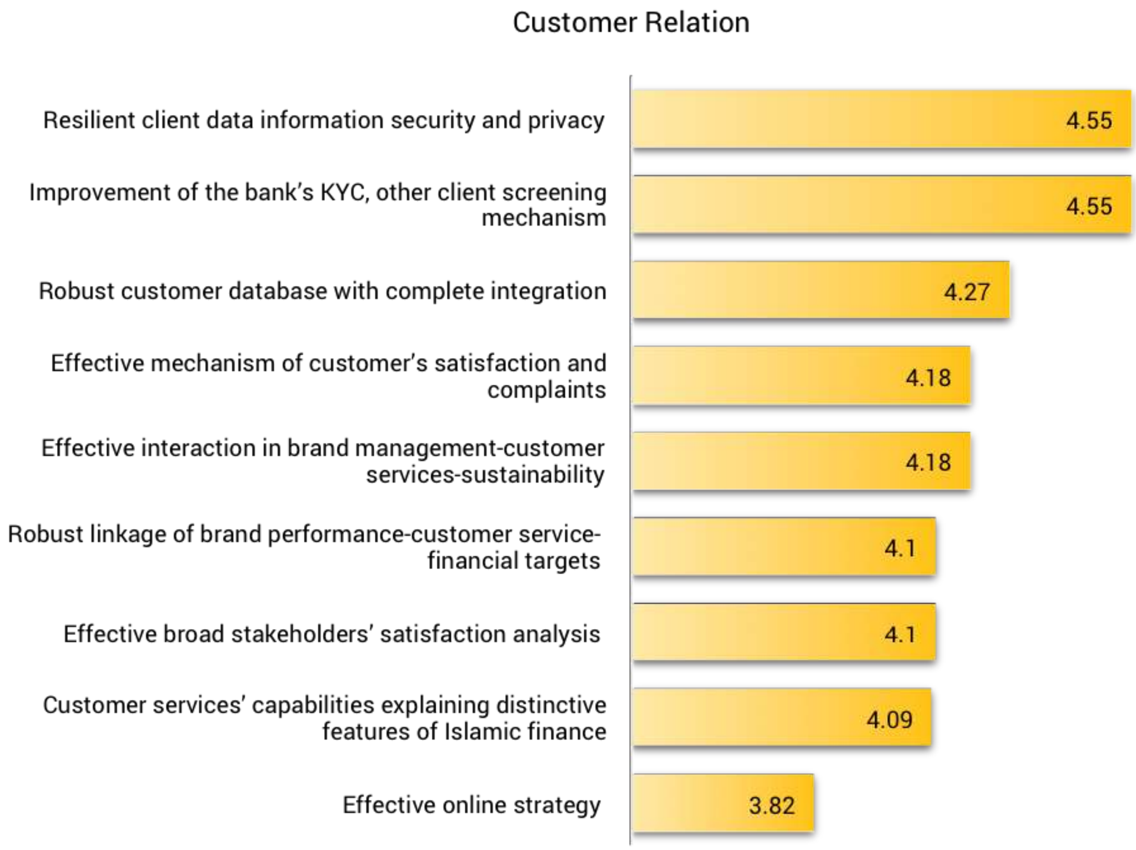


Figure 11: Customer Relations

Figure 12: Fair Treatment of Clients

Figure 13: Financial Inclusion and Social Impact Financing

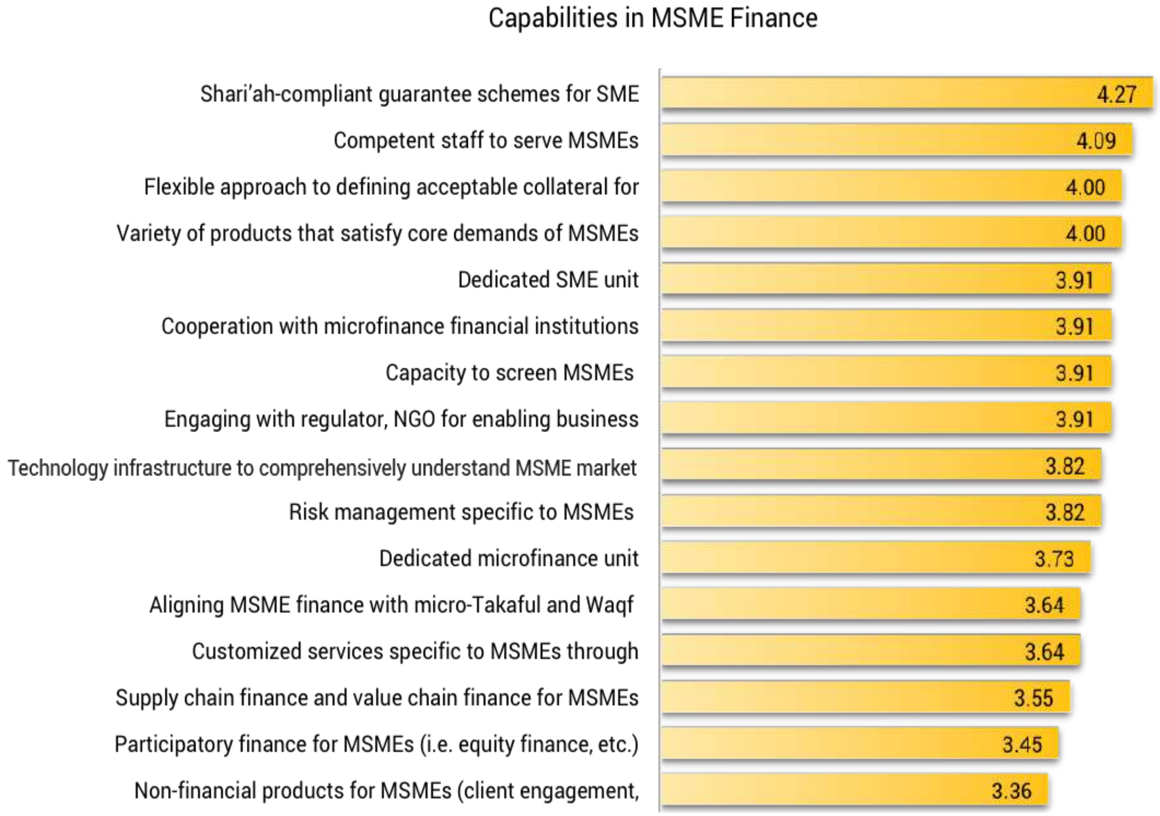
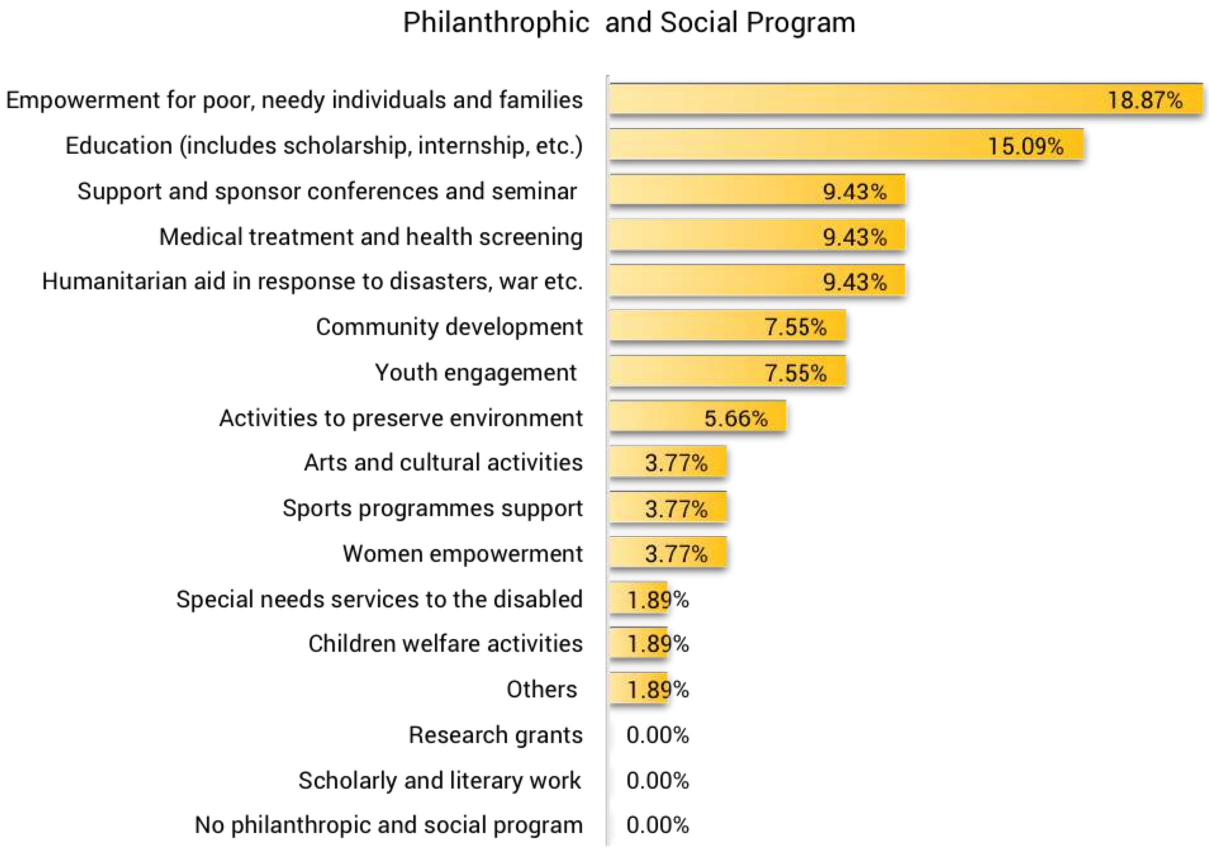


Figure 14: Capabilities in MSME Finance



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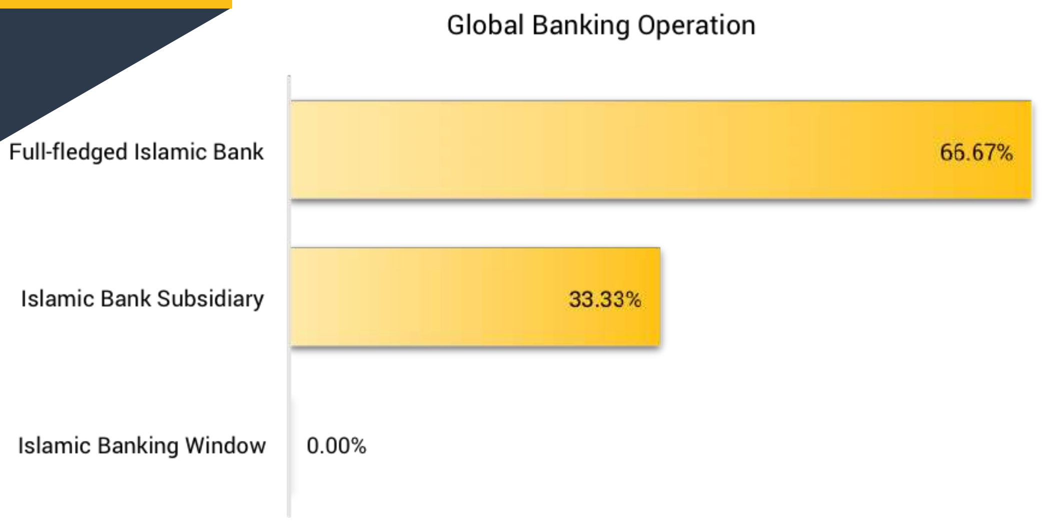

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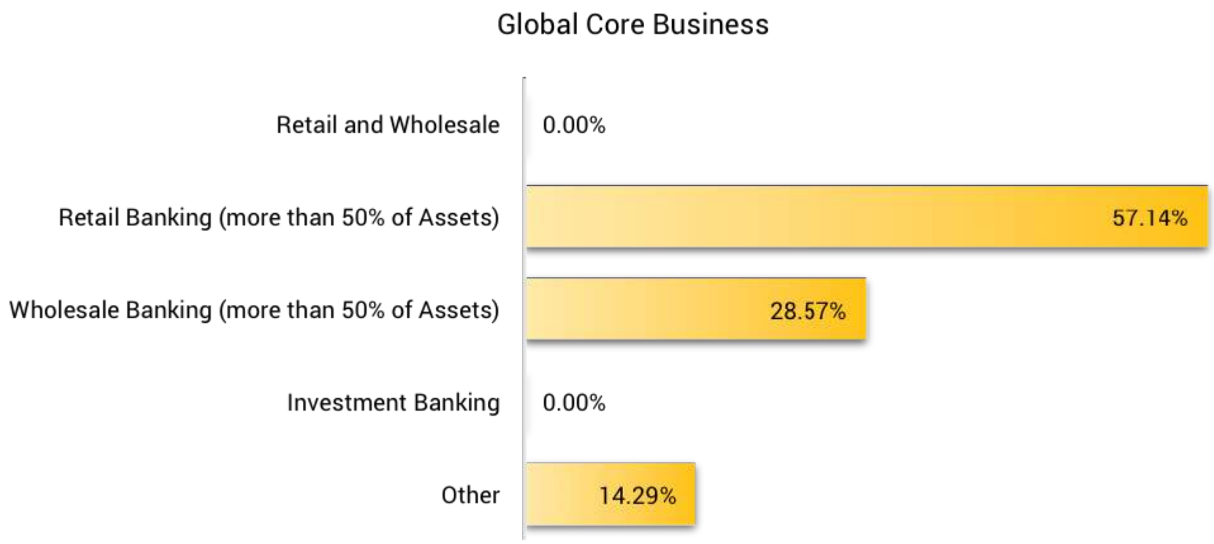
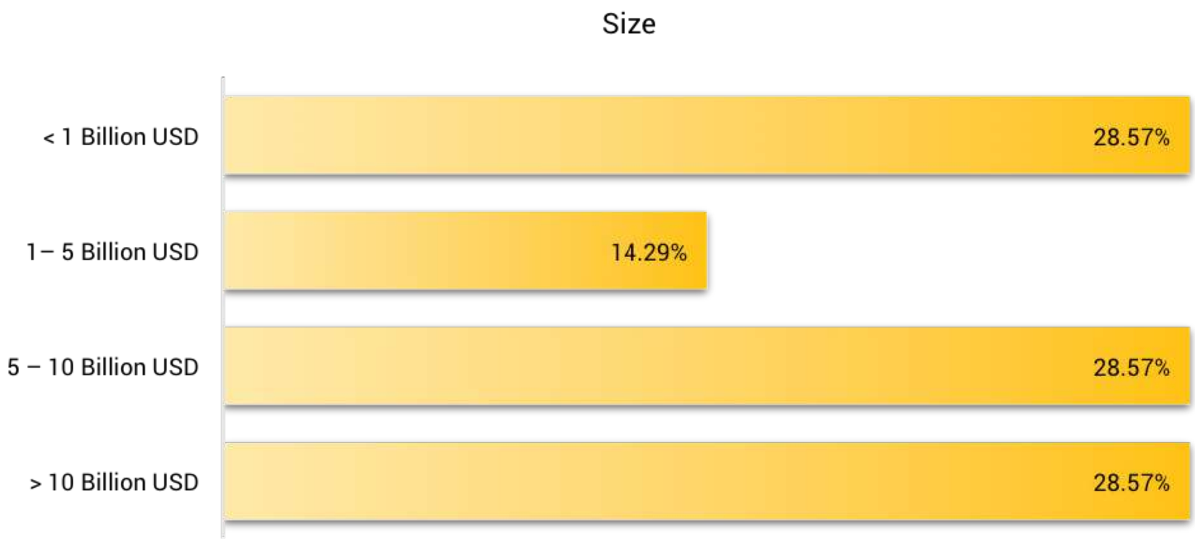


Figure 2: Business Profile of Respondents



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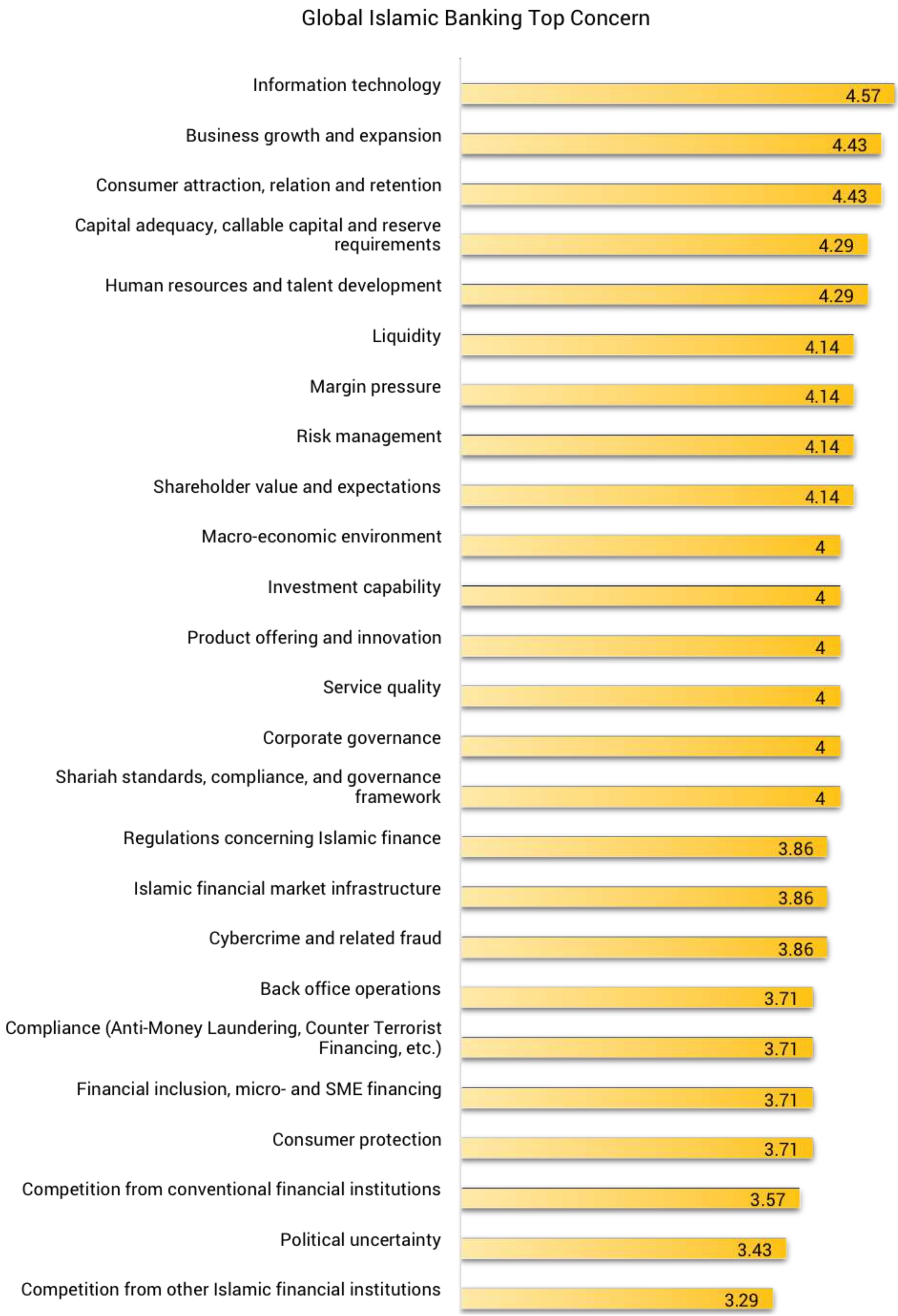

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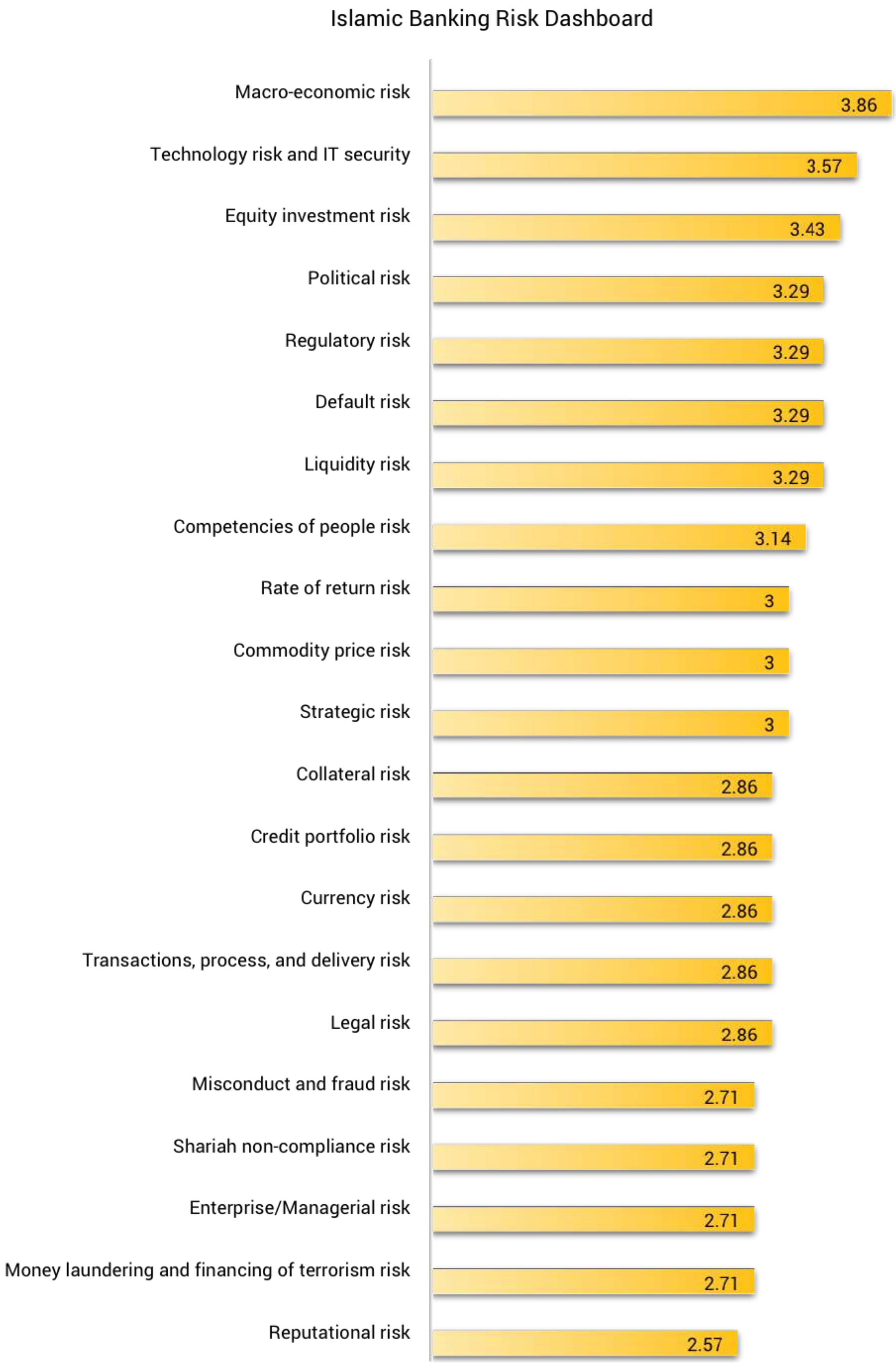

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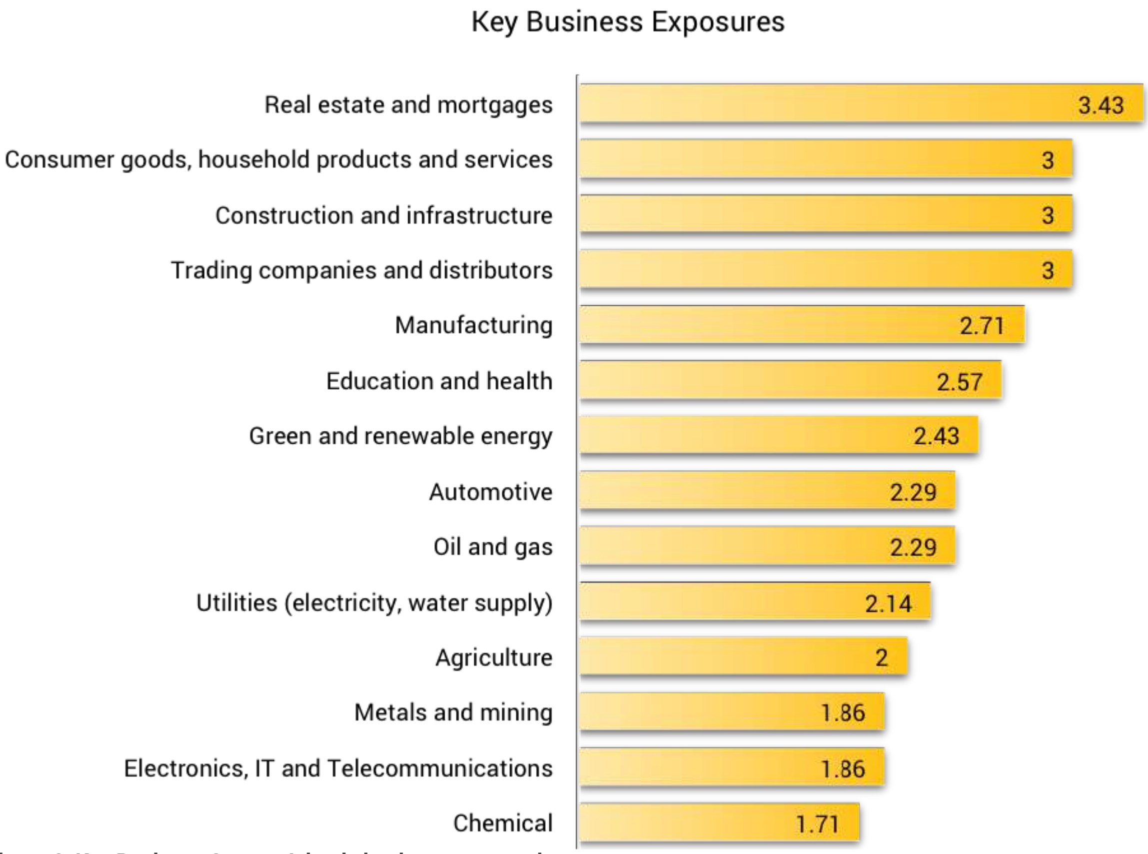

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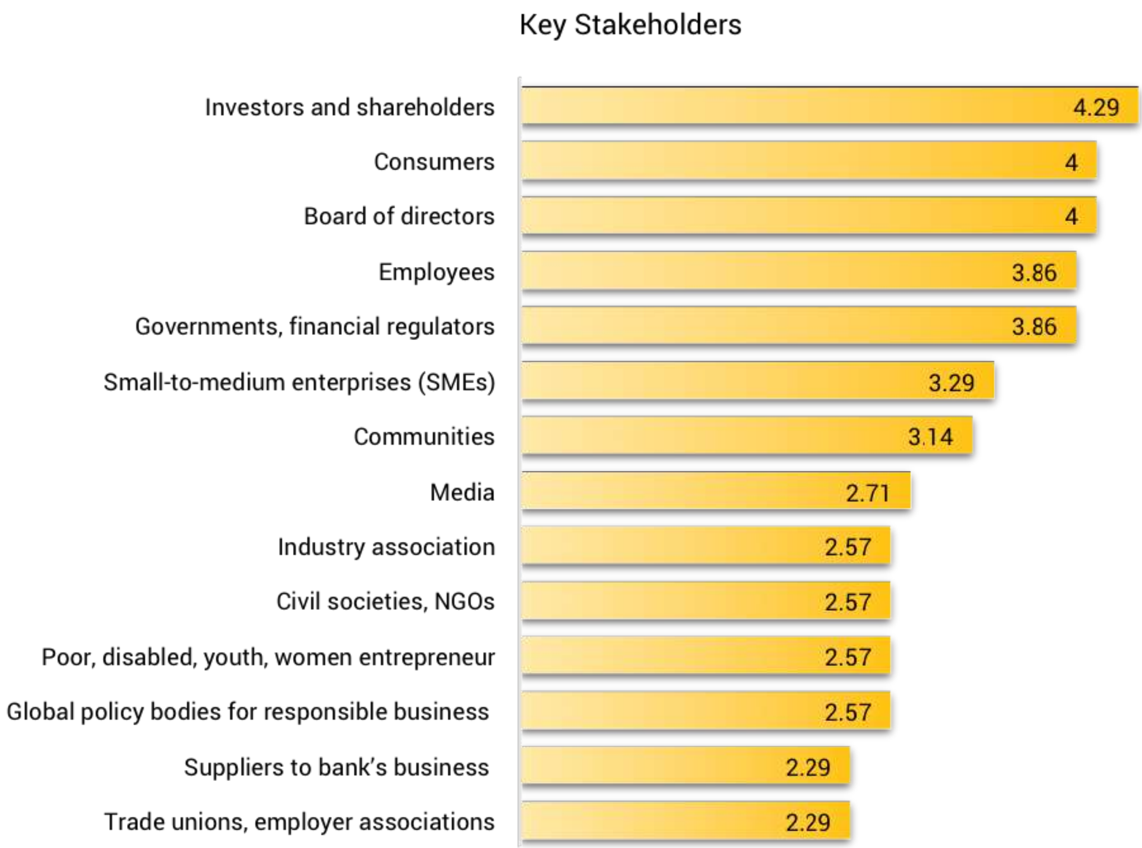

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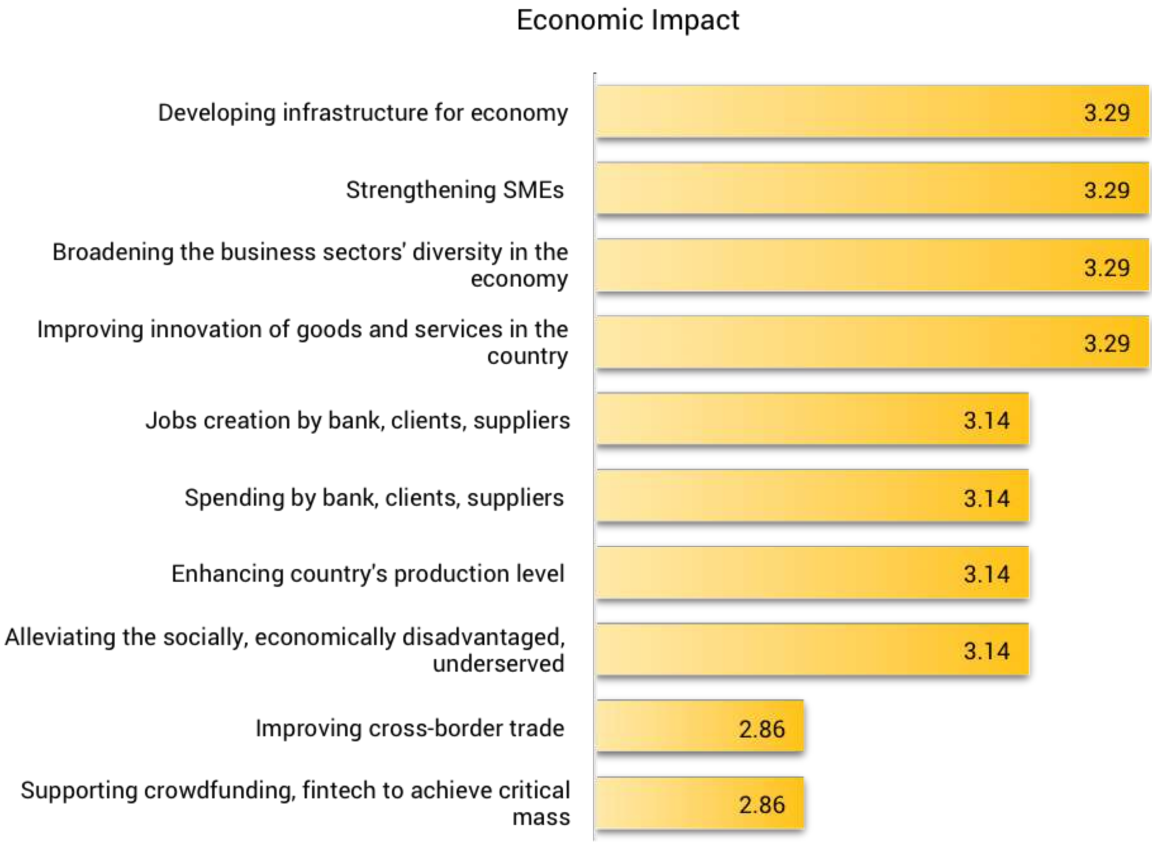

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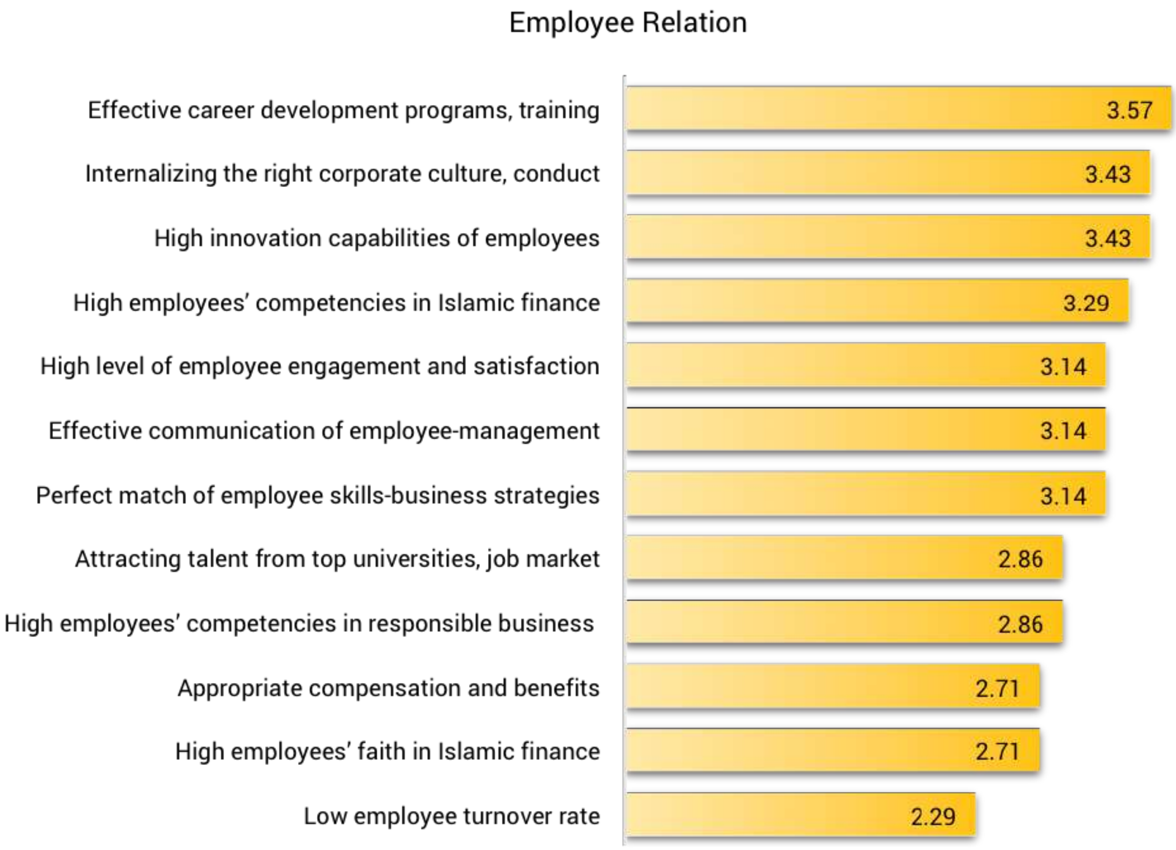

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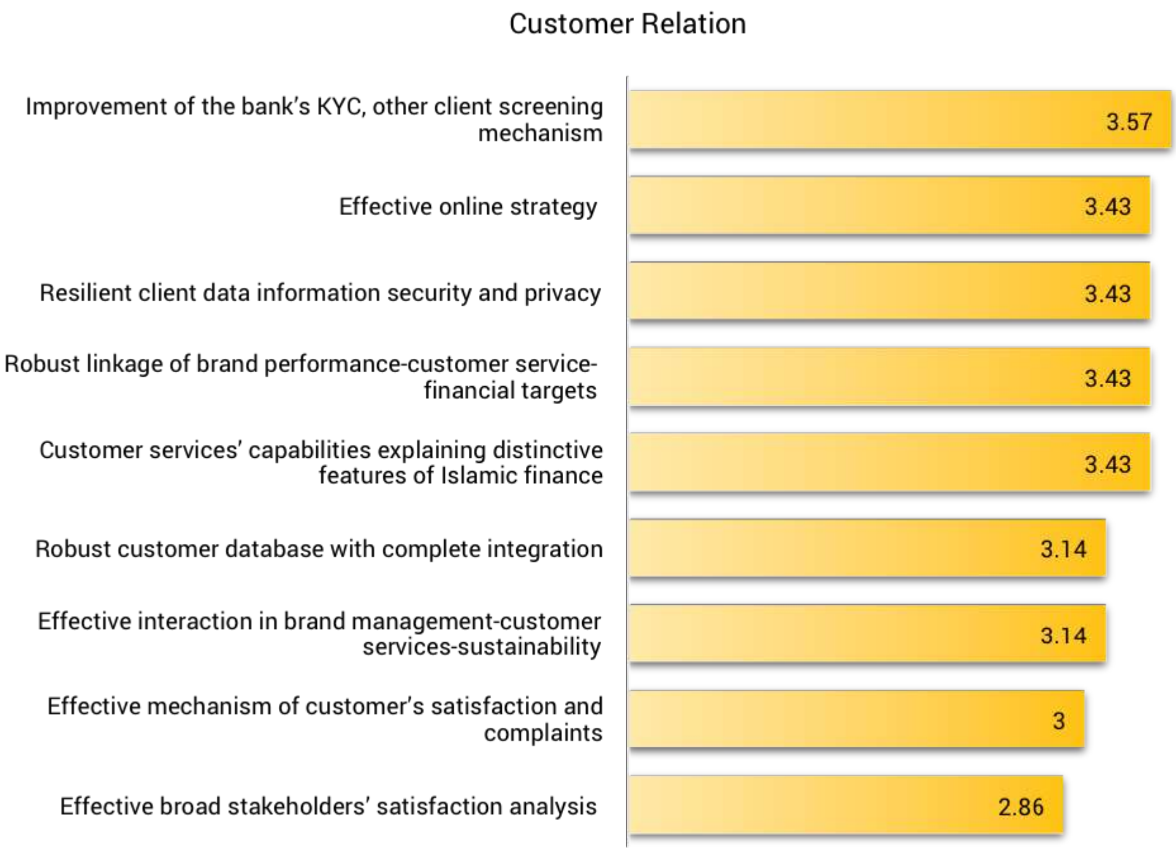


Figure 11: Customer Relations

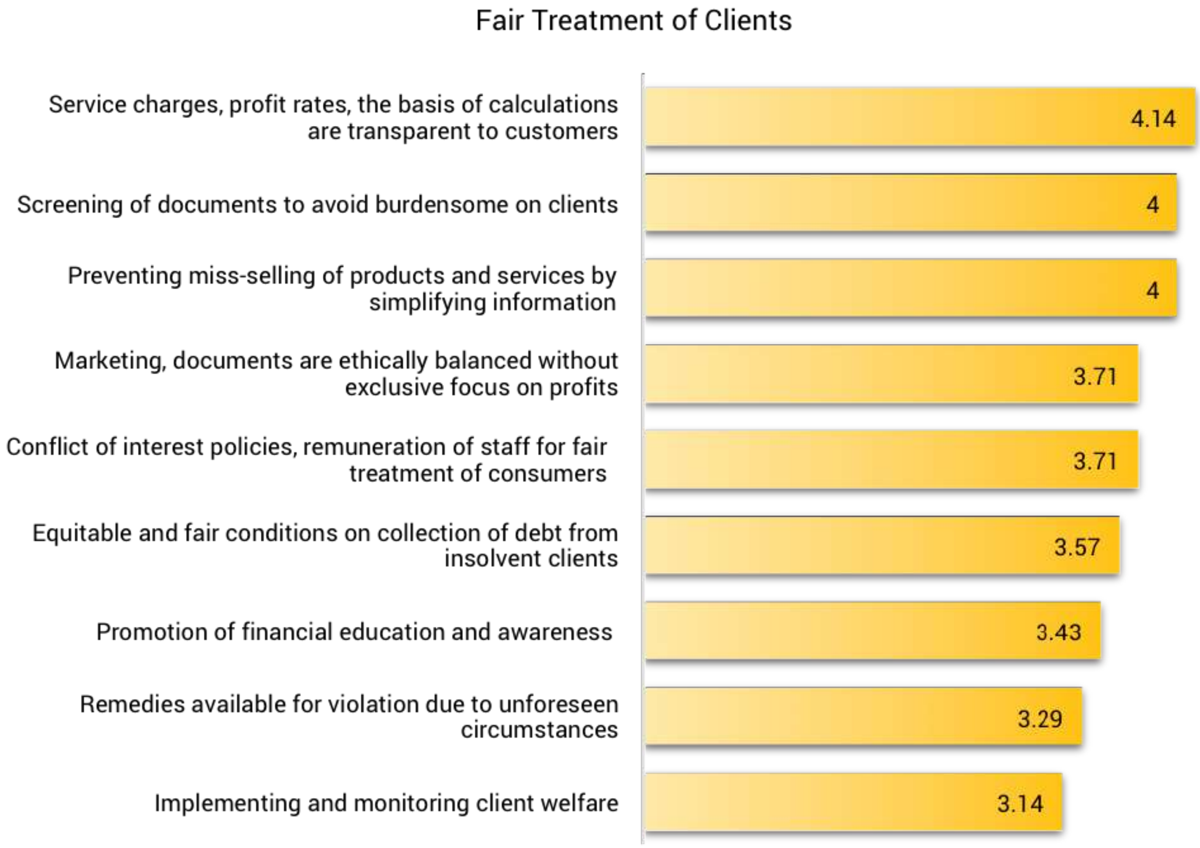


Figure 12: Fair Treatment of Clients

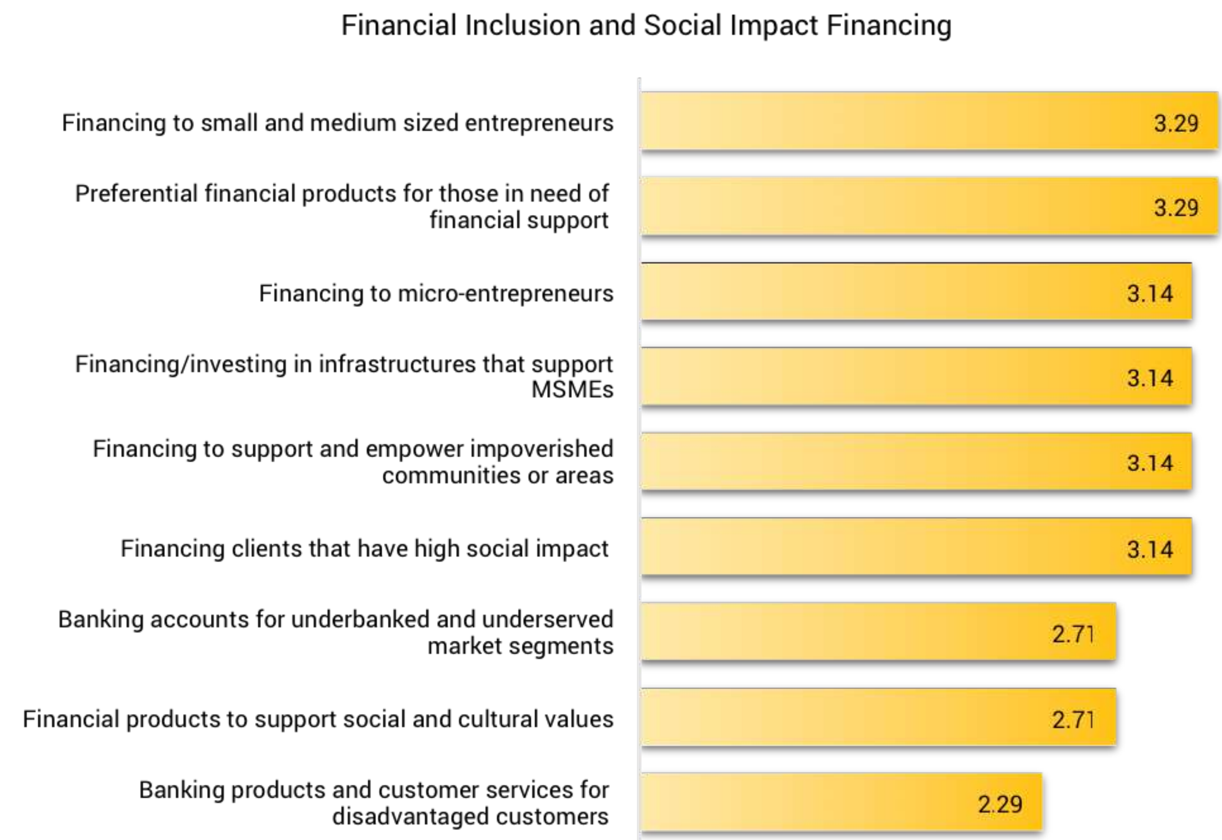
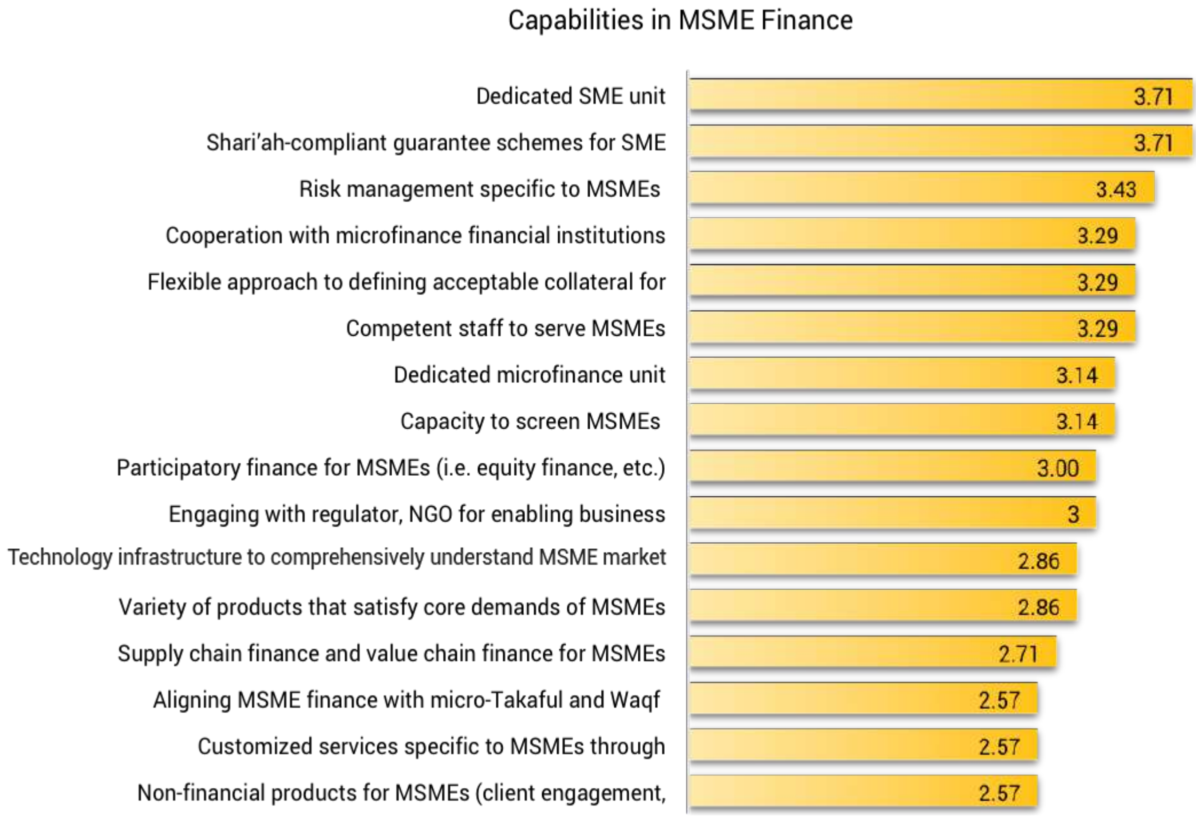


Figure 13: Financial Inclusion and Social Impact Financing



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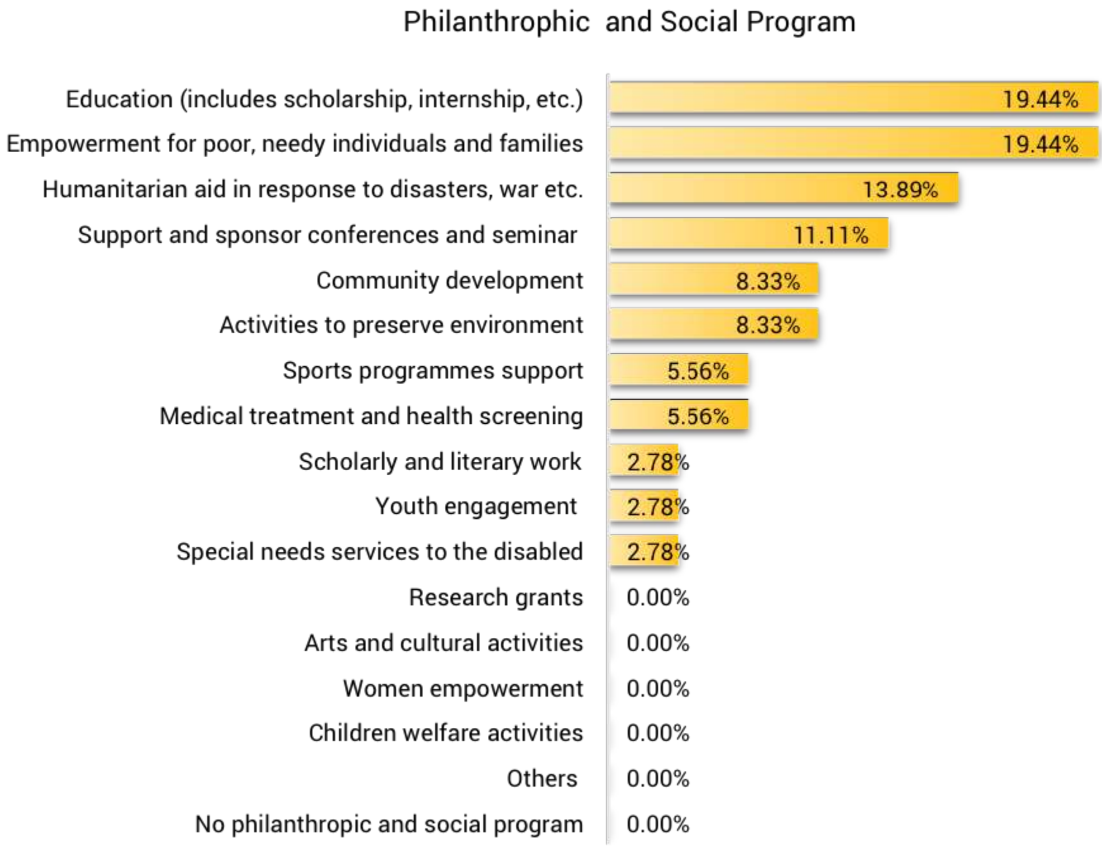
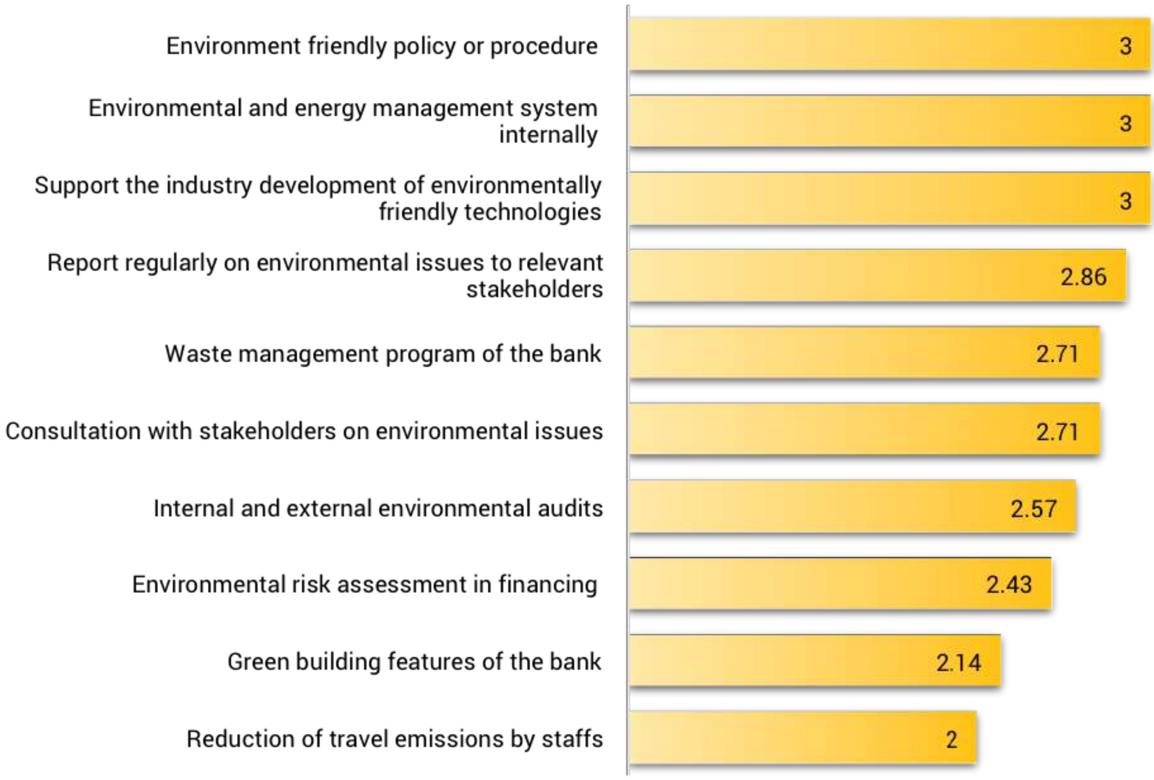


Figure 15: Banks Score "Top Five" Philanthropic and Social Programmes

Environment-friendly Business Practices



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Five Areas to Improve Responsible Business Practices

Figure 17: Top Five Areas to Improve Responsible Business Practices

Figure 18: Improvement in Responsible Business Practices in Future

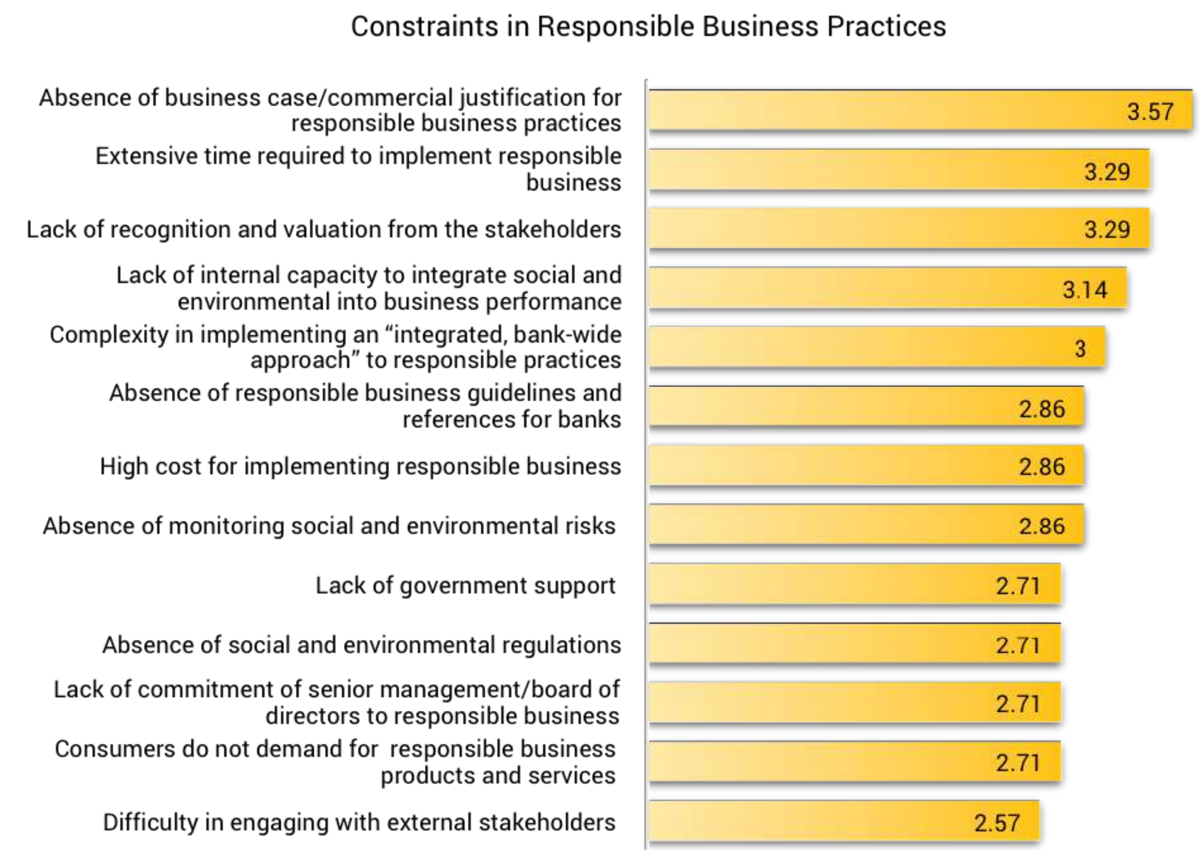
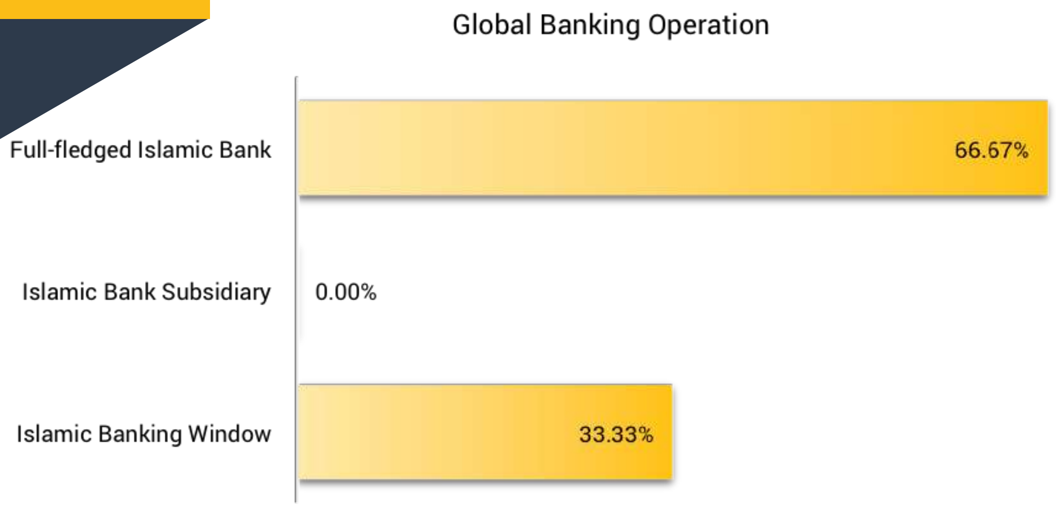


Figure 19: Constraints in Responsible Business Practices

Figure 20: Benefits from Responsible Business Practices

Group 4



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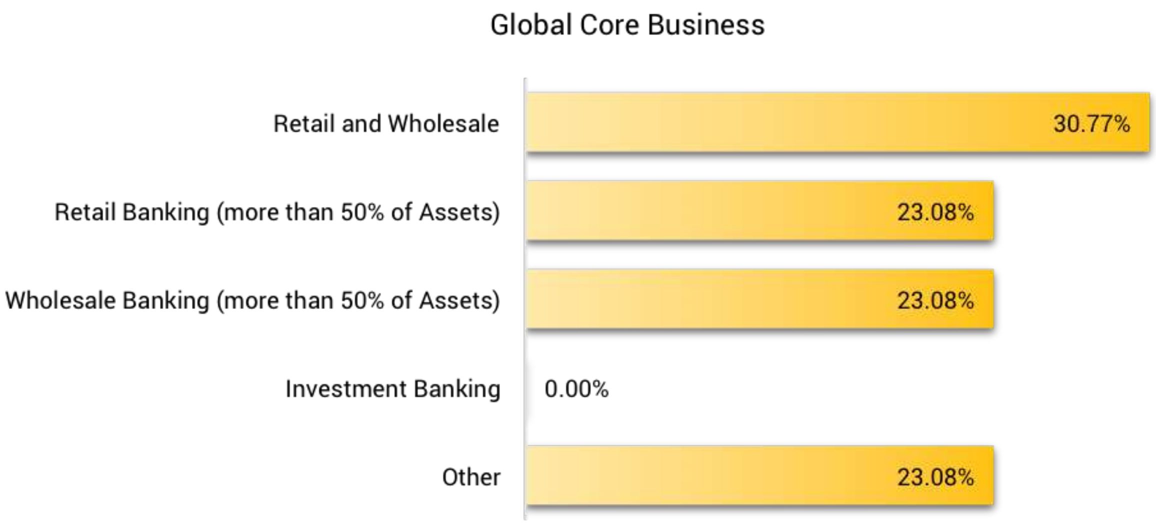

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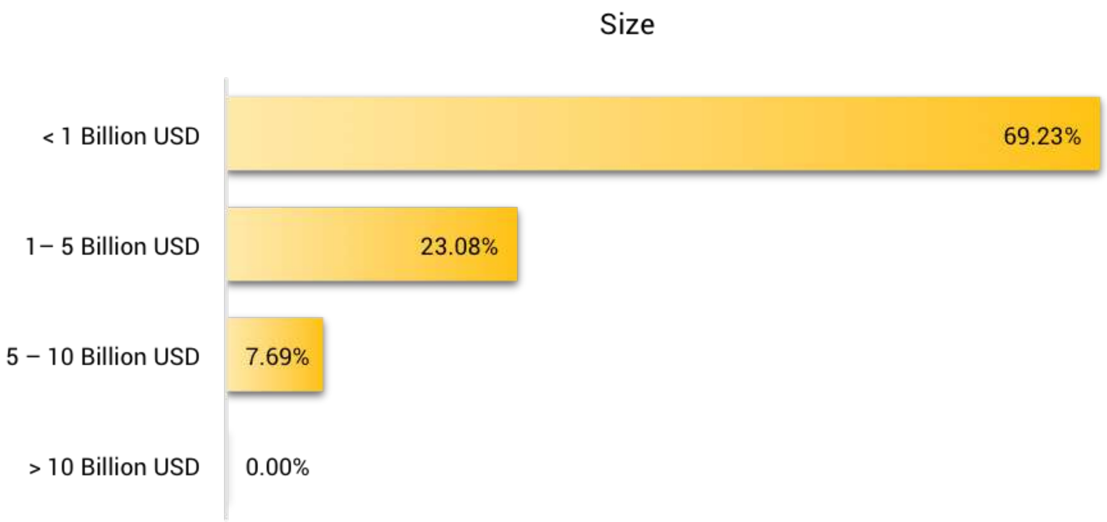

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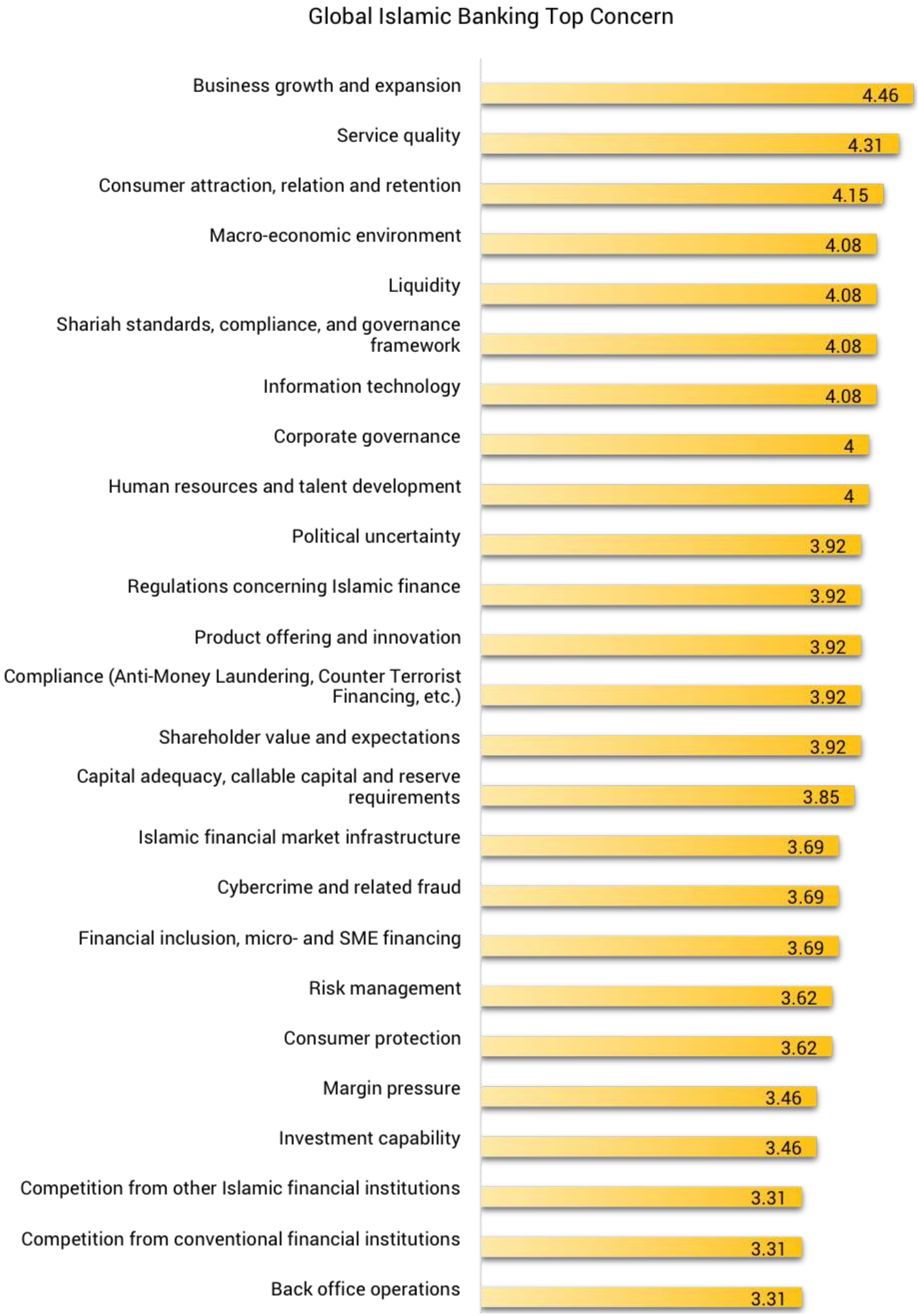

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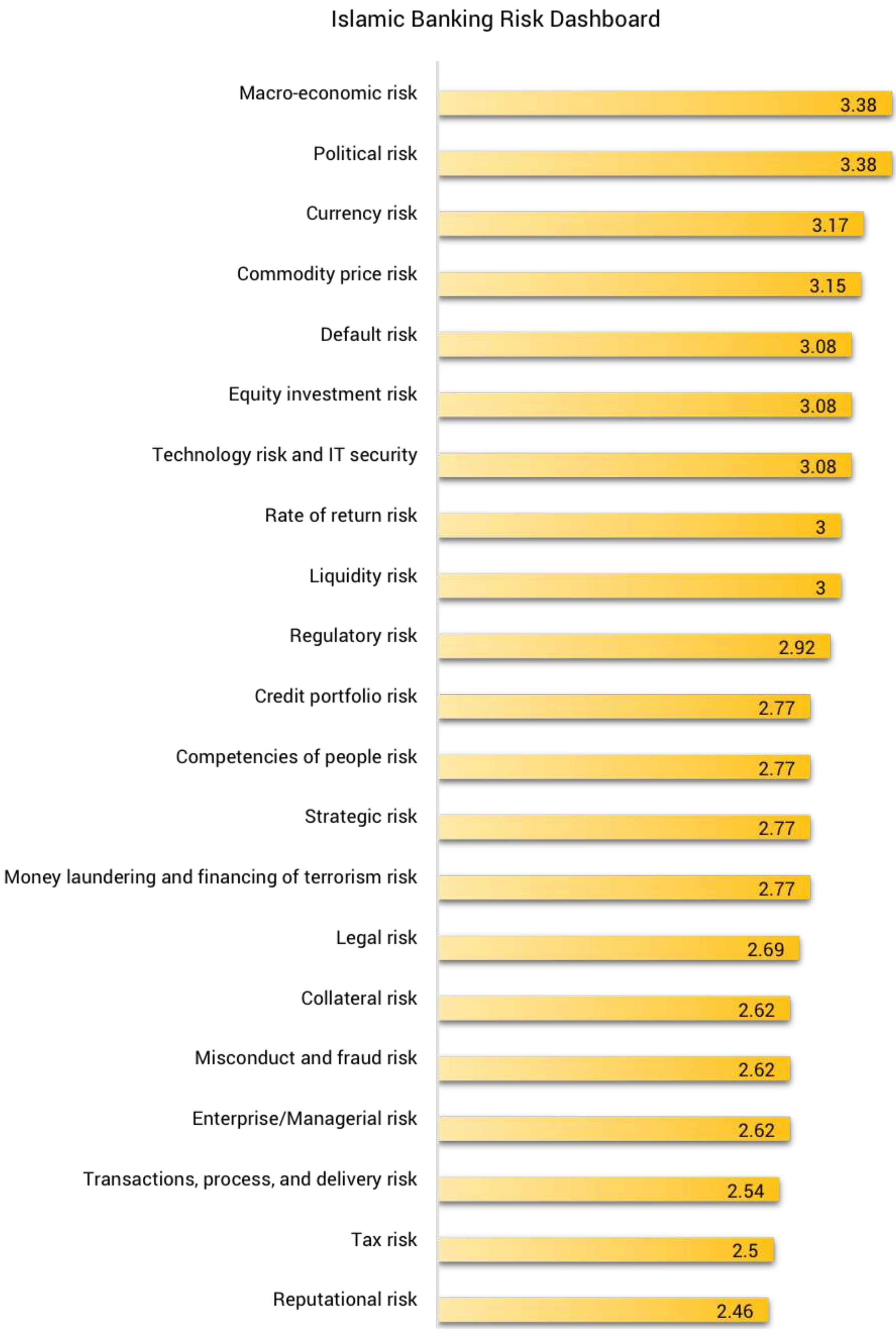

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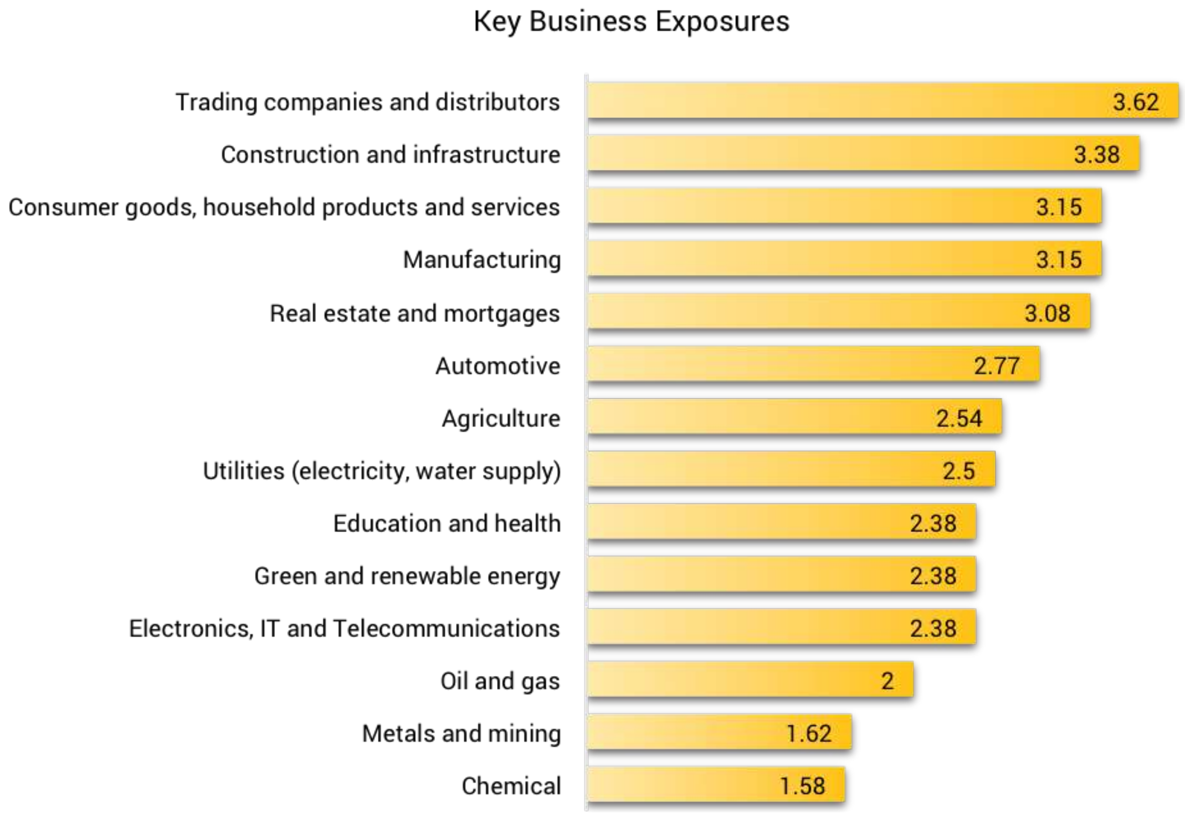

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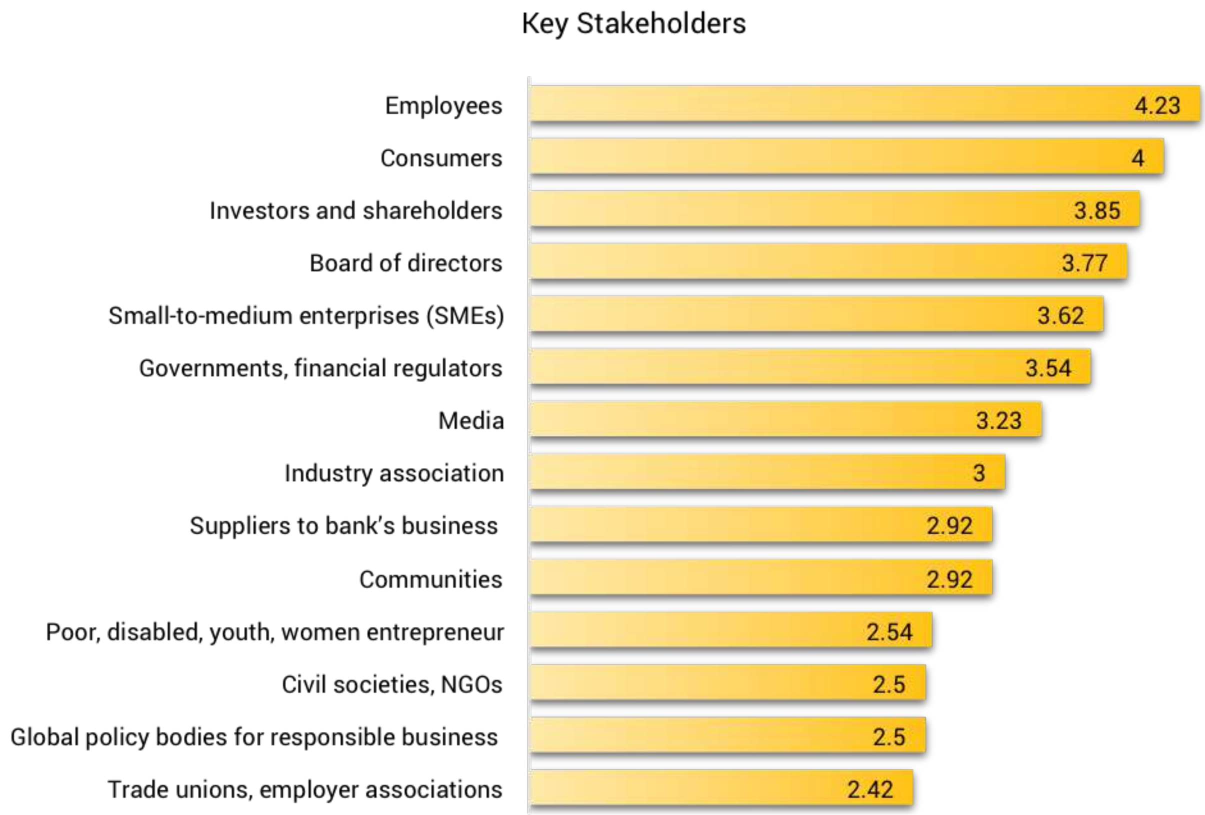

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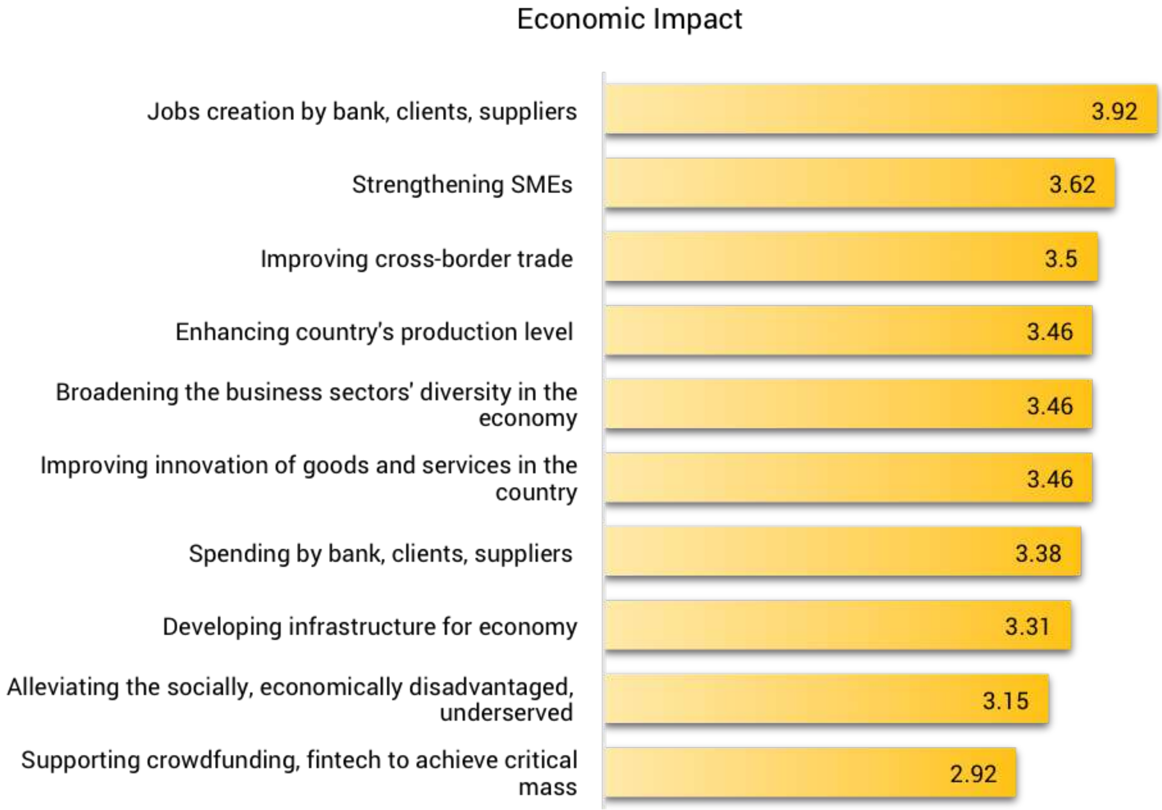

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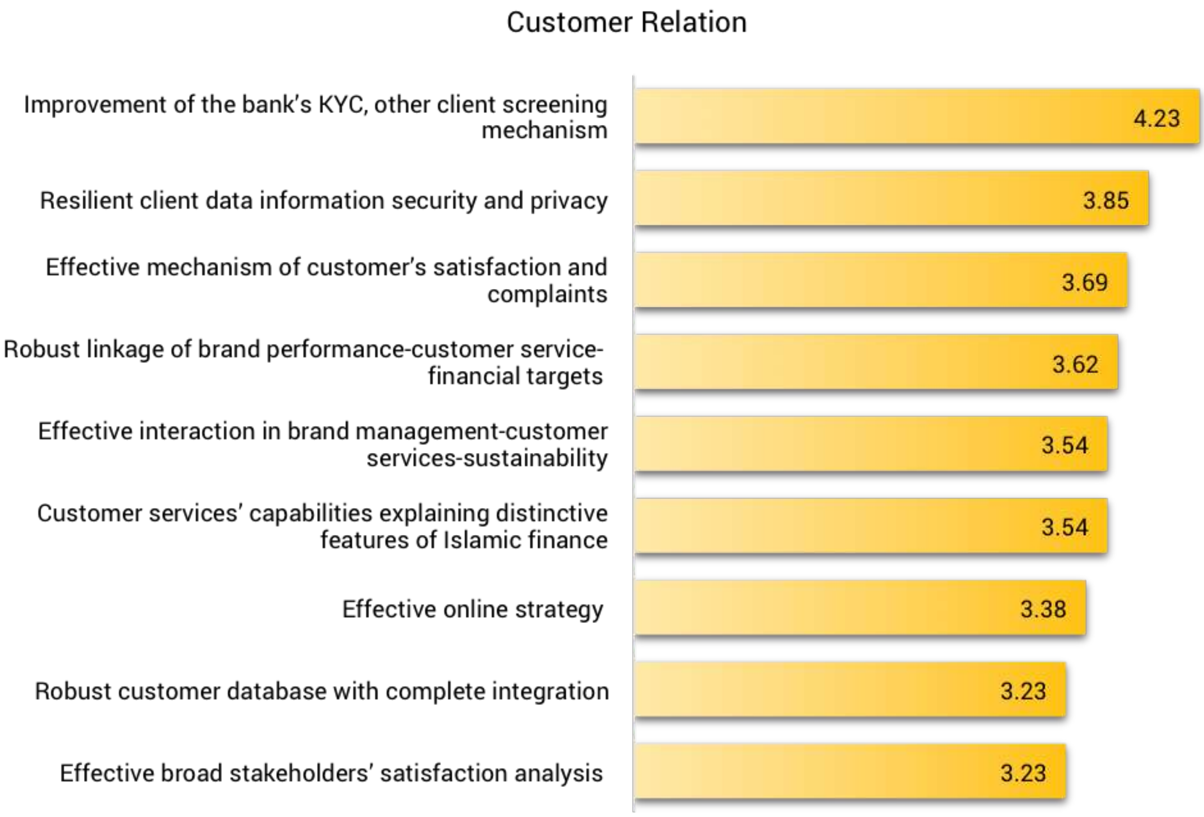

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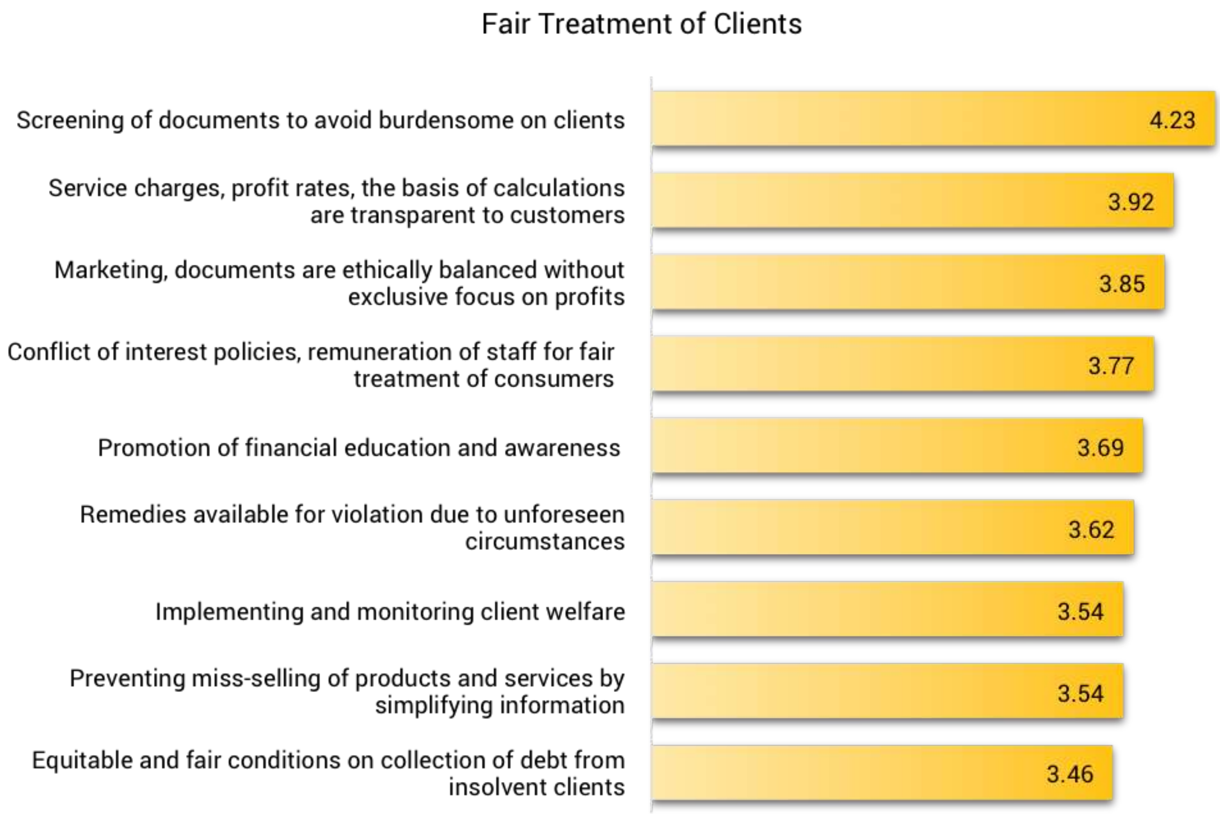

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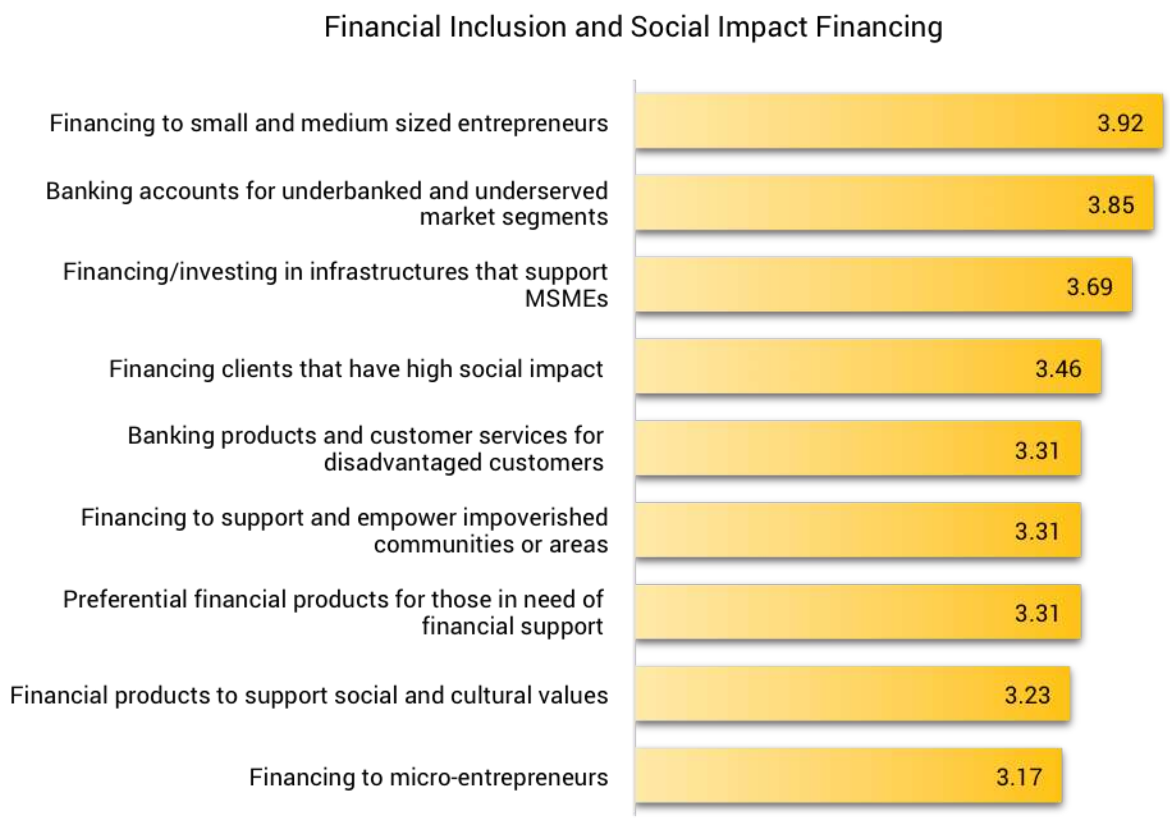

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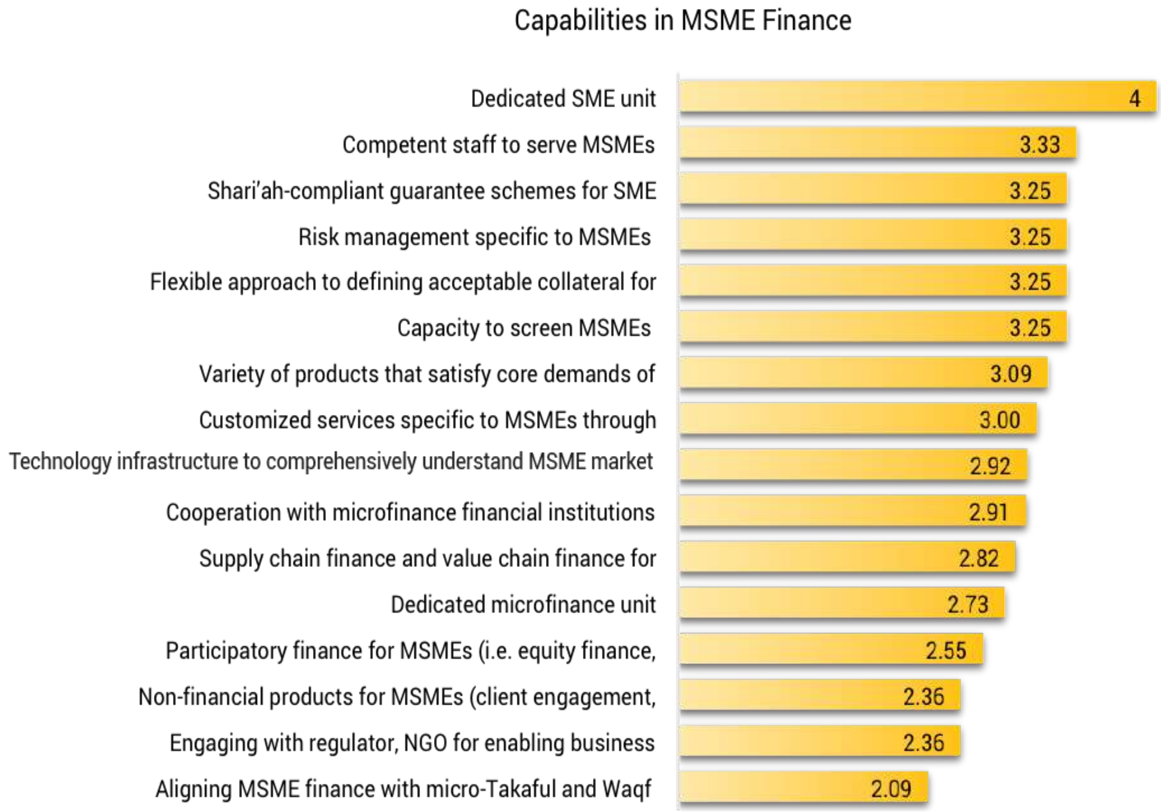

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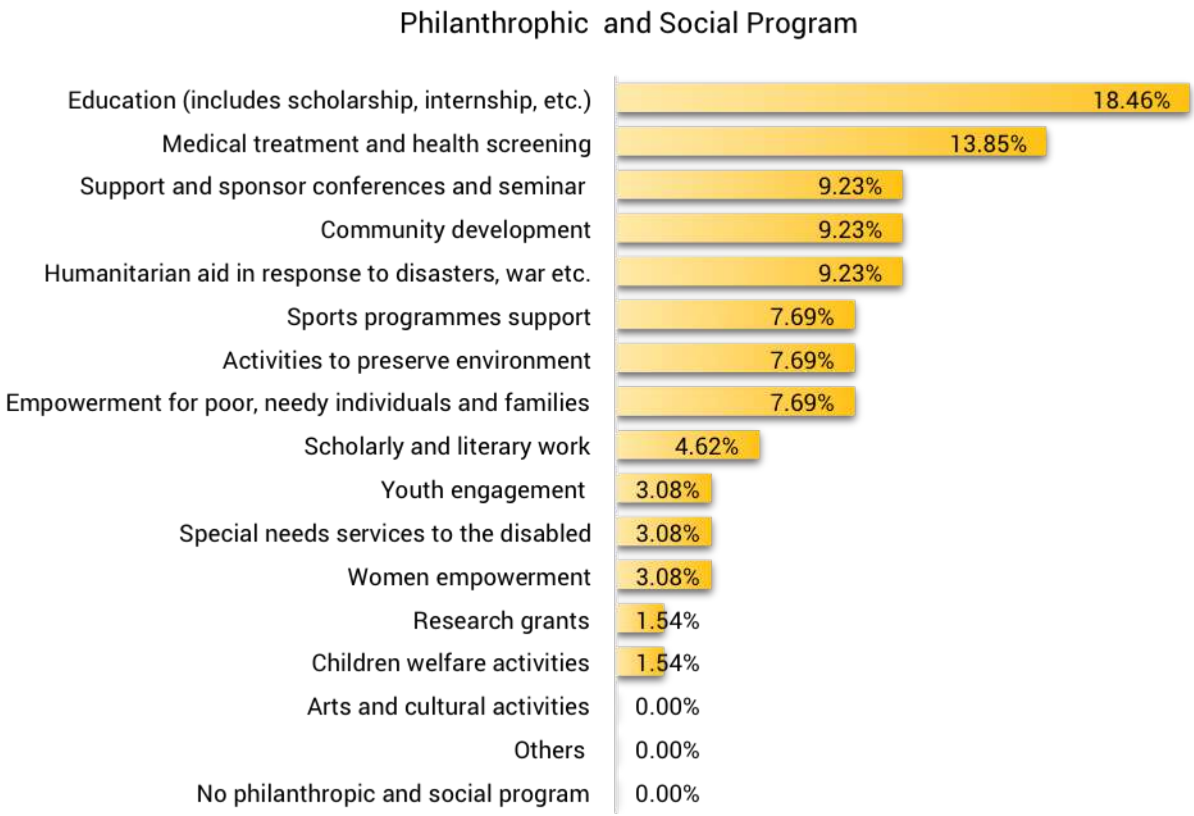

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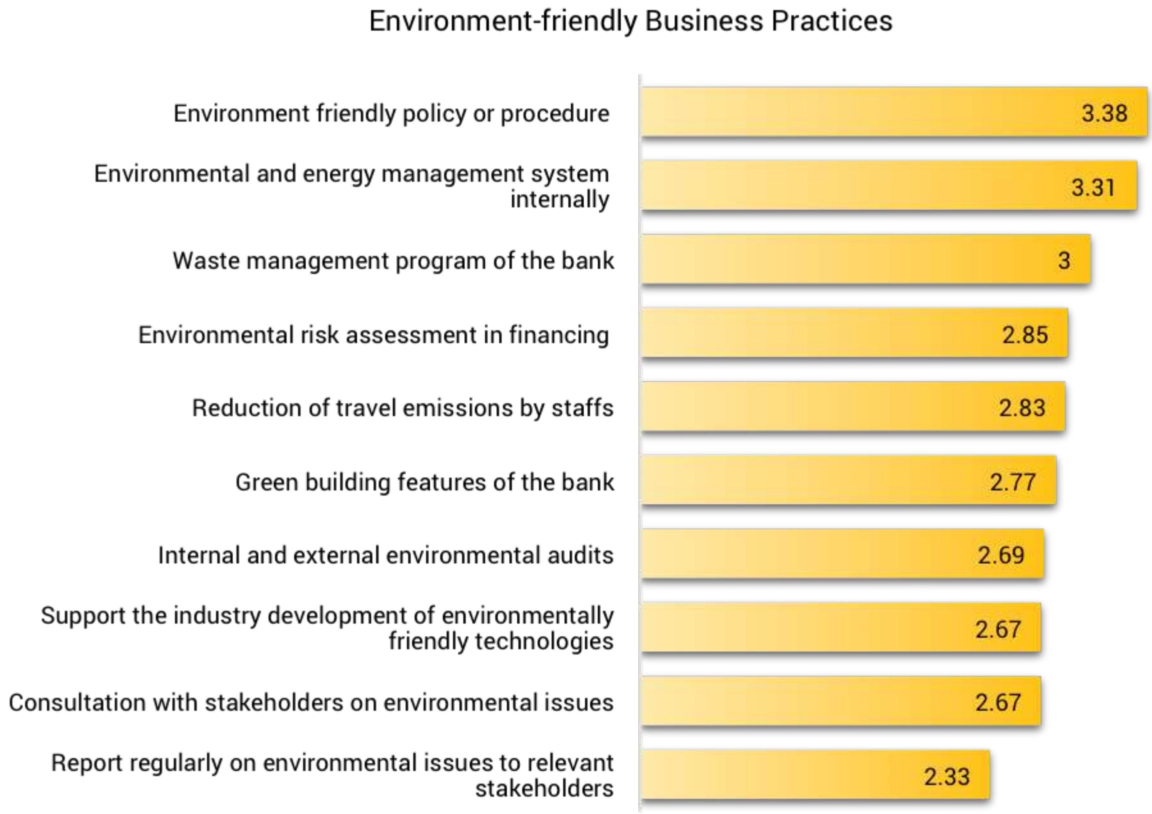

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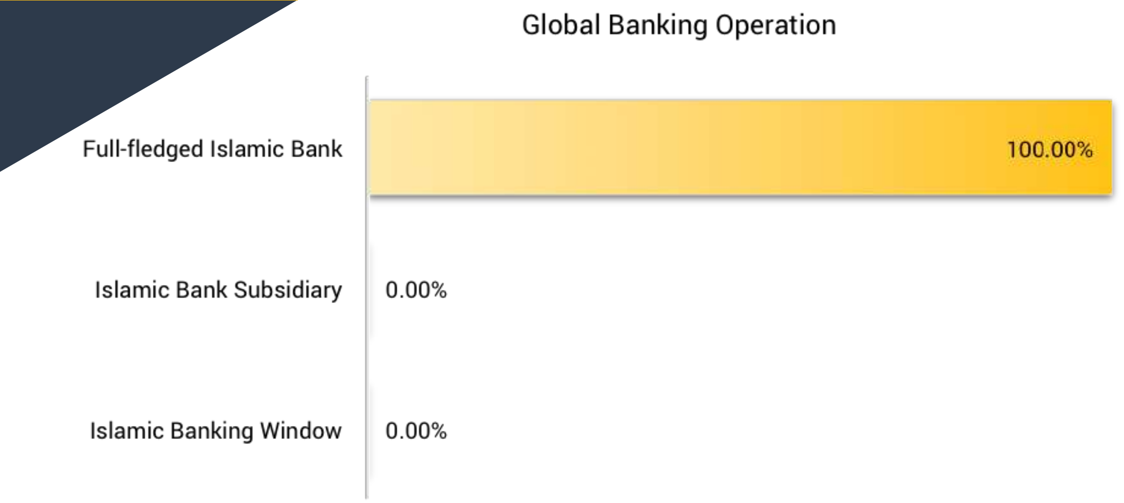
Group 5



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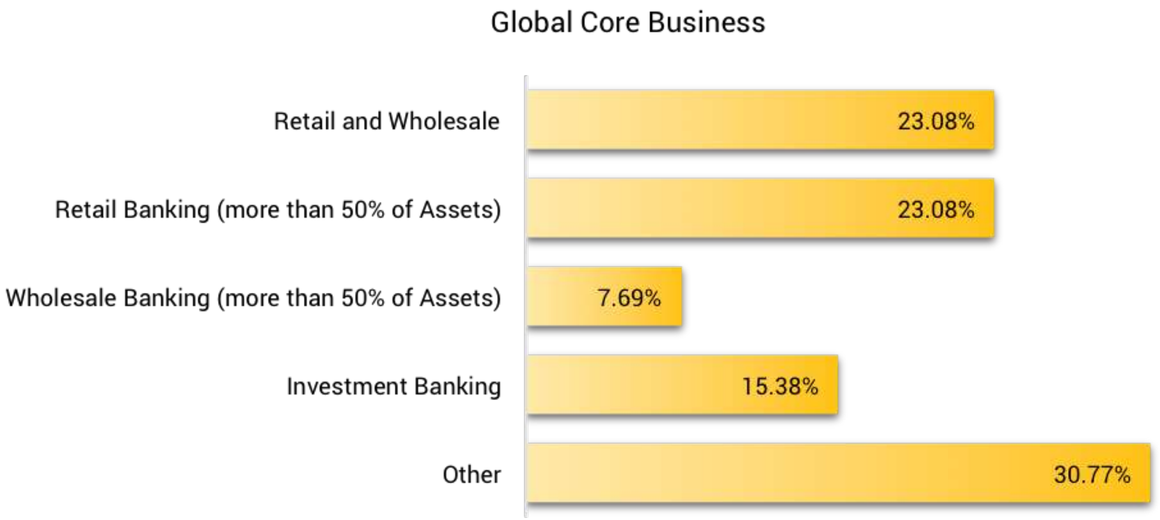

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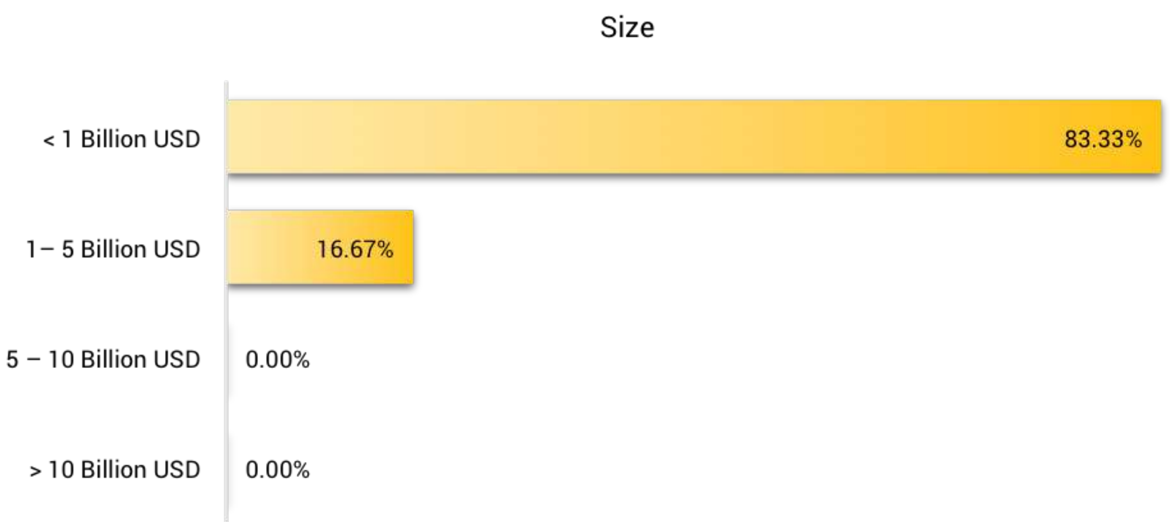

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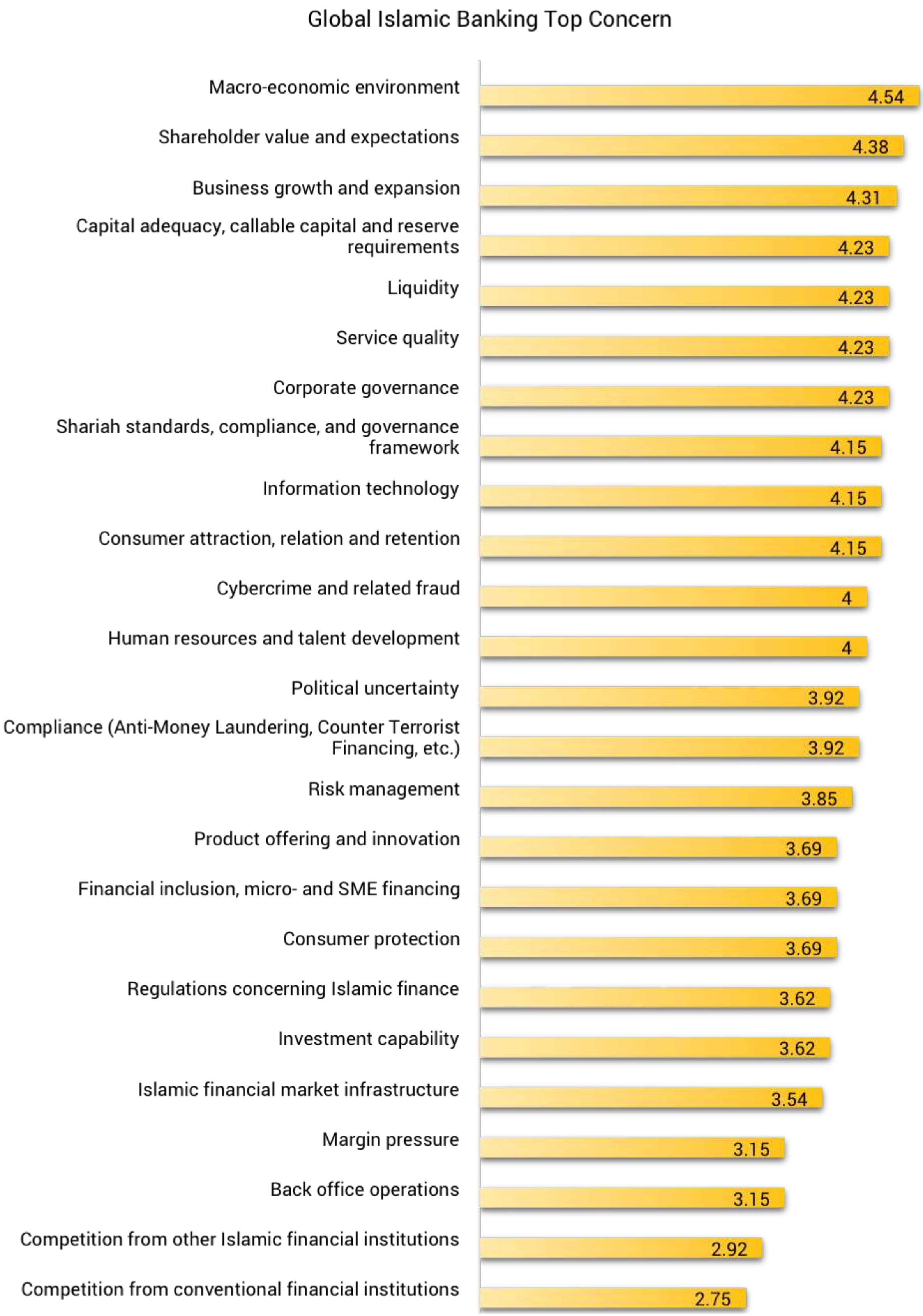

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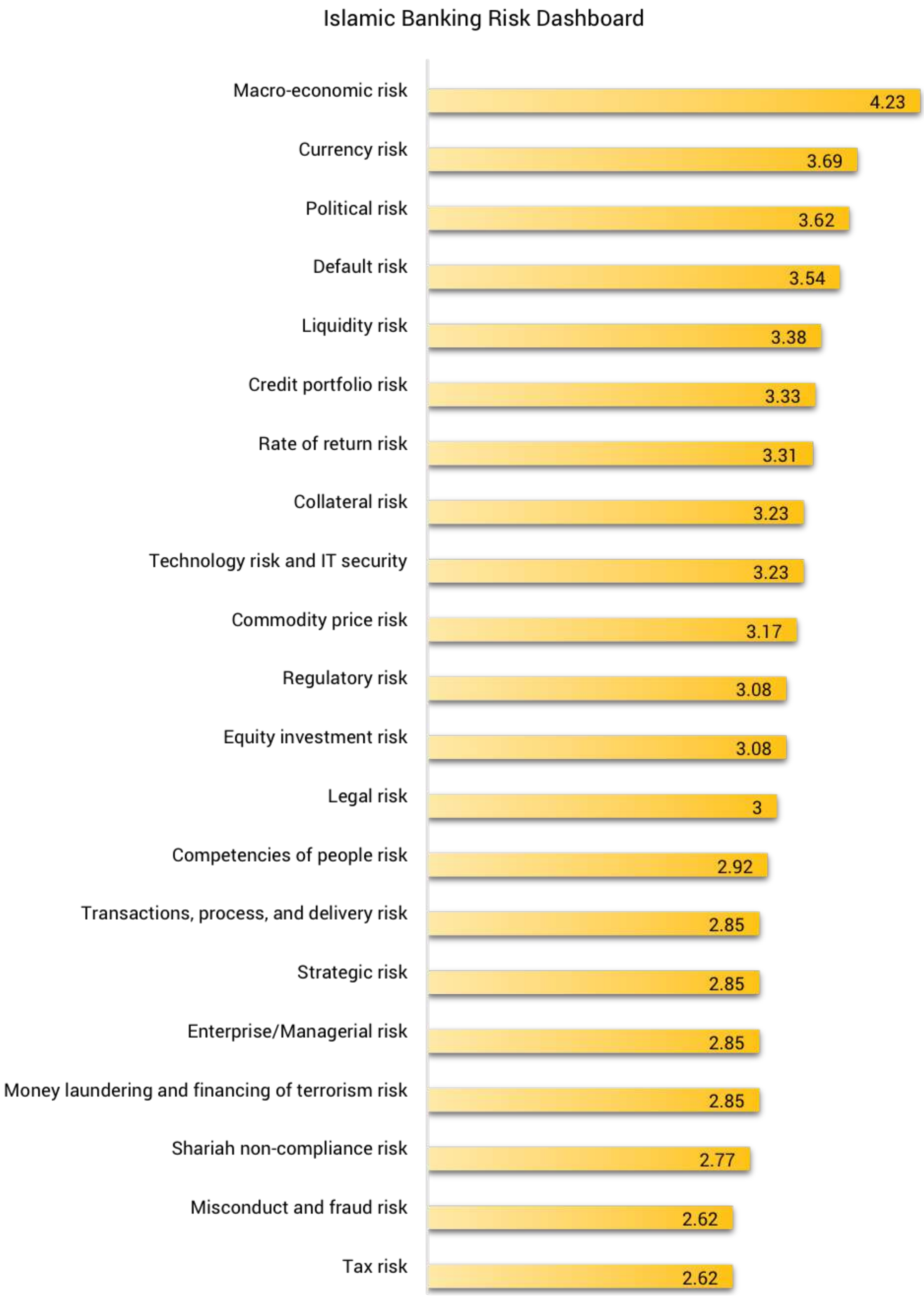

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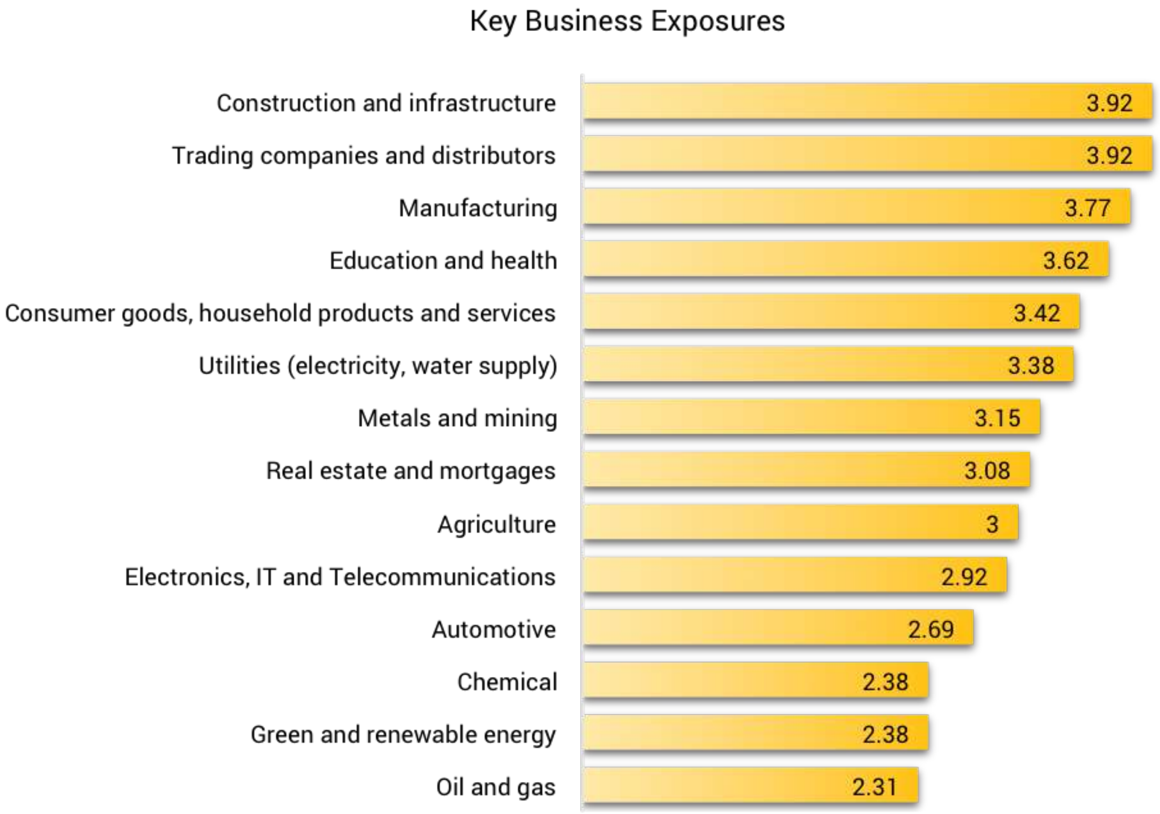

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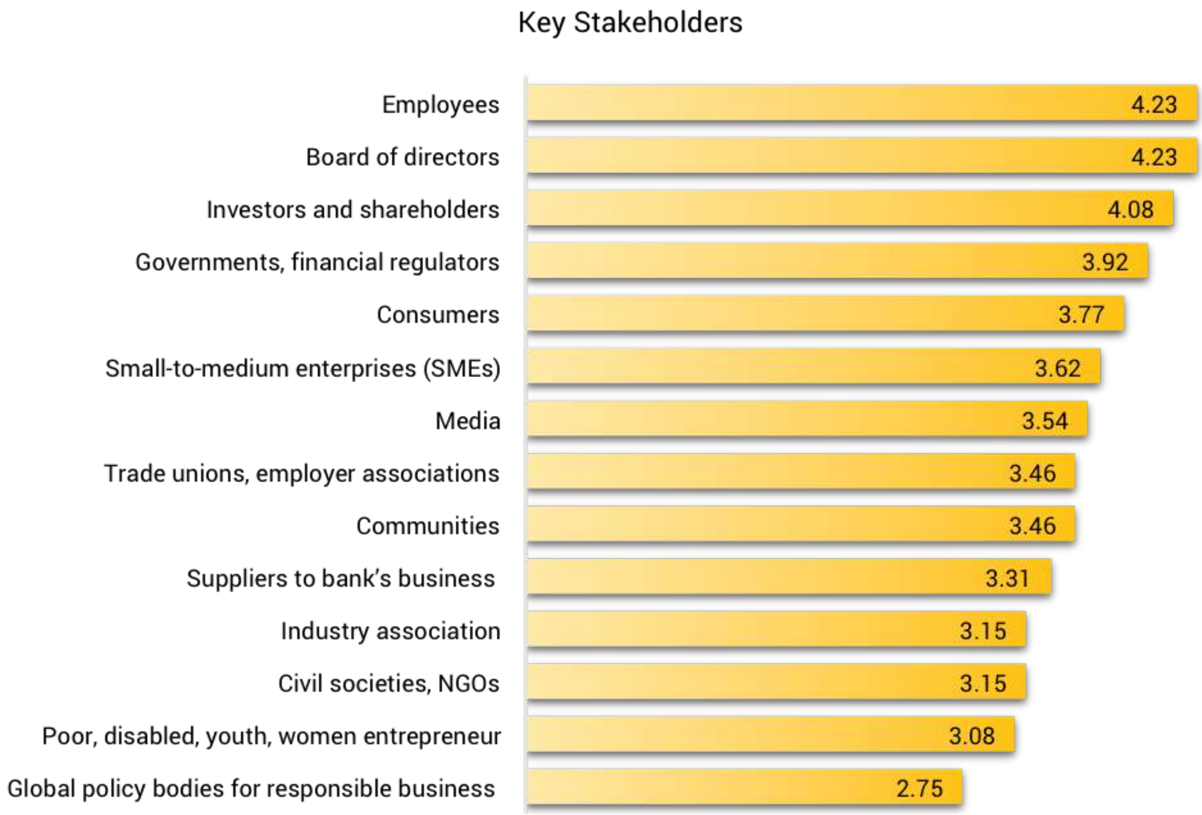

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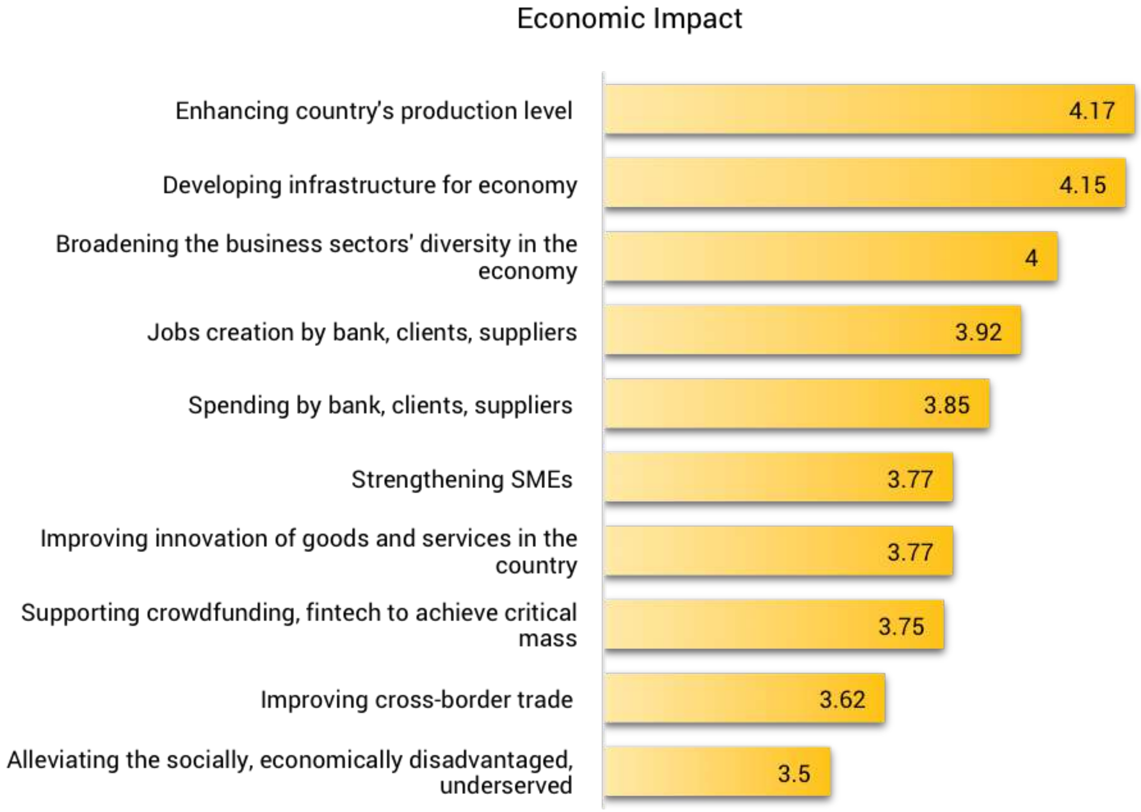

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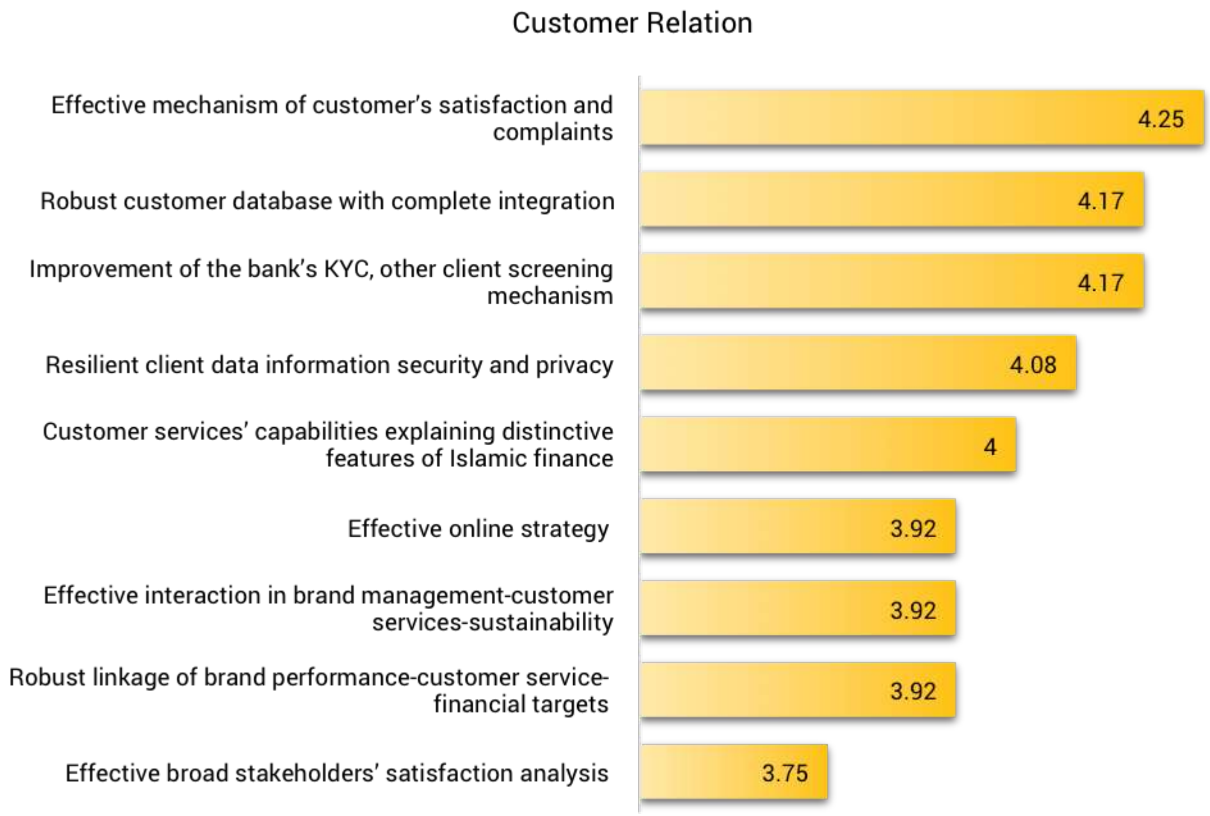

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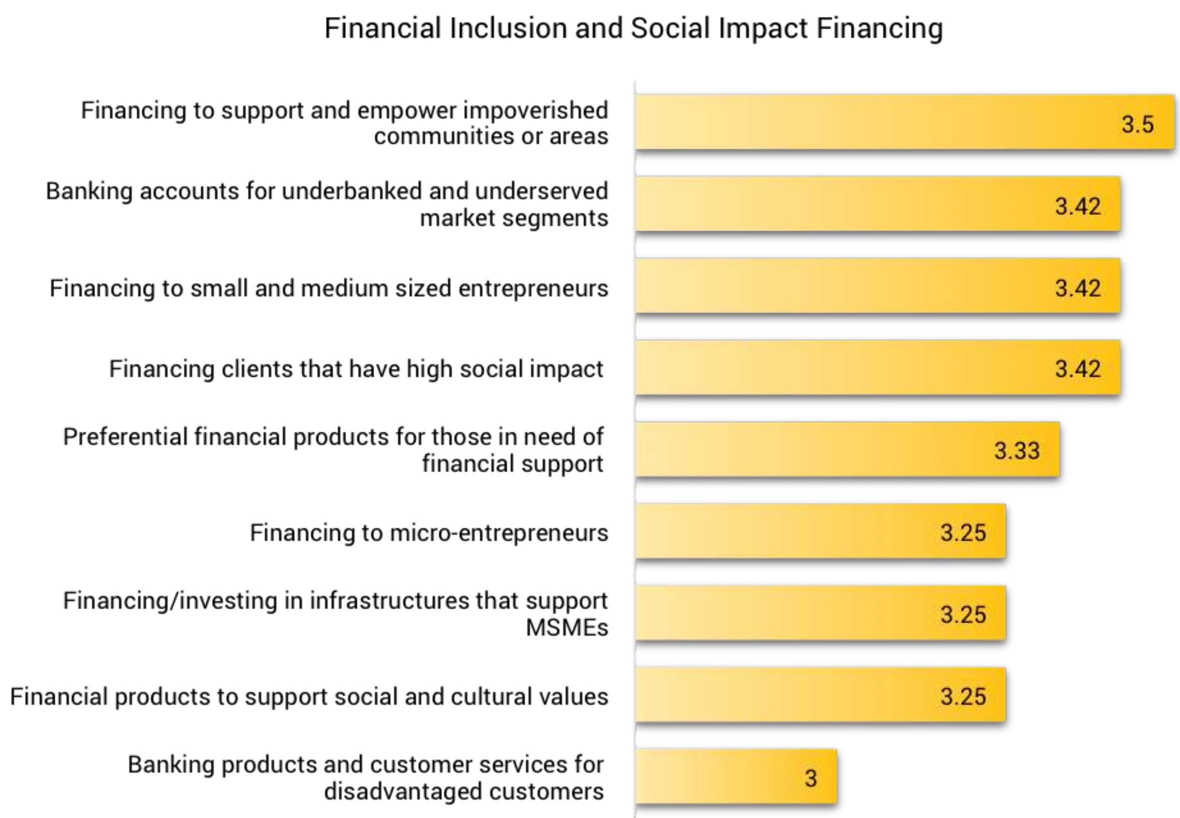

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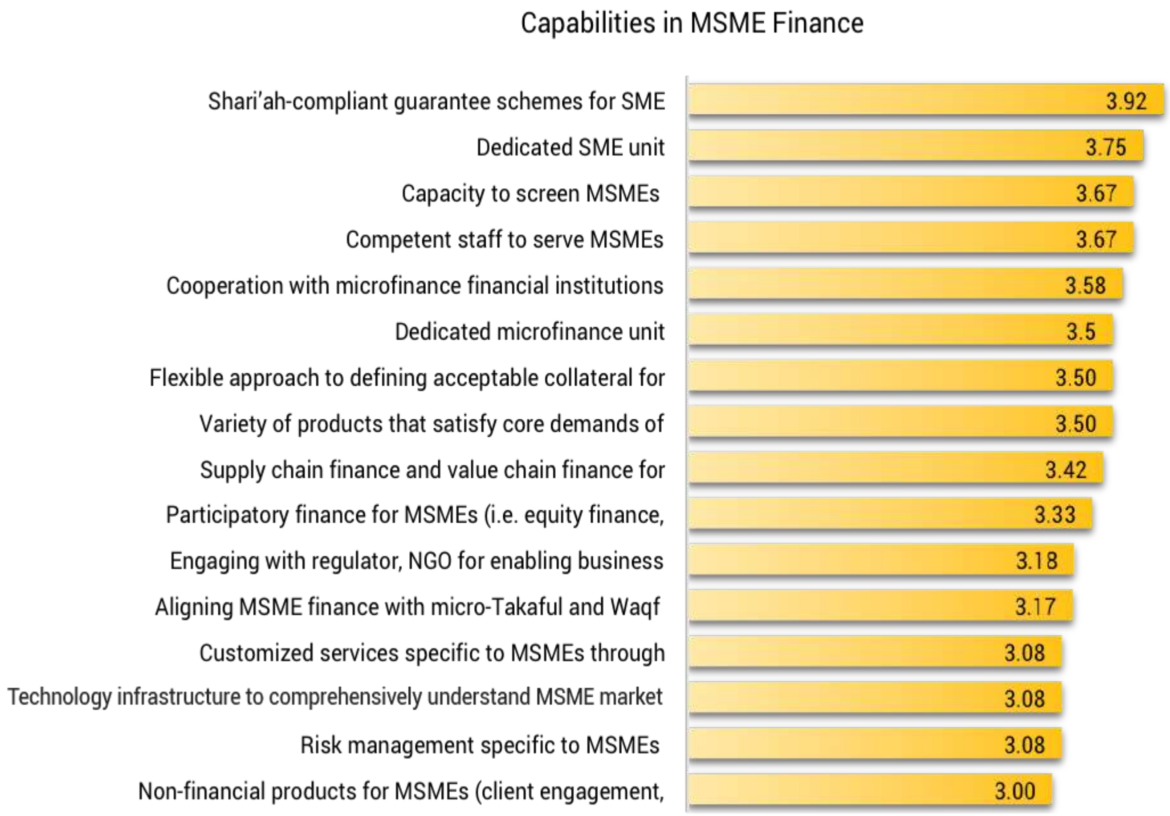

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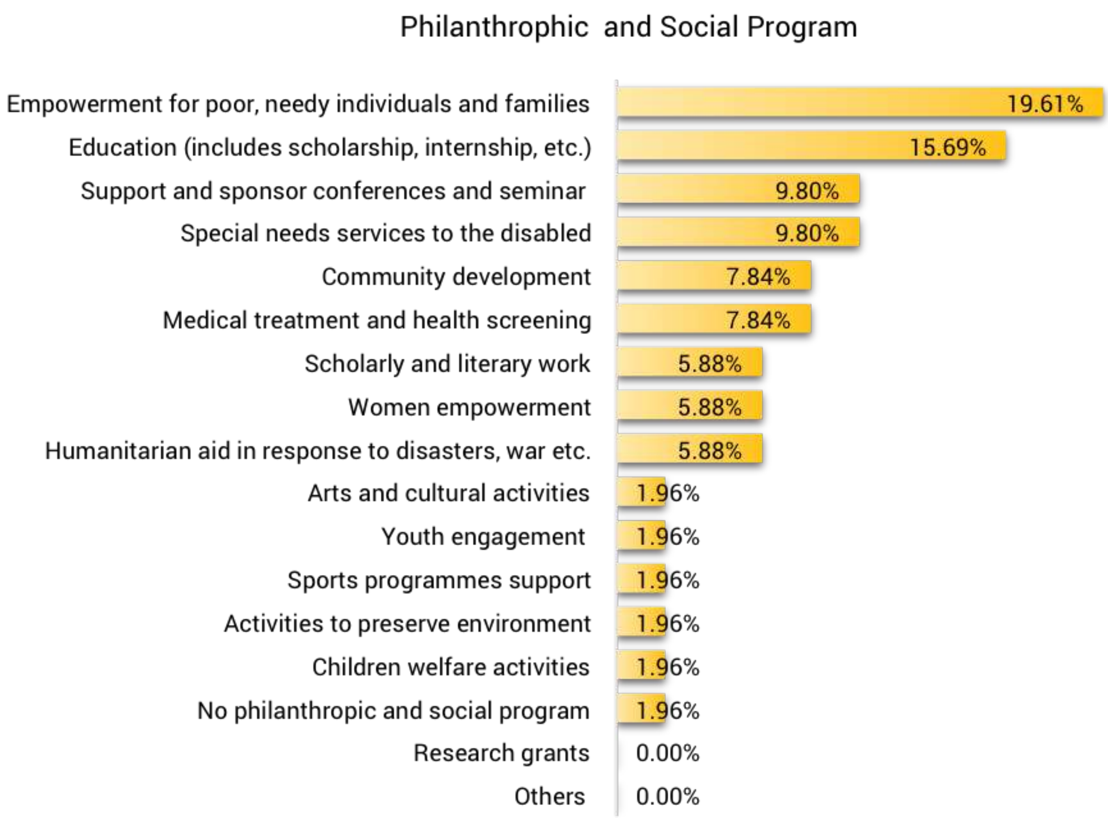

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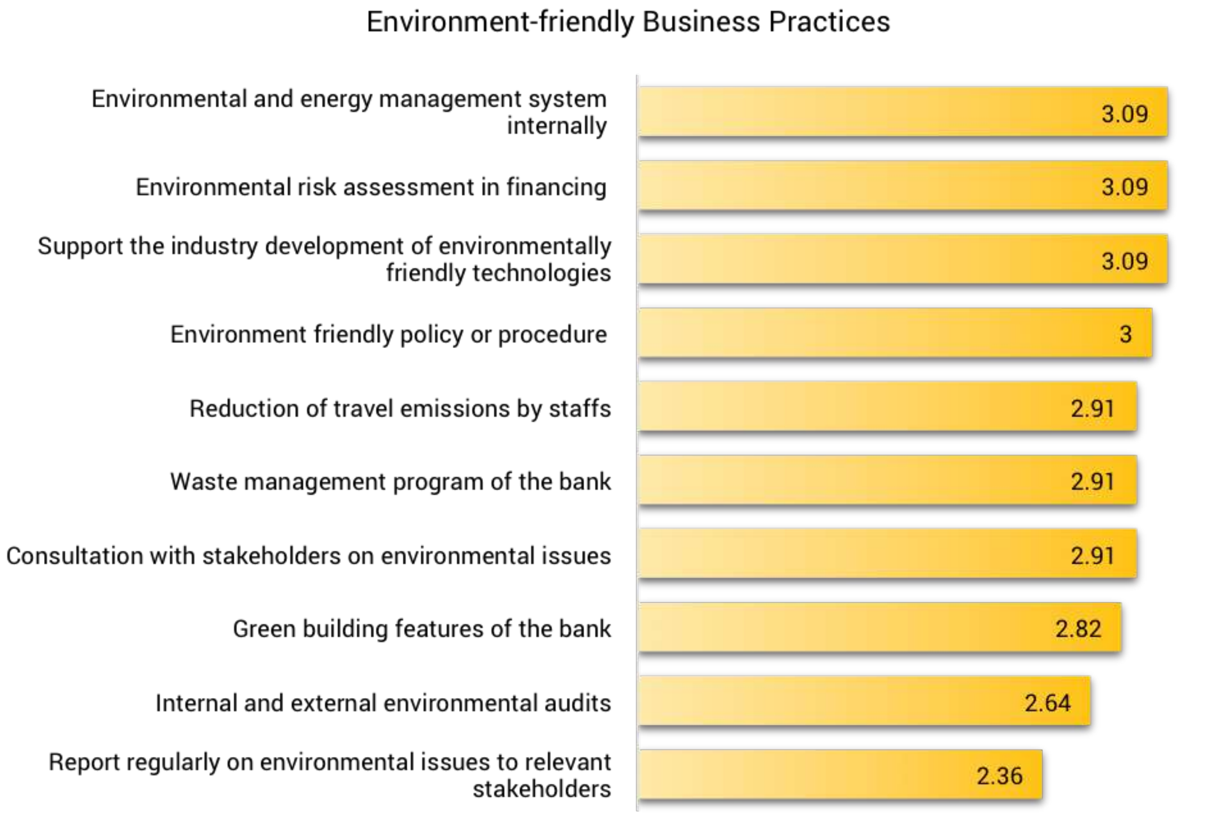

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Figure 18: Improvement in Responsible Business Practices in Future

Constraints in Responsible Business Practices

Figure 19: Constraints in Responsible Business Practices

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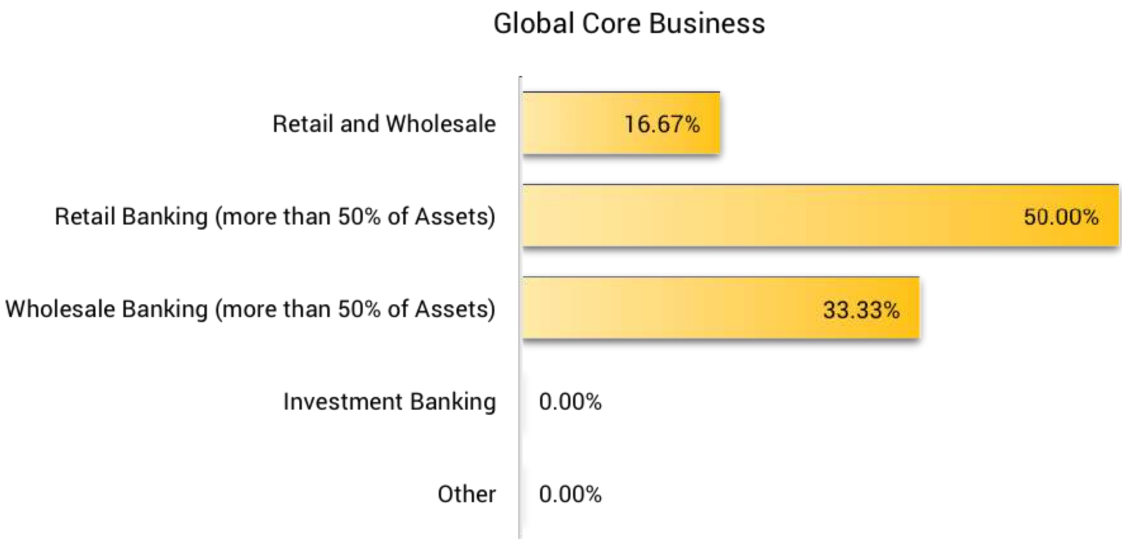
Group 6

Figure 1: Corporate Profile of Respondents



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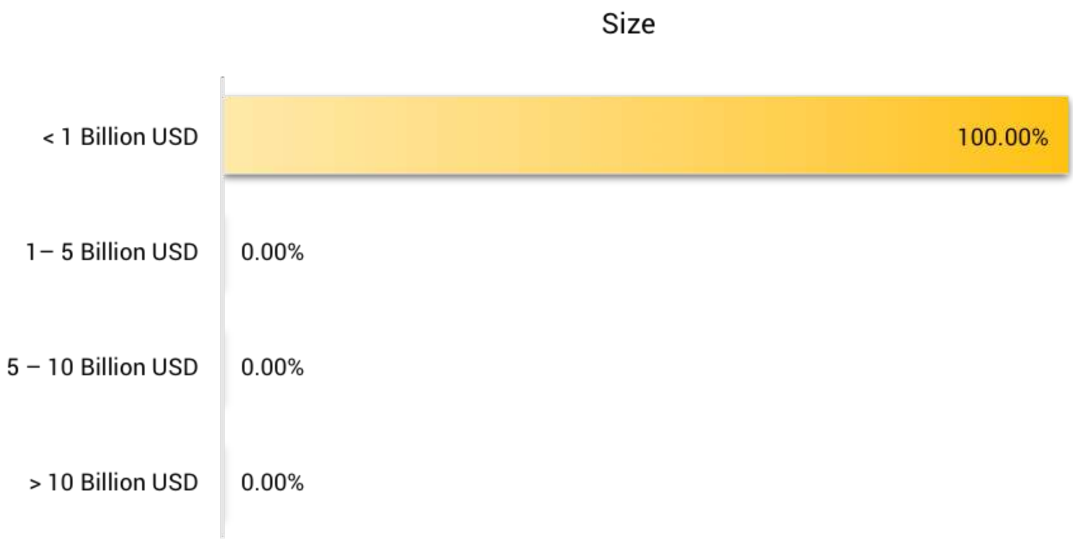

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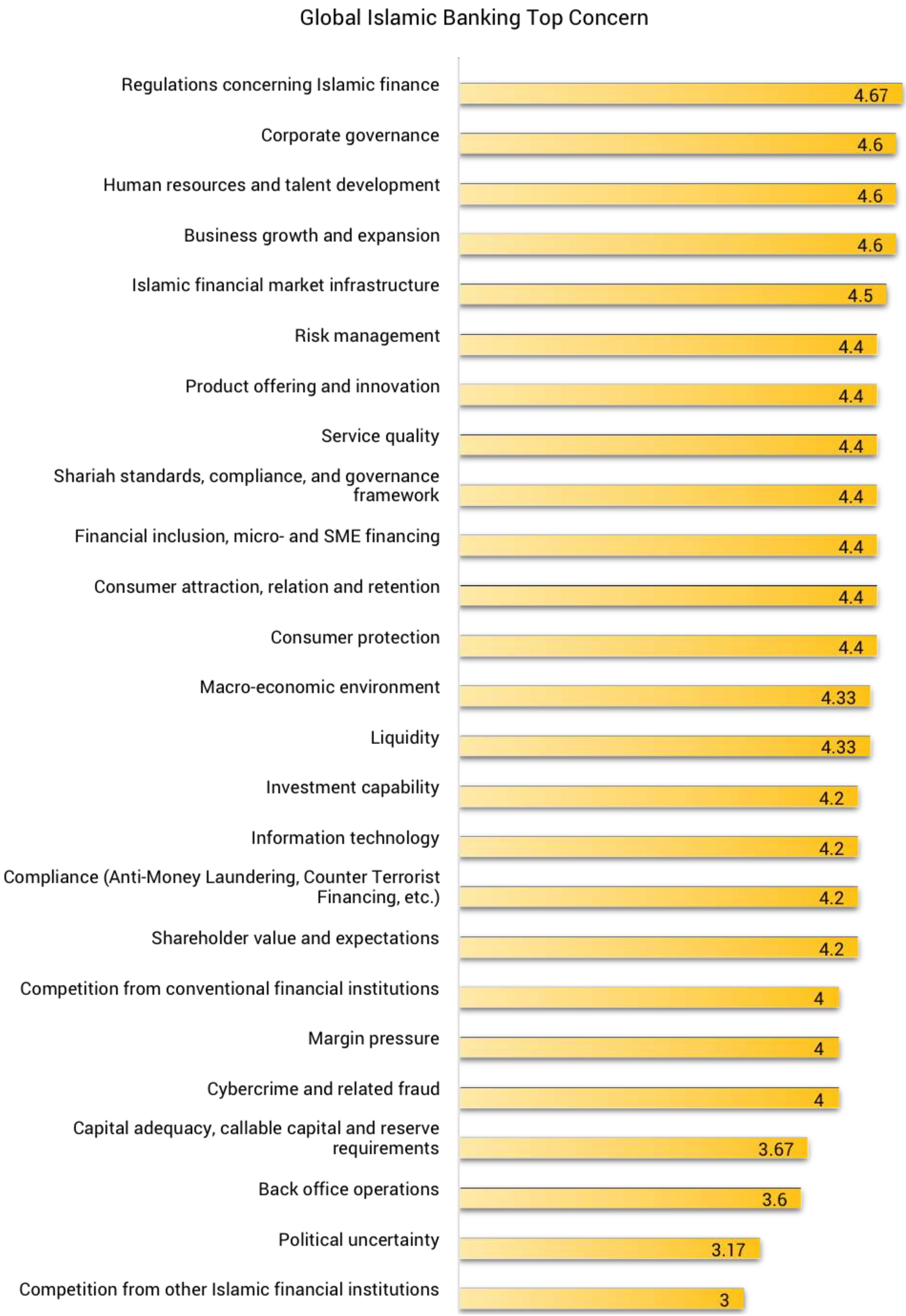

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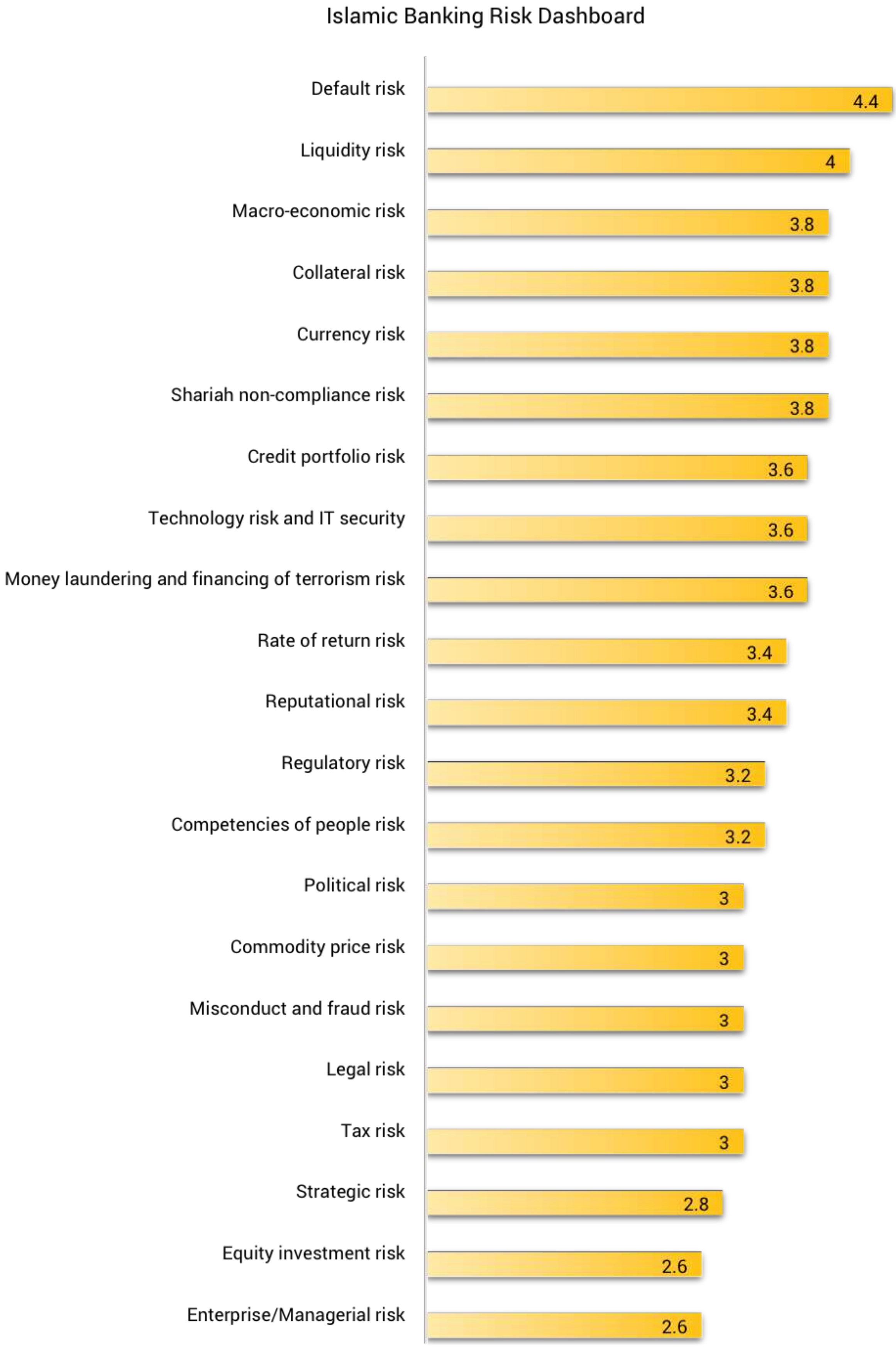

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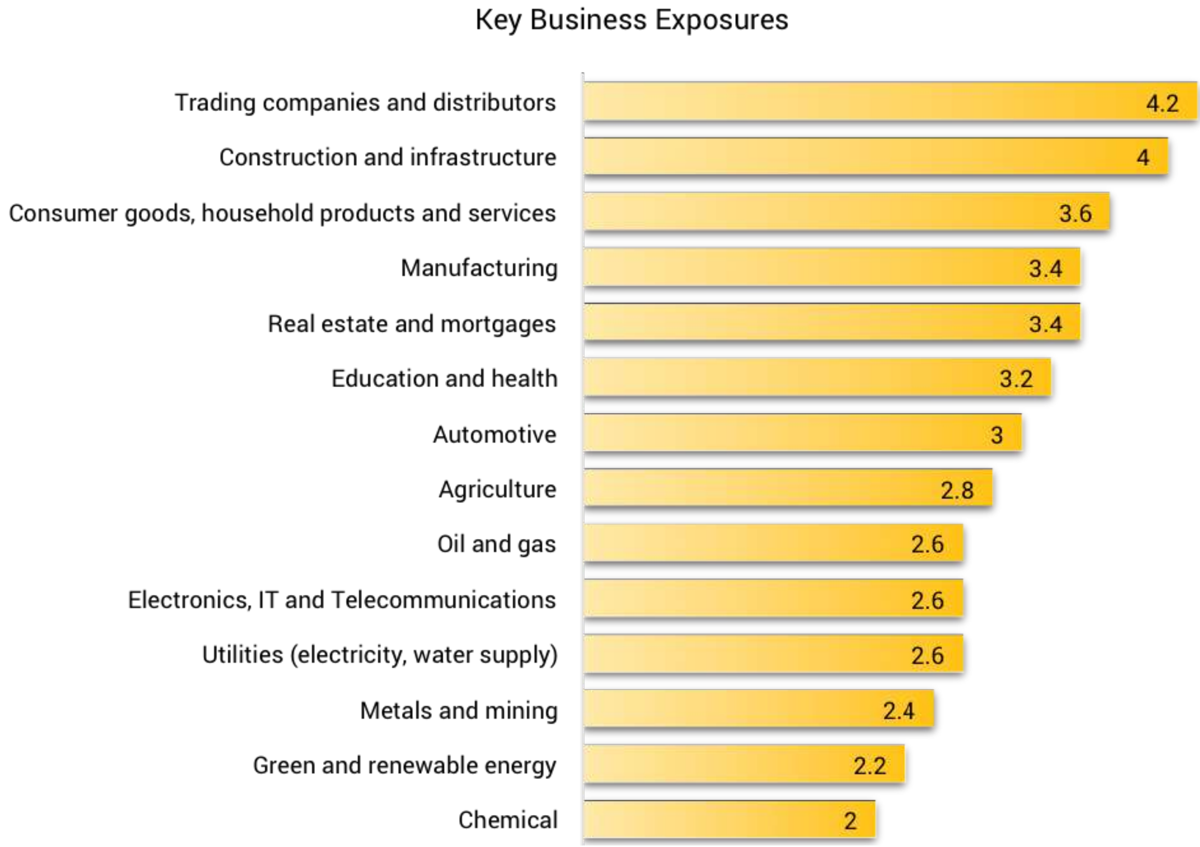

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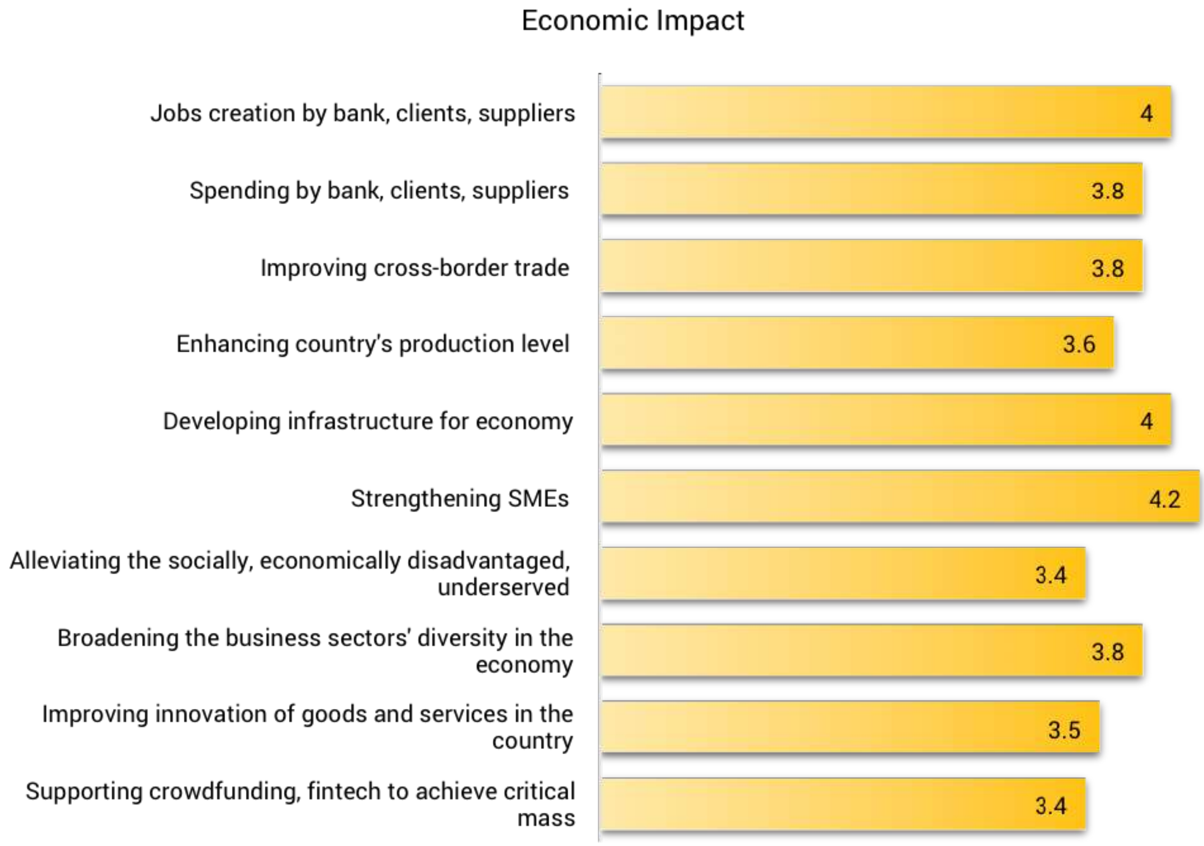

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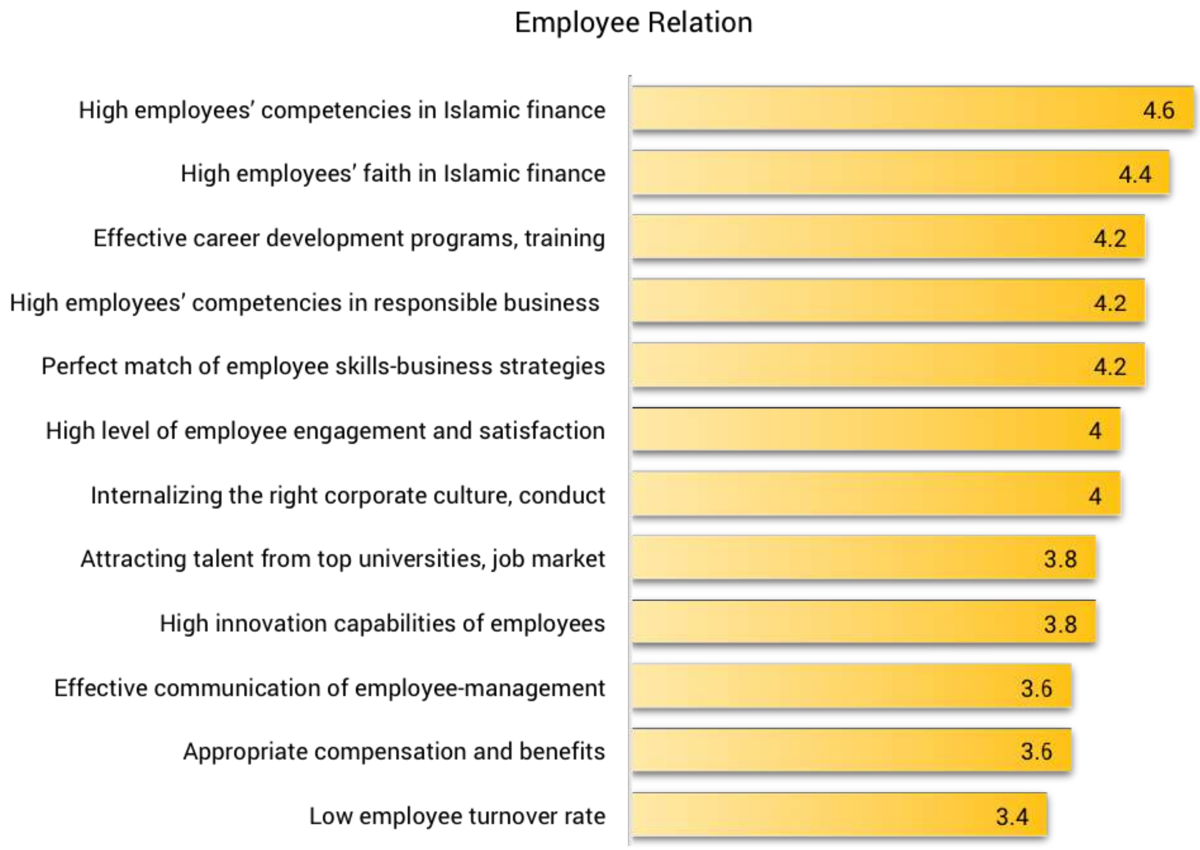

Figure 9: Degree of challenges banks face in promoting high quality employee relations

Figure 10: Employee Performance in Responsible Business

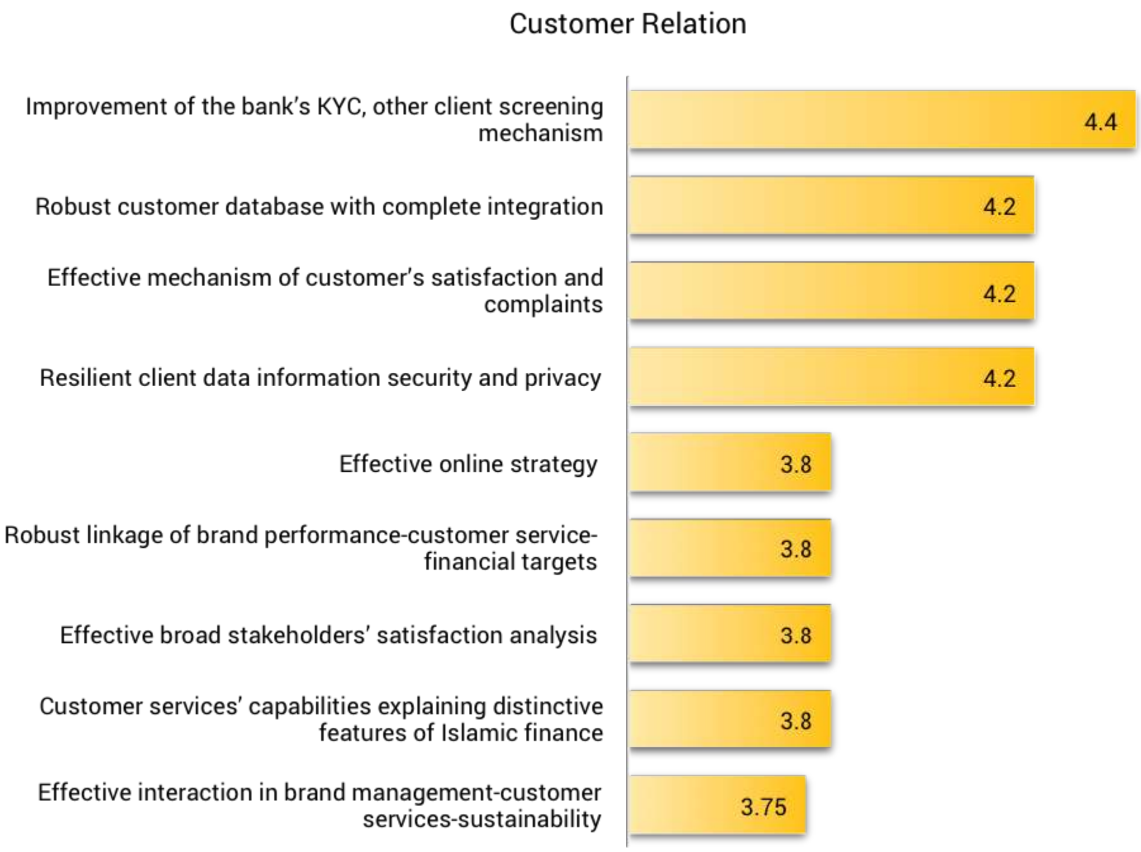

Figure 11: Customer Relations

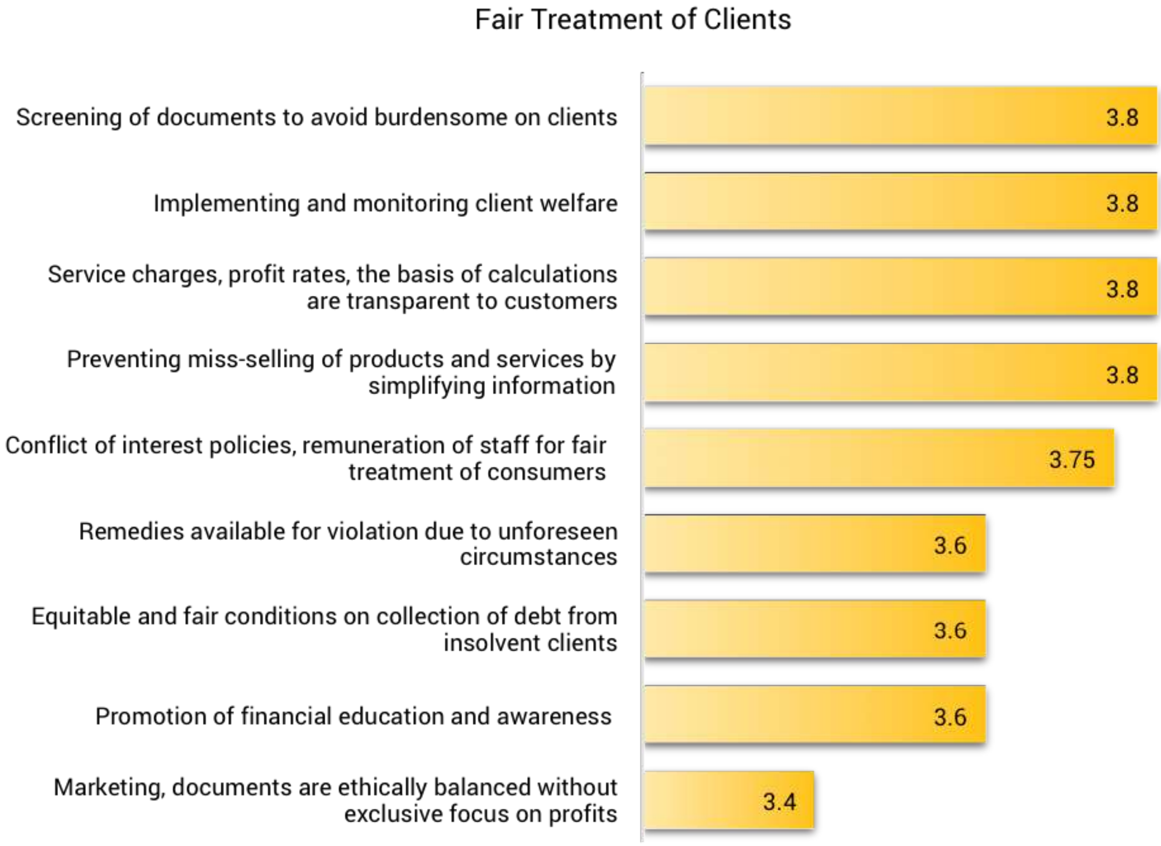

Figure 12: Fair Treatment of Clients

Figure 13: Financial Inclusion and Social Impact Financing

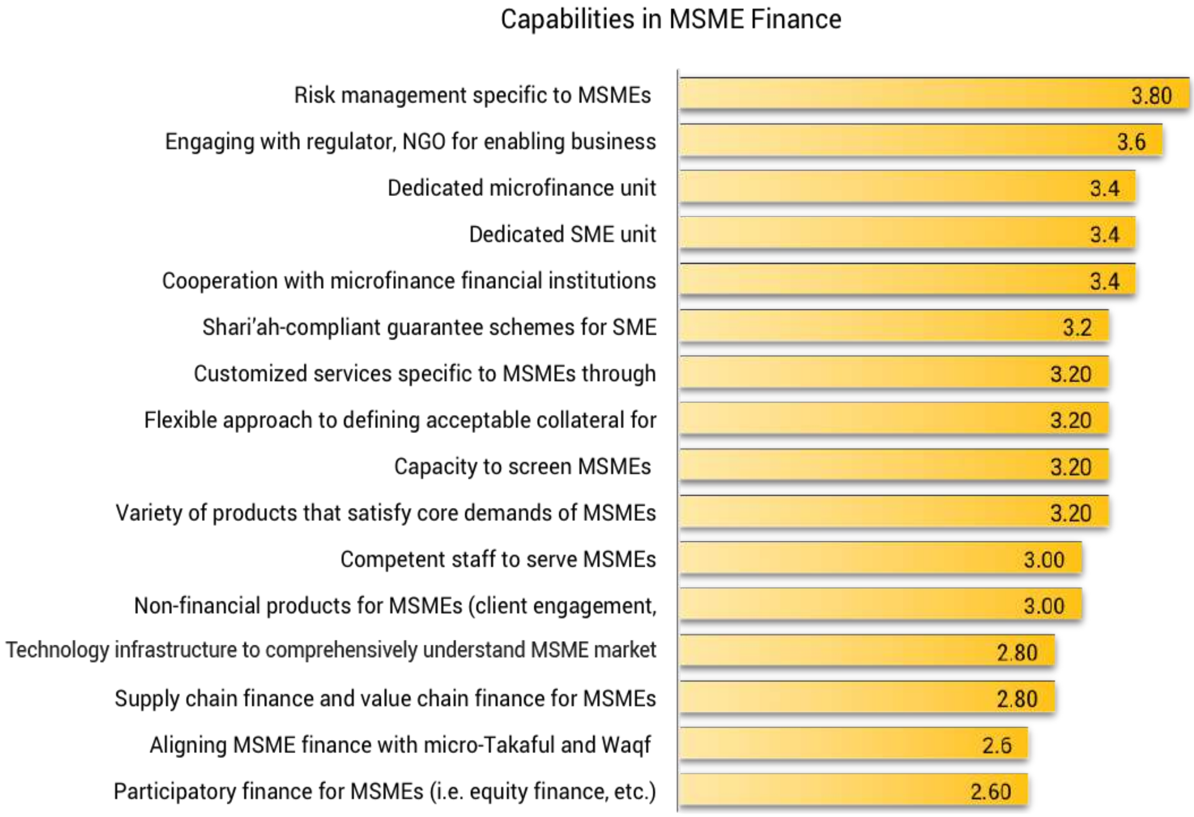

Figure 14: Capabilities in MSME Finance

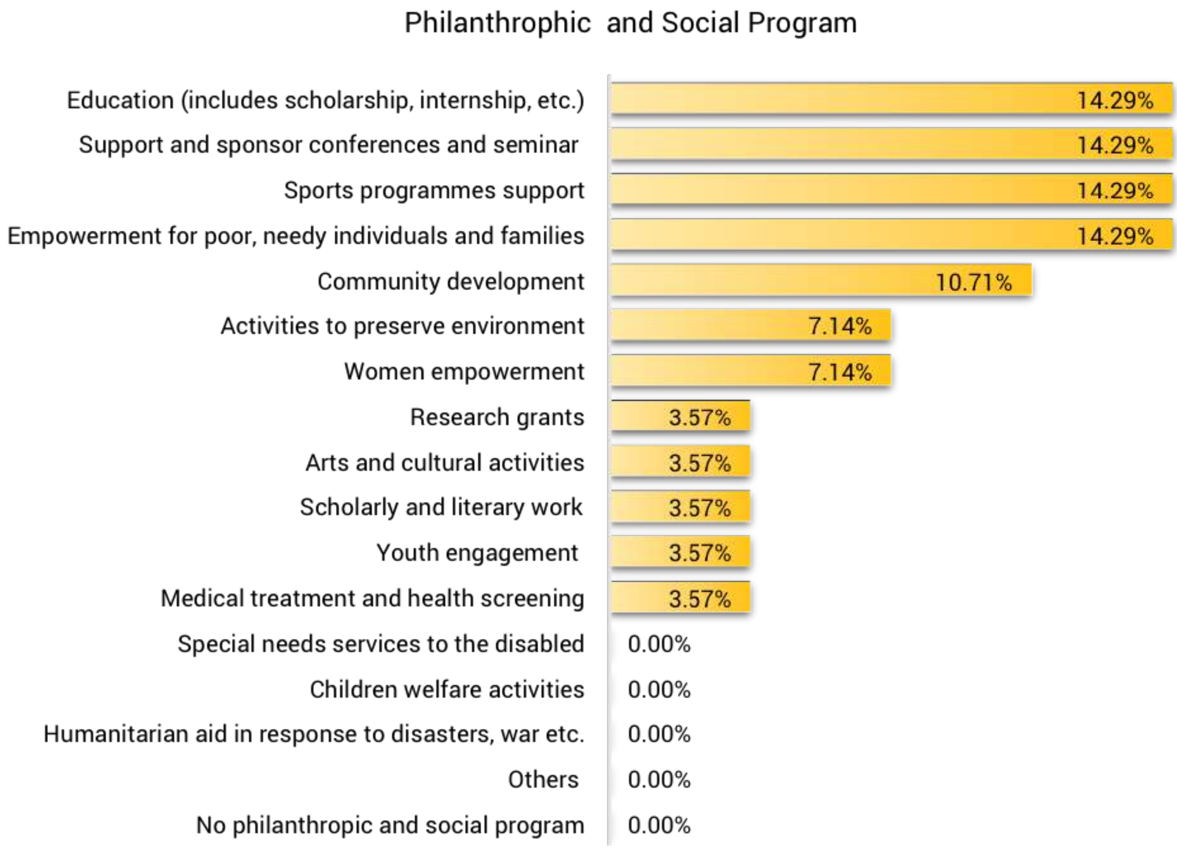

Figure 15: Banks Score "Top Five" Philanthropic and Social Programmes

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Figure 18: Improvement in Responsible Business Practices in Future

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Group 7

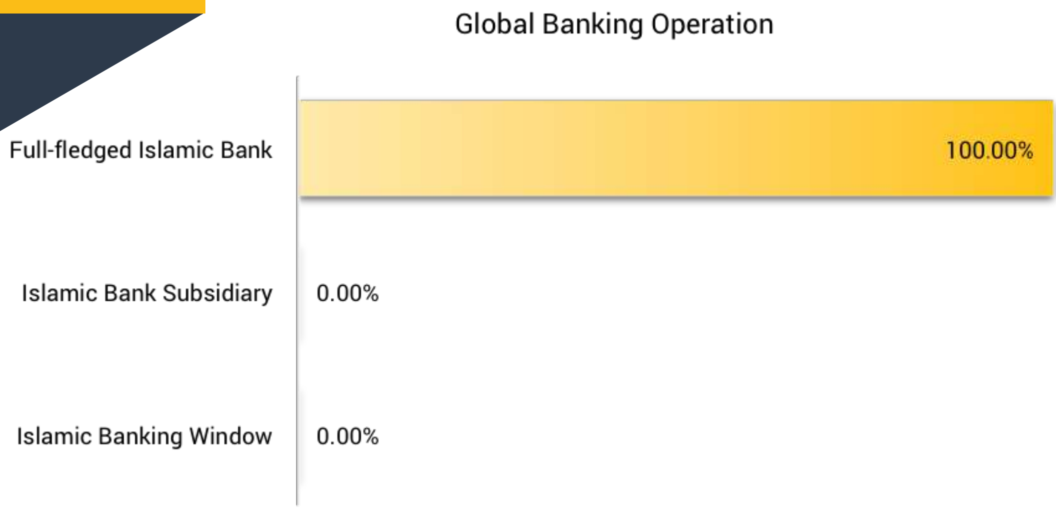


Figure 1: Corporate Profile of Respondents

Figure 2: Business Profile of Respondents

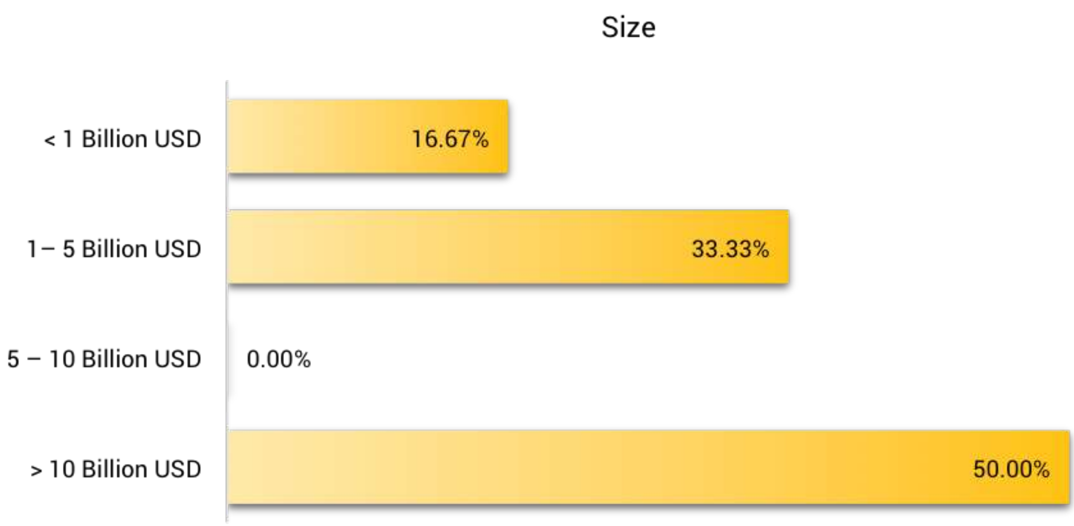


Figure 3: Size of Respondent Banks

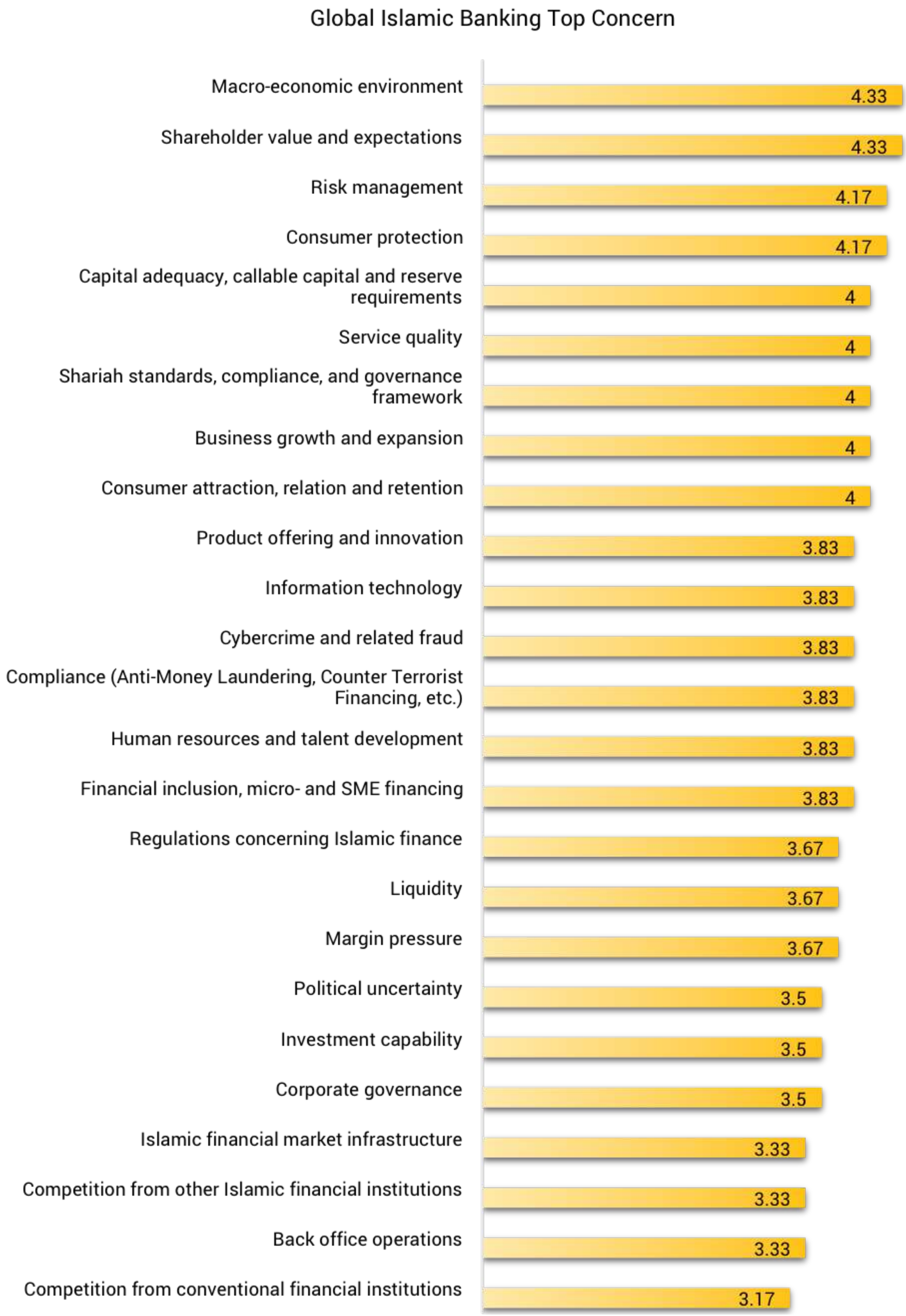


Figure 4: Islamic Banking Top Concerns

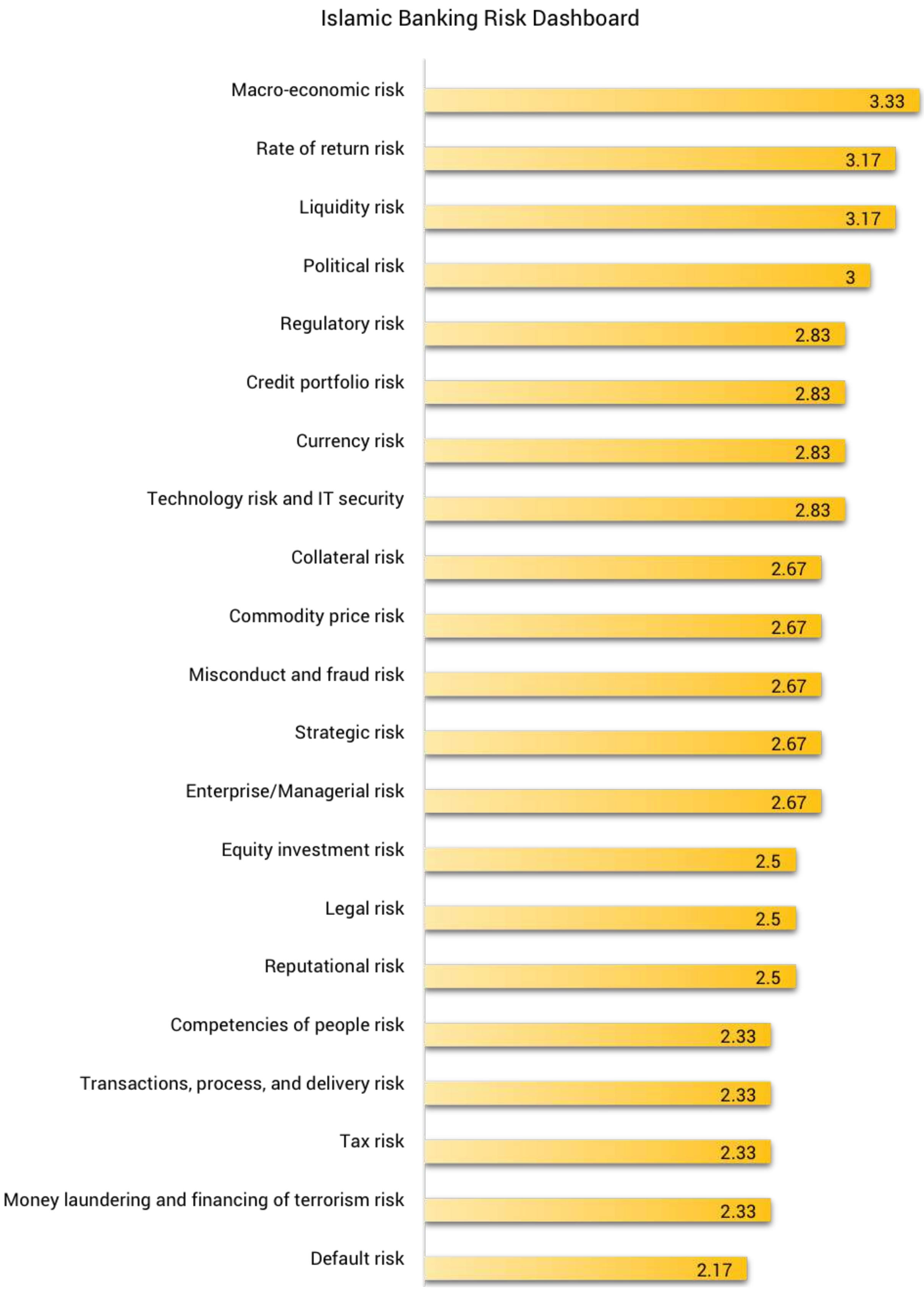
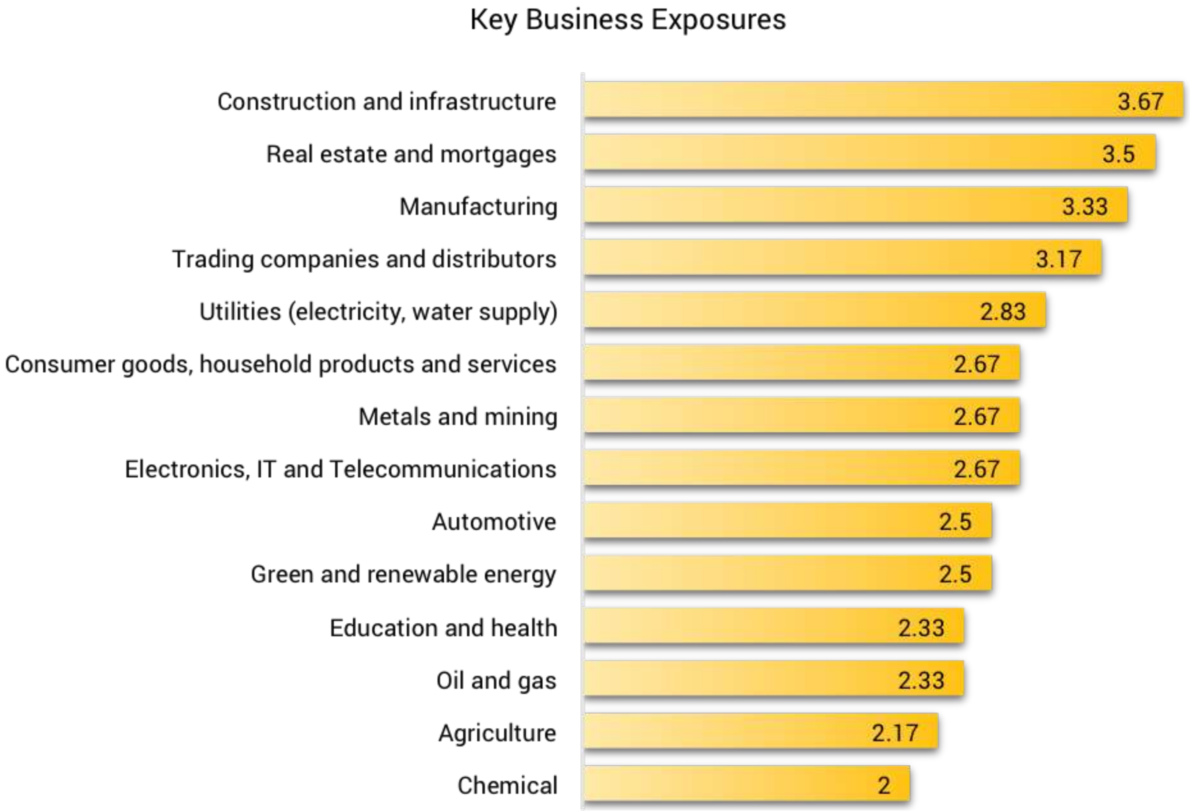


Figure 5: Islamic Banking Risk Dashboard



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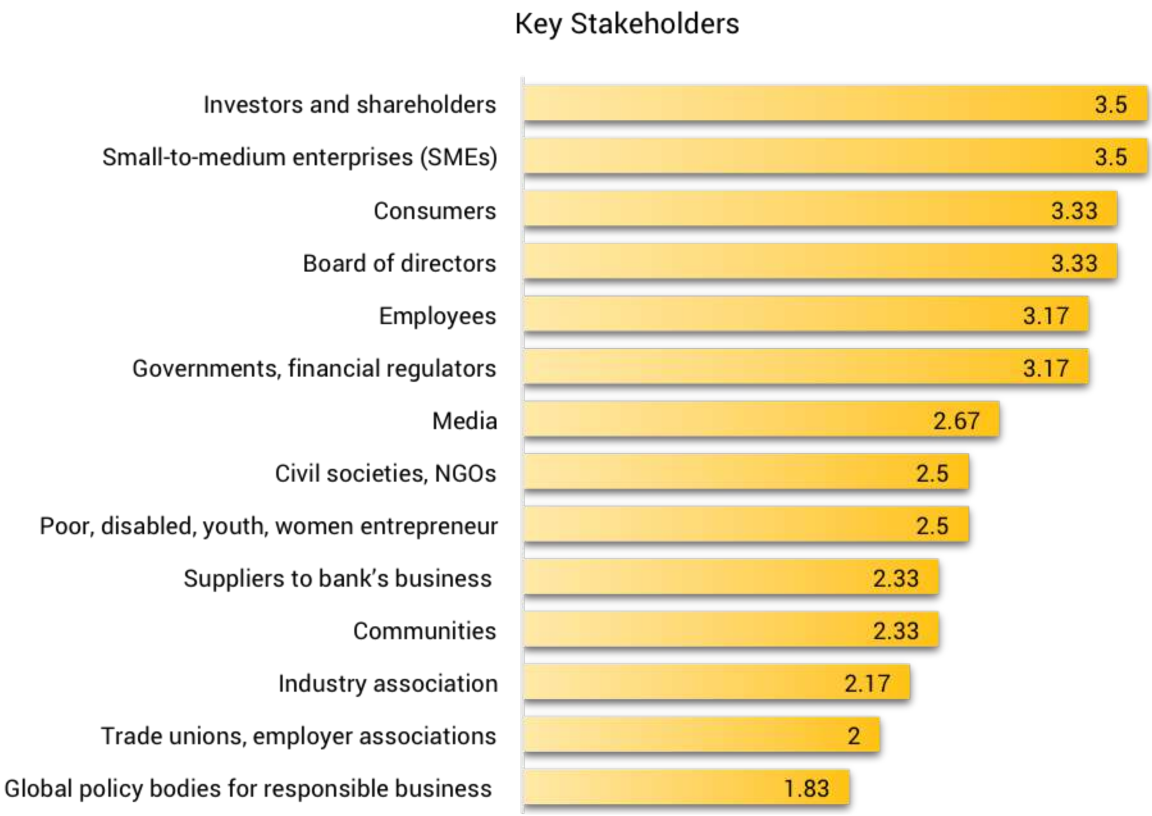

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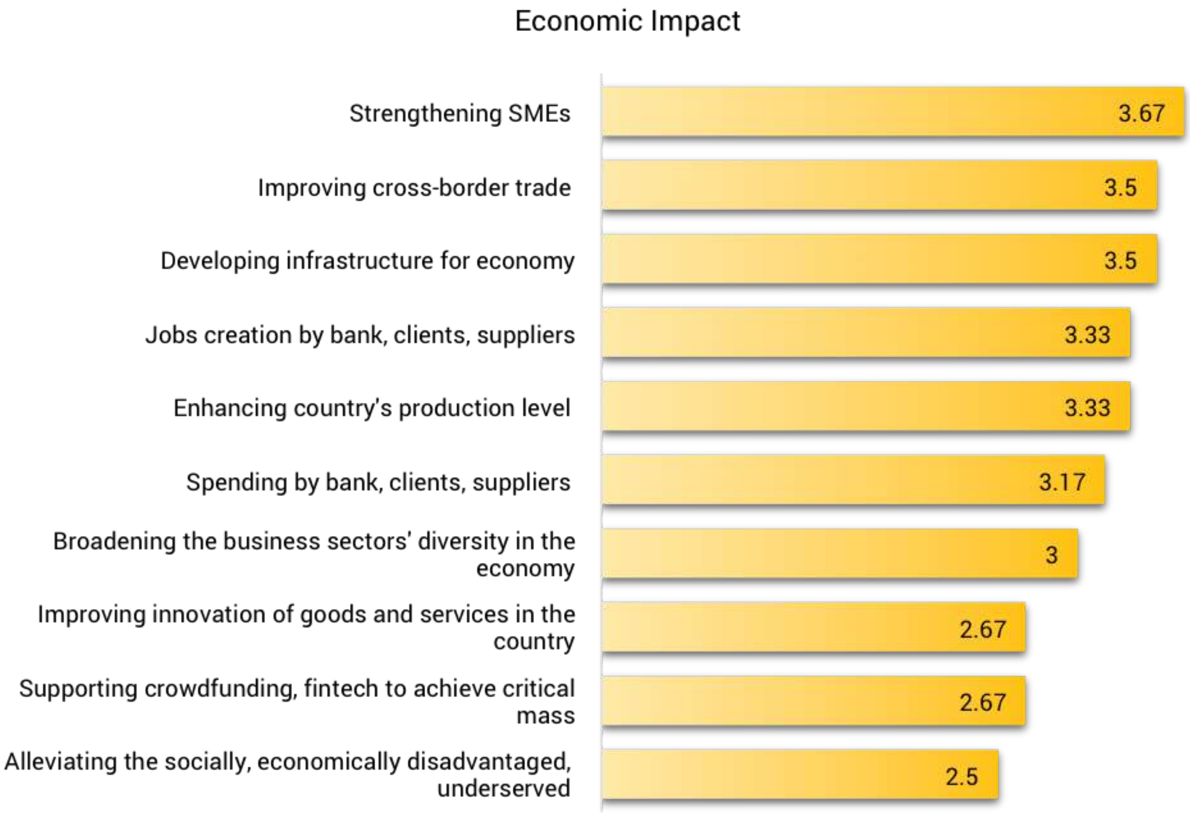

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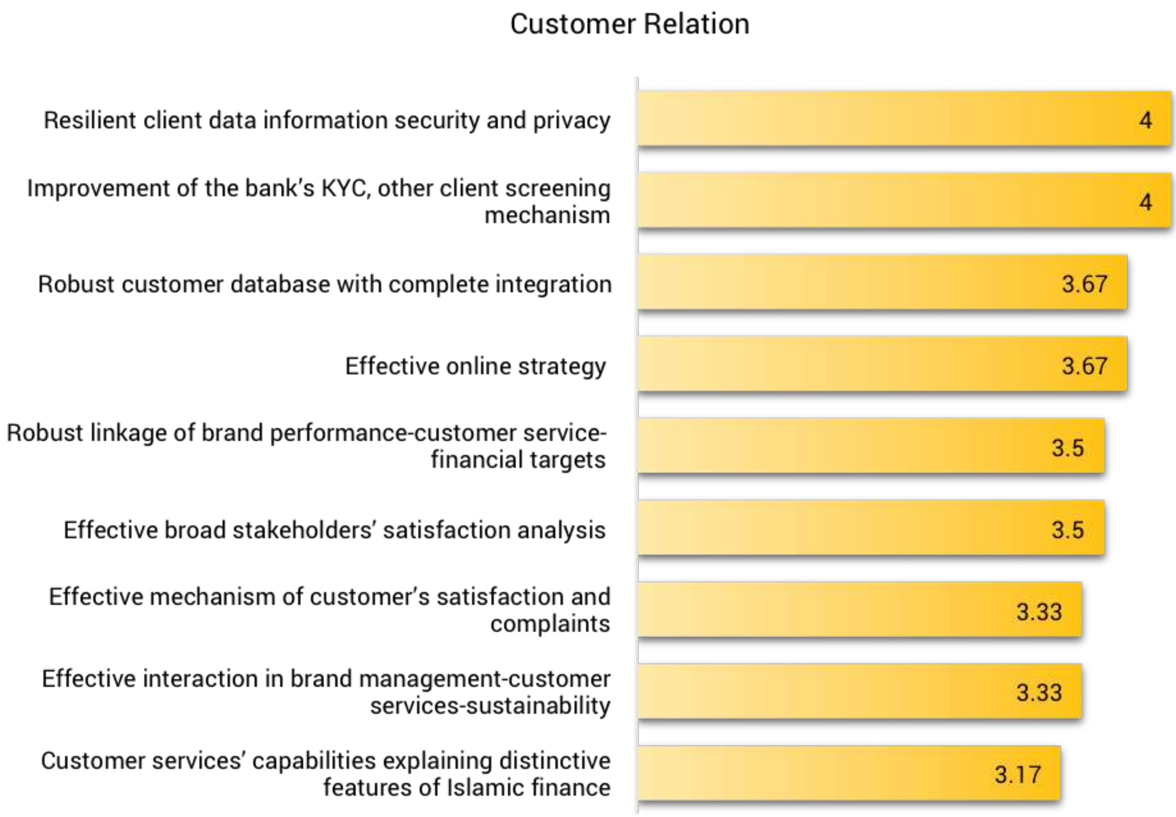

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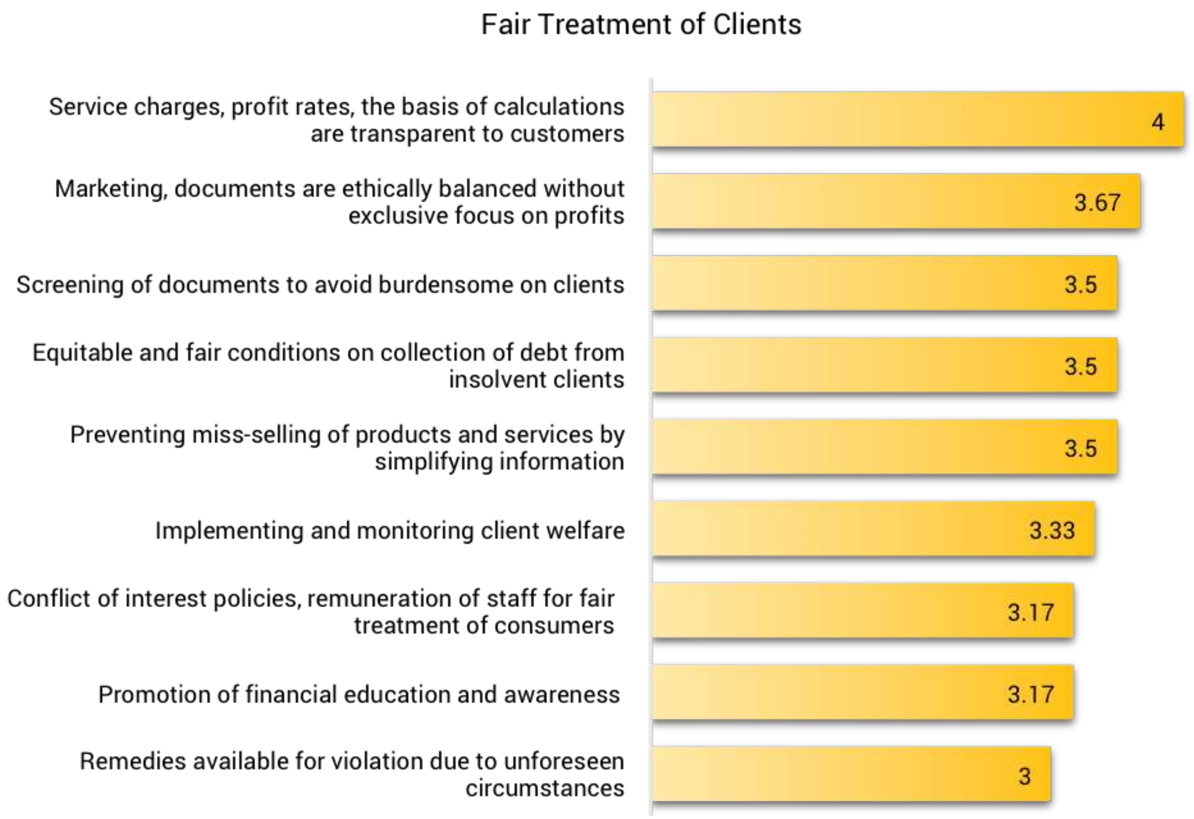

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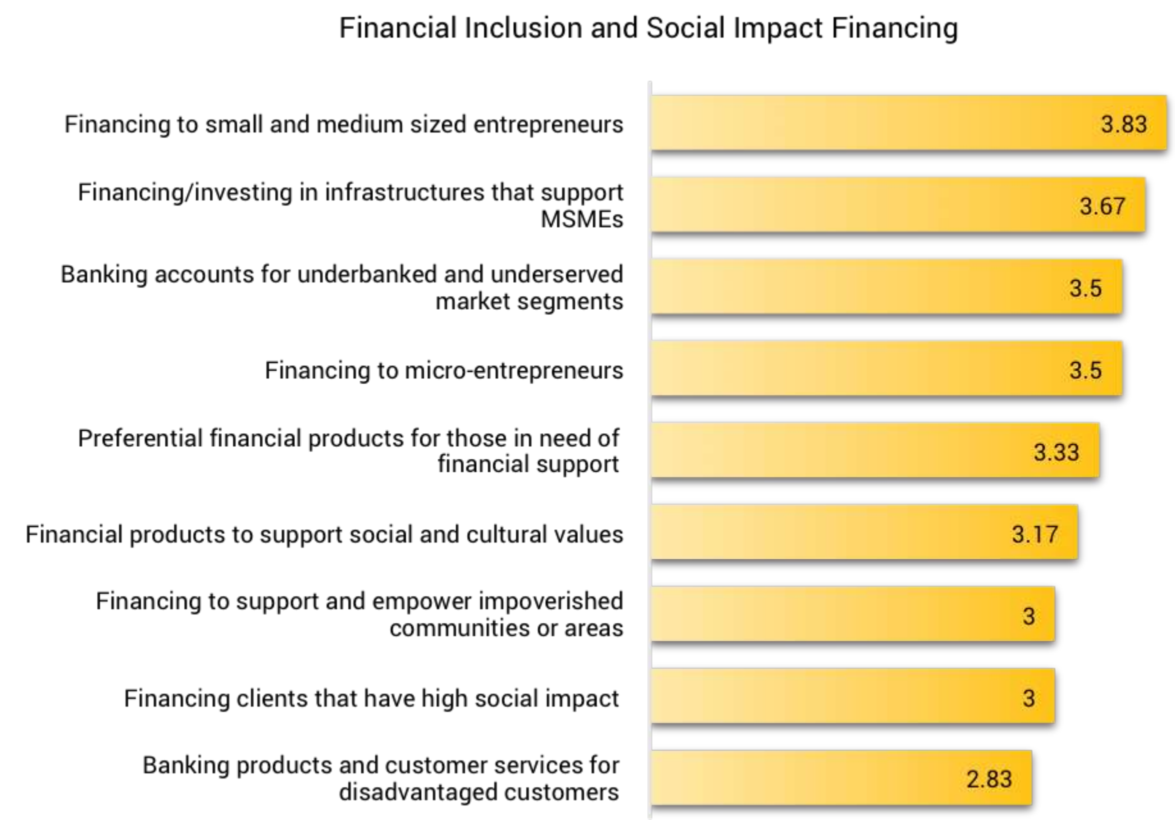

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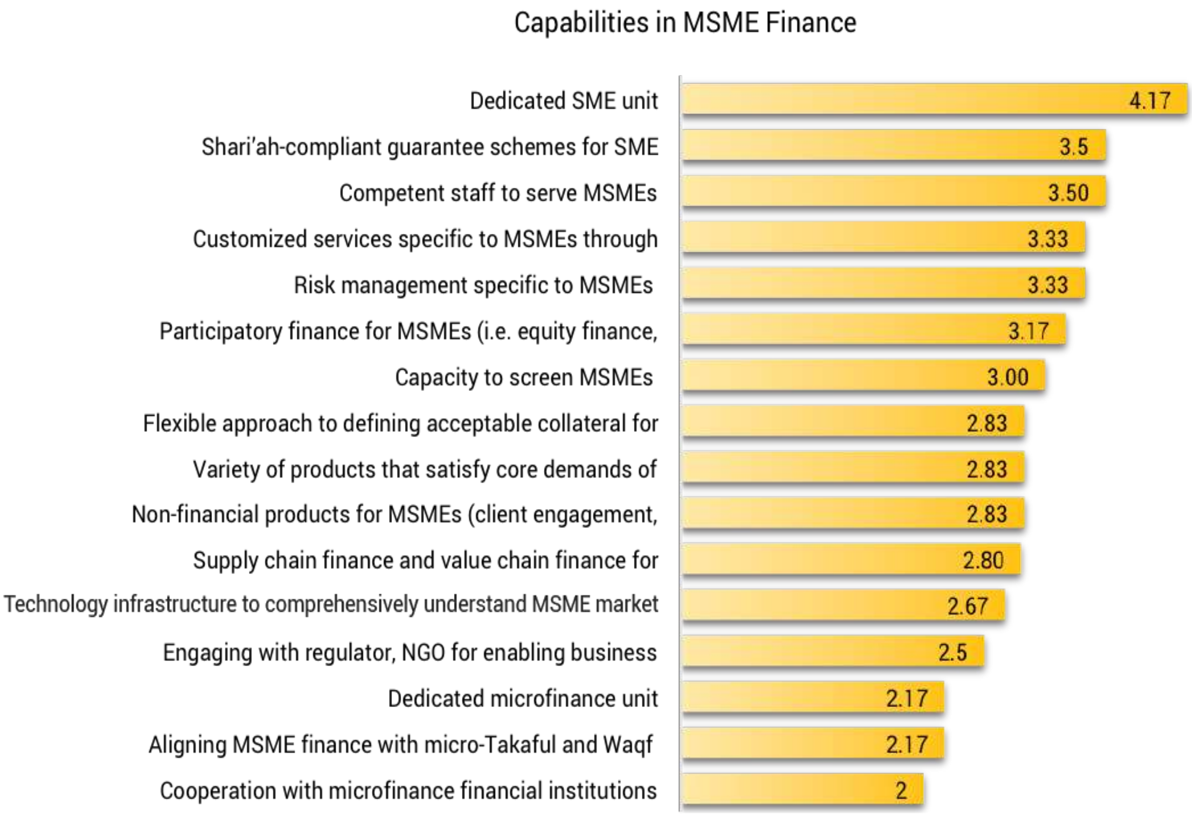

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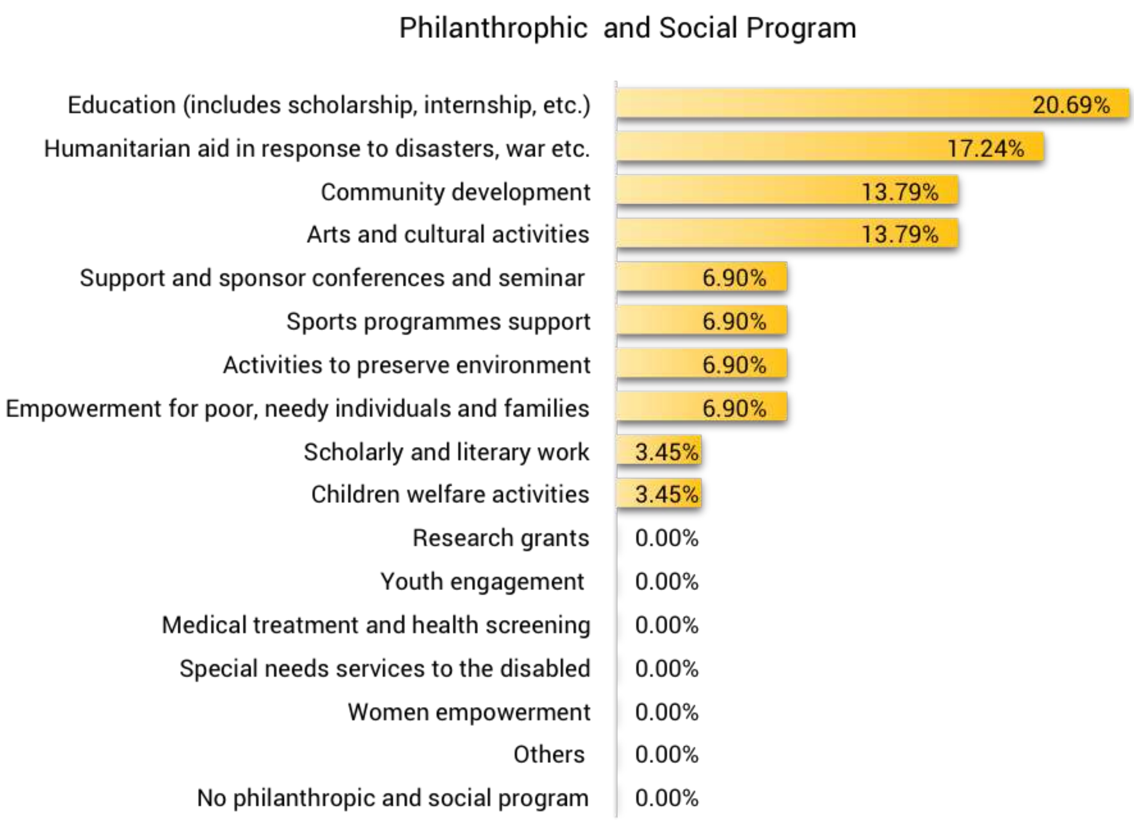

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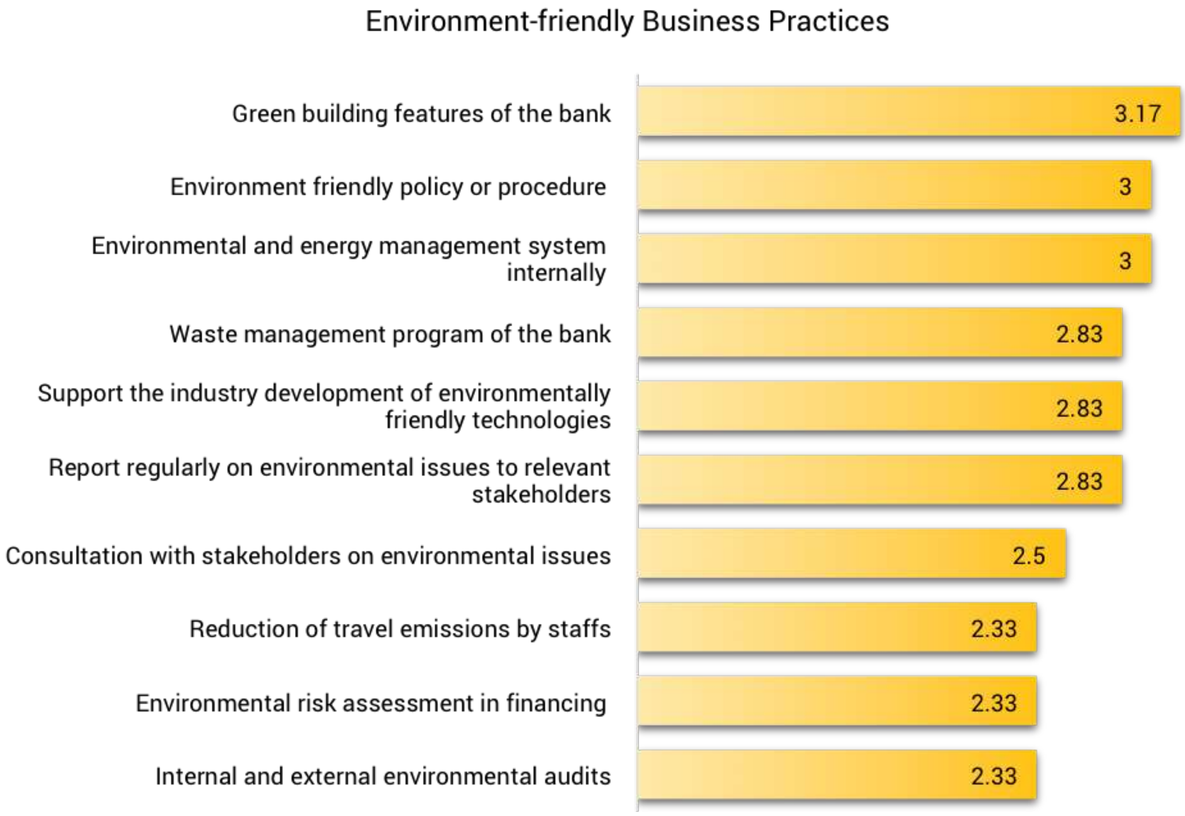

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» Appendix 3: Terminology

No	Terminology	Definition
		G
1	GIBS	Global Islamic Banker's Survey
		I
2	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.
3	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 Shari'ah compliant, with separate funds.
		M
4	Murabahah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed margin profit
5	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.
6	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 capital.
		S
7	Shariah	Divine Islamic law that encompasses all aspects of human life as revealed in the Qur'an and the Sunnah.
8	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
9	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.
10	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
11	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.
12	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.
13	Wakalah fi al-Istithmaar	A Wakalah investment

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