General Council for Islamic Banks and Financial Institutions

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI

15th ANNIVERSARY 2001 - 2016

ISSUE 4 • January . 2017

CIBAFI BRIEFING

Rethinking Values for Sustainable Growth

*This Briefing is an outcome of CIBAFI Global Forum: **"Rethinking Values for Sustainable Growth"** held in May 2016. The event marked the 15th anniversary of CIBAFI's establishment and was held at the Four Seasons Hotel, Manama in the Kingdom of Bahrain.*

I. CIBAFI Global Forum

General Council for Islamic Banks and Financial Institutions (CIBAFI), the umbrella organisation for Islamic financial institutions convened its first annual event in May 2016, entitled CIBAFI Global Forum: "Rethinking Values for Sustainable Growth". The two-day Forum was organised under the patronage of the Central Bank of Bahrain and received an enthusiastic response from participants and speakers. It brought together various stakeholders from the Islamic finance industry, multilateral development institutions, policy-makers, diplomatic representatives and academia. The Forum was attended by delegates from more than 28 countries. During the Forum, issues related to changing global business environment were discussed with particular reference to the development of business strategies for Islamic finance that are based on sustainable growth and sound ethics.

Two key business innovation ideas emerged from the discussions at the Forum:

1. ***The need for a structural shift in banks' business models from solely satisfying shareholders towards a broader approach that entails satisfying the needs of all stakeholders, such as customers, society and the environment, as well as shareholders.***
2. ***The need to use innovative financial technologies to develop banks' business models, both as a competitive edge and as a way to enhance service levels to customers.***

II. Moving beyond "shareholder value" to a broader concept of "stakeholder value"

1. Towards a more responsible and socially connected financial industry

In recent decades, there has been increasing awareness of the global challenges posed by poverty, poor health, and lack of access to basic services such as water and energy. Climate change has emerged as a new issue of global concern.

These challenges are no longer seen as discrete problems facing 'other' people. There is now much more appreciation of how problems are interconnected – poverty or civil strife in one region of the world may lead to refugee problems or even security problems in another.

As governments grapple with challenges that are increasingly global in scope and impact, businesses are looking beyond narrow performance indicators ('profits', 'share price') to the wider consequences of how they operate. 'Social responsibility' has become a mainstream issue for all global companies.

The financial industry is not immune from this trend. Banks are recognising the need to look beyond their balance sheets at the effect that their actions have on the wider economy and on society as a whole. The issues that are being addressed as part of this wider focus are often grouped together as EESGD - economic, environmental, social, governance and development factors. In many cases, these factors coalesce around questions of 'responsible finance' and 'sustainability'.

2. Intersections between Responsible Investment and Islamic Finance

Socially responsible investment acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and of the long-term health and stability of the market as a whole. Like Islamic finance, ethical finance is typically associated with the avoidance of unethical investing such as the gambling, tobacco, and adult entertainment. Islamic finance entails specific prohibitions that are part of a broader ethical framework and sees wealth as something that one holds in trust from God which must therefore be used for the benefit of society as a whole. Closely related to responsible and ethical finance are impact investing, social finance, philanthropy, and corporate social responsibility. Islamic finance, which draws guidance from divine sources, fits easily into this value-based system. Rooted in risk sharing and Ihsan (beautiful deeds), Islamic finance offers distinctive perspectives on property rights, social and distributive justice, social capital and development. This distinctiveness places Islamic finance at the center of a financial universe that seeks to integrate stakeholders in the process, direction and goal towards sustainability.

3. Leading practices: Integrating responsible business practices and sustainability

3.1. Focus on integrating impact-driven business

Islamic banks need to consider their consumers, society, and the environment when responding to the global trend towards responsible business practices and the shift in banks' business models from satisfying shareholders to meeting stakeholders' values and well-being. Islamic banks could focus on impacts that deliver value addition to their broader stakeholders such as: (1) economic impacts; (2) employee relations and development; (3) customer relations; (4) banking product responsibility and socially responsible products; (5) financial inclusion; (6) community relations and corporate philanthropy; (7) environmental policy, environmental management system and procedures.

Islamic banks need to better align social and environmental impacts with the overall business strategy of their organisations. This includes sustainability targets and an organisational structure that provides strategic guidance and support in executing their social and environmental initiatives. An essential aspect of integration is the relevance of materiality analysis, value creation and impact evaluation conducted by banks. In that case, the best practices from best-in-class banks have proposed this as an essential aspect of integration in order for financial institutions to deliver optimal solutions to their stakeholders. It has been well proven from both academic and industry research that incorporating such sustainability strategies, focusing on materialitiy areas, gives significant impacts to financial performance of financial institutions over the long term.

3.2. Frameworks for ethical finance

The Global Forum also noted the significance for Islamic financial institutions in adopting the Equator Principles (EP) for determining, assessing and managing environmental and social risks in projects. To date, 82 financial institutions in 36 countries have adopted the EPs, covering more than 70% of the international project financing in emerging markets. With growing concerns about environmental and social issues globally, the EPs have enhanced the attention paid to social/community standards and responsibility, including consultation with local communities that are affected by projects to be financed. Several other responsible environmental and social management practices have also been spurred by the EPs, for example, the Carbon Principles in the US and the Climate Principles worldwide.

In the OIC markets, banks from Bahrain, Egypt, Morocco, Nigeria, Oman and the United Arab Emirates have adopted the Equator Principles.

There are promising prospects for more Islamic financial institutions to consider adopting the EPs given the alignment of these principles with the value propositions of Islamic finance. In realizing these prospects, collaborative knowledge sharing and consultation in technical areas such as environmental and social impact assessment, environmental and social management system would be constructive.

These developments and concerns give credence to the importance of promoting responsible finance and sustainability in emerging markets, particularly the OIC markets, which have the largest concentration of Islamic financial institutions. Islamic financial institutions could also consider adopting globally recognised principles such as the United Nations Principles for Responsible Investment (UNPRI), corporate sustainability reporting, and participating in the United Nations Environment Programme (UNEP) Financial Initiatives. As a result of sustainability and integrated reporting, Islamic banks may align social and environmental impacts with the overall business strategy of their organizations.

Extending Business Lines to Encourage Competitiveness

Islamic banks view financing activities as the key drivers of growth, rather than advisory or transactional services. Service and fee based activities remain secondary. Nonetheless, the recent trend shows that Islamic banks are keen to expand fee-based services to bring higher returns against their existing assets. As a result, developing new products and business lines will be crucial as banks try to grow.

1. Participation and strategies for infrastructure and project finance in high-growth countries

Many Muslim-majority countries are 'emerging economies' and have experienced rapid economic growth in recent years. One of the consequences of this has been the boom in projects and infrastructure, which are important drivers of economic growth of these countries. While the funding has come partially from public sources (i.e. government spending), there has been a strong private sector contribution through investments in Sukuk infrastructure, as well as Islamic banks' project financing. Specific to project finance, the size of the Islamic tranche is increasing in size, along with a growing number of Islamic banks' participation in some large projects. This is due to a strong link with governments in the form of PPP (Public-Private Partnerships) like projects, which presents Islamic banks with a higher credit quality, especially in Muslim majority countries. For example, PPP projects such as Jordan's Queen Alia International Airport, and Malaysia's Kuala Selangor Expressway.

Despite the promising growth of the industry, there remain some important issues that need to be incorporated in the investment framework of infrastructure and project finance within emerging countries. The first issue relates to impediments to long-term infrastructure financing and investment. These include an underdeveloped infrastructure asset class, lack of transparency and information flow, and policy uncertainty.

Islamic banks need to address issues such as mismatch between available infrastructure investment options and investors' risk profile, high capital charges on infrastructure investment (Basel III), short-term focus, and lack of standardization in instruments.

The second is the need to comprehend a complete set of risk factors in the infrastructure and project finance such as macro level risk (political, macroeconomic, legal, social, etc.), meso level risk (project selection, residual, construction, design, operation, etc.), and micro level risk (relationship, third party, etc.).

Specific to Islamic project finance, some challenges are related to a competition on price and tenor, Shariah structures, and risk allocation to Islamic banks (project risk, ownership risk, third-party liabilities, etc.). Risk mitigation techniques need to be developed and incorporated to minimize the corresponding risk exposures. Islamic banks can utilize some hedging tools such as the involvement of development banks for monitoring incentive and countering political risk. The other tools that banks should use relate to indirect guarantees such as revenue producing contracts and off-take agreements from purchasers of products and services generated by the project; as well as various Shariah-compliant hedging instruments and Takaful.

The third issue is that Islamic banks need to adapt their co-financing activities to the emerging trend of PPP projects in emerging countries. The main advantage of the PPP model is the strong focus on driving down the total capitalized life cycle cost including capitalized risk, as under PPP, the private sector (which is assumed to be more efficient than the public sector) raises finance and executes a project, while without PPP the government would have to raise the funds themselves and implement the project. This is achieved by the use of output-based specifications, a single contract between the public procurer and the consortium, and life cycle cost as one of the bidding criteria.

2. Enhancing private banking capabilities of Islamic banks

The total private wealth in emerging countries has grown rapidly over the last five years. Some of the Muslim-majority countries have been the most consistent of the emerging markets with respect to the growth of high-net-worth individuals (HNWIs), ultra-high-net-worth individuals (UHNWIs), and especially the affluent segment. GCC recorded growth in their investable and liquid assets by 16% or more each year since 2010. The evidence shows the key drivers of such impressive growth are related to the region's powerful macroeconomic and socio-demographic forces. This is attributable to the strong rebound in global equity markets, economic growth, as well as huge government expenditures on megaprojects and job creation This trend highlights important market opportunities for financial institutions in the form of a much broader affluent segment and various inadequately served wealth sub-segments.

To counter the challenges, Islamic banks need to develop distinctive strategies and develop capabilities to succeed in the private banking industry. Some of the key strategies include 360-degree view of clients' assets and corresponding behavioral profiles, as well as appropriate sub-segmentation of the high-net-worth (HNW) population. In such cases, best practices tailor superior product offerings to sub-segments, which further shift the focus towards customer-centric, branch-agnostic, and flexible coverage and service models. The strategic priority needs also to follow the global trend of:

1. Real-time access to portfolios
2. Research and advice through mobile and tablet technologies
3. Comprehensive channel strategy
4. Quality and personalization of advice and service-related interactions using big data
5. Social media presence

III. New Financial Technologies as Tools to Provide Different and Better Service

1. The global trend in financial technology

As the world is getting more and more complex with technology, leading businesses are now advancing the concept of the 'Sharing Economy'. The size and coverage of Paypal, Applepay, Alipay to name a few, and other disruptive firms now compete with some of the largest global businesses in financial industry.

The banking and finance industry has seen more advancements in technology in varied forms, including online banking and mobile banking applications. However, this has surpassed the threshold notions of the past technological advancements and have started affecting the financial world with a much more forceful technological disruptions. These are done by Fintech (a recipe of finance and technology) firms focussing on innovative financial solutions to help people do their financial and business activities in more convenient, smarter and cost effective ways than what traditional banking platforms offer.

There is a critical need for the Islamic financial industry to recognise and understand the nature of these disruptions in the mainstream and global banking industry. As financial institutions may lose some or most of the control over their customers' transaction experience as digital transaction platforms consolidate, Islamic banks need to focus on the nature of the disruptions that they expect will hit the industry rather than on what is disrupting their business-as-usual. These Fintech advancements can play roles as enablers in the financial ecosystem, and also act as disruptors and change the course of the everyday financial and business transactions.

Thinking ahead, Islamic banks can act as disruptors themselves, through leveraging their resources and embracing cutting edge technologies. Very few banks globally seem to have done this, i.e. being disruptors themselves. One example is DBS Bank, which has launched "Mobile-only" banking with absolutely no bank branches: a mobile app provides all the customer's services.

2. The development of mobile money and banking

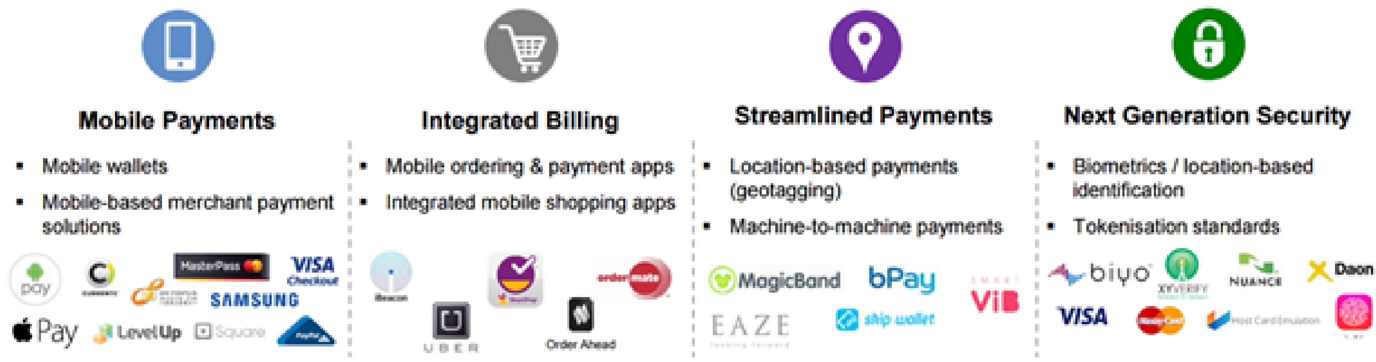
As new mobile money models go online, the banking sector has started to feel the pressure as customers move money using these channels away from the usual banking methods. As businesses embrace mobile as the primary channel for customer engagement and transaction, the trend is stimulating larger growth across the expanded mobile and financial ecosystems. As firms and consumers are embracing these technology solutions, not many financial institutions, including the Islamic ones, seem to have a complete grip on these payment channels. Real-time payment options, access to balance and transaction information, notification of balance changes and other options available through modern smartphone apps are already delivering consumers more transparency and confidence in mobile payments than the traditional plastic cards (and their statements). These platforms are helping shape new payments infrastructure, for real-time solutions, and many have been validated by the developed countries' regulators.

Mobile money has positively impacted millions of people, especially in the SME sector and in many underdeveloped economies as mobile money solutions bring financial inclusion and improves their financial conditions. Secured mobile proximity payments are seen as a newer way to transact using smartphones. These can now be used at merchant establishments without customers having to part with the plastic cards which holds their sensitive information.

The two common types of mobile money services MSVAs (mobile stored value accounts) and AMWs (advanced mobile wallets), can form part of financial institutions' wider digital service ecosystems and can enable them to stay relevant in the e-commerce value chain. These services with regional and country coverages may also act as major drivers of adoption for mobile money services.

Then there are virtual currency processors that specialise in enabling merchants to accept virtual payments from customers. The payment technology platforms use peer-to-peer technology to operate with no central authority or intermediary financial institution. Some other platforms accept virtual currency from online customers and convert the transaction into real currency at a locked-in exchange rate and receive state-backed currency in their bank accounts. The services support payments in multiple currencies with direct bank deposits in many countries throughout the world, and can also be integrated with other e-commerce, online stores and retail point-of-sale systems. For example in emerging economies such as Kenya, the use of M-pesa, a money transfer service, has pushed the boundaries of the payment and money transfer industry, simplifying and economising financial transactions through the use of technology. Islamic financial institutions can take a cue from these financial technology innovations and be at the forefront of these changing business scenarios.

Key Innovations of the Cashless World



Source: World Economic Forum 2015

3. Value addition of Financial technology firms for customers

At a time when social networking is massively impacting today's consumers' lives, commerce has exploited it and made a powerful combination. By linking user accounts to bank accounts (and their purchases), firms target their customers' by discovering their choices and purchase behaviours, clearly assuming that an actual purchase is a strong indicator of likely future purchase behaviour. Cloud-based Fintech service providers have lowered the barriers to entry across many financial sectors by reducing operational costs and seed capital requirements for a business.

In addition, there remain untapped areas that Fintech has targeted where significant resources were under-utilised. For example, creating secure platforms for individuals and firms with idle money to lend (and borrow) with customised terms and preferences. There are many other areas where Fintech is yet to show its presence, such as in the area of supply chain finance, which although is in a nascent phase, is expected to be a significant contributor to disruption in the financial markets. This is the right time for the Islamic financial industry to discover areas where it can make a difference to gain global financial industy recognition and exploit technology in the larger spheres of Islamic financial transactions.

4. Types of Fintech as enablers and disruption

To serve the role of enablers, Fintech companies have used advanced machine learning techniques to build predictive algorithms to measure customers' behaviours and preferences, moving from archaic and complex financial products to modern and simple financial solutions. With increased collaboration of social technology with hard transactions through digital tools, these companies have identified the barriers and explored opportunities to change the way consumers interact with their money.

With advancements in fields like such as behavioural sciences, opportunities abound to introduce performance enhancing techniques into the investment decision making process. Supported by data analysis, leading-edge data-capturing and analyzing tools allow consumers to invest, track, measure, and improve on their asset performance while taking into account inputs across multiple dimensions. Significant data and powerful tools for analytics have helped the new breed of real time investment strategies to take shape.

Investment opportunities and strategies which were available only to select class of high-net-worth individuals through private banking services can now be used by an average investor through their smartphone device. The use of automated online advisor services (robo-advisors) leverages on leading edge technology to provide low cost and efficient wealth management services to investors. While some robo-advisors are completely automated, some aspects of the services may have human advisors to combine the digital automation interface by personalized professional advice.

On the other hand, as disruptors, these firms can make many financial areas and functions redundant. Digitization can disrupt the industry and change the nature of supply and demand. Financial institutions need to find new, cheaper and easier ways to match these two aspects, as they face new competition from Fintechs. Islamic financial institutions need to leverage their customer relationships, enrich products and services with information, social content, and connectivity and address the unmet demand by unbundling or tailoring financial solutions through the use of technology. From the supply side, exploring latent supply, making capacity available in smaller chunks, changing the cost structure by de-humanising and disintermediating its many functions etc. will hold the key.

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5. Technology risk

Security, privacy and other trust-related issues, be they real or perceived, are prominent barriers to adoption of technology in providing solutions in many areas of the financial industry. Regulating these financial technology firms has been debated by industry stakeholders globally. Considering the significance of the online industry and the impact which it can have on traditional banking channels, it might prove to be prudent to regulate this emerging industry. As the industry has the potential to disrupt the financial sector and throw surprises, a sound regulatory framework will prevent those disruptions. If regulated wisely, Fintech platforms can develop more effectively and proportionately. And if the sector is left unregulated, there might be a risk of inappropriate practices being adopted by the players, which may have harmful consequences for the economy.

On the other hand, regulating this nascent and growing sector may be perceived as inhibiting its growth. Too stringent regulations may stifle the progress of innovative, efficient and accessible avenues for users, including those who do not have access to formal financial channels, thus depressing financial inclusion. Some may argue that the emerging stage of the industry neither poses an immediate systemic risk nor any significant impact on monetary policy transmission mechanisms.

The equilibrium would lie in developing an appropriate regulatory and supervisory toolkit that facilitates the systematic growth of the sector so that its potential to provide an alternative opportunity for growth and development of the economy can be exploited. And as an important subset of the global financial industry, Islamic finance can be a significant contributor not only to its growth but also finding a right balance in its regulation.

Conclusions

- Banks need to have a structural shift in their business models from solely satisfying shareholders towards meeting broader stakeholders' values and well-being.
- Islamic banks need to adapt their co-financing activities to be aligned to the emerging trend of the PPP projects especially in emerging countries.
- Isalmic banks need to develop distinctive strategies to overcome challenges using strategies for 360-degree view of clients' assets, corresponding behavioral profiles, appropriate sub-segmentation of the HNW population etc.
- Adapt to and use innovative financial technology to develop banks' business models, both as a competitive edge and as a way to enhance service levels to customers.

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 Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry 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 practices, 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.

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