General Council for Islamic Banks and Financial Institutions

CIBAFI

المجلس العام للبنوك والمؤسسات المالية الإسلامية

Global Islamic Bankers' Survey

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20 YEARS OF CIBAFI

Islamic Banking Sector: A Look into the Future

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About the General Council for Islamic Banks and Financial Institutions (CIBAFI)

CIBAFI is an international organisation established in 2001 and headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organisation 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 130 members from 34 jurisdictions, representing market players, international intergovernmental organisations, professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance.

In its mission to support the Islamic financial services industry by being the leading industry's voice in 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) Advocacy of Islamic Finance Values and Related Policies & Regulations; 2) Research and Innovation; and 3) Training and Professional Empowerment.

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Acronyms

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ACG	Arab Coordination Group
AI	Artificial Intelligence
AML	Anti-Money Laundering
API	Application Programming Interface
ASAS	Association of Shariah Advisors in Islamic Finance
AT	Additional Tier
ATM	Automated Teller Machine
B2C	Business to Consumer
BIBF	Bahrain Institute of Banking and Finance
BWI	Indonesian Waqf Board
C2C	Customer to Customer
CAF	Country Assessment Framework
CBDC	Central Bank Digital Currency
CBR	Correspondent Banking Relationships
CD-ROM	Compact Disc Read-Only Memory
CEO	Chief Executive Officer
CFT	Counter Financing of Terrorism
CIIF	Chartered Institute of Islamic Finance Professionals
CIS	Commonwealth of Independent States
CSR	Corporate Social Responsibility
CWLS	Cash Waqf Linked Sukuk
DCC	Digital Call Centre
ECL	Expected Credit Losses
ESG	Environmental, Social and Corporate Governance
ETF	Exchange-Traded Fund
FAA	Financial Accreditation Agency
FAS	Financial Accounting Standards
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GVC	Global Value Chain
IBFIM	Islamic Banking & Finance Institute Malaysia
ICD	Islamic Corporation for the Development of the Private Sector
IF	Islamic Finance
IFI	Islamic Financial Institution
IFISAP	Islamic Finance Impact and Strategy Assessment Program

IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IIFM	Islamic International Financial Market
IILM	International Islamic Liquidity Management
INCEIF	International Centre for Education in Islamic Finance
IsDB	Islamic Development Bank
ISRA	International Shari'ah Research Academy for Islamic Finance
IT	Information Technology
KPI	Key Performance Indicator
MCPS	Member Country Strategic Partnership
MDB	Multilateral Development Bank
P2P	Peer to Peer
PCI	Payment Card Industry
POS	Point-of-Sale
PPP	Public-Private Partnership
RSAs	Regulatory and Supervisory Authorities
SDGs	Sustainable Development Goals
SME	Small Medium Enterprises
SMS	Short Message Service
SPRP	Strategic Preparedness and Response Package
STI	Science, Technology and Innovation
UAE	United Arªb Emirates
UK	United Kingdom
UN	United Nations
VBI	Value-Based Intermediation

STATEMENT BY
The Secretary General

After five successful editions of the CIBAFI Global Islamic Bankers' Survey (GIBS), I am pleased to welcome you to the sixth edition of the GIBS. This year's edition coincides with the 20th Anniversary of CIBAFI. Thus, we have decided to publish a special edition of the GIBS report.

With the theme of "Islamic Banking Sector: A Look into the Future", this report includes a dedicated section on the Future Outlook of the Islamic Banking Sector with an objective to reflect on the Islamic banking sector and the evolving trends that will shape the future landscape of the industry.

In addition to the analysis conducted on the results of the survey, the GIBS report this year includes special articles written by prominent industry leaders who expressed their perspectives towards the future development and growth of Islamic finance on different topics and areas. We hope this report will highlight the outlook of the Islamic banking sector for 10 years down the road as well as the factors that will affect the growth and the development of the industry.

In the context of the challenges the world is currently facing, it is necessary to contemplate the future and identify the opportunities and actions needed for the industry to continue with its growth and development.

Technological developments, sustainability, issues related to Maqasid Al Shariah, human capital, regulatory challenges and so many other challenges require all industry players to combine their efforts for the purpose of contributing to the progress of the industry and reinforcement of its position in an ever-changing and competitive market.

This report gives a voice to the perspectives and opinions of top banking officials regarding these issues, as well as insights into how the industry can progress in the coming years. CIBAFI extends its warmest thanks to the banking officials who took the time to participate and share their views in the survey.

We hope that this report will help paint a clearer picture of the Islamic finance industry as we move forward.

Dr. Abdelilah Belatik
Secretary General

Acknowledgements

The Secretariat would like to convey its sincere thanks to its member and non-member banks and financial institutions who took part in the survey and provided their valuable inputs. We also express our gratitude to the individuals who have contributed in making this report a success.

We would like to appreciate CIBAFI Secretariat members and Peter Casey, CIBAFI consultant for their contributions and efforts in the different phases of developing this report. We are also thankful to Abdulwahab Issa Abdulwahab Al-Rushood, Kuwait Finance House, Dr. Abdurrahman Yazici, Social Sciences University of Ankara, Prof. Dr. Ahmet Faruk Aysan, Hamad Bin Khalifa University, Dr. Abdou Diaw, African Center for Higher Management Studies (CESAG), Dr. Rushdi Siddiqui, iPortal, Mehmet Fehmi Eken, Islamic Development Bank, Peter Szalay as well as DDCAP Group for providing valuable feedback and comments to the survey over the course of its preparation.

Furthermore, the Secretariat would like to convey its special thanks and sincere appreciation to the leaders of the industry who contributed to this year's edition of the GIBS Report with exclusive articles making the 6th edition of the GIBS Report unique and special.

CIBAFI would like to express its appreciation and gratitude to the industry leaders and subject-matter experts for sharing their expertise and vision on the future of the Islamic banking sector:

- H.E. Dr. Bandar M. H. Hajjar, President, Islamic Development Bank (IsDB) Group
- H.E. Datuk Nor Shamsiah Mohd Yunus, Governor, Bank Negara Malaysia
- Professor Dato' Dr. Azmi Omar, President and CEO, International Centre for Education in Islamic Finance (INCEIF), Malaysia
- Mr. Omar Mustafa Ansari, Secretary General, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Bahrain
- Mr. Ventje Rahardjo, Executive Director, Komite Nasional Ekonomi dan Keuangan Syariah (KNEKS), Indonesia
- Professor Ning Su and Professor Chris WH Chan, Ivey Business School, Canada

We trust that the report will provide valuable insights to the Islamic bankers around the globe in measuring the pulse of the Islamic financial industry, as together, we drive it towards greater paths of success.

Dr. Abdelilah Belatik
Secretary General

Executive Summary

The Islamic banking industry has seen tremendous growth over the last forty years, and various optimistic projections have been made regarding the immense potential for its future development. The future growth of the Islamic banking industry, however, depends on multiple factors; e.g., industry policies and regulations, Islamic banks' resilience and risk management, innovation and technology adoption, sustainable practices, and how Islamic banks are addressing the related challenges and leverage on the offered opportunities in the coming years.

This year's CIBAFI Global Islamic Bankers' Survey (GIBS) is unique since it presents a reflection on the Islamic banking industry and the evolving trends that will shape its future landscape. Taking into consideration the position of the industry in light of the global economic impacts of the COVID-19 pandemic, we invited our esteemed respondents to consider how the Islamic banking sector might develop in the future. The GIBS 2021 asked respondents to contemplate a 10-year projection, a period which far-sighted executives might reasonably consider even in the present uncertain times. Additionally, the report includes some special articles from different experts and leaders of the industry to share their perspectives regarding the future of the Islamic banking industry.

Islamic banks globally have indicated a decline in the level of optimism towards the future of the Islamic banking industry, with the lowest recorded score in all the published editions of the GIBS report. However, under the circumstances of the COVID-19 pandemic and its effects on worldwide economic activities, as well as its uncertain outlook, it is only to be expected that optimism is in a downturn.

The banks also shared with us their top concerns for the near future, with customer attraction, relation, and retention appearing as the most challenging concerns for banks in 2021. The results show that banks are putting customers at the centre of their concerns and recognize that retaining existing customers - not to mention attracting new ones – is becoming very challenging, especially in the situation of the COVID-19 pandemic.

Another concern shared by Islamic banking officials is risk management. Given the COVID-19 pandemic situation as well as the increased adoption of technology, it is not surprising that managing the risks associated with such disruptive events is one of the top concerns for banks.

This year, we extended the risk dashboard by adding two new risks: "risk related to extreme disruptive events" and "climate change risks." The results show that the newly added risk related to extreme disruptive events is on the top of the risk dashboard and for an obvious reason. With the emergence of the COVID-19 pandemic in late 2019, all economic sectors are facing unprecedented challenges, and the Islamic banking industry is no exception. Despite proactive measures taken by regulators and governments around the globe, it appears that the banks are anticipating some challenges in the future, as the outlook for the COVID-19 situation remains uncertain.

Similar to last year, credit risk is the second most concerning risk, posing a serious risk to several Islamic banks. Given the links between the pandemic and credit risk, it is not surprising that credit risk is a frontrunner when it comes to banks' perceived risks. As we can understand, banks are adjusting their credit risk measures by incorporating new pandemic-related data points to ensure that the output remains effective and robust. They are also revisiting previously calculated expected credit losses to incorporate the uncertainty factor and scale of the pandemic and therefore likely to witness an increase in their expected loan loss provision.

Moreover, seeing the impact of the COVID-19 pandemic, we also raised some open-ended questions to Islamic banks to share their experiences on government initiatives, institution's performance, changes in customer behaviour, risk management, and strengths and weaknesses that had been revealed during the pandemic.

Banks reported that the most common initiatives by the governments, across many jurisdictions, are: decreasing interest/profit rates on monetary policy tools; reducing the limit for mandatory cash reserve on deposits with banks; postponing payments and granting grace periods; concessional financing to SMEs; reducing working hours; and supervisory focus on business continuity plans. They also shared with us the effects of the pandemic on their institutions' performance, which are the result of a decrease in earnings, higher provisions and expected credit losses, increased level of risks, and affected liquidity ratios of the banks.

Furthermore, on the changes in customers' behaviour, most of the banks we evaluated are experiencing a surge in customer demand for electronic channels. Some banks also reported changes in customers' financial behaviour, notably a reduction in demand for financing products due to concerns on movement restrictions. Moreover, the banks' responses, in general, show us that the main weakness is related to their inability to meet increasing customer demands for digital or mobile banking services. As for strengths, the banks believe that their quick response and flexibility to adopt new operational measures is turning out to be an advantage in the time of the pandemic. Some banks also expressed fears that governments, keen to help their economies recover from the pandemic, may direct the activities of the banking system in ways that may impede the system's long-term health.

Banks are also experiencing challenges in risk management, such as mitigating credit risk, investment risk, collateral risk, and liquidity risk. In some cases, this has led to changes in processes. Moreover, operational risk is also posing multiple challenges where the banks are experiencing technology risk, cybersecurity risk, and significant business disruption and delivery risk.

The survey also had intriguing insights into how Islamic banks see the outlook of the Islamic banking sector. We asked banks to respond to some open-ended questions. The analysis shows that banks are generally optimistic about the future of the industry over the next 10 years. There is, however, a recognition that in the areas where Islamic finance is well-established it may be difficult for growth to exceed that of the general economy.

Therefore, to sustain higher growth rates, the expansion will have to come from areas where Islamic finance is relatively new, and from those where, despite a long-term presence and a predominantly Muslim population, it continues to represent a small proportion of the overall financial sector.

Furthermore, there is a clear demand from the industry for the practical implementation of international standards. Some of these are regulatory standards; while others are transactional standards, such as standard documentation for interbank transactions.

It is also interesting to note that industry leaders recognize the need to respond to and adopt the innovations in technology that are transforming financial services, though some of them start from very different bases, not only in their operations, but in the national infrastructure available. However, only a handful of banks see themselves as challengers, using technology to implement new business models or to leapfrog established banks.

Another area which we explored is sustainability in the Islamic banking sector, as there is increasing concern internationally that banking should contribute to wider sustainable development aims. We found that some banks have embarked on the process, which many recognize will be a long journey of building sustainability into both their operational practices and their core business strategies – most notably the areas in which they are willing to advance finance. For other banks, sustainability is expressed through a distinct set of programmes and activities, rather than fully integrated into business strategy. However, for some banks, it does not seem to have had much impact at all.

The publication of the survey findings will allow readers to comprehend the bigger picture that depicts the major concerns and risks faced by Islamic banks in times of the pandemic. Also, that how Islamic banks, in different jurisdictions, are formulating contingency plans and strategies to counter the implications of the COVID-19 pandemic on their business models. More importantly, this report provides stakeholders with a perspective of Islamic banks and industry leaders on the outlook of the Islamic banking industry as well as insights on the factors that may impact the growth and development of the industry, 10 years down the road.

CIBAFI's Global Islamic Bankers' Survey

Introduction

For the past five editions, GIBS have been presenting remarkable findings for the Islamic banking industry to identify its risks and assist its future growth in different areas, including growth drivers, responsible business practices, strategic thinking, and financial technologies.

This year, we are pleased to present CIBAFI's sixth GIBS Report, an edition that coincides with 20 years of CIBAFI's existence as the official umbrella of Islamic financial institutions (IFIs) worldwide. With the theme "Islamic Banking Sector: A Look into the Future", the GIBS 2021 represents a moment of reflection on the current context of the Islamic banking sector, as well as speculation as to the evolving future landscape of Islamic finance.

A Comprehensive Survey

Following the previous editions of CIBAFI surveys, we are pleased to report once again a substantial number of responses this year - 100 responses from Islamic banks in 33 different countries. This number shows a significant improvement from the responses received in the first year, 2015, with 83 responses from 35 countries. The data amassed this year, in addition to the data gathered in previous editions, helped to provide a comprehensive overview of both the progress made and the challenges being faced by Islamic banks. The purpose of the GIBS 2021 is to shed light on bankers' perspectives on the future of the Islamic banking sector and the factors affecting its growth and development.

Instead of having four sections as in previous editions, the GIBS 2021 comprises three sections. The first two sections are common between all editions of the GIBS; the third section addresses the main theme of the GIBS 2021, with five sub-sections focusing on different aspects of the future of the banking sector. In addition, the GIBS 2021 report includes some special articles from different experts, leaders and regulators of the industry.

Below is the structure of the GIBS 2021 report:

Part 1: CIBAFI Islamic Banking Confidence Index (permanent section)

Part 2: CIBAFI Islamic Banking Risk Dashboard (permanent section)

Part 3: Future Landscape of the Islamic Banking Sector (thematic section)

- Sub-section 1: Islamic Banks' Growth and Expansion
- Sub-section 2: Policies and Regulations within the Islamic Banking Sector
- Sub-section 3: Islamic Banks' Resilience and Risk Management
- Sub-section 4: Innovation and Technology within Islamic Finance Industry
- Sub-section 5: Sustainability within the Islamic Banking Sector

CIBAFI hopes that the results of the survey will provide Islamic financial institutions with a comprehensive picture of the outlook of the Islamic banking sector, as well as insight from Islamic banks on the factors impacting the growth and development of the Islamic banking sector.

Table 1. Respondents by Regions and Countries

Group	Region	Countries from which banks responded	Number of banks in this group that responded
Group 1	GCC	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE	20
Group 2	Middle East ex-GCC	Egypt, Iraq, Jordan, Palestine, Syria, Yemen	21
Group 3	Southeast Asia	Indonesia, Malaysia	6
Group 4	West, Central, and South Asia	Afghanistan, Bangladesh, Pakistan, Sri Lanka	16
Group 5	North Africa	Algeria, Libya, Morocco, Sudan, Tunisia	24
Group 6	Sub-Saharan Africa	Burkina Faso, Djibouti, Guinea, Kenya, Mauritania, Nigeria, Somalia	8
Group 7	Europe	Bosnia Herzegovina, Turkey, UK	5
Total number of countries and banks		**33 Countries**	**100 Islamic Banks**

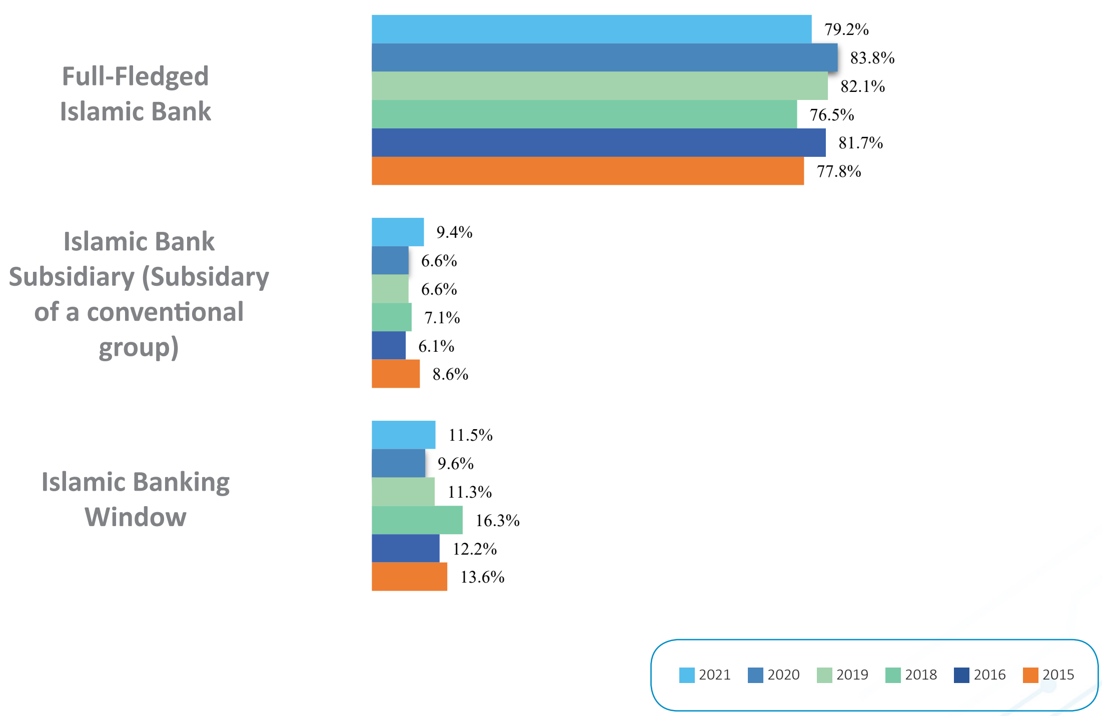
Survey Methodology

The CIBAFI Secretariat sent the questionnaires to the CEO offices of CIBAFI's member and non-member Islamic banks, with the final responses received in January of 2021. The survey, therefore, reflects the views of the Islamic banking community towards the end of 2020 and the start of 2021. This was, of course, during the height of the COVID-19 pandemic. While government interventions had eased some of the most pressing financial concerns, there remained uncertainty about the long-term economic effects. In addition, some banks faced operational issues because of movement restrictions, employees working from home, etc. These factors should be borne in mind when interpreting the results.

As in previous years, questions were asked related to confidence, concerns, and perceived risk, allowing readers to track the change and development of attitudes over time. All parts of the survey comprised both "closed" and "open-ended" questions. The open-ended questions allowed industry leaders to share their insights using more in-depth and detailed written responses.

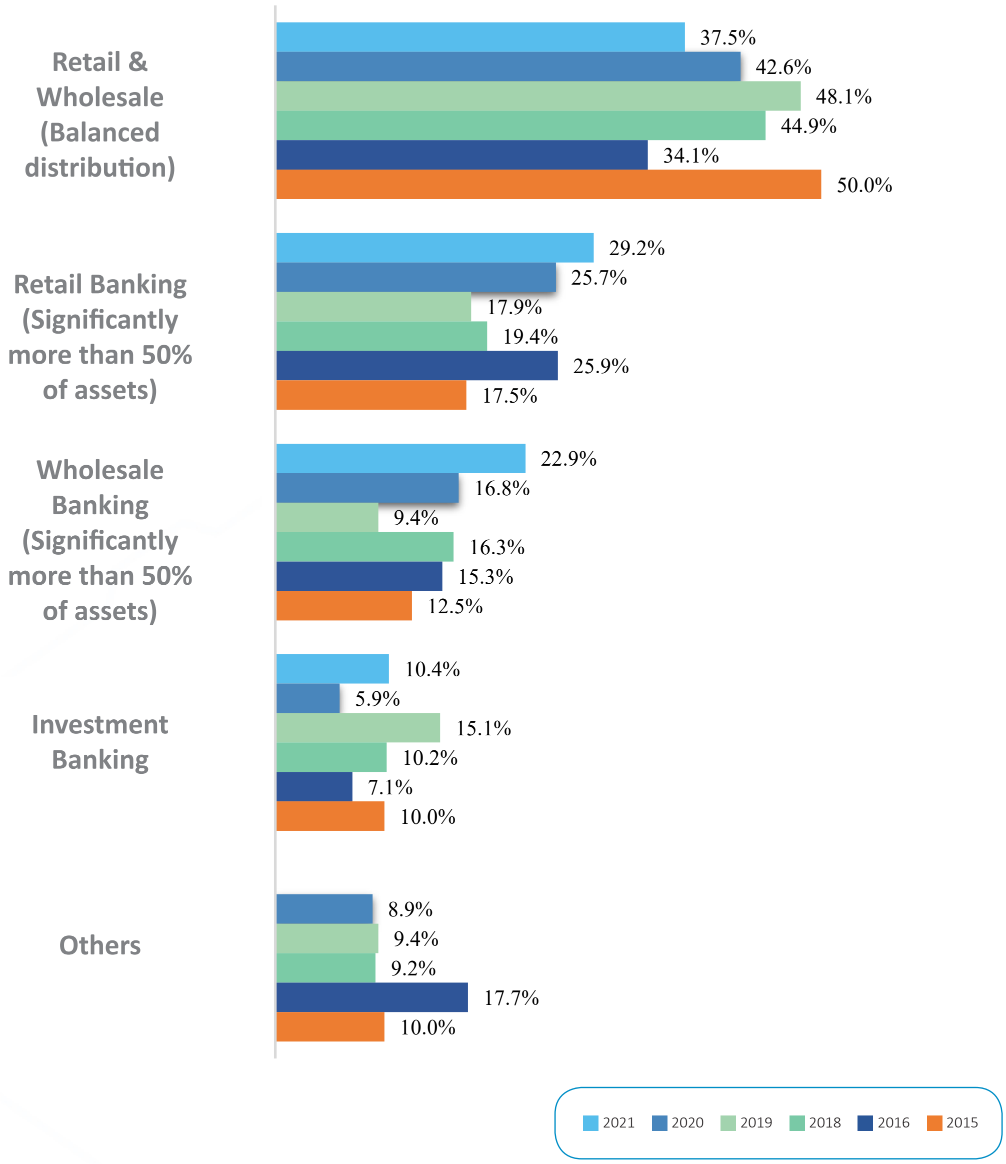
The responses of the questions in the section of general information show that this year, around 79% of the respondents to the survey were full-fledged Islamic banks, 9% were Islamic bank subsidiaries, and around 12% were Islamic banking windows of conventional banks.

Fig.1. **Global Banking Operation**



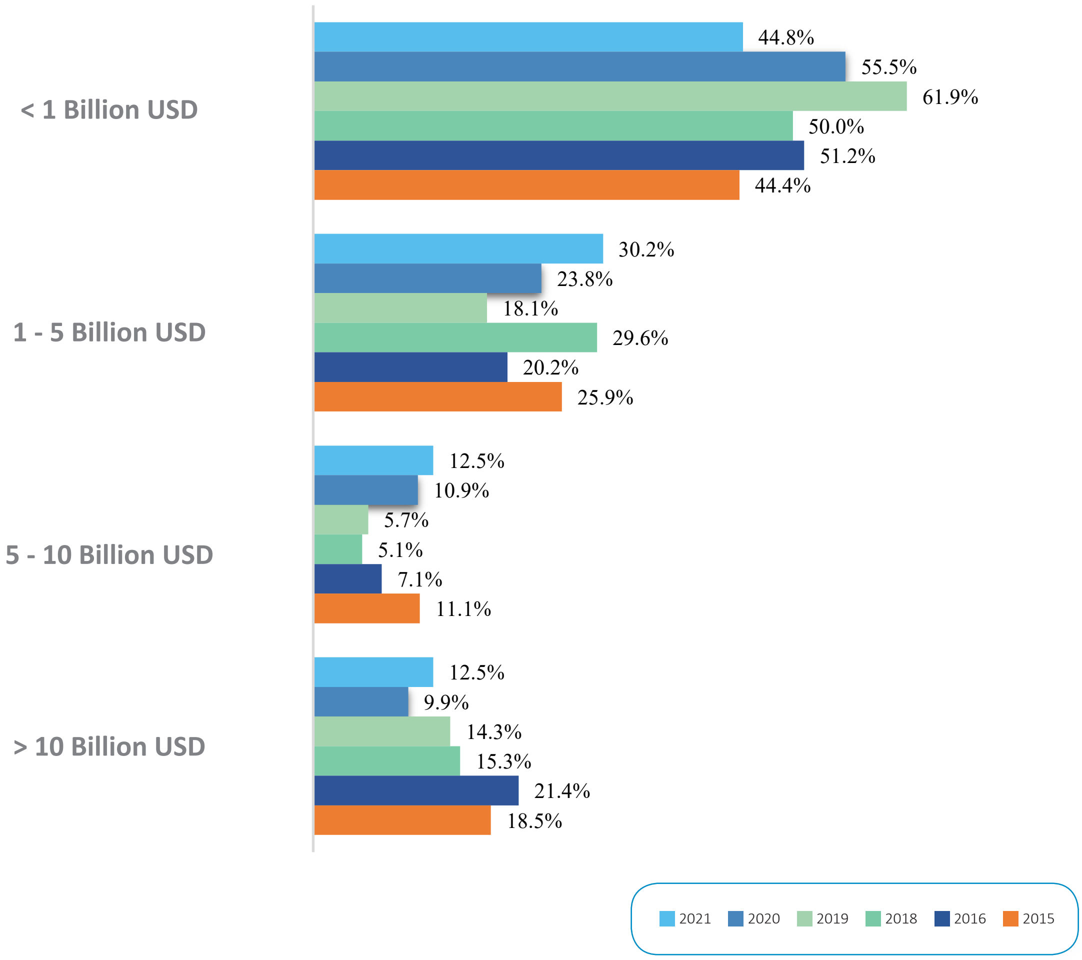
Slightly more than one third (around 38%) of respondents indicated that their activity is both retail and wholesale with a balanced distribution, while about 29% indicated that significantly more than 50% of their assets lie in retail banking. Around 23% mainly deal with wholesale banking, while about 10% of respondents indicated that investment banking comprises their core business.

Fig.2. **Global Core Business**



Regarding the size of total assets, around 45% of respondents indicated that the size of their total assets is less than one billion USD, while below one-third of respondents (around 30%) said that their assets are between one and five billion USD. This portion had a significant increase compared to 2020. There were also increases in the percentage of respondents reporting that their asset size is between five and ten billion USD, and those with asset size above ten billion USD.

Fig.3. **Size of Total Islamic Assets**



PART I:

CIBAFI Islamic Banking Confidence Index

Part I. CIBAFI Islamic Banking Confidence Index

This survey is the sixth survey which CIBAFI has undertaken to produce its CIBAFI Islamic Banking Confidence Index. This index has proven valuable in showing financial institutions' confidence in the Islamic banking sector, both globally and within the contexts of different jurisdictions in varied geographical locations.

To put these results in context, a score of 1.00 is classed as "extremely pessimistic", 2.00 is classed as "pessimistic", 3.00 is classed as "fairly optimistic", 4.00 classed as "very optimistic", and 5.00 classed as "extremely optimistic."

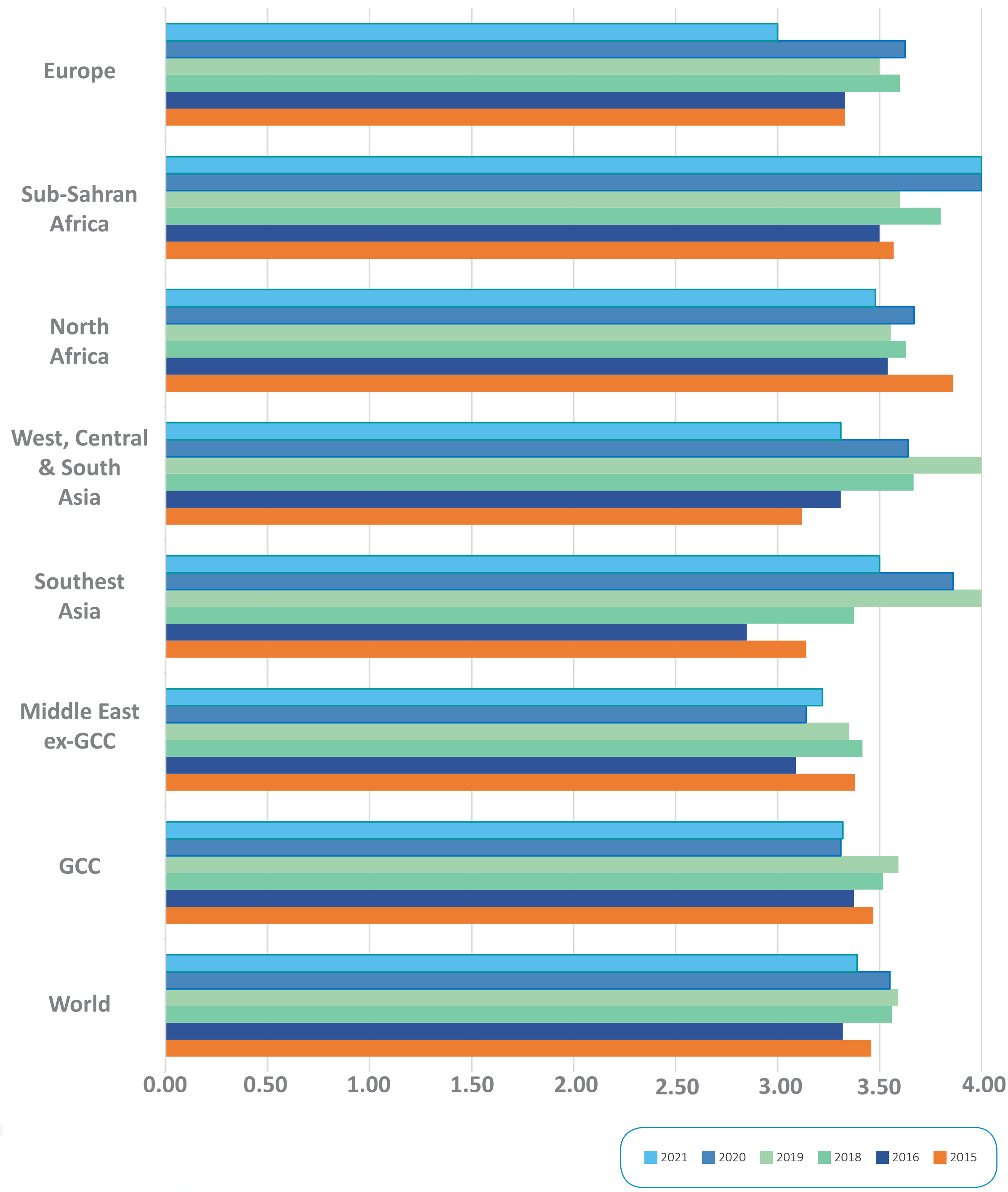
Less optimism towards the future of banking sector

When asked the question, "How optimistic are you about the future of banking in your jurisdiction in 2021" the overall trend of the institutions' responses showed a continuous decrease of optimism. Although the global reported score is still overall quite positive, it is the second lowest score for optimism reported since 2015. The responses this year averaged 3.39, showing a decline from 3.55 in 2020. However, a decline is hardly surprising, given the COVID-19 pandemic and its effect on economic activity generally.

This year's results showed that the majority of the regions (4 out of 7) experienced a decline in the level of optimism. The largest decline can be seen in Europe, with a score that went from 3.63 in 2020 down to 3.00 in 2021. Likewise, decline is noticed in West, Central, and South Asia from 3.64 in 2020 to 3.31 in 2021; followed by Southeast Asia, declining from 3.86 in 2020 to 3.50 in 2021; then by North Africa with a score of 3.48 in 2021 compared to 3.67 in 2020.

On the other hand, three regions showed signs of optimism. Sub-Saharan Africa maintained last year's score of 4.00. For GCC and Middle East ex-GCC, slight increases are reported, moving from 3.31 and 3.14 in 2020 to 3.32 and 3.22 in 2021, respectively.

Fig.4. Overall Industry Optimism Level

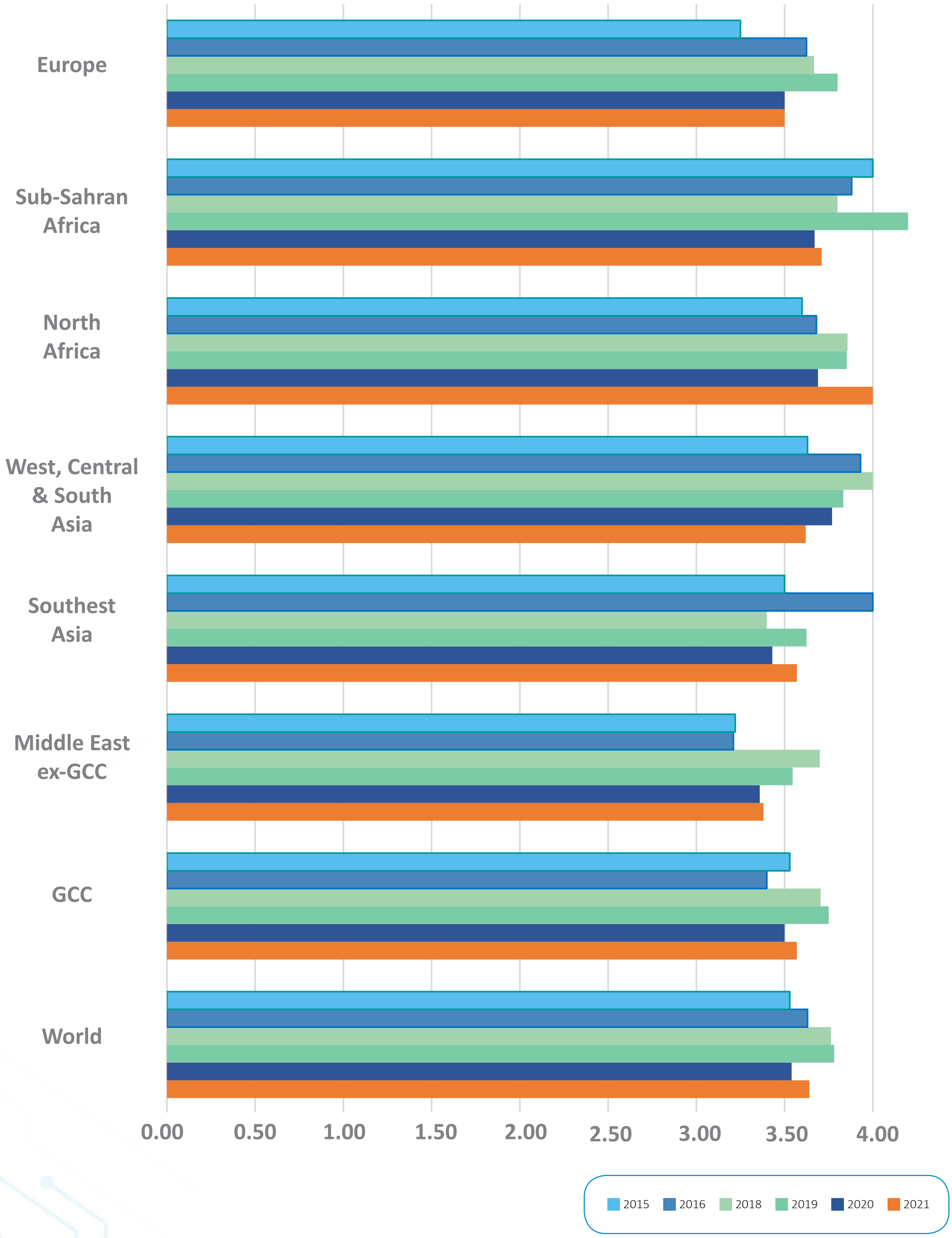


Banks' optimism towards future of Islamic banking takes a blow, yet remains positive

Concerning the level of optimism towards the future of Islamic banking, the global picture showed a further decline from that recorded last year. The banks' optimism level towards the future of Islamic banking in 2021 is 3.53 compared to 3.63 in 2020. This year's score is the lowest recorded optimism level in all the published editions of the GIBS report; however, this score is still considered a positive sign regarding the future of Islamic banking and remains higher than the score for the banking industry generally.

The regional breakdown showed a slight boost in the optimism of the GCC, Middle East ex-GCC and Sub-Saharan Africa recording a score of 3.53, 3.22 and 4.00 in 2021 compared to 3.40, 3.21 and 3.88 in 2020, respectively. However, four regions reported a decline in optimism regarding the future of Islamic banking, including a significant decrease in Southeast Asia; West, Central, and South Asia; and Europe, from 4.00, 3.93 and 3.63 in 2020 to 3.50, 3.63 and 3.25 in 2021, respectively. The fourth region, North Africa, showed a slight decline from 3.68 in 2020 to 3.60 in 2021.

***Fig.5*. Islamic Banking Industry Optimism Level**

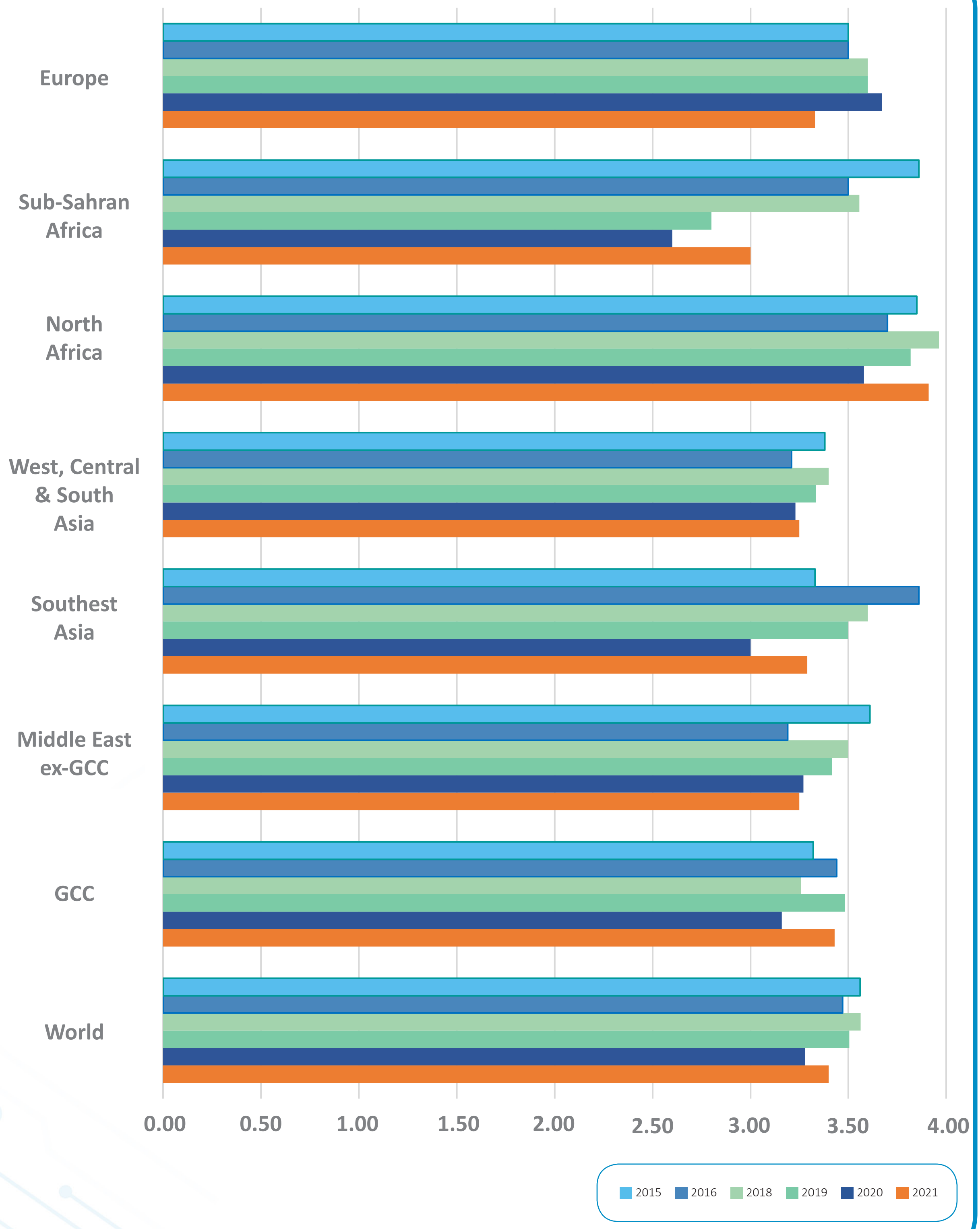


A slight improvement in optimism level regarding revenue growth

Unlike the previous questions that evaluated the level of optimism toward the future of the banking system and the Islamic banking sector, the optimism level reported regarding revenue growth shows a slight increase with a score of 3.56 in 2021 compared to 3.47 in 2020. The explanation of this result could be related to a positive expectation regarding the economic recovery and the termination of payment deferrals, following the approval of vaccines in late 2020 and early 2021.

The most significant boost in optimism level regarding revenue growth is evident in Middle East ex-GCC, with a score of 3.61 in 2021 compared to 3.19 in 2020, followed by Sub-Saharan Africa with a score of 3.86 in 2021 compared to 3.50 in 2020. The most notable decline is reported in Southeast Asia, from 3.86 in 2020 to 3.33 in 2021.

Fig.6. Revenue Growth Expectations



Islamic Banking Concerns for the Upcoming Years

The next section of the confidence index highlights the biggest concerns of banking executives in the coming years – what new challenges are expected to arise and which issues will gain priority based on the experiences of previous years. The survey gave Islamic banking leaders a list of 25 possible challenges and they were asked to assign a score of severity to the challenges they felt would be facing their institution in the next one to three years. The scores range from 1.00 to 5.00 – with 1.00 considered "not at all important" as a challenge, and 5.00 considered "extremely important."

The results of last year showed an increase in severity for almost all challenges. This year's results showed levels generally similar to those recorded in 2020. The figures should, however, be interpreted in the light of the pandemic, which is likely to have impacted the concerns in different ways.

Consumer attraction, relation and retention is the most concerning challenge.

Customer issues was present as one of the most concerning challenges since the launch of the GIBS. This year the customer attraction, relation, and retention moved to the first position after being the second most concerning challenge in 2019 and 2020. The severity given to consumer attraction, relation and retention is 4.32 in 2021 compared to 4.26 in 2020.

The results show that banks are putting the customer at the centre of their concerns: customer retention is important, as is the attraction of new customers, and both issues present unique challenges. Many factors could be the reason behind ranking customer issues at the top of the concerns list for Islamic banks, including the emergence of new players offering innovative products and solutions making the market a very competitive environment for banks following traditional business models. The implications of the pandemic have also affected economic activities, thus affecting the demand for financial products and services and the relation binding the customers and banks.

Risk management gaining more severity and becoming the second concerning challenge.

The 2021 results showed a continuing precedence of risk management, bringing it from third place in 2020 with a score of 4.23 to second place in 2021 with a score of 4.29.

Given the circumstances related to the pandemic as well as the increased adoption of technology, it is not surprising that managing the risks associated to such disruptive events is one of the top concerns for banks. This was reflected in some of the open-ended responses, where banking officials indicated that unexpected events such as the pandemic and risks related to information technology are challenging factors affecting risk management.

More concerns for Macro-economic environment.

This year's results showed that more importance is given to macro-economic environment issues, since it rose from the sixth position in 2020 (at 4.17) to the third position in 2021 with a score of 4.22.

Concerns over macro-economic issues were also noted in the open-ended responses from banks where the concern regarding the macro-economic environment is associated to the disruption caused by COVID-19, the drop in oil prices and political issues within some countries. One bank from North Africa said the following: "Macro-economic instability is totally associated to fluctuations in oil prices as well as to current global economic conditions due to the COVID-19 pandemic." A bank from the Middle East ex-GCC indicated that, "The current conditions in the country, which were reflected in the macro-economic indicators, make the economic environment a real challenge for the banks."

Shareholders' value and product offering: concerns that lost priority.

Concerns related to shareholders' value were prioritized in the previous editions of the GIBS. Shareholders' value ranked first in 2015, 2018 and 2019, while it ranked fourth in 2016. This year, the priority of shareholders' value has dropped, bringing it down to two positions compared to last year, to rank sixth this year with a score of 4.17.

Product offering and innovation is also a concern that had less priority this year compared to last year. Product offering and innovation ranked eleventh with a score of 3.96, compared to fifth place with a score of 4.18 in 2020.

Fig.7. Global Islamic Banking Top Concerns (2021)

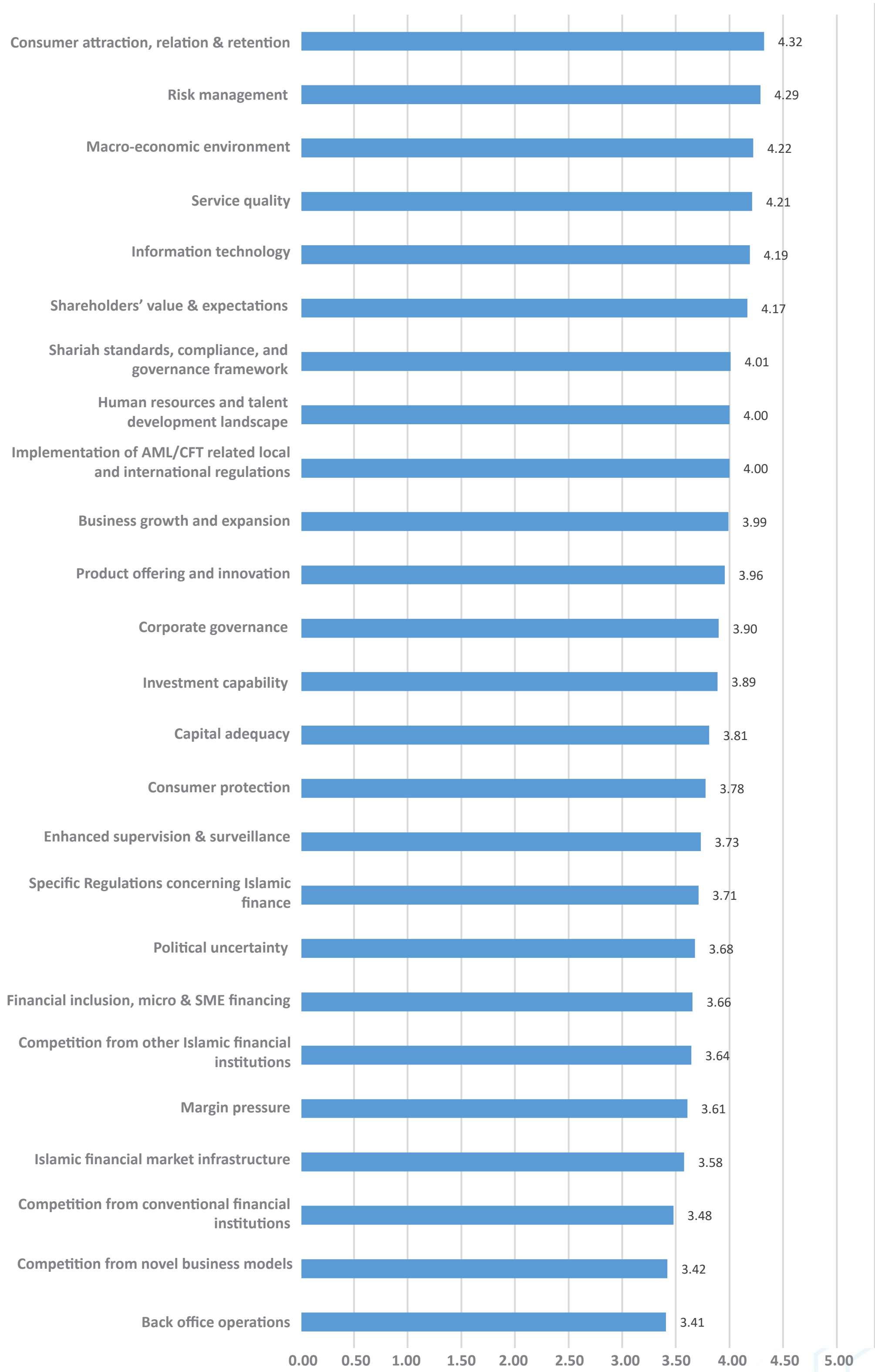
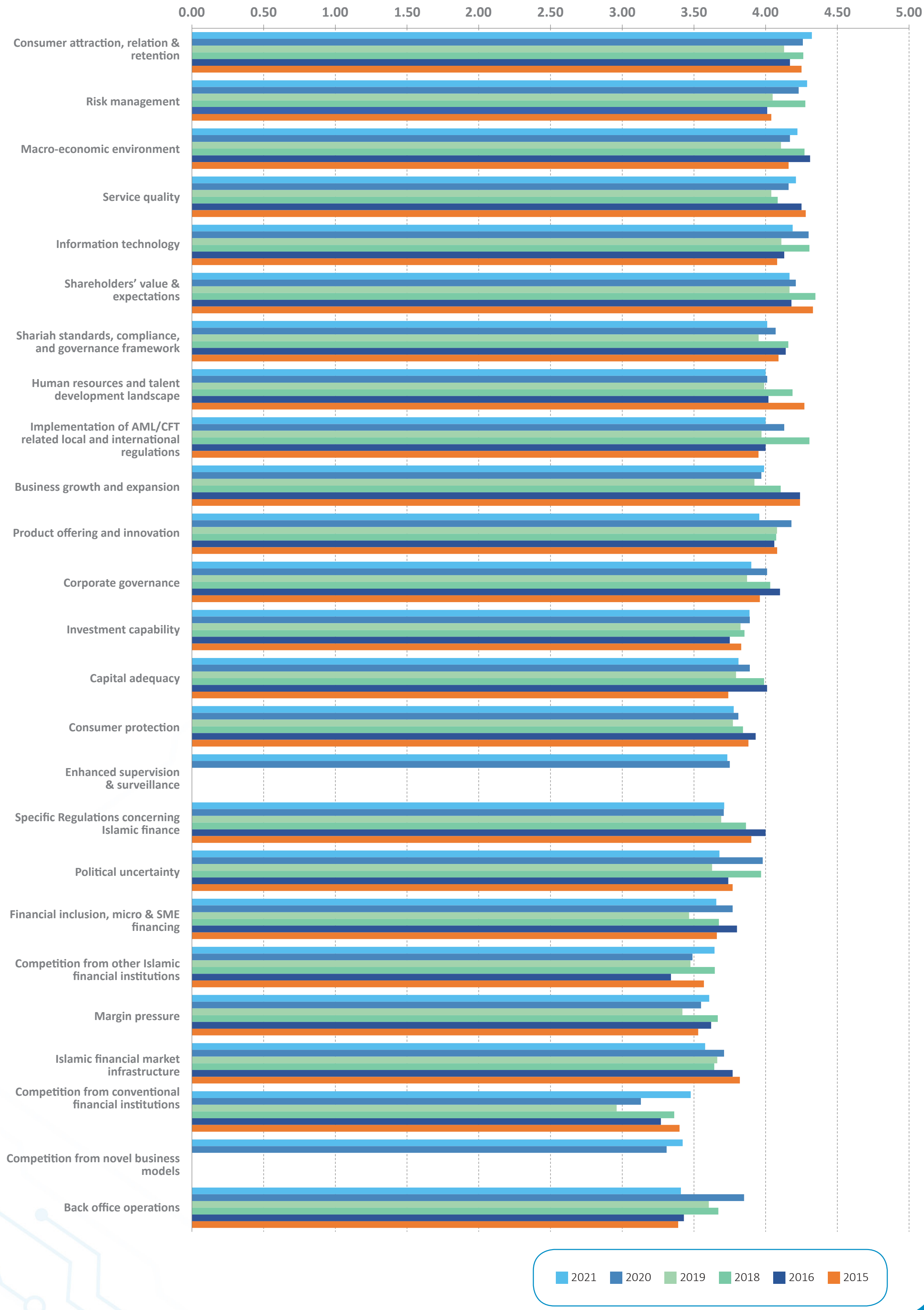


Fig.8. Global Islamic Banking Top Concerns



Regional Concern Variations

The importance given to the concerns is subject to demographic differences, where some concerns are specific to certain regions than others. In addition to analyzing the common concerns between all the regions, it is also important to identify the specific issues each region is facing.

Anxieties surrounding customer attraction, relation and retention appear as a common challenge that is considered important for banks in all the regions, albeit with varying levels of importance. In the GCC and Sub-Saharan Africa, customer issues scored 4.50 for both regions making this challenge the most concerning one. The same concern ranked second in the Middle East ex-GCC, Southeast Asia, and North Africa with scores of 4.22, 4.50 and 4.35, respectively. Concerns related to customers are also considered important for regions such as West, Central, and South Asia; and Europe but with less priority compared to previous regions.

Many regions associated the issues of customers with concerns related to product offering and innovation. One bank from Middle East ex-GCC mentioned that “Customers are always in need to fulfil their needs through enhanced and creative banking products.” Another bank from North Africa cited that “Concerns related to customers are associated to the failure to offer innovative products.”

Banks from the GCC, Middle East ex-GCC and Europe expressed concerns regarding the macro-economic environment with high priority allowing it to rank in the first position with scores of 4.50, 4.33 and 4.50 respectively. One bank from the Middle East ex-GCC cited that “There is no doubt that the macro-economic environment in the region poses a major challenge on the financial environment generally, and on our bank particularly.”

Service quality is considered more pressing in North Africa and Sub-Saharan Africa, ranking as the top concern with scores of 4.40 and 4.50, respectively. Both the Southeast Asia region and the West, Central, and South Asia region rated service quality as the second-highest concerns, with scores of 4.50 and 4.31 respectively. Information technology is another concern that has more importance in Europe and Sub-Saharan Africa with scores of 4.00 and 4.38 respectively, ranking at second place.

Some institutions expressed concerns regarding shareholders’ value and expectations, with different levels of priority. Banks from West, Central, and South Asia, GCC and Sub-Saharan Africa gave it a high score, allowing it to rank in first position in West, Central, and South Asia with a score of 4.38 and in third position in GCC and Sub-Saharan Africa with scores of 4.28 and 4.25, respectively. Capital adequacy appears in the list of the top three concerns recognized by banks in Sub-Saharan Africa and Europe.

Table 2. Major Concerns of Islamic Banks across Regions [1]

Geographical Breakdown	Top Concerns	Score
Group 1: GCC	Consumer attraction, relation and retention	4.50
	Macro-economic environment	4.50
	Risk management	4.39
	Shareholders' value and expectations	4.28
	Information technology	4.28
Group 2: Middle East ex-GCC	Macro-economic environment	4.33
	Consumer attraction, relation and retention	4.22
	Risk management	4.22
	Information technology	4.22
	Political uncertainty	4.17
Group 3: Southeast Asia	Product offering and innovation	4.67
	Consumer attraction, relation and retention	4.50
	Information technology	4.50
	Service quality	4.50
	Business growth and expansion	4.50
	Macro-economic environment	4.33
	Financial inclusion, micro and SME financing	4.33
Group 4: West, Central, and South Asia	Shareholders' value and expectations	4.38
	Service quality	4.31
	Shariah standards, compliance, and governance framework	4.25
Group 5: North Africa	Service quality	4.40
	Risk management	4.40
	Consumer attraction, relation and retention	4.35
	Macro-economic environment	4.35
	Shariah standards, compliance, and governance framework	4.20
Group 6: Sub-Saharan Africa	Service quality	4.50
	Risk management	4.50
	Consumer attraction, relation and retention	4.50
	Capital adequacy	4.50
	Implementation of AML/CFT related local and international regulations	4.38
	Information technology	4.38
	Shareholders' value and expectations	4.25
	Corporate governance	4.25
	Investment capability	4.25
	Consumer protection	4.25

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

Group 7: Europe	Macro-economic environment	4.50
	Risk management	4.00
	Information technology	4.00
	Service quality	3.75
	Consumer attraction, relation and retention	3.75
	Capital adequacy	3.75
Global	Consumer attraction, relation and retention	4.32
	Risk management	4.29
	Macro-economic environment	4.22

1: Extremely not Important ; 2: Not Important ; 3: Fairly Important ; 4: Very Important ; 5: Extremely Important

Differences by Bank Size

When we compared the list of concerns based on the banks' size, the results show differences in priority. Small banks are more concerned about risk management, while large banks consider information technology as the most important concern. Consumer issues is obviously a common concern between small and large banks, since it ranked second for both.

Product offering and innovation is also a concern, though bank size is significant; it appears to be more concerning for large banks than for small banks.

At the bottom of the list, large banks appear to be less concerned about political uncertainty, since it ranked last. For small banks, it ranked at the thirteenth position. This may, however, be partly a reflection of the jurisdictions where smaller banks are established.

Fig.9. Small Banks' Top Concerns

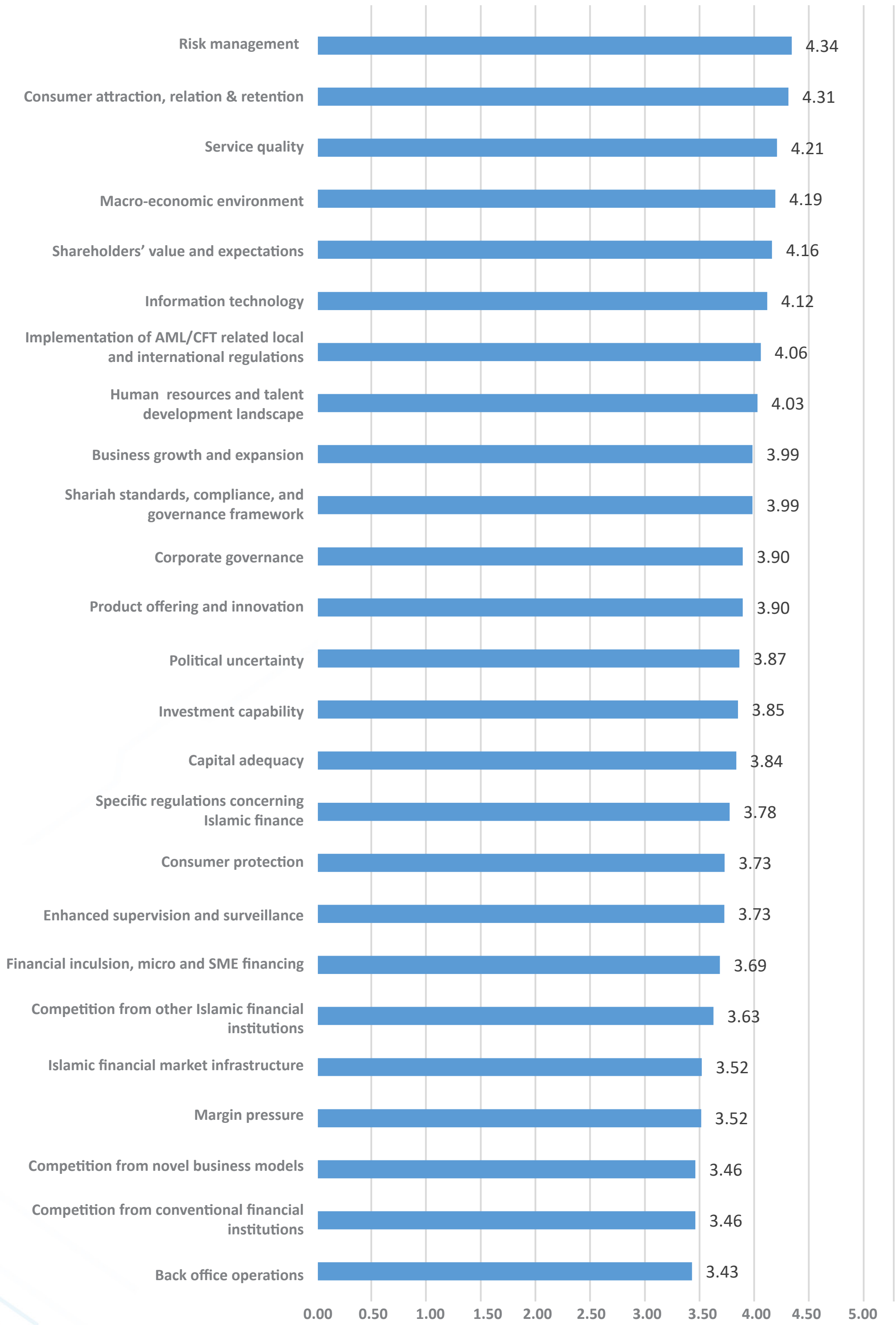
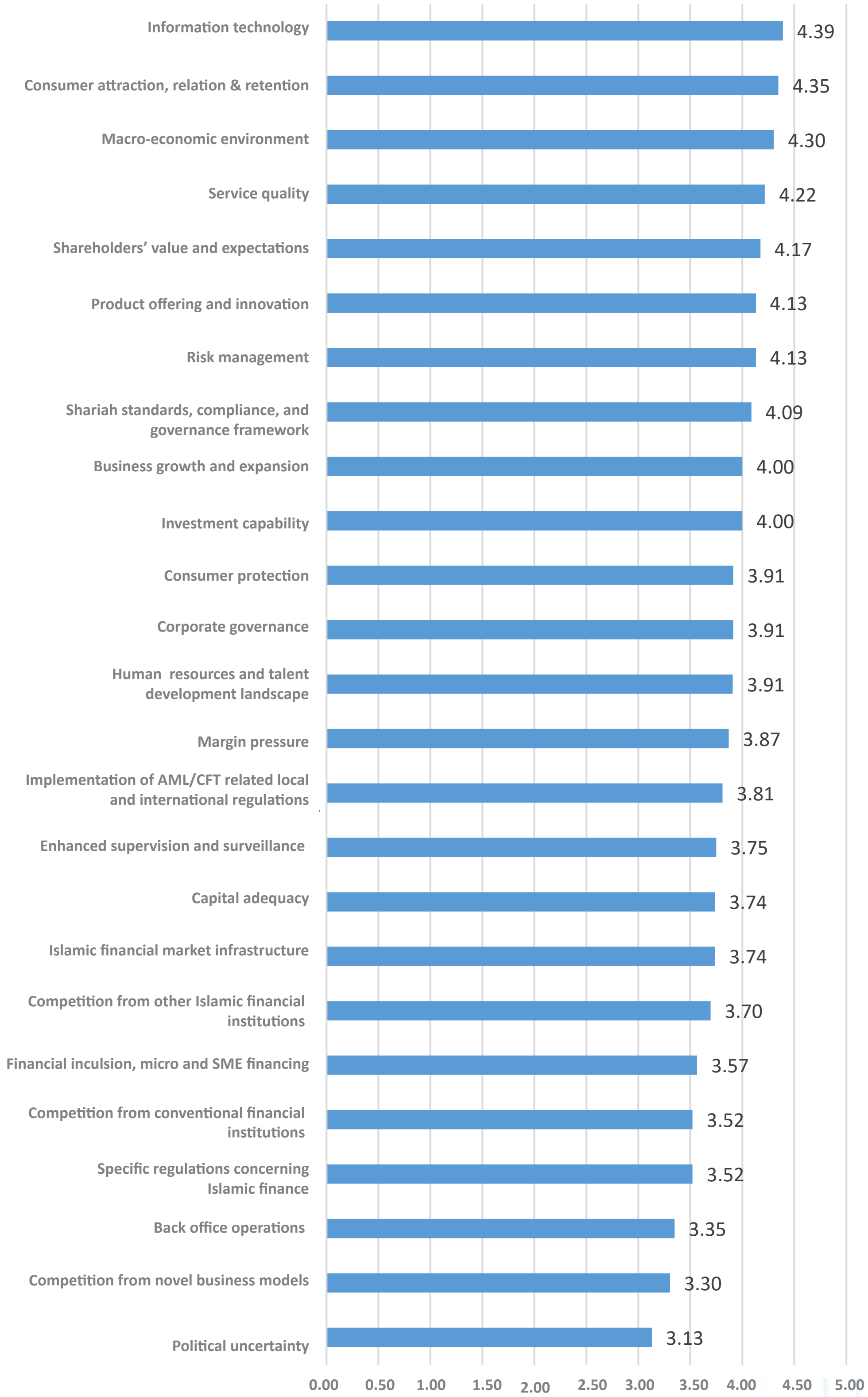


Fig.10. Large Banks' Top Concerns



Strategies Suggested to Overcome IFIs' Top Concerns

Recognizing the challenges and the concerns is half the solution to overcome these challenges; the other half is to identify and adopt strategies to address the concerns of the banks. To identify the top concerns that the Islamic banks are facing and the adopted strategies to overcome them, the survey provided the respondents with the possibilities to elaborate on possible solutions via the open-ended responses.

Macro-economic environment is a common concern.

The macro-economic environment is among the top three concerns in the majority of regions and was highlighted on many occasions in the open-ended responses.

Banks from the GCC, North Africa, and Southeast Asia raised concerns regarding the uncertainty of the macro-economic environment in the wake of COVID-19. A bank from the GCC stated, "Given the unprecedented business disruption brought by the COVID-19 pandemic in addition to the evolving and volatile macro-economic condition, the bank continues to be agile in its approach towards growth." The same bank associated its strategy to overcome the micro-economic environment with digitalization when mentioning that, "The bank continues to invest in its digital capabilities as an avenue to reach out and serve its customers in a safe, quick and efficient manner." Another bank from the same region mentioned, "In view of the current conditions due to the COVID-19 pandemic – as well as the drop in oil prices in global markets and the repercussions of its large effects on the markets and their reflection on the banking sector – we worked to overcome them by focusing on asset quality and reducing potential risks, as well as by finding innovative solutions and products for our customers."

Citing the same worries, a bank from the Middle East ex-GCC indicated that its strategy is based on taking into consideration challenges related to the macro-economic environment and adopting the highest degree of caution to mitigate negative effects by focusing on the least affected economic sectors.

More priority given to risk management.

Aligned with its position in the list of the top concerns this year, some banks highlighted the priority given to risk management in their open-ended responses. A bank from Middle East Ex-GCC indicated that the unexpected events such as the pandemic presented a challenge in terms of risk management. Another bank from the same region mentioned they are facing increased credit and operational risks in light of macro-economic instability. To overcome these challenges, the bank mentioned that its strategy to enhance risk management is based on adopting best practices for identifying, measuring, monitoring risks and spreading the risk culture throughout the management levels of the bank. A bank from Europe gave a very general statement regarding managing risk by stating that they have additional monitoring of their clients.

Continuing concerns regarding information technology.

Information technology stands as one of the concerning challenges for Islamic banks from different regions and ranks top of the list for larger banks. The COVID-19 pandemic has accelerated the pace of digitalisation, creating some serious challenges to institutions that were not ready for such a fast change. In addition, both this and remote working trend increase the risks of cyber-attacks. One bank from the Middle East ex-GCC linked information technology with the operational aspects of banking by mentioning that "In the current situation due to COVID-19, information technology (systems, networks, e-services) is a very important aspect to operate." From the same region, one bank mentioned that its strategy to face the issues related to information technology is "Training programmes for the staff, adopting recent systems and commitment from Board of Directors to development and innovation." Another bank from North Africa shares the same strategy of training programmes for employees to improve their capabilities and skills when it comes to information technology.

A bank from the GCC recognizes the role of information technology in particular under the circumstances imposed by COVID-19 and cited, "Given the great importance that information technology represents through the great role it plays, especially during this particular stage, which made institutions completely dependent on it to conduct their business in light of the closure and imposed conditions. We have paid great attention to information technology and invested in it to develop it and enable it to perform all work in an innovative way that fulfills the requirements of our clients – both individuals and companies."

Other issues presenting a challenge for Islamic banks.

Banking officials also shed some light on additional issues facing Islamic banks. Some of these challenges are specific to Islamic banks – such as Shariah standards, compliance, and governance framework. A bank from the GCC said, "Higher cost of business from the need to establish infrastructure to support heightened supervision and evolution in Shariah standards and governance framework might make cost of doing business for Islamic finance players rise up faster than conventional counterparts. However, given the importance of such standardisation in the longer run, [the bank] will continuously upgrade its infrastructure and capabilities and strive to create an organisation-wide awareness and capabilities to ensure compliance across all areas." Capital adequacy is also one of the concerns that has been highlighted by banks and to address the challenges associated to this a bank from GCC mentioned "The Bank is currently working on various measures to improve the capital. In fact, the Bank recently announced that the Board of Directors are working on issuing Additional Tier 1 (AT1) capital of up to [USD 177 million] to strengthen the Bank's consolidated equity and meet the regulatory requirements. The Bank is currently in the process of obtaining necessary regulatory approval for this issue."

PART II:

CIBAFI Islamic Banking Risk Dashboard

Part II. CIBAFI Islamic Banking Risk Dashboard

Islamic Banks' Top Risks

The CIBAFI Islamic Banking Risk Dashboard, conducted since 2015, is a useful tool to see the challenges on the banks' radar at the global and regional level, as well as how the perspectives of these challenges evolve over time. Each institution was asked to assign a value to each of the 22 categories, ranging from 1.00 (no risk at all) to 5.00 (extremely risky).

While the Global Islamic Banking Top Concerns Dashboard in Part I covers global concerns that banks have while operating within the scope of their respective environments, as well as big-picture items such as concerns about Islamic banking mechanisms in general, the Islamic Banking Risk Dashboard is intended to reflect the risks associated with the functioning of the banks themselves. To this end, political, macro-economic, and other risks are foregone in the pursuit of an understanding of which risks the bank expects to affect its day-to-day operations in the next few years.

To keep the survey up-to-date but manageable to answer, the dimensions of risk are tailored each year. This year, the survey incorporates two additional types of risks in the risk dashboard: (1) risk related to extreme disruptive events, such as pandemics and (2) climate change risk.

Major Disruptive Events on the Top

This year, the newly added risk related to extreme disruptive events such as the COVID-19 pandemic is on the top of the risk dashboard and for an obvious reason. With the emergence of the COVID-19 pandemic in late 2019, all economic sectors are facing unprecedented challenges and the banking industry is no exception, being faced with both economic and operational issues.

Although regulators and governments around the globe have already proactively intervened and introduced measures to support the banking sector, the banks, however, are anticipating some challenges in the future as the length and severity of the COVID-19 pandemic remains uncertain.

On the risk dashboard, risk related to extreme disruptive events such as the COVID-19 pandemic scored 3.90 (see Figure 11), which is the highest score for any type of risk since 2015. Nevertheless, it is important to note that the risks associated with pandemic risk are closely related to other defined risks, such as credit risk. As mentioned by one bank from the GCC group, "Both these risks [pandemic and credit risk] are inter-related. The COVID-19 pandemic has resulted in an impact across all sectors which has, in turn, impacted customers' repayment ability resulting in higher provisions and ECL [Expected Credit Losses] cost to the bank. With the second wave of lockdown in many countries, this impact will have a negative effect on many of the economic sectors (e.g., airline, tourism, transport etc.), and this is expected to continue in 2021."

Moreover, the banks are vigilant in the developing situation of the COVID-19 pandemic and taking appropriate measures to mitigate the associated risks. Another bank from the GCC region elaborated, "Credit risk increased significantly in 2020 and may continue over the next 1-3 years due to COVID-19. A conservative credit risk strategy implemented by the bank based on multiple factors such as sector, risk rating and so forth risks related to extreme disruptive events such as COVID-19 in 2021 remains the main risk. The bank put in place a conservative strategy to weather the crisis at all levels."

When it came to bank size, there was a disparity in how larger banks viewed disruptive events compared to smaller banks. For larger banks, this risk scored only third, below both cyber-security and credit risk. Since they gave credit risk a similar score to small banks, this may suggest that, while they face similar economic issues to small banks, they feel better prepared to cope with the operational impacts of extreme events.

Growing Concerns Over Credit Risk

Given these links between the pandemic and credit risk, it is not surprising that credit risk is still a frontrunner when it comes to banks' perceived risks. Credit risk was the second most concerning risk last year, and this year we can see (in Figure 11) it retains its position with a slightly higher score of 3.67. Moreover, the banks are also revisiting previously calculated expected credit losses to incorporate the uncertainty factor and scale of the pandemic and therefore likely to witness an increase in their expected loan loss provision.

In response to the pandemic crisis, the banks are adjusting their credit risk measures by incorporating new pandemic-related data points to ensure that the output remains effective and robust. A bank from the West, Central, and South Asia region stated that the "Bank has taken several measures to mitigate the impact of an increase in credit risk due to the COVID-19 pandemic. One of the prominent measures under a macro-prudential policy adopted by the Central Bank was to provide repayment holidays to the customers who were unable to meet their payment obligations due to cash flow constrained amid countrywide lockdown. Moreover, the bank further improved due diligence measures for allowing new financing to the customers."

Regarding credit risk mitigation measures, a bank from the GCC region explains that "The bank is reviewing areas of stress on a continuous basis and has tightened in those segments primarily for expats. The bank will continue to take a cautious approach towards financing individuals from these segments (e.g., suspension of high-risk industries like airlines, tourism etc., increase in minimum income requirement for expats for personal finance, discontinuation of variable income add-back to income such as incentives, flying allowance etc. and reduction of rental income add-back, credit score requirements for buyouts and top-ups etc.). The bank is proactively monitoring the portfolio in terms of regular client visits, review of updated financials, transactional monitoring etc. to minimize losses arising out of the pandemic. The portfolio has been segregated into high, medium, and low risk categories, and accordingly, priorities are set for necessary actions."

On the same note, a bank from the GCC region shared its viewpoint on credit risk, stating: "With the prolonged issue of the COVID-19 pandemic, which is expected to continue until 2022, credit risk has become one of the top risks in our institution whereby customers continue to get affected by the pandemic. In this regard, the bank will continue to be vigilant on the market sensitivity to ensure vulnerable customers are identified, managed and monitored accordingly."

Technological Risks Still Front and Centre

In the last two years, banks have reported their growing concerns over cyber-security risk and technology risk by placing them among the top three on the risk dashboard. This year, banks assign the highest scores yet to cyber-security risk (3.59) and technology risk (3.43) (see Figure 11). It is perhaps not surprising that owing to the severe operational challenges posed by the COVID-19 pandemic, technology risk and cybersecurity risks appear strongly as a source of concern for Islamic banks. Although the movement towards digitalization and automation in the Islamic banking industry was there before, the COVID-19 pandemic has further expedited the transformation where banks are adopting digital channels to meet the increasing demand for online products and services. Moreover, banks are facing some operational challenges that contributed to an increased cyber-security risk, for example, business execution and system failures as well as business disruption due to changes in employee working arrangements.

The regulators, in almost every region, issued various directives for banks to scale down their operational activities (e.g., reducing branch operating hours, employees, etc.) concerning the health of their employees and customers and encouraged banks to deploy alternative services methods (e.g., contactless, online/internet and phone banking). The situation that arises from the COVID-19 pandemic has created many technological challenges for banks to uphold their standards of customer experience while mitigating operational hurdles. Islamic banks that were less prepared to implement adaptable technological solutions are more vulnerable to cybersecurity risk and technological risk.

On the issue of cybersecurity risk, a bank from the North Africa region shared that, "COVID-19 imposed several challenges for all institutions, including on the part of cybersecurity. Our institution was prepared to work online, and with heavy control. This procedure reduced the stress and facilitated availing services to clients. The only challenge that remains is the process of monitoring daily security breaches and threats which is mainly dependent on the placement of sound technology and human aspect." A bank from the Southeast Asia region mentioned that, "Arising from digitalisation of the business environment, the bank must always continue to be vigilant on emerging risk from cyber threats and be equipped with updated and effective controls necessary to manage new techniques of attacks."

Interestingly, large banks gave the highest score (3.77) to cybersecurity risk, placing it on the top of the risk dashboard. Large banks are more concerned with cybersecurity risk, perhaps because they feel more exposed to cyber-attacks and breaches due to their greater presence in cyberspace. Smaller banks also gave the notably high score of 3.53 to cybersecurity risk, making it a chief concern for them as well. One possibility could be that they feel more vulnerable than in the past to cyber-attacks owing to weak or outdated information technology infrastructure or because they do not have a strong cybersecurity processes in place.

Moreover, highlighting the significance of technology risk, a bank from the Sub-Saharan Africa region stated that, "With the development of technology systems and their application in the banking business, banks have become more exposed to fraud, either because of the failure of regulatory systems to keep up with technological development or because of the deficiency of the human element and the lack of qualification to use technology, or because of the development of technology at a rapid pace exceeding the capabilities of banks in different countries. One of the bank's strategic initiatives in this area is to keep pace with developments in regulatory systems and training and qualifying the human element and raising its efficiency." It is noteworthy that technology risk is the fourth most important concern for both large and small banks, with a significant score of 3.50 and 3.41, respectively.

Liquidity Risk Maintains its Score

On the risk dashboard, perceived liquidity risk is another salient concern on banks' radar. In comparison to last year, the liquidity risk maintained the same score of 3.22. Overall, and following the introduction of new risks and the separation of cybersecurity and technology risks, liquidity risk is now in fifth place on the risk dashboard. However, it is further down the list, tied for ninth place, when it comes to large banks.

It is noteworthy that liquidity risk remains a significant concern for many Islamic banks this year. Although the regulators in almost all regions introduced various measures (e.g., reducing cash reserve ratios and offering concessionary repurchase arrangements for retail banks) to minimize liquidity risk for the banking sector, the economic distress caused by the COVID-19 pandemic is still posing a serious liquidity risk for some banks. A bank from the North Africa region put it this way: "The spread of COVID-19 has increased the severity of the economic crisis in the world. It has negatively affected the [bank's] established goals, and as consequential events of the pandemic and economic slowdown, the level of liquidity risk has increased for the bank."

Another bank from the North Africa region shared their strategy to mitigate liquidity risk, referring to the "Maintenance of high liquidity ratios that grants the bank a margin of safety in the face of developments as well as following risks limits and early warning indicators on a regular (monthly) basis. The bank hedges against risks concentrated in the sources of financing."

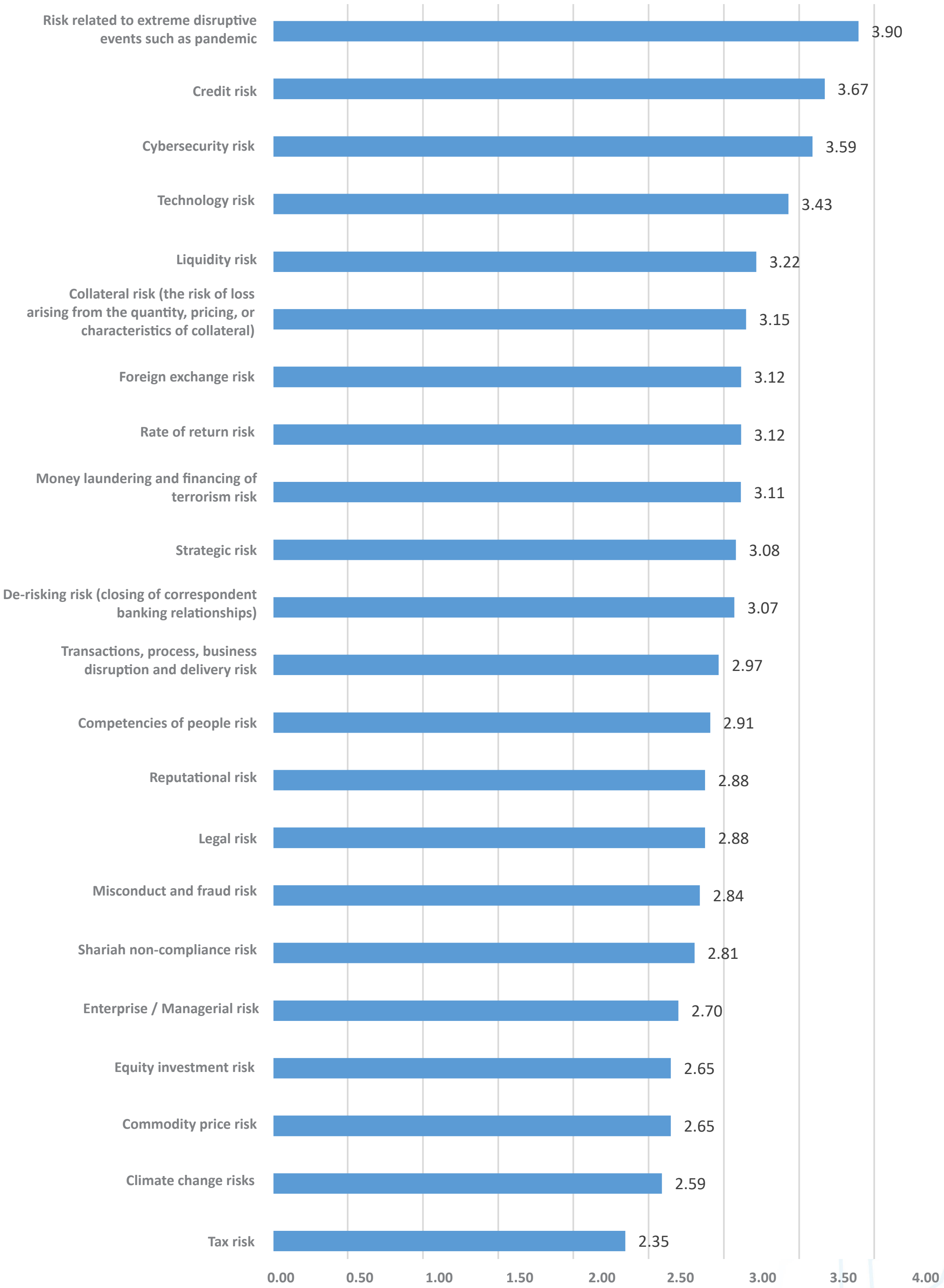
Equity Investment Risk at All-time Low

An encouraging result from the dashboard is that institutions remain relatively unconcerned with equity investment risk. This year, the equity investment risk hit the lowest of all time, with a score of 2.65. This indicates that perhaps banks feel comfortable in managing their capital market investments, or that they are limiting their exposure to capital markets owing to the current situation arise from the COVID-19 pandemic.

Tax Risk at the Bottom of the Concerning Risks

This year, tax risk scored 2.35, which is its second lowest score since the first edition of the GIBS. It is also noteworthy that since 2015, tax risk is of the least concern for most Islamic banks on the risk dashboard. This suggests that in the jurisdictions in which most Islamic banks operate, the tax systems do not place them at a disadvantage; or, at least, that acceptable ways or transaction forms can be found to mitigate any disadvantage.

Fig.11. Global Islamic Banking Risk Dashboard (2021)



Unique Differences by Geographical Region

A closer look at the regional data gives us a better understanding of how top risks differ by geographical location.

Keen Focus on Credit Risk

Credit risk is another featured top risk for several regions. A closer look at the regional data revealed that the Southeast Asia and Europe regions cited credit risk as their most important risk for the coming years with a score of 3.67 and 4.00, respectively. The GCC and West, Central, and South Asia regions listing credit risk as their second most concerning risk with high scores of 3.65 and 3.50, respectively. These high scores are likely owing to the highly volatile economic outlook as a result of the COVID-19 pandemic, where banks are anticipating credit losses in the near future and, in some regions, the continuing effects of low oil prices.

Rising Concern for Cybersecurity Risk

Consistent with the previous year's scores, the cybersecurity risk remained in the top three on the risk dashboard for Islamic banks in most (5 out of 7) of the regions. In recent years, losses from cyber-breach events saw an increase, directing banks' attention towards cybersecurity related risks. The concerns over cybersecurity risks are now more intensified owing to the COVID-19 pandemic where banks are offering additional online services and shifting their internal operations onto cloud-based platforms.

The banks in the North Africa region, with the highest score of 4.21, are the most concerned about the cybersecurity risk – possibly due to the increasing number of cyber-attacks in the region or their vulnerability to cyber-attacks because of weak or outdated information technology infrastructure. On the other side, Europe is the least concerned region on cybersecurity risk. This is perhaps because the banks are more confident in having strong cybersecurity processes and risk-mitigating strategies in place.

Table 3. Major Risks of Islamic Banks across Regions [2]

Geographical Breakdown	Top Concerns	Score
Group 1: GCC	Risk related to extreme disruptive events such as pandemic	3.94
	Credit risk	3.65
	Cybersecurity	3.29
Group 2: Middle East ex-GCC	Risk related to extreme disruptive events such as pandemic	4.11
	De-risking risk (closing of correspondent banking relationships)	3.89
	Technology risk	3.72
Group 3: Southeast Asia	Credit risk	3.67
	Technology risk	3.67
	Risk related to extreme disruptive events such as pandemic	3.67
	Liquidity risk	3.50
	Cybersecurity	3.50
	Reputational risk	3.33
Group 4: West, Central, and South Asia	Risk related to extreme disruptive events such as pandemic	3.73
	Credit risk	3.50
	Cybersecurity	3.38
Group 5: North Africa	Risk related to extreme disruptive events such as pandemic	4.21
	Technology risk	4.21
	Cybersecurity	4.21
	Credit risk	4.11
	Liquidity risk	4.11
	Money laundering and financing of terrorism risk	3.79
Group 6: Sub-Saharan Africa	Risk related to extreme disruptive events such as pandemic	3.57
	Cybersecurity	3.50
	Technology risk	3.25
	Credit risk	3.25
	Foreign exchange risk	3.25
Group 7: Europe	Credit risk	4.00
	Collateral risk (the risk of loss arising from the quantity, pricing, or characteristics of collateral)	3.25
	Liquidity risk	3.25
	De-risking risk (closing of Correspondent banking relationships)	3.00
Global	Risk related to extreme disruptive events such as pandemic	3.90
	Credit risk	3.67
	Cybersecurity	3.59

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

Banks’ Responses to Open-Ended Questions

In this year’s survey, we also raised some open-ended questions to allow banks to share their experiences with the effects of COVID-19 and initiatives taken, either suggested by government bodies or their own initiatives, to address the situation. Banks were asked to describe the implications of the COVID-19 pandemic on their institution’s performance and what actions the institution has taken or will take to recover from the identified implications. We also asked about changes in customer behaviour, about what strengths and weaknesses had been revealed in each institution by the implications of the COVID-19 pandemic, and what changes institutions were experiencing in terms of risk management in general and operational risk in particular.

Initiatives (by government bodies or institutions) to Ease the Economic Impact of the COVID-19 Pandemic

Most of the banks that responded reported that their governments and central banks have taken multiple initiatives to ease the economic impact of the COVID-19 pandemic. Initiatives common across many jurisdictions include: reducing profit/interest rates on monetary policy tools; reducing the limit for mandatory cash reserve on deposits with banks; directing banks to postpone payments and grant grace periods (without imposing extra charges) to customers affected by COVID-19; concessional financing to help small and medium enterprises; reducing the working hours in banks; and supervisory focus on business continuity plans.

In some jurisdictions, the governments also issued directives on social distancing and health safety measures for customers and employees of the banks; promoting electronic means to deliver banking products and services; and establishing a fund to support affected individuals and SMEs in the private sector. One jurisdiction also reported that the authorities formed a special committee to monitor and manage the performance of financing following the moratorium and directed banks to develop detailed business plans and risk strategies for 2021 in accordance with market sensitivity and economic condition to ensure the banks continue to grow amid the pandemic.

Regarding the banks’ own initiatives, in some jurisdictions, the banks took additional measures to ease the economic impact of the COVID-19 pandemic on society in general, and their customers in particular. For example, some banks postponed payments and extended grace periods for their customers, provided Qard al-Hasan (benevolent loans) to individuals and SMEs and donated monthly funds to support humanitarian and social activities.

Implications of COVID-19 Pandemic on Institutions’ Performance and Institutions’ Response

In another question, the banks were asked to describe the implications of the COVID-19 pandemic on their institution’s performance and what actions the institution has taken or will take to recover from the identified implications.

A bank in the GCC region mentioned that "Due to deferral of instalments, financing income has come down, but costs remain the same, which impacts the earnings." Therefore, the bank has "Deferred the variable costs, where possible and took multiple actions for recovery, for example, liquidity is being monitored closely, working towards digital banking channels, and automation of certain processes (where possible)."

Another bank from the region stated that "The COVID-19 pandemic has impacted all sectors which has in-turn impacted customer repayment ability resulting in higher provisions and ECL cost to the bank. With the second wave of lockdowns in the country, this will have a negative effect on many of the impacted sectors and is expected to continue into 2021."

A bank from the Middle East ex-GCC region stated that "The biggest impact [of the COVID-19 pandemic] is the postponement of the payments of due instalments, which increased the levels of risks and affected the liquidity ratios and the ability of the bank to provide financing. There are other effects as well, like COVID-19 infection of employees and the temporary closure of workplaces in the event of COVID-19 positive cases.

Therefore, to deal with the situation, the bank took the following measures:

- Activation of the business continuity team;
- Creation of COVID-19 precautions that adapted the working location, implemented flexible working hours, and facilitated working from home for employees who are most vulnerable to COVID-19 pandemic (e.g., employees who suffer from health problems and working mothers);
- Implementation of a number of measures to enhance liquidity indicators, the most important of which is the liquidation of a number of deposits invested with other banks;
- Implementation of Tawarruq financing for unpaid instalments, in compliance with the instructions of the Monetary Authority and under the approval of the Shariah Supervisory Board; and
- Updates to the business continuity plan to enhance the bank's ability to deal with scenarios of epidemics and disease cases."

In the Southeast Asia region, a bank stated that it is, "Expecting a slow growth in overall bank financing portfolio and an increase in overall impaired financing." To recover from these implications, the bank is, "Proactively identifying and monitoring potentially vulnerable customers and continues engagement with respective stakeholders. Moreover, the bank has also aligned the business plan and strategy with market sensitivity and economic conditions."

However, some of the banks, from different regions, believe that the COVID-19 pandemic has limited or no implications on their institutions. A bank in the Europe & Others region mentions that, "With its strong capital and portfolio structure, our bank plans to pass this period with minimal impact. Possible effects of COVID-19 were taken into account while determining the next period strategies. The bank will focus on the effective use of capital and customer productivity in the upcoming period."

Some banks focused their responses particularly on operational matters. A bank in Middle East ex-GCC region stated that "Until now, there was stability and not too much influence, but the COVID-19 pandemic has increased the health concerns and with this increase, the policies of closure and social distancing are applied which may have a harmful effect." Nevertheless, the bank has put some measures in place to address the situation, such as: "Issuing instructions aimed at protecting employees in compliance with precautionary measures; compliance with quarantine orders; and sterilization of offices, phones, and all surfaces in the bank."

Behavioural Changes in Institutions' Customers

When asked about the changes in the behaviour of institutions' customers, the banks shared their experiences and trends that were noticed in the time of the COVID-19 pandemic. In general, most banks are experiencing a surge in customers awareness and demand for electronic channels. A bank in the Middle East ex-GCC reported: "Customers' awareness of the importance of using the bank's electronic platforms and utilizing the capabilities of the DCC (digital call centre) has increased, which provides a wide range of services without the need for the customer to physically be present at any of the bank's branch."

A similar experience was shared by a bank in the West, Central and South Asia region, stating that: "The banking industry in the country promoted digital banking during the pandemic to raise the awareness of technology which provide easy access to pay utility bills, mobile bills and also give various discounted offers on e-commerce platforms. We witnessed a more than 25% increase in customers' transactions routed through digital banking channels." Another bank from the region mentioned that "In the COVID-19 situation, customer behaviours massively changed. Customers demanded increases in online services like internet or mobile banking & SMS banking etc."

In the GCC region, a bank stated that "A significant rise in mobile and digital-related services is noticed. The e-banking platform saw a rise in customer transactions. Additionally, the bank also launched a new mobile application to encourage customers to bank online. The mobile app allows users to instantly open an account directly from their mobile phones while reducing the need to physically visit a branch. The bank also recently launched a new service that allows customers to transfer money to various countries around the world almost instantly."

Some banks also reported changes in customers' financial behaviour. One bank, from the Middle East ex-GCC said that "At the start [of COVID-19], we noticed that many customers withdrew part of their savings in order to keep it in cash for fear of any difficulties in the liquidity of banks, but this trend soon stopped after the banks were able to convince their customers of their ability to provide liquidity in the current situation regardless of the effects of the pandemic." Similar behaviour was reported by other banks, some of which noted a subsequent increase in savings, perhaps due to more limited opportunities to spend. Another bank from GCC shared that: "There was a reduction seen in demand for financing products due to concerns about meeting people outside and movement restrictions placed during this time by the government. There is an increase in delinquencies due to job loss, income reduction, unpaid leave, etc."

Strengths and Weaknesses of Institutions in the Time of COVID-19

We also asked banks to describe their strengths and weaknesses discovered in the wake of the COVID-19 pandemic. The banks' responses, in general, show that the main weakness that appeared is related to their inability to meet increasing customer's demand for digital or mobile banking services. As to strengths, the banks believe that their quick response and flexibility to adopt new operational measures (e.g., remote working, operational hours, social distancing policies, and commitment to wear masks and gloves) are turning out to be the strength in the time of COVID-19 pandemic.

In the GCC region, a bank stated: "Our bank showed great ability in adopting new work models and procedures with the same efficient and secure infrastructure it had before the pandemic. However, the bank needs to pay more attention to e-services solutions."

Similarly, another bank from the region mentioned the following strengths:

- "Technical capabilities that the bank maintains, which enabled it to provide virtual work platforms that helped employees perform their tasks away from the real work environment;
- The bank's financial solvency and its ability to tolerate the economic and health impacts of a pandemic in an acceptable manner;
- The credibility of management, the strong relationship with customers, and their trust in the bank, which curbed withdrawals of funds;
- Close supervision of the Board of Directors and executive management of events and follow-up of any financial deviations immediately and with interest; and
- The strong relationship that binds the bank with the monetary authority and other banks."

The bank also identified some weaknesses:

- "The approved business continuity plans did not go into much detail in the COVID-19 scenario, so the contingency plans were gradually built after taking into account new observations and parameters;
- With the exception of the alternative worksite, there was no prior preparation for many locations in the bank to receive employees and enable them to perform their duties far from their original workplace; and
- The level of customers' awareness of electronic services and their risks was not at the required level, which was realized by the bank by intensifying and diversifying methods of communication with customers to raise their level of awareness and commitment."

A bank from North Africa region said that "The strengths of the bank represented in the readiness of the technology infrastructure, which provided workers and customers with online communication to conduct transactions through technology. Whereas the weaknesses are represented in the difficulty in implementing investment and financing (credit) transactions."

In the GCC region, another bank shared: “The weakness was the limited infrastructure towards e-banking and delivery mechanism, which is being considered to be an important factor to overcome and propel the business growth. On the strength side, the bank was very comfortable in the liquidity position, which is due to regular monitoring in place.”

A bank in the Southeast Asia region identified the following points as their strengths in the COVID-19 pandemic:

- “The swift response of action to introduce work from home alternative or remote working arrangement; and
- For financing portfolio, bank’s customers are among the government sector with low risk of payment method."

In regard to weaknesses, the bank identified that:

- "Communication between bank staff is limited as work from home arrangements require them to use personal devices i.e., mobile phone instead of landline making them unreachable; and
- Communications with customers are sometimes limited due to certain areas in the country being under lockdown.”

Changes in Risk Management

The survey also asked banks to share their experiences in terms of changes in risk management in general and operational risk in particular due to the COVID-19 pandemic. The findings show, in general, that most of the banks experienced challenges in risk management which were to mitigate credit risk, investment risk, collateral risk and liquidity risk. In some cases, this has led to changes in processes. Moreover, operational risk, in particular, is also posing multiple challenges where the banks are experiencing technology risk, cybersecurity risk and significant business disruption and delivery risk.

In regard to risk management in general, a bank in Middle East ex-GCC region stated that “The bank has increased the levels of supervisory controls and continuing commitment checks as well as setting the highest levels of technical protection for systems.” In the North Africa region a bank said, “The bank is working to reduce the absolute level of risk as changes related to risk management include in hedging against liquidity risk and the return from financing, price changes and market fluctuations.”

In relation to operational risk, a bank from the GCC region shared that, “The bank was quickly able to adapt and move to work-from-home model without impact to the day-to-day functions and none of the operations are impacted. Process-oriented risk departments such as collections and credit underwriting were able to seamlessly move to work-from-home. The bank was able to quickly react to the situation and was able to roll out multiple relief programs in a short period of time to assist customers impacted by the near to medium-term impact on income. This involved approval of new programs along with cooperation from multiple units within the bank, such as risk, collections, customer service, credit, operations, Shariah, legal, etc.”

A bank from the Middle East ex-GCC region stated its experience in addressing operational risk mentioning that, "COVID-19 has generated new operational risks, where each employee has become a risk to the organization, the bank has adopted a health policy in line with international standards to avoid these risks." A bank in the North Africa region shared that, "In relation to operational risks, the bank is managing event risks, payments risks, technology and systems risks."

Another bank from the same region stated that, "Before the emergence of the COVID-19 pandemic, the bank began providing PCI (Payment Card Industry) requirements, and during the period, the network protection procedures were strengthened to prevent breaches, and there was also a significant increase in the digital services provided through the bank's website. In addition to providing sterilizers and other preventive means, workplaces are sterilized from time to time, especially those in which cases of infection appear. The capabilities of the emergency teams were strengthened, and alternative communication channels were provided with the network in the event that some employees were required to work from home."

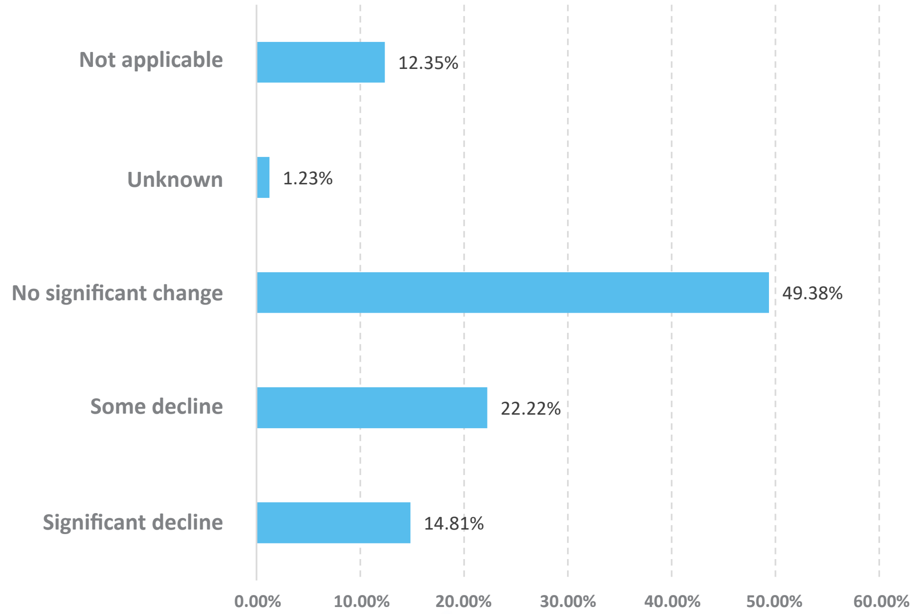
De-Risking Effects in Perspective

De-risking risk deals with the possibility of being cut off in correspondent banking relationships due to the perception of having too high a risk profile. From the correspondent's point of view, concerns may be solely about the profitability of the relationship but are often about perceived risks of money laundering, terrorist financing or sanctions breaches, and the compliance costs of preventing these. Concerns may be specific to the bank but may also be about the jurisdiction in which it is located. A possible loss of correspondent relationships has been a concern for some years, and we have therefore been tracking banks' perceptions of this risk. Last year, the de-risking risk score declined slightly to 3.02, but this year rebounded to 3.07, marginally below the figure for 2019.

To fully explore the issue of de-risking risk and to understand its effects on banks' strategies in the past year, we asked Islamic banks, "To what extent did your institution experience a decline in correspondent banking relationships (CBR) as a result of de-risking over the last year?"

The results show that about 15% of the responding banks said that they had witnessed a "significant decline" (as compared to about 18% in 2020), while about 22% stated that they had experienced "some decline" (2020: 13%) and around 12% of respondents said that the question is not applicable to their bank (2020: 35%). Moreover, it is interesting to note that this year almost half of the respondents (around 49%; 2020 33%) said that they had witnessed "no significant change" in their correspondent banking relationships as a result of de-risking measures that had been taken.

Fig.12. **Decline in Correspondent Banking Relationships (CBR)**



Large banks were less affected than small ones, with no large banks reporting a significant decline and 58% reporting no significant change.

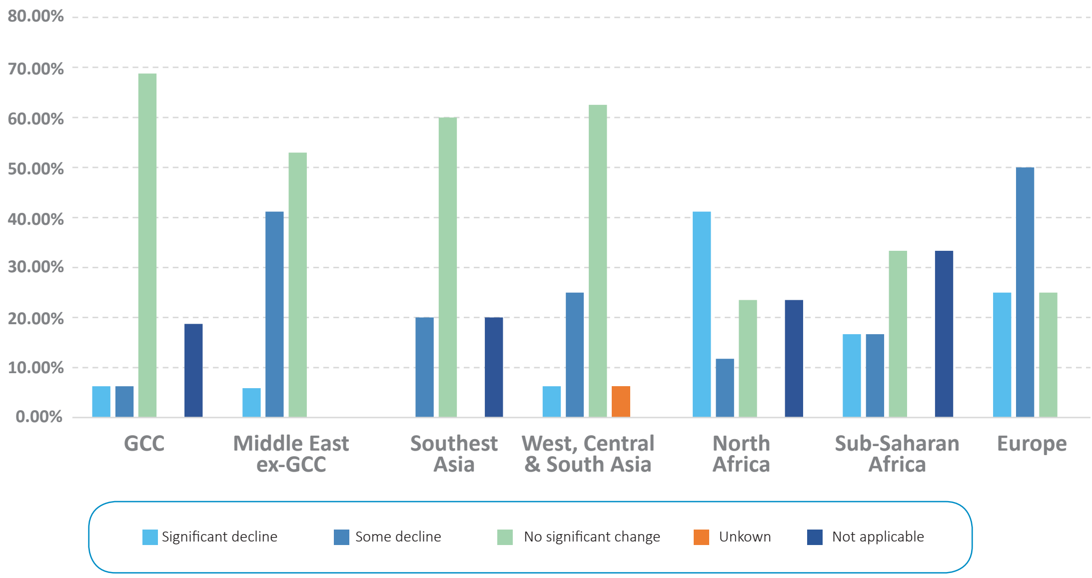
Regional Breakdown of De-Risking Effects on CBR

As we might expect, the breakdown of geographical location paints a more vivid picture. Of the banks who reported “significant decline” or “some decline”, the region most affected was North Africa followed by Europe. Among Islamic banks in Europe & Others, 25% of respondents reported a “significant decline”, while 50% reported “some decline.” This means that three out of the four Europe & Other respondents have seen negative effects from de-risking measures. The most substantial impact in terms of numbers, however, was in North Africa, where 41% of Islamic banks reported a “significant decline” and 12% reported “some decline.” This is somewhat surprising because one might have expected that the easing of sanctions on Sudan would have led to an improvement in correspondent banking relationships there.

Islamic banks in the West, Central, and South Asia region indicated that 63% of banks had experienced “no significant change”, with the balance split between “some decline” (25%), “significant decline” (6%), and “unknown” (6%). The Sub-Saharan Africa region had a similar experience with 17% of respondents reported a “significant decline”, while 17% reported “some decline” in CBR in consequence of de-risking over the last year.

Finally, Islamic banks in GCC appeared to be the least affected in this case, where only 6% had seen a “significant decline”, and 6% reported "some decline", while 69% had seen "no significant change" in CBR in consequence of de-risking over the last year.

Fig.13. Decline in Correspondent Banking Relationships (CBR) across Regions

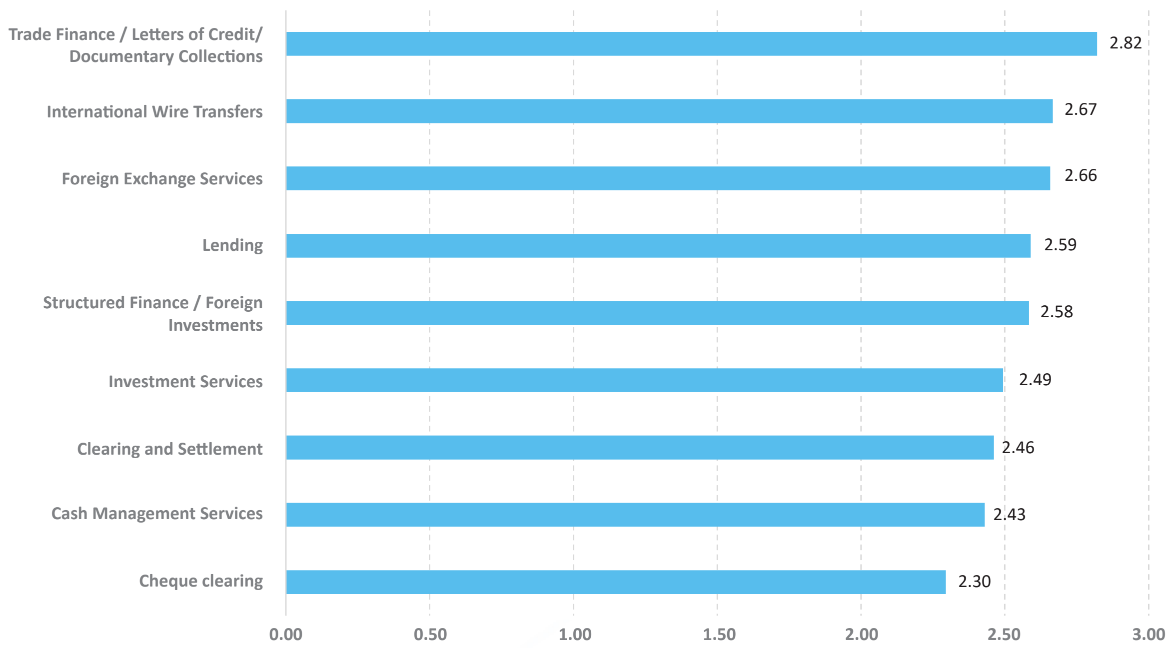


De-Risking Effects on Products and Services

The survey went on to probe further for details about how de-risking had affected the products and services of the bank. The loss of correspondent banking relationships can impact various banking products and services, for example, trade finance and conducting foreign currency-denominated capital, international wire transfers, check clearing and settlement and cash management services. We asked Islamic banks, "To what extent were the following products and services affected in your institution as a result of de-risking (closing of correspondent banking relationships)?" with values ranging from 1.00 "not affected at all" to 5.00 "significantly affected".

This year, the findings showed that the service most affected was trade finance / letters of credit / documentary collections, with a score of 2.82, followed by international wire transfers as the second most affected with a score of 2.67 and foreign exchange services in third place at 2.66.

Fig.14. De-risking Effects on Products and Services



There are some changes in the order from last year when international wire transfers were most affected. However, the most significant change is that all the figures have materially declined. It is difficult to square a perception of slightly increased risk with a reduction in impacts across the board, but this may be an artefact of questionnaire design.

PART III:

Future Landscape of Islamic Banking Sector

Part III. Future Landscape of Islamic Banking Sector

Because this year marks the 20th Anniversary of CIBAFI's existence, we decided it was appropriate to use this survey to look forward and invite respondents to think about how the Islamic banking sector might develop over a longer period than our usual focus of three to five years. We chose a period of 10 years, which far-sighted executives can still reasonably contemplate even in the present uncertain times. We also used a number of open-ended questions to avoid conditioning the responses too greatly by the Secretariat's inevitably limited perceptions of what the future may hold.

Because of the different situation of Islamic banks in different regions and jurisdictions, we expected that responses would also be very different. This is what we have found, and we therefore report some parts of this section in a more granular way than usual.

In addition to analysis conducted on the results of the survey, we have invited some industry leaders to write special articles on specific area of Islamic finance. These articles represent the perspectives of their writers regarding the future of the industry.

Transforming IsDB Member Countries' Economic and Finance Development in the Post-COVID-19 Era

H.E. DR. BANDAR M. H. HAJJAR
President, Islamic Development Bank (IsDB) Group

Introduction

The global economy has experienced unprecedented challenges with the emergence of the COVID-19 pandemic, which led to a global lockdown. Many countries responded to the pandemic by implementing extraordinary precautionary measures, leading to the closure of entire sectors, which stressed global food supply chains, decreased raw materials prices, and created logistics network disruption. IsDB member countries have also been affected by the pandemic and the IsDB Group has since been actively pursuing initiatives (including through Islamic finance) to help achieve fast economic recovery of its member countries.

IsDB Group's Role During the Pandemic

In line with its socio-economic development mandate as a Multilateral Development Bank (MDB), IsDB Group responded to the outbreak of COVID-19 with the launch of a US$ 2.3 billion Strategic Preparedness and Response Package (SPRP) that considered short, medium, and long-term requirements of its 57 member countries based on a three R's framework: Respond, Restore, and Restart tracks.

The IsDB Group deployed all available financing instruments to channel the funds to support its member countries quickly. In fact, this facility extended financings, grants and insurance to both the public and the private sectors to reduce the spread and the impact of the pandemic within the IsDB member countries.

To ensure the transparency and governance of this process, the IsDB also launched the COVID-19 Global Coordination Platform enabled by blockchain technology to support the member countries in the fight against the COVID-19 pandemic. This coordination platform encourages partnerships to initiate joint efforts to counter COVID-19 implications. For instance, under the joint partnerships and cooperation initiative, the IsDB Group, along with the Arab Coordination Group (ACG) comprising Arab development institutions, pledged the sum of US$ 10 billion to help countries to mitigate COVID-19 effects. So far, about US$ 8.6 billion has been approved/committed by the ACG institutions in various projects and programs and under different financing schemes.

In recognition of the crucial role of Science, Technology and Innovation (STI) in enhancing our member countries' response to the pandemic under COVID-19 SPRP, the IsDB has also undertaken several actions such as mobilizing several global partnerships on STI-based COVID-19 innovative solutions from key health partners operating in the field of diagnostics and healthcare technology delivery (to immediately respond to shortages of essential healthcare supplies and strengthen local production capacity of medical health care products and pharmaceuticals).

IsDB's New Financing Approach Focusing on Impact-based Development

As a longer-term impact-based development measure, the IsDB has also launched its new business model which focuses on helping member countries create sustainable socio-economic development that can resist disasters of all kinds. The first step in this direction was to identify the member countries' actual needs and the sectors in which they enjoy comparative advantages. The goal is to create added value and decent job opportunities for the 100 million youth joining the job market by 2030.

In this regard, the IsDB has launched a renewed version of the Member Country Strategic Partnership (MCPS) Agreement, based on the Global Value Chain (GVC) notion. This focus on value chains allows the Bank to prioritise its projects in areas with highest impact and at the same time provide greater opportunity for countries to be interconnected through the GVCs. Currently, we have 25 countries on the list of new partnership agreements to be implemented over the coming years.

Future of the Banking Industry and Role of Islamic Finance

Within the discussion of economic and financial development, the IsDB also considers the Islamic finance industry and its instruments as critical enablers of achieving growth and development objectives. Islamic finance with its risk-sharing principles, ethical dimensions and mutual solidarity and in-built social finance elements is well-suited to counter adversities during challenging economic times such as this COVID-19 pandemic.

The financial services industry is one of the critical infrastructures of a country's development; however, it has been facing some challenges and transformation since the global financial crisis of 2007-08. This trend will continue as in the coming decade, a new wave of disruption will likely unfold with technology being a game-changer. Developing technologies such as blockchain and quantum computing offer unique opportunities for financial services companies to operate seamlessly, while improving efficiency.

On the other hand, demographic changes across the globe will also have an impact on the offerings by the financial sector. In particular, the Gen Y, Gen Z and millennial population brackets are evolving the marketplace with their preference for technological solutions.

With the expansion of social media, e-commerce and digital marketplace, consumers are expecting more rapid and personalized transaction and shopping experiences. Led by the millennials, businesses are transforming their processes in terms of how products and services are formulated to attract and retain customers, and the financial services industry is not immune from such demands.

The IsDB Group believes the next generation of financial services will be focused on moving surplus capital across the value chain faster and more efficiently and transparently. The advancement of technology infrastructure, changing customer demands, development of real-time transactions, and need for economic growth have had deep impacts on the financial services ecosystem.

The Islamic finance industry needs to adapt to emerging technologies to enable financial access. This will require Islamic banks to collaborate with technology companies to improve market access and empower financial inclusion. Moreover, the Islamic finance industry needs to speed up the launch of new finance platforms such as crowd funding and peer-to-peer financing platforms to enable micro-development (i.e., pull in investments for SMEs and support development of small-scale projects).

The IsDB also considers a “development partners” approach to be key to future success. In such an approach, Islamic banks can play a key role in engaging with MDBs, Governments, Public Sector Organisations, etc. to structure public and private partnership investments for supporting infrastructural development of member countries.

In all of the above, the underlying pursuit of the UN Sustainable Development Goals (SDGs) and concerns about climate change and social impact remain key for all industrial sectors and the financial institutions too need to reprioritize their role in the society and contribute to sustainable development. These universal objectives are enshrined in the Maqasid Shari'ah that are the guiding principles of Islamic finance. The Islamic financial institutions in the coming decade need to reevaluate strategies to put forward solutions inline with the Maqasid Shari’ah which are, by default-setting, in line with the pursuit of many of the SDGs.

IsDB Group’s Support for Islamic Finance

The IsDB Group prioritises Islamic finance development as a core strategic pillar in its 10-Year Strategy Framework. Over the years, IsDB has supported the development of the Islamic Financial Services Industry, particularly Islamic banks, through various initiatives. These initiatives include equity investments, technical assistance, capacity building activities, development of Islamic financial products/funds as well as the development of long-term policy frameworks jointly with other international organizations.

The IsDB Group continues to look for newer ways to support the global Islamic finance industry's development. One such initiative is the recently launched Islamic Finance Country Assessment Framework (IF-CAF) program. IF-CAF will provide an early indication of the strengths and weaknesses of a country's Islamic finance ecosystem. This framework will enable IsDB to use a prioritization matrix to identify the most high-impact Islamic finance technical assistance and advisory opportunities. This project is expected to continue on a long-term basis to cover all 57 IsDB member countries as well as support the Bank's MCPS / GVC initiatives.

Another related project to be launched in 2021 is the Islamic Finance Impact and Strategy Assessment Program (IFISAP). IFISAP aims to assess the impact of past Islamic Finance Technical Assistance and Advisory interventions in member countries and propose newer strategies for improvement in future interventions. Part of this program will include evaluation of the Islamic finance development globally through IsDB interventions and developing improved Islamic finance technical assistance and advisory mechanisms to generate value-chain based economic development of member countries through the Islamic finance industry.

Collectively, the various IsDB Group interventions have paved the way for introducing and strengthening Islamic finance across the world by creating the requisite enabling environment consisting of legal, regulatory and supervisory frameworks and building local capacities and transferring knowledge.

Closing Remarks

The COVID-19 pandemic has amplified the development role to be played by MDBs and other international financial institutions. In addition to achieving the development goals set before the pandemic, there is an urgent need to reverse the adverse economic, financial and social effects created by the pandemic. In such a context, one lesson that we can learn is that we need to develop tools and products that carry ethical values, integrate profitability with environmental and social impact, and establish financing institutions for all segments to achieve justice and fairness.

In this regard, we at the IsDB Group view Islamic finance as having an essential role to play in supporting the recovery efforts of our member countries. In this regard, we look forward to the findings of the CIBAFI Global Islamic Bankers' Survey Report 2021 to understand the nature of challenges of Islamic banks. We at IsDB are always ready to support the Islamic finance industry through innovative solutions and appropriate interventions.

Section A: Islamic Banks' Growth and Expansion

We asked how respondents saw the growth and expansion of their own institutions and the global Islamic banking sector in general in the next 10 years, and what the factors affecting that growth would be.

In general, respondents were optimistic about their own futures, and about the industry in general. Their views of the factors affecting growth naturally depended on the situation of their own jurisdiction, and of Islamic banking within it.

One particularly comprehensive analysis from a well-established bank in the GCC was as follows:

- "The popularity of Islamic banking is on the increase not only in our country but across the globe. Today Islamic banking is just not restricted to the Muslim community, and it has a wide and growing appeal. Increasing acceptance of Islamic finance of the non-Muslim section of society will be a key driver.
- The growth in the halal industry is likely to have a positive effect on the Shariah-compliant banking industry. Sectors such as Islamic healthcare, fashion, cosmetics and other related products are expected to grow at unprecedented rates thereby supporting the growth narrative of the halal industry and the Shariah-compliant banking industry.
- Increasing standardisation particularly in Shariah interpretation and legal documentation is expected to drive operational efficiency in the medium to long term and support further innovation within the industry. Various industry bodies and standard setters in the industry are working together to advance this agenda globally.
- The goals or objectives (Maqasid) of Shariah share some links with ESG considerations and the broader aim of sustainable finance. The onset of responsible financing gaining momentum, is likely to increase the demand for Islamic banking products and services.
- With Islamic banking relatively well-penetrated in the Middle East and Southeast Asia, new emerging markets such as North Africa and the Commonwealth of Independent States (CIS) countries will drive growth. Active efforts on the regulatory landscape and strategic initiatives in these markets will drive growth.
- Technological advances will reduce operational costs therefore allowing Islamic financial services providers to reach the underserved markets with more affordable digital financial services."

Another comprehensive analysis, this time from West, Central, and South Asia, read: "Our bank has a positive growth trajectory for the next 10 years. The bank is expected to grow many folds due to various strategic initiatives taken in the recent past, and the bank has been able to overcome a lot of challenges.

With respect to the global Islamic banking sector, growth in numbers and market size is an objective, however more meaningful growth for Islamic banking required is in terms of developing a strong Islamic banking governance framework.

The factors affecting such a growth are:

- Training and development – development of theoretical concepts and the right mindset;
- Focus on research and innovation;
- Support from regulatory, legal, accounting and taxation systems;
- Understanding of emerging technologies and Shariah implications of transactions executed through these technologies;
- Ability to transform Islamic financing modes to be executed through systems and mobile devices rather than paper format documentation;
- Developing financing products which cater for personal financing needs (education, health, marriage, home appliances etc.)."

A bank in North Africa said: "[For] rapid growth and wider spread of the Islamic banking industry and an increasing acceptance of its products in the global banking markets, the most important factors that will affect the growth are:

- Regulatory and supervisory frameworks such as: laws, legislation and regulations;
- The ability to prepare qualified trained staff;
- Product diversification and development;
- Improving service quality ;
- Control of credit, operational and compliance risks;
- The challenge of digitalization."

The factors set out in these analyses recurred in many others.

For some banks, however, jurisdiction-specific issues were dominant. For example, Sudan, with an entirely Islamic banking system, is becoming more open to the global financial system after a period when it was effectively cut-off by sanctions.

One analysis from a bank there said the following:

"It is expected that the bank will expand through electronic channels, in a way that will enhance financial inclusion. It is also expected to strengthen the capital base, increase the volume of resources and enhance digital transformation.

It is expected that the growth rates of the global Islamic banking sector will continue, with rates that are not less than the current, in addition to keeping up with the requirements of electronic transformation that were needed during COVID-19.

Factors affecting the level of the bank are the entry of huge institutions to the Sudanese market which requires intensifying work to keep up with technology and improved products and services also allowing the entry of advanced systems after the ban on Sudan was lifted.

At the global level for the Islamic banking sector, there is no doubt that is it not isolated from the technical development and innovation that the banking industry is witnessing in addition to the ability of the Islamic banking system to deal with the crises afflicting the global economy as well as the need for Islamic financial services and products according to the prevalence of Islam and an increase in the number of Muslims."

Some banks in Sub-Saharan Africa and in the Middle East ex-GCC cited political and economic instability in their countries, or international constraints on those countries, as factors inhibiting their development. A bank in West, Central, and South Asia was also concerned about possible political instability there following the impact of the COVID-19 pandemic on its country's economy.

For some banks, their view of the future was particularly driven by their own competitive positioning. One bank, which believed it had the opportunity to become a regional champion, said:

"Our Islamic banking window is set to grow a very fast rate with possibilities of rolling out the products to subsidiaries within the region. We expect the balance sheet and profit to more than triple in the next ten years."

Another bank, aiming at a different strategic niche, said: "We [bank] see a continued extraordinary growth and expansion of our bank in the next 10 years, since it is the only player in this ultra-micro business. And with our focus in digital banking, this means an extraordinary possibility for continued growth and expansion."

Although several banks mentioned technology and digitalization, for only a few did this appear to be the dominant factor. For several, this issue was couched in terms of keeping up with developments in the conventional industry. For a small number, however, it did appear as an opportunity to challenge that industry. One bank in the GCC said: "In our view, Fintech disruption would be a key opportunity to service, support and attract new segments including the regional unbanked and underbanked. Millennial and Generation Z customers will continue to play a significant role in the growth of Islamic finance within the next 10 years. According to third party projections, this younger segment is expected to contribute to as much as 75% of total bank revenue by 2030. Our institution would focus towards increasing its global footprint through our Islamic finance franchise within our presence countries. A key theme would be an Islamic banking digital offering to corporate and retail customers."

We also asked about the key pillars of the banks' strategies to develop over the next 10 years. Some banks said that they had no such longer-term strategy, sometimes citing an uncertain environment as a reason why no such strategy could be developed. Others responded in very general terms, or in terms which echoed the analyses already quoted.

One of the most comprehensive responses, from North Africa, gave the strategy as:

- "The expansion of bank branches;
- Developing the internal work system and infrastructure, focusing on the field of information technology, which allows the development of more digital services and enhances the bank's ability to create new sales channels in order to attract new customers;
- Creating new products and services with a competitive advantage;
- Introducing banking products and services through the media;
- A marketing strategy aimed at spreading the culture of Islamic banking awareness and deepening confidence with the public;

- Coordination and cooperation with Islamic banks operating in the local and international banking market; and
- Development of Islamic banking awareness in cooperation with universities, institutes, graduate school students who wish to pursue their specialization in Islamic banks to provide appropriate support for their research projects."

A GCC bank stated its development strategies as follows:

" Drive sustainable growth- enhancing its products and services propositions in order to increase share of wallet from customers and capture higher non-funded income growth.

Digital and analytics advancement - introducing state-of-the-art digital solutions through the launch of a digital bank proposition for its commercial and retail customers, enhancement of digital platforms for wholesale and commercial customers as well as upgrade of its core banking, data and analytics capabilities.

Customer centricity - continuously working on re-engineering key processes, improving critical customer journeys, and instilling a "customer first" mindset across the organization.

Smart risk management - strengthen its control framework and reinforce strong standards of governance by proactive risk policy management, setting up market leading risk and control infrastructure and practices and implementation of risk-aware culture.

Enhance human capital strength - strengthen organizational culture, promote agility and empowerment, invest in upskilling of its staff, redesign organization structure, roles and responsibilities, and invest in human capital tools that will support its strategic aspirations."

Employees are at the heart of the bank's operations and therefore any issue that could affect the workforce system will have serious implications on the bank's operational and organisational aspects which could go beyond the institutional boundaries and impact the financial system. The COVID-19 pandemic brought numerous changes that disrupted the banking workforce and raised challenges associated with the adoption of remote work and the health of the employees.

Islamic and conventional banks are both exposed to these challenges and in addressing them to safeguard the workforce, ensuring employees' well-being, which is related to Maqasid Shariah, and the organizational and operational stability.

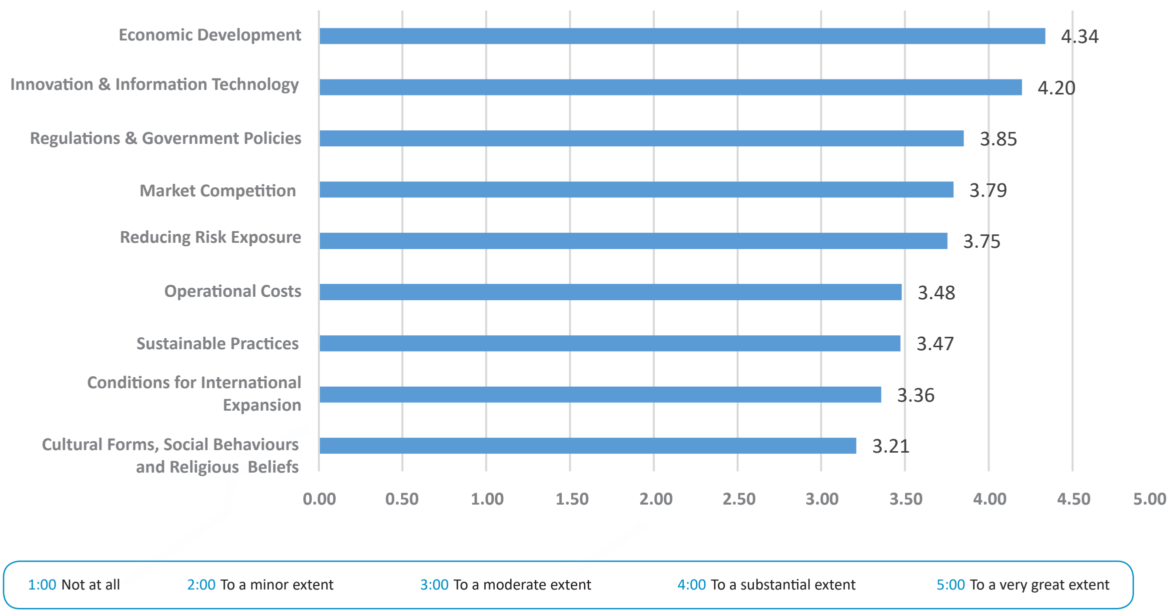
To adapt to these changes and maintain the role of the bank as a wheel of the economy, it is necessary to devise and implement strategies that can help in addressing the contemporary challenges faced by the bank's workforce. Below are some of the strategies and actions that can be implemented:

- Improving the business continuity planning strategy to include facilitating the remote work and ensuring its efficiency by making use of technology while preserving a high level of security.
- Adopting an agile approach of working and rapid change culture.
- Ensuring employees well-being by reinforcing safe health practices and providing access to medical care.

- Updating the IT infrastructure to handle the new working mode and providing the needed training to employees.

We complemented the open-ended questions with a follow-up question asking to what extent specific factors would impact the institution's growth and development. The responses are shown in Figure 15. Perhaps unsurprisingly, economic developments were top of the list, with innovation and information technology in second place.

Fig.15. **Factors Impacting Institution's Growth and Expansion in the Next 10 Years**



Human Capital Development in Islamic Finance

PROFESSOR DATO' DR. AZMI OMAR
President and CEO, International Centre for Education in Islamic Finance (INCEIF)

The need to build a large pool of qualified and competent Islamic finance professionals, Shariah experts, academicians, researchers, and trainers is paramount for the continuous development of the Islamic finance industry. The industry, which began in the 70s, has now reached US$2.9 trillion at the end of 2019 and is expected to grow further to US$3.7 trillion by the end of 2024. If we look at, say, ten to fifteen years ago, the Islamic finance industry was faced with numerous challenges including lack of supervisory and regulatory framework, limited accounting, Shariah and prudential standards, and lack of qualified human capital. Today although the issue of supply of human capital to the industry is to a certain extent resolved due to the significant number of Islamic finance education providers, the issues of quality of human capital and relevancy of programmes to match industry needs continue to beset the industry.

According to the various issues of the ICD-Refinitiv Islamic Finance Development Report, the number of Islamic finance education providers increased significantly from 477 in 2014 to 972 in 2019, an increase of 100%. These providers offer academic programmes from bachelor's degrees up to Ph.D. level, and some offer professional certifications and various specialised training programmes. Indonesia is by far the leader, with 347 institutions offering Islamic finance programs, followed by Malaysia (65), United Kingdom (55), UAE (52) and Pakistan (45).

Unlike others, countries such as Bahrain, Malaysia, UAE, and more recently Indonesia, took a more strategic and structured approach to develop Islamic finance talents for domestic and global needs. Bahrain established the Bahrain Institute of Banking and Finance (BIBF) and hosted CIBAFI, AAOIFI and IIFM. Malaysia established a number of dedicated institutions with specific mandates for education, research, training, and accreditation in Islamic finance. These include the International Centre for Education in Islamic Finance (INCEIF), International Shari'ah Research Academy for Islamic Finance (ISRA), Islamic Banking & Finance Institute Malaysia (IBFIM), Association of Shariah Advisors in Islamic Finance (ASAS), Chartered Institute of Islamic Finance Professionals (CIIF) and Financial Accreditation Agency (FAA). Malaysia also hosted IFSB and IILM. UAE or more specifically, Dubai, established the Dubai Islamic Economy Development Centre; meanwhile, Indonesia created a National Committee for Islamic Economy and Finance chaired by the country's President.

The recent advent of the COVID-19 pandemic has impacted the Islamic finance industry and Islamic finance education providers in many ways. Deloitte identified a number of megatrends that have accelerated due to the effects of the COVID-19 pandemic on the financial sector (2021 Banking and Capital Market Outlook).

We are now witnessing a rapid acceleration of digital adoption, workspace moving from physical to virtual, a focus on health, safety, and surveillance issues, and a concern for sustainable finance agenda – to name a few.

Looking ahead, human capital development in Islamic finance cannot remain static but must stay relevant to the requirements of the industry and the effects of the COVID-19 pandemic. To develop the right talent pool, industry players, academics, and talent developers must collectively re-evaluate and refine the learning and development requirements, anchored in incorporating new learnings and more understanding of businesses that translate into value-added services to clients and society and addressing gaps in skills and competencies required to support the industry's direction. Apart from technical knowledge, human skills and behaviours such as critical thinking, problem solving, creativity, innovation, teamwork, and resilience and agility and including digital fluency and analytics are some of the requisites of Islamic finance professionals. New emerging areas such as Islamic Fintech, Islamic social finance (Qardhul Hasan, Zakat, Sadaqah, and Waqf) and sustainable finance are some of the important additions to the required skills and knowledge. Besides, the overall framework to develop the talent pool should be based on a Maqasid Shariah approach to economics and finance.

For Islamic finance education providers, they will need to consider some of these actions and strategies to produce the required talent:

(i) Establish partnerships with the Islamic finance industry to incorporate industry requirements into the curriculum.

(ii) Appoint senior leaders of the Islamic finance industry as Adjunct Professors and Professors of Practice. These professors will bring their wealth of experience into the classroom thereby bridging the gap between theory and practice.

(iii) Consider Action Based Learning instead of internship as a way to provide industry experience to students. Here at INCEIF, we collaborate with industry partners to identify challenges face by them and get our students to undertake the analysis and design applicable solutions to those challenges.

(iv) Learning methodologies in this current and post-COVID-19 pandemic will no longer be the same. Islamic finance education providers must invest in and implement a hybrid learning model to incorporate in-person and online learning.

At the same time, Islamic finance industry will have to continuously invest in the talent development of their staff. They will need to reskill, upskill and retrain their staff. The action and strategies could include:

(i) Forming partnerships with Islamic finance education providers to develop customised programmes to meet company needs.

(ii) Redesigning the traditional learning & development models to create a more immersive learning environment.

(iii) Implementing a hybrid learning model to incorporate in-person and online learning.

(iv) Augmenting corporate training programmes with massive open online courses and other externally available content.

In conclusion, a collaborative approach bringing Islamic finance education providers, the Islamic finance industry, accreditation body, and regulators can bring a significant change to the quality of the education programmes and its graduates. Collectively, these efforts will produce the desired human capital for the industry based on the Maqasid Shariah approach referred to earlier.

Section B: Policies and Regulations within the Islamic Banking Sector

We asked respondents for their evaluation of the policy and regulatory frameworks in their jurisdictions, and the benefits, challenges, limitations, and gaps in them.

Some jurisdictions, for example in Sub-Saharan Africa, clearly had very limited frameworks, though in some cases banks evaluated them as appropriate to the nascent stage of Islamic finance in those jurisdictions. Nevertheless, one common challenge seen was that frameworks devised for conventional banking were being applied without consideration of the needs specific to Islamic banking. An example of a problem with this came from a jurisdiction where the law forbade banks from dealing in movable or real estate by buying, selling or bartering – a clear problem given the dependence of Islamic banking on trade-based contracts such as murabahah and ijarah. A related issue, though at a higher level of development, was a lack of Shariah-compliant tools available to some central banks for use in liquidity management and other market interventions.

Banks in more advanced jurisdictions, especially in the GCC and Southeast Asia, appeared reasonably content with the regulatory and policy frameworks, though they would like to see more consistency across jurisdictions and also in effective supervision of the frameworks and, in some cases, more active encouragement of the sector.

Two particularly interesting and comprehensive evaluations came from two banks in different jurisdictions in West, Central, and South Asia. The first bank stated: “If we follow the AAOIFI & Islamic banking guidelines we could touch our expected vision.

Benefits - the policy should have clear objectives and frameworks for implementation to ensure that, if regulation is used, the economic, social and environmental benefits justify the costs, distributional effects are considered and the net benefits are maximized.

Challenges - (1) Adhering to principles of government, (2) Mechanisms to actively provide oversight of regulatory policy, (3) Being cost-justified and cost-effective, (4) Doing public consultation practices and reviews of existing regulations functioning in practice, (5) Staying free of conflict of interest, bias or improper influence, and (6) Appropriate risk assessment, risk management, and risk communication.

Limitations and Gaps - **(1)** Lack of any separate Islamic banking law for the Islamic banks, (2) Lack of Islamic Capital Market and Islamic financial instruments, (3) Insufficient legal protection for Islamic banking, and (4) Absence of Islamic inter-bank money market."

Another bank in the same region voiced these concerns: "The central bank's Islamic banking department has been working to develop a progressive, sound, and stable Shariah compliant banking system. The regulatory framework is backed by local Shariah scholars, and as a result greater reliance can be made by the customers.

Benefits- (1) Provides stability to Islamic banking industry, and (2) Increases customers confidence in Islamic banks.

Challenges- regulation often creates stiffness and limits the options through which transactions/ financings can be done. Also, additional documentation requirements which need to be simplified and digitized, where possible. Furthermore, the benchmark rate under Islamic banking is referenced to a conventional interbank rate. This is creating confusion among Islamic banking customers about the difference between conventional banking and Islamic banking.

Limitations - various regulations for example taxation and law are not found in sync with Islamic banking regulations which creates limitations in executing businesses.

Gaps - standardization of practice."

Next, we asked about the development of the Islamic finance ecosystem for the next 10 years in the respondents' jurisdictions. The answers suggested fairly divergent understandings of what the question was intended to mean.

However, one bank in the Middle East ex-GCC set out a pathway: "Development of the Islamic finance system for the next 10 years is depending on many things, more banking instruments and methods strengthening capital, expanding the base of shareholders, strengthening capital adequacy, creating strong entities, coordinating between Shariah bodies in the banks, developing financial instruments sufficient to manage liquidity, attracting stable deposits, identifying realistically financing margins, diversification in financing formats and guided training."

A North African bank expected a substantial change in its legal, regulatory and supervisory frameworks, including: "Developing and controlling dealing in Islamic sales formulas; continuous training and development of banking staff; expanding the use of modern banking technologies;

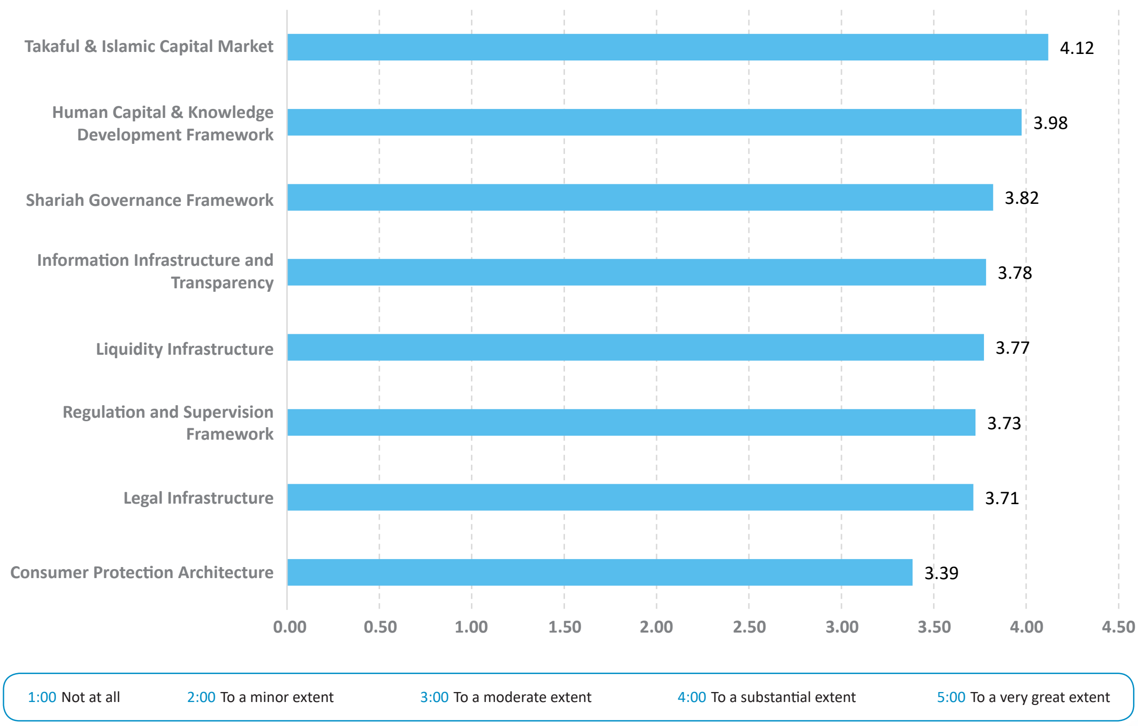
proper governance and management system restricted to international banking standards including the standard of capital adequacy and disclosure of financial statements of banks." Another bank in the same jurisdiction expected this to be accompanied by entry of some substantial foreign banks, which might pose a competitive challenge to the domestic industry.

A bank in West, Central and South Asia set out its ambitions for the ecosystem as:

- "Islamic Capital Market Development;
- Islamic Finance as Inclusive Finance;
- The Regulatory Framework;
- Working towards a roadmap for the Islamic finance industry."

We asked about the components of the Islamic finance infrastructure that would need development over the next 10 years, and to what extent. The responses are set out in Figure 16.

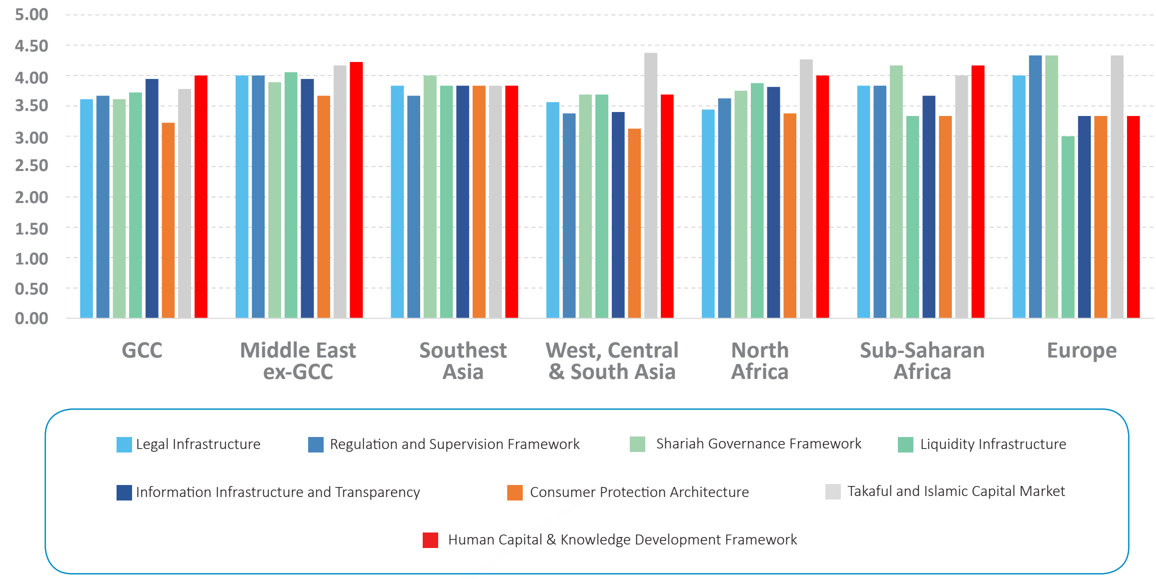
Fig.16. **Components of Islamic Finance infrastructure, which will need Further Development During the Next 10 Years**



It is interesting that the highest priority, from Islamic banking respondents, was the other traditional components of the Islamic finance industry, perhaps underscoring the need for the industry to function within a complete ecosystem.

As one might expect, there were some significant regional divergences as shown in figure 17.

***Fig.17.* Components of Islamic Finance Infrastructure, which will need Further Development during the Next 10 Years - Regional Breakdown**



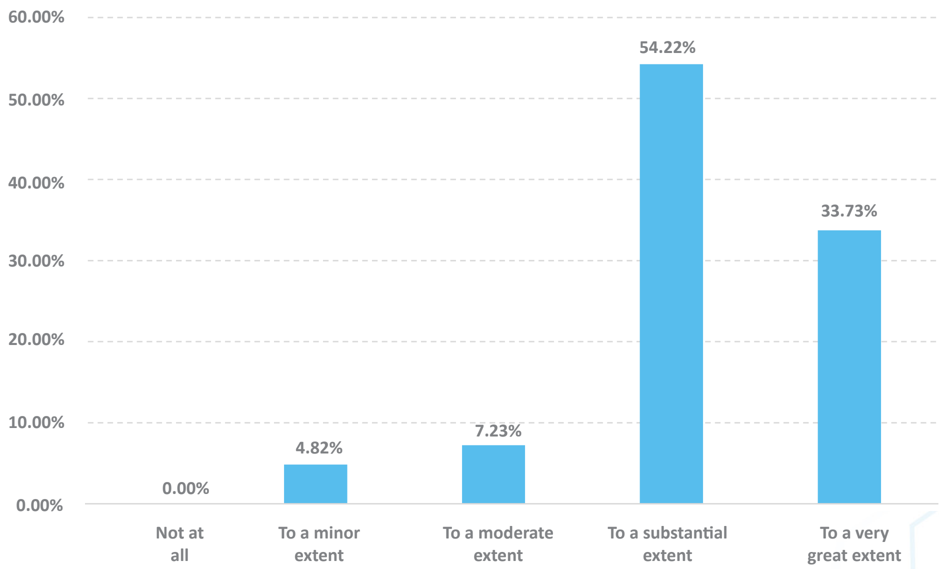
Human capital and knowledge development was seen as most important in both the GCC and the Middle East ex-GCC, but takaful and the Islamic capital market stood out particularly in West, Central, and South Asia and in North Africa. The regulation and supervision and Shariah governance frameworks were prominent in Sub-Saharan Africa and the Europe, though in both cases the number of respondents were small.

Although all the scores given fell within a relatively narrow band, there were some divergences between large and small banks as to priorities as shown in figure 18.

Fig.18. Components of Islamic Finance Infrastructure, which will need Further Development during the Next 10 Years – By Banks' Size

We also asked about the extent to which regulatory harmonization would contribute to the growth of the Islamic banking sector.

Fig.19. Contribution of regulatory harmonization to the growth of the Islamic banking sector



In discussing how harmonization might help, a few respondents concentrated on how it might overcome difficulties which they had already identified in their local regulatory frameworks. More typical, however, were global views like these three comments, from different regions.

A bank from Middle East ex-GCC stated that "Regulatory harmonization represents the backbone of managing the balanced growth of Islamic financial sector, as they represent the mean that can be relied on through a general model that accommodates the status of Islamic banks in all countries and builds goals through the benefit from experience in the banks."

In the same context a bank from Southeast Asia highlighted the benefits from harmonising the regulatory standards by stating that "In harmonising the regulatory practices across the globe, the Islamic Financial Services Board's principles-based standards and guiding principles provide a flexible and implementable base to regulatory and supervisory authorities for the development of local regulations and guidelines."

The same bank continues by mentioning that areas to facilitate cross-border activity in Islamic finance are (i) clarity on cross border regulatory issues and home host supervisory framework, (ii) streamlined financial reporting and compliance process, (iii) standardisation of documentations to support active interactions between Islamic financial institutions (IFIs), and (iv) managing differing Shariah views and practices.

The benefits of harmonising the regulation were also indicated by banks from GCC. A bank consider that Islamic banking sector has gained substantial importance in the last two decades, particularly in the post-2008 era. The growth thus achieved could be significantly sustained and enhanced by achieving regulatory harmonisation and also by achieving regulatory convergence across the Islamic banking space.

Another bank from the same region said that "When regulatory guidelines are developed to be uniform across the participating authorities this will bring in synergy, clarity and seamless uniformity, which in turn would foster international trade and finance in the Islamic banking sector. Similarly, when regulatory requirements across countries (and regions) become more aligned (if not similar) and the technical documents and standards are uniformly adopted across, this will further foster Islamic banking to newer heights in next 10 years."

When it comes to the needed measures of harmonisation, a bank indicated the following that could be considered to achieve the aforesaid objectives:

- "Greater coordination and exchange of information among Islamic regulators in general and central banks in particular;
- Standardising Islamic finance guidelines uniformly across jurisdictions;
- Standardising the legal framework for Islamic finance across regions and countries;
- Standardising documents and templates of Islamic finance and Sharia-compliant products and services;
- Developing information technology systems that are Sharia-compliant as well as standardised across regions; and
- Harmonisation of Financial Reporting Standards for Islamic banking sector across the globe."

Among the interesting points that emerge from these and the other responses are:

- The issue of documentation standardization appears at several points. From the larger and well-established banks, the emphasis here appears to be on the documents needed for interbank and cross-border transactions. For smaller banks, it appears to be on standardization of the products they offer to their customers. In some cases, this may be a response to an environment with greater requirements for regulatory approval of individual products than would exist in, say, Europe.
- A key issue for many respondents is not simply the creation of international standards but, in many areas, their adoption nationally and practical supervision to those standards.
- In some cases, what is required is not only implementation of standards but the removal of national provisions which may be appropriate for conventional banking but are not for Islamic banking.

Financial Reporting in Islamic Finance

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It is now universally acknowledged, especially by the conventional financial industry, that developing Islamic finance products is not merely the changing of nomenclature or terminology; fundamental differences exist in the nature and structure, especially with regards to the risk and return profiles, and the right and responsibilities of the depositors and shareholders. The primary objective of shareholders, investors, and customers of an Islamic financial institution (IFI) is to comply with the precepts of Shari'ah principles and rules while conducting their financial activities. Therefore, a need arises that recognition, measurement, and disclosure of these transactions should reflect permissibility in terms of compliance with such principles and rules.

The purpose of accounting is to represent the underlying circumstances, events or transactions having financial implications fairly and faithfully to the users of the financial statements. The accounting profession has been in a constant endeavor to develop a set of rules (or standards), that is widely accepted and practiced, to ensure faithful representation of financial information in an understandable manner and to enable the users of the financial statements to compare the performance of organizations across sectors and jurisdictions. However, difference in structures of transactions between the IFIs and their conventional counterparts, and the contrasting contractual relationships between institutions and their customers are an impediment to faithfully presenting financial information of IFIs to interested stakeholders using the conventional accounting GAAP or IFRS. The Islamic finance transactions require a different lens to portray their true nature. Hence, many jurisdictions initiated the process of development of accounting frameworks, or adoption of one that incorporates Shari'ah principles and rules.

Considering the imminent need to standardize such endeavors, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in Bahrain in 1991 as a not-for-profit organization responsible for development and issuance of standards for the Islamic finance industry. AAOIFI is managed by a Board of Trustees, and is supported by three technical boards: the Shari'ah board, accounting board, and governance and ethics board, which have their respective committees and working groups. A well-equipped Secretariat facilitates the working of these boards and committees. The standard-setting process is very rigorous and includes drafting of preliminary studies, consultation notes, and exposure drafts. Extensive public hearings and roundtables are conducted to solicit comments from industry, profession and academia before the final standard is issued.

AAOIFI has issued 116 standards and pronouncements in issue in the areas of Shari'ah, accounting, auditing, ethics and governance. AAOIFI standards are adopted by central banks and regulatory authorities in a number of countries, either on a mandatory basis or for guidance purposes. Currently, AAOIFI's standards and technical pronouncements are adopted in more than 40 regulatory jurisdictions either fully or partially, as guidelines / reference materials, or as a supplementary reporting basis. A few jurisdictions have developed their own Islamic financial accounting standards that are normally aligned with AAOIFI.

AAOIFI financial accounting standards (FAS) cater to specific Shari'ah requirements that are stipulated and derived from AAOIFI Shari'ah standards. The objective is to fulfil the information needs of Shari'ah-conscious stakeholders, or to cater to the difference in the structure and risk profiles of Islamic finance transactions, as against conventional transactions.

Future of Islamic Finance with Respect to Reporting and Disclosure

It is incorrect to reject the conventional accounting endeavors altogether. Islam recognizes any of these efforts as worthwhile as long they are not in contradiction with the Shari'ah principles and rules.

There are many common objectives between users of accounting information of both the IFIs and the conventional financial institutions, such as the desire to maximize profit and to increase the shareholders' wealth. The conventional accounting objectives that are Shari'ah compliant, would remain relevant and acceptable to IFIs in the same way as they are applicable to conventional organizations.

AAOIFI accepts this fact and due consideration is given while standards are being developed to ensure alignment with conventional GAAP or IFRS where there is no Shari'ah conflict. The objective is to have similar accounting practices wherever allowed by Shari'ah principles and rules.

AAOIFI and Future of its Financial Accounting Standards (FAS)

Islamic finance is experiencing unprecedented growth throughout the world. Products and services are being evolved at a rapid pace, that in turn requires development of accounting policies and treatments that show the essence of the transactions. Taking cognizance of the industry growth, and increasing regulatory requirements, AAOIFI initiated a comprehensive project on revising and overhauling AAOIFI accounting standards in 2018 and consequently, more than ten FAS were issued since 2019, including revised versions of the AAOIFI Conceptual Framework for Financial Reporting, and first time adoption of AAOIFI FAS. The revised conceptual framework provides a comprehensive frame of reference about the fundamental principles required for setting future accounting standards and forms a basis for resolving accounting differences in a manner suitable and in compliance with Shari'ah principles and rules. It introduces the main objectives as well as the concepts underlying financial accounting and reporting by IFIs.

The current projects include comprehensive overhaul of the existing Takaful standards, development of a standard on accounting for Waqf institutions, revision of the accounting for Zakat standard, accounting for Sukuk in the books of the originator and review of the existing standards for potential updates or withdrawals.

The efforts of AAOIFI have been fruitful in developing the global financial industry in the past three decades, and it is hoped that continued efforts coupled with industry engagements will further harmonize and standardize its practices with those of the conventional counterparts in the future.

Section C: Islamic Banks' Resilience and Risk Management

We invited respondents to say how they viewed their institution's resilience, both financial and operational, and how they expected it to be strengthened over the next 10 years.

Some respondents were small, often relatively new banks, for which the priority was to increase the customer base, sometimes in an environment where the knowledge of Islamic banking was limited.

Some were primarily focused on improving the bank's infrastructure and human resources.

A bank from the Middle East ex-GCC wrote: "Our bank adopts a diversification strategy with methods and tools dedicated to managing the various types of risks that it may face through existing activities or emerging events. This includes focusing on backup infrastructures and alternative teams of human cadres and working to enhance the culture of cross-training within the various units of the bank in order to ensure readiness and capacity for business continuity, high efficiency, and flexibility of performance in the face of various potential risks.

The bank is working to raise the efficiency of human resources within the institution and the trend to expand and create new units that will reduce dependence on external supply of services in support of the bank's activities in order to enhance the competitive advantage and increase the bank's flexibility in facing future risks."

Some focused primarily on risk management, like this GCC bank which wrote: "Regarding operational resilience, the bank has implemented and will continue to enhance risk controls and loss mitigation strategies and substantial resources are devoted to developing efficient policies and procedures in order to minimise losses and ensure compliance with regulatory requirements.

On the financial resilience front, the bank remains one of the healthiest capitalised Islamic bank in the country. We expect this to continue. Our Strategic Pillar – 'Smart Risk Management' will ensure the bank continues to strengthen its control framework and reinforce strong standards of governance by proactive risk policy management, setting up market leading risk and control infrastructure and practices and implementation of risk-aware culture across the bank and not just limited to product design and sales management."

Others had a more immediate focus on strengthening their institution's financial position. One in West, Central, and South Asia commented frankly: "The capital base of this bank is very poor. The next 10 years a part of profit will be spared to strengthen the bank."

Another institution from the same region said: "Currently our bank has industry average shock resilience capacity. We have prudential strategic plans to strengthen the shock resilience capacity in mid-term and long-term basis.

The following qualitative measures are in place to strengthen the shock resilience capacity of our bank:

- Quality, consistency, and transparency of the capital base will be raised;
- Risk coverage of the capital framework will be strengthened;
- Taking initiatives to improve the leverage ratio;
- Introducing a series of measures for promoting to build up of capital buffer in good times that can be drawn upon in periods of stress; and
- Ensuring sound liquidity risk management and supervision."

When asked about the challenges that might impact resilience, and the steps the banks were taking to meet them, banks' responses varied greatly. Some banks naturally referred to COVID-19 and the risk of a similar pandemic in the future. Other possible external disruptions that were mentioned included terrorism and cyberattacks.

Some banks focused on issues specific to their own jurisdiction, including political instability, local security challenges and economic instability including fluctuating exchange rates. They also mentioned issues in the legal and regulatory systems. A number of these have already been mentioned, but one new worry which several banks voiced was the tendency in some jurisdictions to require banks to direct a significant amount of their financing in particular ways. Some banks saw a particular risk that governments might use this power in the COVID-19 recovery phase in ways which would harm the long-term interests of the banks.

Some banks referred to the difficulty of keeping up with technology, and possible challenges from Fintech. Others pointed to operational risks arising from changing regulatory rules, including Shariah requirements but also AML/CTF requirements, sanctions, etc.

As regards the steps the banks were taking, the responses were largely couched in general terms or repeated points already cited. This is hardly surprising, given an overall emphasis on being flexible to deal with unexpected challenges.

We also asked about the specific role of governance in building a long-term resilient institution. There was a general recognition of the importance of governance and, in many instances, bank governance is mandated in some detail by regulators. However, banks also recognised their own responsibility.

One bank in the Middle East ex-GCC wrote: “The governance model must be transparent and realistic, and there is no doubt that the implementation of governance institutionalization effectively and in all limbs of the institution guarantees the high financial and operational flexibility and long-term preparedness to face all kinds of risks. Work is underway at a rapid pace to reach high levels in practical application of our corporate governance through structuring the bank, forming committees, issuing committees’ work charters, a matrix of tasks and powers, separating the board, implementation management and an annual assessment of progress in corporate governance.”

One from West, Central, and South Asia wrote on the effectiveness of governance boards:

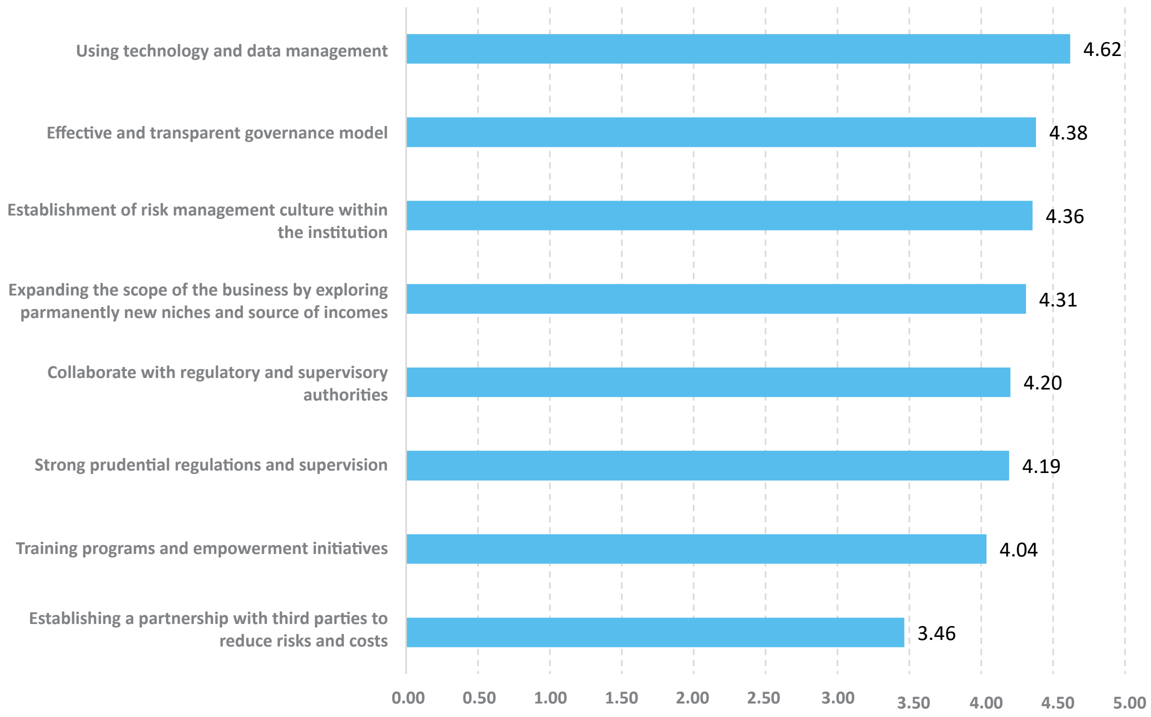
“An effective governance model outlines how people in authoritative positions hold themselves accountable to their stakeholders. Governance models incorporate ethics, integrity, and a responsible code of conduct for all leaders, volunteers, and workers so that people can be held accountable for their actions, resulting in a better and stronger organizational structure for the future.

In order to fulfil its purpose, our bank has established boards that focus on governance. We have established board-level risk committees, clarifying the goals of all the committees so as to ensure that a tone of the organization has been set by the higher authority. Second, we have an enterprise-wide risk management structure so as to ensure that risk management is not treated in silos but is integrated across the bank. For example, the relationship managers in the business units not only have the responsibility to bring in business but the KPIs have been updated to ensure only genuine customers to the bank and regularly monitor their performance and keep the Risk Management Department abreast of the repayment behaviour of the customers before they can become an issue for the bank. This not only ensures adequate risk management but also ensures the principles of three lines of defence.”

A bank in North Africa commented that: “Conventional banks differ from Islamic banks in the availability of the Shariah Supervisory Board for Islamic banks. Conversely, the availability of Shariah governance in Islamic banks helps them monitor all transactions that take place within them; thus, it ensures the correctness of its banking operations.” Other banks, however, did not comment on the role of Shariah supervision in this context, suggesting that they see it as a specialised function rather than part of the more general governance structure of the bank.

We asked one closed-ended question, about the role of specific elements in improving the institution's longer-term resilience. The results are in Figure 20.

Fig.20. **Role of Specific Elements in Improving the Institution's Longer-term Resilience**



This pattern was very similar between large and small banks.

Digitalization: Navigating the New Normal

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During the last decade, digital technologies have been rapidly and fundamentally changing the global business landscape. Driven by digital technologies, incumbent companies, industries, and markets have been reshaped or disrupted, whereas unprecedented opportunities have emerged to define the new paradigm of the economic growth and societal development. In 2020, in particular, the COVID-19 pandemic, while significantly affecting people and nations worldwide, also accelerated the adoption of digital technologies. The impact of digital transformation and digital disruption is systematic and long-lasting. The trend of digitalization will continue in the post-pandemic world.

The Changing Landscape of Islamic Banking

The global trend of increased and deepened digitalization is reflected in the results of the 2021 Global Islamic Bankers' Survey. The survey on the future landscape of Islamic banking sector indicates that globally, "innovation and information technology" is the second most important factor (with an average score of 4.20 out of 5.00) that impacts institutions' growth and expansion in the next ten years. The 2021 Global Islamic Bankers' Survey has also painted a nuanced picture of the current state and future trend of digitalization among Islamic banks. Specifically, while there is variation across regions and markets, globally, the surveyed Islamic banks have ranked "using technology and data management" as the top measure for resilience and risk management, and "technology and its rate of development" as the top challenge in product development and innovation.

The survey demonstrates strong interests in and commitment to digitalization among Islamic banks. Most surveyed organizations have been actively involved in developing innovative products – 63.3% have been involved "to a substantial extent" or "to a very great extent." Overall, the industry's strategic demand for innovation and information technology represents significant opportunities and necessity for increased and rapid digitalization in the coming decade.

For example, one bank commented the key role of digital innovations with the community of Islamic banks: "Digital developments are the most important developments in innovation and technology in Islamic finance during the next ten years, and the motivation behind these developments is to keep pace with the developments surrounding Islamic banks."

Some banks have explained both business value, such as cost reduction and revenue growth, and important social benefits such as improved financial inclusion provided by digital technologies. As one bank commented:

“Technological advances will reduce operational costs therefore allowing Islamic financial services providers to reach the underserved markets with more affordable digital financial services.”

Other banks have also identified the specific technologies that are being adopted, including: “Formative Artificial Intelligence; Distributed Ledger technology/Blockchain and digital money; Next generation robotics for banks; Advance network technologies like 7G/8G; Cognitive technologies; More of Open Data (Government and Private); Core modernization; and Cybersecurity/privacy technologies.”

The Global Digital Disruption

Globally, the types of digital technologies that have driven the changes in both public and private sectors in general, and the banking industry in particular, are very diverse. The most prominent examples include mobile technologies, artificial intelligence, big data, telecommunication technologies such as 5G, as well as a variety of emerging innovations such as blockchain, cryptocurrency, and virtual and augmented reality. Collectively these technologies, coupled with changing consumer needs and preferences, play a major role in redefining the business landscape in different industries, from retail to finance, from manufacturing to transportation, and around the world. Across these diverse industries and markets, the key players in today’s digital economy consist of three main categories, broadly speaking. Each of these categories need different strategies and practices to navigate their business environments.

The first category consists of incumbents, namely, businesses that have been successful in establishing their mature organizing and operating model, and strong market positions. In response to the rise of digital firms, the incumbents could adopt different strategies and build their own digital capabilities. Incumbents can leverage the added capabilities afforded by digital technologies to experiment with, design, develop, and adopt new technologies to defend themselves against emerging competition, or create new opportunities for value creation. For example, in the financial services sector, major established banks worldwide, have all launched digital banking apps, offering various retail banking services to consumers.

Incumbents use digitalization to more significantly redefine their business models and pivot their business into new directions. Such systemic transformation could bring significant, inimitable competitive advantage, further strengthening the incumbent’s market leadership, even in a changed market landscape. Ping An, a leader in life and general insurance in China, for example, had effectively leveraged digitalization to evolve from a traditional financial services firm into a digital ecosystem. Through a portfolio of investments in digital technologies and digital-enabled businesses, today Ping An owns and operates one of the world’s largest wealth management platforms, telemedicine platforms, clinic enterprise platforms, and provides cloud-based services to other companies. In essence, Ping An is no longer just one of the most valuable insurance groups worldwide, but also a major technology company with strong competitive advantages in its own verticals.

The second category consists of companies that have become digital ecosystems. Some have established as their position as the de facto digital infrastructure in certain markets and even nations. These companies are very well known to the public. In the US, Apple, Amazon, and Google are some of the most prominent examples. In China, Alibaba and Tencent are among the most influential and far-reaching. Each of these companies owns multiple platforms that are synergistically connected with one another. Amazon, for example, operates online retail, video production and distribution, financial services, etc. Alibaba has a highly diversified collection of platforms, supporting activities from global business-to-business trade, to B2C and C2C[3] online retail, to logistics, to financial services. Capitalizing on the almost unrivaled data set gathered over the years, these platforms change almost all industries they compete in or partner with.

The third category includes what we call digital niche players. Many of these companies are technology companies focused on specific segments, either providing technology services to other businesses, or using technology to carve out a specific value proposition. An example of the former type is Square, which offers, among other products, software and digital devices enabling small businesses to process mobile payments. An example of the latter type is Robinhood, an online brokerage that uses its easy-to-use mobile app and website to allow retail investors, including many young and less experienced first-time investors, to invest in and trade stocks, ETFs, and other financial products. Enjoying almost unparalleled popularity during COVID-19 when people worked from or stayed at home, Robinhood had almost become a synonym for retail trading. Robinhood's role in the recent GameStop saga illustrates its influence in the marketplace.

In addition to digital disruptions in the private sector, a trend of central bank digital currency (CBDC) is emerging. As a digital form of a country's fiat currency that complements or replaces paper currency, CBDC programs are being piloted or launched by central banks in China, Sweden, South Korea, Brazil, Thailand, etc. Successful implementation of CBDC will reduce cost of managing and transferring cash; enhance financial inclusion; reduce/ eliminate illicit money laundering activities; execute monetary policy more seamlessly and quickly.

Overall, the world is going through accelerated and unprecedented digitalization. The ongoing digital transformation and disruption taking place in different markets and countries is creating a new normal for the global economy. It is important for different stakeholders, including financial institutions, regulators, policymakers, and governments, to learn, experiment, adapt, and capitalize on, this new normal, in order to thrive in our ever-changing digital age.

[3] B2C, or business to consumer, is the type of commerce transaction in which businesses sell products or services directly to consumers. Customer to customer (C2C) is a business model whereby customers can trade with each other, typically in an online environment

Section D: Innovation and Technology within Islamic Finance Industry

We asked how respondents saw innovation and technology adoption evolving over the next 10 years, and how their institution was investing in it. All the banks which commented recognised the importance of technology, and the large majority recognised the importance of investing in it themselves. Relatively few, however, seemed willing to look beyond their immediate plans for relatively short-term implementation. It was also clear that banks were starting from different technological bases. Some regarded as important innovations like electronic bank cards and wide ATM networks which in other places are well-established practice.

Two of the more comprehensive reviews came from banks in West, Central, and South Asia and Southeast Asia. The bank in West, Central, and South Asia read as follows: "With advancing technologies like distributed ledgers, smart contracts, and digital payment platforms, financial services must be innovative in order to remain relevant in the modern era. Using a combination of technology, consumer-centric services and flexible business practices; technology offers genuine alternatives to traditional banking and payment systems offered by financial services institutions.

Some examples of this technology adoption and innovation are:

- Bank branches remain a necessity but by increasing the use of technology keeping the budget low and enhancing the customer experience. Some of the relevant technologies are digital account opening and P2P payments;
- Video conferences and remote assistance which will help to interact with remote areas branches in a completely new way, 24/7, thereby improving the customer relationship;
- Branchless banking, agent banking, sub-branch facility, mobile banking, internet banking and green banking are some examples of innovation and technology adoption;
- Leveraging AI to gain customer insights- AI enables a wide range of innovations, namely data analytics and customer intelligence which will help to manage the bank's wealth of data, which can then be tapped to discover new customer information such as trends, habits, and behaviours to better understand their needs and personalise banking services; and
- Cloud computing continues to thrive - the adoption of cloud computing allows banks to improve their resilience and capability in supporting the digitisation of our society in a time- and cost- effective manner. Banks will benefit from a fundamental boost in computing power, which makes it much easier to house and analyse data lakes."

The bank in Southeast Asia commented the following on emerging technologies: "For long, banks have been reluctant to update their systems – and for good reason. The current systems that they use are the product of years of continued innovation to meet immediate customer requirements. However, this has resulted in siloed systems being used for the transaction, savings, investment and loan accounts. This is not suited for the digital age when the competition for banks is coming from technology-based Fintech start-ups. Banks and other traditional financial services providers have had to respond with an array of digitization and innovation initiatives. These initiatives employ cutting-edge technologies to ensure a customer-centric perspective rather than the traditional focus on products, real-time intelligent data integration rather than slow analysis being performed after-the-fact and open platform foundation.

In the next 10 years, the following technologies will make their permanent footprint in the banking arena:

- Augmented Reality;
- Blockchain;
- Robotic Process Automation;
- Quantum Computing;
- Artificial Intelligence;
- API Platforms;
- Prescriptive Security;
- Hybrid Cloud;
- Instant Payments; and
- Smart Machines.

Due to the volatile nature of technology start-ups and lack of sustainable technology adoption and being from a developing country with moderate capital, our institution is not immediately jumping to any significant adoption of new trends right away. However, we are keeping a close eye on several technologies mentioned above and already been using a few."

A follow-up question focused on the technologies that would come to the fore in Islamic banking specifically. Answers to this naturally overlapped with those to the previous question, but brought out a few interesting points.

One bank in the GCC said: "Competition is the main driver. In banking, there are three main pillars: Product innovation; Customer service; and Operational efficiency.

In Islamic banking, since the product innovation is much restricted to be mainly on what has been invented by Shariah scholars, then banks will be focusing more in utilizing technology to address the two remaining pillars. It will be mainly in digitization and automation."

However, other banks placed significant emphasis on product innovation. One, in another part of the Middle East, listed as the areas of innovation: "Innovate Islamic financial products that are compatible with the progress made by humanity and consistent with Islamic Shariah; intensifying efforts to spread the concepts of Islamic finance; adopt the recent techniques in communication and information technology; provide diverse financial services that suit all customer segments."

Some banks were particularly focused on the operational efficiencies available through technology. One, in North Africa, said: "Novelties are the possibility to open accounts online and conducting operations and financing online. The drivers are:

- Reducing the cost of transactions through digital transformation, which creates more space to Islamic financial institutions to decrease their prices and perform more transactions;
- The ability to conduct smaller financing, which may not currently be offered to clients due to the high costs associated with each financing request;
- Expanding the spread in areas where it does not have a physical presence, without the need to invest large sums of money to open new branches or hire new employees; and
- Reaching a greater number of consumers to provide them various products and services at lower prices."

Others were more focused on customer experience as a competitive factor. A GCC bank said, "The single most important driver for most innovation across banks can be attributed to the adoption of technology. Adapting to new-age Fintech trends such as cloud computing, digital transformation, big-data analytics and AI will be a hygiene factor/industry norm. But what drives the underlying adoption of the technology will be ensuring the right omni-channel experience for the customer across all elements. Innovation will not be limited to products alone, but across customer experience, channels, process innovation, product design and technology solutions." A bank in West, Central, and South Asia made a particular point about customer experience, saying: "Customers no longer want a car loan; instead, they want a car. The loan process does not need to be separated from the purchase. In the next 10 years, we will observe a seamless relationship between consumer goods sector and Islamic banking due to interfaces and open APIs. Smart banks will be the next big thing. The main drivers behind this change will be customer expectations and increased level of competition."

One bank looked beyond technology to social innovation, albeit technology-enabled, in an emerging halal economy ecosystem, and an Islamic community ecosystem.

We asked about emerging innovations in other parts of Islamic finance, and how they would impact on the responding institutions. Our aim was to explore the possible impacts on banking of developments in areas like Islamic capital markets or Takaful or perhaps central bank operations. In fact, many respondents again discussed innovations in banking, but some new issues did emerge.

A bank in the Middle East ex-GCC said that: "The emergence of digital currencies and their occupation of a place within the concerns of individuals and enterprises imposes on the Islamic bank's challenges related to how to deal with this trend and take advantage of any available opportunities."
An institution in North Africa referred to the need for "A means of linking Islamic banks to commodity markets and internal and external trade services." One in the Europe mentioned developments and new products in corporate finance and wealth management, seeing opportunities for itself in servicing these. Another, in West, Central, and South Asia mentioned robo-advisors and also "online legal/fatwa systems", raising the interesting question of the role of technology in Shariah governance.

A bank in West, Central, and South Asia suggested that areas for innovation included "Islamic products in services, derivative products under Islamic Shariah and Islamic capital market instruments." Another, in Southeast Asia, said: "Innovation in Shariah transactions will impact greatly our institution's business. Government support for Shariah transactions, such as requiring all halal certified institutions to transact using Islamic banking will improve the overall Islamic finance sector."

Our next question focused specifically on the areas of banking in which innovation would have the greatest impact, including back office as well as customer-facing activities. Among the areas mentioned were: cybersecurity management, fraud risk management, social network and other aspects of marketing, compliance, record keeping and communication. In fact, there was a general view that few aspects of banking would be untouched by technology.

One GCC respondent put it this way: "Innovation and digitization adoption have a multi-faceted benefit for any organization. It makes banking cheap, simple, compliant, fast, secure, available anywhere and at all hours.
Most importantly, innovation and digitization will help Islamic banks to reduce their cost to serve, which will directly optimize the cost base of banks ensuring more value is created for shareholders and for the bigger community.

Blockchain technology can also be used to automate and streamline contract execution for Shariah-compliant financing and investments, which tend to be complex and involve voluminous documentation. Cost savings are likely to arise as a result of streamlining and automation of internal processes and lowering costs to acquire and serve customers.

Risk management is also likely to benefit from innovation / digitization as innovative credit scoring and greater product segmentation leverage big data capabilities."

We asked what actions by bodies other than the institution responding would make innovation easier, and who should be taking those actions. Unsurprisingly, a number of responses looked to governments and regulators.

A GCC bank was fairly representative of the whole when it said: "Actions by the regulator particularly on legislation on open banking which involves data sharing, authentication, and management is expected to catalyse partnerships and collaboration within the ecosystem.
Also, government support to build centres for start-ups to interact and collaborate, provide early stage funds and connect fintech companies with investors, bigtech and banks will be key in enabling the entire ecosystem.

Governments and regulators however, will need to strive for the balance between customer protection and innovation / technology-led growth."

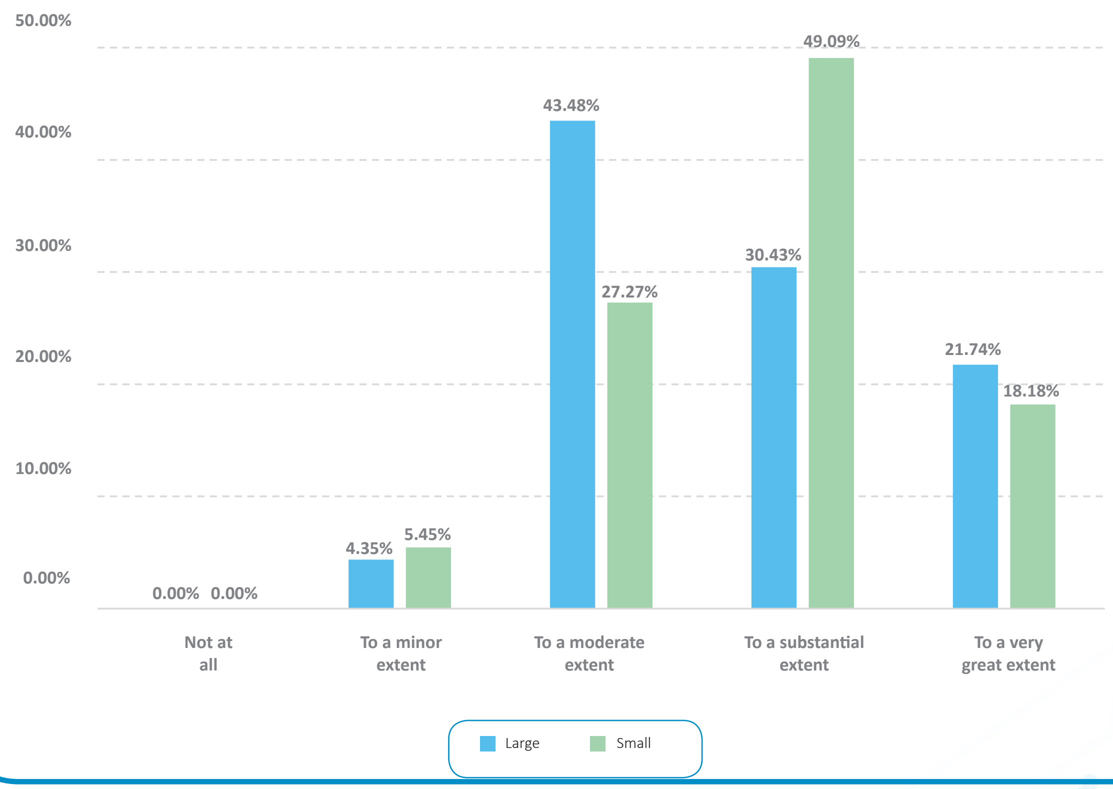
Some other banks extended the actions they were seeking from government to cover the communications system more widely. One in the Middle East ex-GCC looked to "Continuous updates of the technical infrastructure and the applications of e-government programs; the role of communication companies in developing services and increasing the number of subscribers; providing the legislative environment and laws to protect the rights of all parties."

A bank from North Africa said it could benefit from "Establishing regulatory frameworks to stimulate innovation and adopting technology, to gain the confidence of customers as a result of fear of fraud and piracy, in the absence of adequate consumer protection frameworks in the field of electronic financial services and no data privacy laws." Comments like this draw attention to the fact that Islamic banking does not operate in a vacuum, but in the context of a wider legal and regulatory system, of infrastructure provision, and indeed of social behaviour.

Some Islamic banks described their customers as needing to innovate. One institution in the West, Central, and South Asia region set out an ambitious list of aspirations, apparently for its commercial customers, drawn from an external source and including a variety of technologies appropriate in retail settings, covering subjects such as inventory tracking, customer service and management information systems.

We asked to what extent the institution was involved in developing innovative products, and about the strategy and processes for doing so. Predictably, the raw data differed between large and small banks, as shown in figure 21.

***Fig.21.* Institutions' Involvement in Developing Innovative Products - By Banks' Size**



What is surprising here is that, overall, the large banks rated themselves as less involved in developing innovative products than the smaller ones. One possibility is the presence among the small banks of some highly innovative challengers, though the comments suggest only a handful of these. Another possibility is that banks have different standards as to what ranks as highly innovative; there is some evidence for this from the comments.

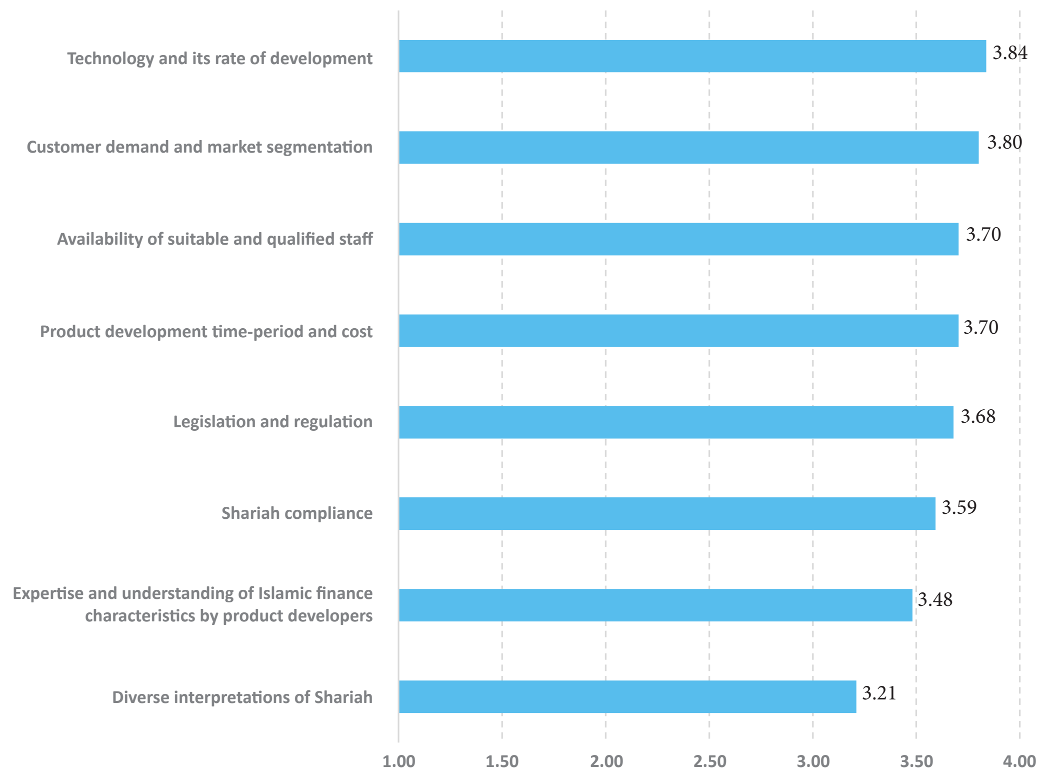
As to their processes, some banks focused on developing products in a dedicated unit, like the bank in West, Central, and South Asia which said, "Our bank is taking an aggressive approach towards the implementation of new and innovative products and services. We believe that the future of banking is dependent upon the agility of the organization. The bank has a separate digital banking unit and has been working on multiple initiatives such as process re-engineering, tab-based account opening. We have also been working on developing an increased awareness within the Bank about digital transformation."

Others emphasized a top-down process involving large elements of the bank, like the bank in Southeast Asia which said: "Products/services must be in line with the bank's 5-year Strategic Plan and Annual Business Plan. This includes analysis on competitors' offering as well as the requests from business units and/or stakeholders (internal & external). The process of developing innovative products will start with Research & Development where the research and analysis as well as fact finding will be performed to determine its feasibility and viability. Then, it will involve the product design that includes the underlying Shariah contract to be used. Proposal paper will then be circulated to the relevant independent stakeholders (such as Risk Management Compliance, Shariah, Legal, Finance, IT) for assessment and feedback. The proposal will then be tabled to the necessary approving authority (Senior Management, Shariah Committee and Board) as per the governance requirements before submission to the regulator for approval."

Some banks placed emphasis on a more bottom-up approach. A North African bank wrote about "Starting from the brainstorming approach to generate innovative and creative ideas, by encouraging all employees, by sending their proposals via e-mail to be collected and classified for use in the process of developing products and services, in addition to the certain participation of dealers in expressing their opinions on the experimental stage of the product or service." A bank in the GCC said, "We believe that no one team is responsible for innovation. Data-backed insights, coupled with strategic and customer first thinking, are the fundamental tenets of innovation. Various teams ranging from customer experience, strategy, operations, finance, customer value management, data and analytics, IT, business, etc. support innovation – from ideation to implementation."

Finally, in this section, we asked to what extent certain specific factors represented challenges when it comes to product development and innovation.

Fig.22: Challenges related to product development and innovation



Most of the factors cluster quite closely together, with "Technology and its rate of development" and "Customer demand and market segmentation" being of the most importance. It is interesting that "Diverse interpretations of Shariah" is clearly in last place. This may result from the fact that a large proportion of respondents operate in a single jurisdiction, and are therefore not impacted by the diversity of interpretation that can sometimes be an issue in cross-border business.

However, the patterns are not hugely different as between small and large banks, except that the large banks tended to give generally higher scores and were noticeably more concerned about technology. This may suggest that they are operating in more sophisticated and more competitive environments.

Building a Resilient Economy through Value-Based Finance

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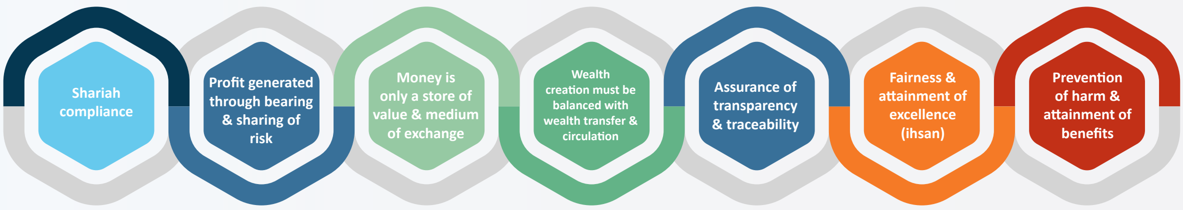
Governor, Bank Negara Malaysia

The world has witnessed remarkable progress in the last decade. Incomes and living conditions across many parts of the world have risen, with much of global growth driven by technological revolution, trade, and investments – particularly in education, healthcare and infrastructure. While society continues to chart progress, the world is confronted with looming threats from climate change, widening income inequality and de-globalisation. The health and economic effects from the ongoing pandemic have also created further challenges that we need to overcome with urgency. Now, more than ever, there is a need for collective action to address these mega-challenges. Investments in greening and digitalising the economy, policy support to promote reskilling of labour in face of challenges, and provision of social support for the most vulnerable will be required, lest this de-rail the sustainability of our future growth and development trajectory.

It is for this reason that the call to action for a more sustainable and inclusive future, as reflected in the international pledge towards the UN Sustainable Development Goals (SDGs), is one that all must respond to – with finance playing a catalytic role. There is growing recognition that the entire financial sector should rise up to this challenge. This is even more so for Islamic finance, given its underpinnings of Shariah principles that advocate for prevention of harm and attainment of benefits, greater fairness and shared prosperity (Figure 23). These fundamental principles provide Islamic financial institutions a purpose beyond profit and call for the mobilisation of financial resources towards productive economic activities, especially those that are aligned with the SDGs.

***Fig.23.* Seven Fundamental Values of Shariah**



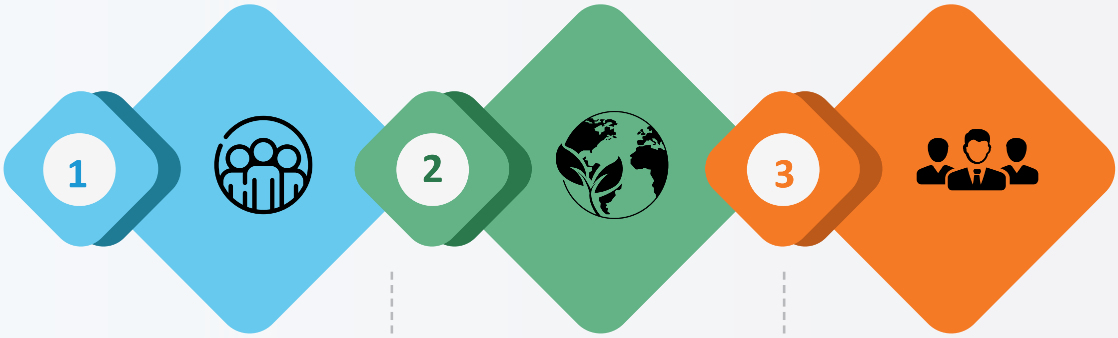
Islamic finance in Malaysia has been on a decades-long journey in this direction. Since its origin nearly four decades ago with the establishment of the first Islamic bank, the Malaysian Islamic financial industry has progressively gained more depth, diversity and scale. Initially focused on providing Shariah-compliant alternatives and promoting financial inclusion, it has since evolved into a well-developed and comprehensive financial system capable of meeting diverse needs of the economy and society. The Islamic financial system now comprises a diverse set of financial players, deep and progressive Islamic financial markets, multi-asset commodity and exchange platforms, and efficient multi-channel payment gateways to facilitate financial intermediation. The regulatory framework also continues to be responsive to the unique risks of Islamic financial business. With an enabling regulatory and operating environment in place, Islamic financing now accounts for more than 40% market share of total bank financing. In 2020 alone, Islamic financing grew 8.5%. Meanwhile, Takaful business commands more than 18% share of total insurance. In the capital market, Malaysia remains a key driver in the global Sukuk market, commanding 45% market share of the global Sukuk outstanding in 2020.

While these headline numbers signify significant progress, the Islamic finance industry in Malaysia is not standing still. The industry is taking more proactive efforts to make a positive impact and contribution to sustainable economic development. The industry began adopting 'Value-Based Intermediation' (VBI) in 2017, an initiative which calls on Islamic financial institutions to place greater emphasis on Shariah considerations beyond compliance and commercial profits in financial practices. This drives Islamic financial institutions to be more deliberate in aligning financing and investment decisions with sustainable business practices, with impact and value creation being duly considered. Consistent with the Shariah objectives – Maqasid Shariah – of promoting wealth sharing, stimulating economic productivity and safeguarding the environment, this is envisioned to bring closer to reality the goals of "finance for impact, beyond profit."

"VBI Financing and Investment Impact Assessment Framework (VBIAF) and Sectoral Guides jointly developed by the industry, regulator and relevant stakeholders provide guidance for the financial institutions on risk management and considerations related to ESG in financing and investment decision making."

Islamic banks and Takaful operators in Malaysia are translating these aspirations into real-world practice by rolling out value-based financial solutions (see Figure 24), thus giving effect to the Maqasid Shariah.

Fig. 24. Examples of Value-based Solutions



Financial inclusion

- Microfinancing and microtakaful programmes
- Digital platform to mobilise waqf (MyWakaf) and donations for socio-economic projects
- National health protection scheme (MySalam)
- Donation riders to support financial protection for 'hardcore poor'
- Mutual takaful digital platform to support community risk sharing

Environmental sustainability

- Financing programme for enviornmentally friendly rice production
- Sustainability-linked financing for energy sector
- Preferential financing rates for purchase of hybrid vehicles and green certified houses
- World first SDG sukuk which references the UN's SDGs for the use of proceeds
- Online market platform for solar panels

Business empowerment

- Working capital financing and education programme for woman entrepreneurs
- Restricted investment account with musyarakah ventures
- Digital platform for supply chain finance
- Digital platform for halal business facilitation

In the area of inclusion, social finance instruments such as endowment (Waqf), donation (Sadaqah) and alms-giving (Zakat) have been infused in the financial offerings for those in greater need. This development has unlocked the potential of Islamic finance to more effectively address the financial needs of lower-income segments. For example, in 2020, a blended finance programme incorporating elements of social finance, microfinancing and structured training was introduced to empower low-income micro-entrepreneurs to generate more sustainable income. By combining philanthropic capital with traditional microfinancing instruments, the programme helps to reduce indebtedness of borrowers whose incomes and livelihoods have been adversely affected by the pandemic. This also improves the credit worthiness of such micro-entrepreneurs.

Islamic financial institutions in Malaysia have also stepped-up efforts to be at the forefront in financing projects that generate positive impacts to the environment. For example, an Islamic bank launched a financing programme for farmers to adopt more sustainable planting and production methods which are less water intensive, while delivering a higher yield compared to traditional planting methods. Islamic financial institutions are also supporting the transition towards a low carbon and climate resilient economy. For example, several Islamic banks have started offering financing with preferential rates for customers purchasing low-emission hybrid vehicles and green-certified homes.

In trade and commerce, Islamic financial institutions also play a key role in supporting business expansion. Complementing the existing trade finance and supply chain finance capabilities, Islamic banks have begun piloting new trade finance solutions using different Shariah contracts to respond to the liquidity needs of SMEs, such as using revenue- and asset-based financial structures. Islamic financial institutions have also started to leverage on digital marketplaces to provide more convenient and efficient access to trade finance solutions. These developments help support the growth of businesses in the halal segment seeking Shariah-compliant solutions, enabling end-to-end business production based on the halalan-tayyiban (wholesome Shariah compliance) principle.

While these examples provide a glimpse into the large potential of Islamic finance, the path forward is to bring about a more sustained and pervasive impact which can help make the world a better place. Sustained regulator-industry collaboration and visionary leadership across financial institutions are key to spearhead further advancements in these priority areas. As aptly mentioned by the American author and educator, Helen Keller, "Alone we can do so little, together we can do so much."

Section E: Sustainability within the Islamic Banking Sector

Sustainability has been an increasing concern in both Islamic and conventional finance –driven largely, though not exclusively, by climate change. A concern for sustainability is a natural concomitant of a values-driven finance system like Islamic finance.

We asked respondents how they understood the concept of sustainable development and sustainable finance for the Islamic banking sector and about their institution's strategy to promote sustainability practices in the next 10 years.

Understandings varied greatly, perhaps for linguistic reasons, and some institutions clearly believed that we were referring primarily to the financial strength and resilience of their own institution. One bank in the Middle East ex-GCC, however, set out a brief understanding as follows: "Sustainable development can be defined as satisfying the basic needs of current generations and achieving their well-being without compromising the rights of future generations and satisfy their needs, with preserving of ecosystems and limited natural resources.

The concept of financial sustainability lies in the fact that social, environmental and administrative factors are taken into consideration when adopting any financial plan. Taking them into account will enable informed decisions to be made by all concerned. We are continuing to perform the social role and applying the sustainability axes for our bank as much as possible and the developments that follow."

A bank in West, Central, and South Asia had this to say about "sustainable banking" initiatives: "Sustainable banking is an integral part of Islamic banking that makes a basis of environmental protection. 'Green banking' plays a caring role for sustainable development in overcoming the institutional obstacles and market challenges, in the way to allocating the investment to the green projects. Green banking involves with banks' strategic and operating plan. The plan takes into consideration the transition towards a low carbon economy and those internal controls, risk management and the projected financial condition based on proper assessment of environmental risks. 'Going green' is indispensable for banks as the quality of assets and profitability; both depend upon the environmental and ecological aspects. This aspect takes care of the corporate social responsibility and is the ecological balanced approach that banks should follow. Green banking thus involves a two-pronged approach.

Firstly, green banking focuses on the green transformation of internal operations of all banks. It means all the Islamic banks should adopt appropriate ways of utilizing renewable energy, automation and other measures to minimize carbon footprint from banking activities. Secondly, all banks should take environmentally responsible financing; weighing up environmental risks of the project, before making financing decisions; and in particular, supporting and fostering the growth of upcoming 'green' initiatives and projects. It is a smart and proactive way of thinking with a vision of future sustainability."

A bank in North Africa set out a number of initiatives it was taking in line with its sustainability strategy: "Sustainable development is a multidimensional process that works on a balance between the dimensions of economic and social development on the one hand, and the environmental dimension on the other hand, and aims to optimize the exploitation of human resources and activities based on an Islamic perspective. To confirm that a human being has the right to use the resources of the earth without the right to own them, taking into account in the development process the response to the needs of the present, without wasting the right of future generations, and reaching the quantitative and qualitative aspects of matter and human beings. As for financial development, it is the bank's goal to continue achieving its charitable mission, 'the Goodwill Fund' in the long term.

The strategy of the bank to achieve sustainable development is as follows:

- Establishing an administrative structure 'the social responsibility of the bank' that has been given great importance, by allocating all means for good functioning and ensuring the appropriate development in the bank's strategy for sustainable development;
- Creating a microfinance product in the speculative form for craftsmen and small enterprises;
- Launching the project 'Peace is a door of sustenance,' which aims to finance 100 micro-projects for the benefit of widows and orphans, with the aim of helping them establish a mini-project that provides them with stable financial income by giving them loans with the possibility of repaying them in the long term;
- Supporting various non-profit societies and voluntary foundations to enable them to serve the community and the environment;
- Granting preferential conditions to institutions that take into account the standards of social responsibility, especially the preservation of the environment and solidarity with vulnerable social groups;
- Contributing to campaigns to address the COVID-19 pandemic, the most important of which is the acquisition of resuscitation beds and respirators for hospitals, and allocating a financial envelope to support efforts in this regard in coordination with civil society;
- Contributing significantly and actively to several economic and scientific forums and conferences, by sponsoring many events periodically and continuously; and
- Paying special attention to education by supporting and sponsoring universities' activities."

A number of other banks referred to the need to embed sustainability goals in all their work, in particular their financing decisions. A number referred to ways in which they were doing this, for example (from a bank in Southeast Asia): "Our institution has rolled out a series of sustainable initiatives that follow SDGs guidelines. Some of those initiatives include loans for electric vehicles, sustainable linked Waqf, mortgage partnerships with green developers, and many more." One bank referred to becoming accredited under the United Nations Country Team 'Together for SDG's Hub' programme. "This partnership ensures that our vision, strategic overlay, priorities, and work processes are aligned with the SDGs." However, a number of banks used language which recognised that full integration of sustainability goals was a long-term process. For example, a bank in the GCC said, "Over the long term, our strategy will be to embed ESG goals in the underlying strategy, having clear objectives and measurable KPIs."

More specifically, a bank in the Middle East ex-GCC said, “Based on this understanding, the bank’s management has allocated part of its support to the local community towards strengthening those interested in scientific research to support the resources of the economy and in projects related to preserving the environment and preserving water resources that are depleting due to climate changes and as a result of [specific local issues]."

A bank in Sub-Saharan Africa referred to: “Responsible lending with regards to reduction of carbon footprint, ensuring that the customer we lend to do not engage in activities that may degrade the environment.” That bank referred specifically to supporting water management, afforestation and poverty reduction, while some banks referred specifically to lending for green energy projects, for example solar power systems.

Banks also referred to making changes in their operational practices, for example trying to use green energy in their own operations and adopting the “3 Rs” concept (Reduce, Reuse, Recycle) within their branches.

We went on to ask about how the challenges of sustainable development implementation in the Islamic financial sector might change over the next 10 years, including as a result of changing public concerns about sustainability.

Several respondents recognised growing public concern about sustainability, and a need trespond to this.
A bank in Southeast Asia said: “The sustainability agenda has gained increasing importance. Consumers are making their purchasing and investment decisions with the environment in mind. Investors and shareholders are making demands for their companies and corporations to adopt environmental, social and governance (ESG) standards. Globally, societies are seeking ways to create sustainable solutions for their communities.
The global environment itself is more challenging than before with increasing volatilities and uncertainties arising from the geopolitical developments and a multitude of factors. Many of these could derail or delay the efforts to stay on course to keep sustainability another focus of business in the financial sector. The first challenge that we face as a developing nation is in striking balancing between sustainability and competing socio-economic priorities, given our limited resources for transition to low-carbon economy. The second challenge is in forging strong collaboration and cooperation among key stakeholders and overcoming the collective action problem.”

Another bank in a different country of that region said, “Future generations will become more aware and sensitive on sustainable practices. It wouldn’t be unlikely that they would hold financial institutions like us accountable for operating sustainably. The more sustainable we are, the higher chance the public will deem us respectable and worthy of having a relationship with.”

A bank in the Europe said: "Sustainable development is an over-used phrase but goes to the heart of tackling a number of inter-related global issues such as poverty, inequality, hunger and environmental degradation in the next 10 years. The biggest challenges for sustainability are: Public Policy and Climate Change; Collaborating for Sustainability; Measuring & Reporting Sustainability; Sustaining Sustainability Programs; Educating Consumers; Creating a Long-term Orientation. These difficulties can be overcome in parallel with the improvement in international policies."

A bank in the Middle East ex-GCC made a specific and timely point about developments in the standards area: "It is expected that global standards for sustainability will appear, in response to repeated calls from various bodies, and will be applied gradually, after a period when sustainability reporting was optional because there were no standards in place. We expect the standards to be measurable and comparable and to operate to build confidence widely. This in turn will make a quantum leap in the sustainability area through achieving the greatest amount of transparency and the disclosures will be relied upon heavily in various banking businesses in general and in Islamic banks in particular."

Finally, we asked what role the institution could play in achieving long-term sustainable development and for recommendations on the best way to involve Islamic banks more strongly on sustainability. At the institutional level, comments naturally overlapped with those set out above.

The following is a regional breakdown of some common ideas:

GCC

- Embed clear sustainable goals and KPIs for senior management.
- Inclusion of ESG / Sustainable factors into the usual risk metrics and cash flow analysis at the time of deal underwriting (factors could be type of security, geography, industry, pricing etc.).
- Strong push from regulatory and associated bodies on specific sustainability disclosures.
- Treatments of ESG / sustainable investments for prudential regulatory perspectives (e.g., lower risk-weight treatment).
- In-country and regional support for innovative approaches to financing environmental, sustainable and socially responsible projects and programs.
- Developing a framework for green Islamic finance instruments that can build on the principles for environmental, social and sustainability in order to ensure the alignment of the issuances with investor expectations.

West, Central, and South Asia

- To establish in-house environment management.
- To ensure environment friendly atmosphere for employees to make everyone environmentally concerned.
- Adherence to the Environmental Risk Management guidelines.
- Launch of green banking products and services supported to environment.
- To provide support to our clients to be more environmentally conscious.
- Financing in green project.
- To support environment friendly organizations as a part of Corporate Social Responsibility activities.
- Alliance with Non-governmental Organizations and other environmental focus groups for green banking activities.

North Africa

- To work on managing Sukuk and to offer them as an alternative to loans to finance countries' budgets on the infrastructure side, as well as supporting the construction sector, real estate and other vital projects.
- To take care of community finance through financing projects, such as: health, education and housing; to take care of social responsibility of the poor communities; to finance sustainable projects such as roads and dams; to take care of financial inclusion.

Southeast Asia

- Increase collaboration and synergy between banks.
- Educate the public through social media channels.
- Educate stakeholders such as government and other institutions involved.

The Future of Islamic Finance Industry

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Impacts of the COVID-19 Pandemic

The uncertainties caused by the pandemic have put the global economy in jeopardy and global recession seems inevitable for all countries. Within just a few weeks of COVID-19's outbreak and spread, the fallout and impact on the world's economy surpassed that of the global financial crisis in 2008. With countries shutting down industries, the economic impacts have amplified and spilled over to most of the global economy, the effects of which are seen in the short-term and will continue to be felt in the long-term. Various measures have already been taken by governments to reduce the economic impact of the crisis caused by COVID-19. Some countries, predominantly emerging markets, are turning to debt to help reduce the economic downturn. The COVID-19 outbreak has magnified existing vulnerabilities, leading to large external and fiscal financing needs.

On the other hand, domestic consumer demands have dropped, mainly due to travel and movement restrictions, curfews, quarantines, and lockdown imposed by most countries. This has disrupted global supply chains and consequently pushed many companies to lower production and shrink employment. A large number of people have already lost their jobs and global unemployment has been rising. In particular, the micro, small, and medium-sized enterprises (MSMEs) sector is significantly disrupted by the pandemic. MSMEs are struggling to survive, at the same time that many are obliged to pay expenses such as instalments on their financings from financial institutions. Consequently, the disruptions also spread to the financial industry.

Potential Business Lines in Global Islamic Finance: Blended Finance

In line with the implementation of the SDGs agenda where the targets should be achieved within a decade from now, global awareness has risen towards how ethical values should be manifested in economic practices. The world has witnessed how economic and business practices without moral values have resulted in tremendous social gaps and environmental crises. The Islamic economy and financial system represent the philosophical values of responsibility and justice. From the market point of view, the sense of responsibility is expressed in how consumers engage in consumption and investment activities that comply with ethical and moral principles. It inherently demands the creation of sustainable products or instruments at the end of the day.

Islamic finance which upholds the Maqashid Shariah (consisting of the maintenance of religion, life, intelligence, progeny, and wealth) fundamentally has the same focus as the

SDGs: sustainable development and inclusivity. A deficiency in these main areas causes the loss of basic needs for society, which in turn endangers human life. Thus, in the same vein as the global agenda of the SDGs, countries with dual economic systems should mainstream Islamic finance practices into the national agenda. The Government of Indonesia is committed to encouraging sustainable development and adopted it in its national and regional planning document namely the National Medium Term Development Plan or RPJMN 2020-2024. Islamic finance development is also mainstreamed in RPJMN because the government believes that Islamic finance development will strengthen national economic resilience.

In the development context, there are many financing gaps occurring in the community, ranging from financing infrastructure development to MSMEs empowerment. The financing agenda cannot be solely resourced from government funds, but also needs to be supported by innovative financing from all parties including the private sector. Thus, the creation of innovative financing products is necessary to boost a sustained and inclusive development. Several schemes and innovative financing sources are needed to be encouraged, such as non-government financing that can be sourced from Islamic social funds, namely Zakat, Infaq, and Sadaqah collection, as well as corporate social responsibility (CSR) funds, and crowd funding.

There are financings from financial institutions as well, such as the Islamic Public-Private Partnership (PPP) scheme, impact investing, and innovative financing through blended finance where integration of commercial and social finance takes place. Those instruments also play a great role in achieving the SDGs. The Indonesian Government have several initiatives in mobilizing Islamic finance for the SDGs, namely Global Sovereign Green Sukuk (Indonesia was the first country in the world that issued green Sukuk), a hospital built though the Islamic PPP scheme, and Cash Waqf-Linked Sukuk which integrates Islamic commercial and social finance.

In the last few years, Waqf stakeholders have tried to develop cash Waqf to be managed productively, trustfully, and professionally so that it can strengthen Islamic social safety nets in society. For instance, last year, the Indonesian Waqf Board (BWI) and Money Waqf Nazir mobilized cash Waqf and invested it in Cash Waqf Linked Sukuk (CWLS) issued by the Government. CWLS can be a benchmark of innovative Waqf management, where it facilitates the citizens to get an investment grade portfolio and at the same time contributes to national social development since the returns will be used to finance health, education, agricultural sectors, and other social programs in the community.

In order to promote the SDGs through blended Islamic finance, the provision of a healthy ecosystem to boost the creation and utilization of Islamic finance as well as impact investing instruments is absolutely necessary. Policies have to be directed to create such an environment.

Islamic Social Finance as Part of the SDGs

In line with the development of the Islamic economic and financial sector, the Islamic social funds sector (which includes Zakat, Infaq, Sadaqah and Waqf) is also a potential and strategic area to be developed. The Islamic social funds sector has great potential in supporting efforts to overcome development problems such as poverty, inequality, and social disparity. Zakat, Infaq, and Sadaqah play an important role in providing social safety nets and ensuring the fulfilment of basic needs for the poor, reducing inequality, encouraging the rotation of the economy, and encouraging the use of idle funds for productive use. On the other hand, Waqf is able to support national development through community economic empowerment and increased investment and welfare in the fields of religion, education and social services.

According to Pew Research's report (2017)[4] , Muslims are projected to be fastest-growing major religious group in the world in the next half century. The number of Muslims is expected to increase by 70% by 2060. This fact indicates that Islamic social finance has enormous potential to solve socio-economic problems in the society. Take the example of Waqf. Indonesia as a country with the largest Muslim population in the world has potential of IDR 2,000 trillion per year for Waqf assets and more than IDR 188 trillion cash Waqf. We can imagine the great potential if Waqf fund is collected well around the world. We can definitely eradicate hunger and poverty, and work towards achieving the SDGs.

Furthermore, we need to expand the scope of Waqf utilization. The Waqf asset or fund is no longer limited to the sole purpose of worship, but should be developed for socio-economic purposes that have significant impacts in reducing poverty and social inequality as well as improving the welfare and community's economic empowerment. Waqf funds and assets can be used in productive schemes such as building hospitals, flats, office buildings, schools, and other public facilities. The profit from those assets can be distributed for the poor or simply to help boosting the micro, small and medium enterprises (MSMEs). Therefore, this potential at the same time should be able to have a significant influence on efforts to drive the economy.

In January 2021, Indonesian Government launched the National Movement of Cash Waqf as an initiative to improve the community's literacy on Waqf. The utilization of cash Waqf should always be developed although cash Waqf might not be new instruments in some countries. One development that needs to be assured is Waqf management in Islamic banks. Islamic banks have a vital role as licensed Islamic financial institutions

[4] https://www.pewresearch.org/fact-tank/2017/04/06/why-muslims-are-the-worlds-fastest-growing-religious-group/

that can collect cash Waqf and support professional asset management. However, Islamic banking institutions need to bring community banking values by providing services to the community, not just making the community a target market. They should be responsible for providing financial services which encourage ethical investment as well as creating stability by linking financial services to the real economy sector. Moreover, an Islamic bank should maintain efficiency and good governance so people can trust their cash Waqf to it. Trust is also one of the main manifestations of Islamic teachings that must be regarded as social capital and guaranteed its sustainability as a mechanism that can keep Waqf operating efficiently.

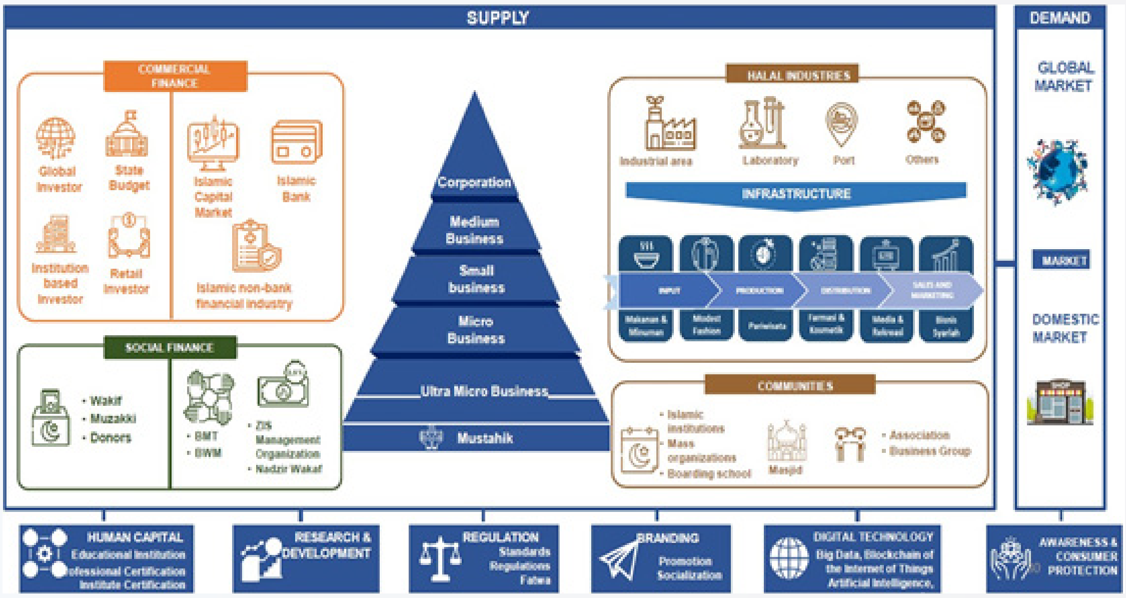
Last, but not least, digitalization can increase financial inclusion and enhance Islamic finance growth. Governments collaborating with other parties should establish links and matching between halal industries and Islamic finance services. The use of technology is needed to synergize Islamic financial technology and Islamic banking digital services in order to serve MSMEs and un-bankable communities as well as strengthening community-based traditional market. Optimization of Zakat and Waqf collection and distribution also could be enhanced using digital tools.

Islamic Economic and Financial Ecosystem

In order to encourage the role of the Islamic economy as a source of economic growth, integration of every element to support the Islamic economy is needed which is reflected in a strong Islamic economic ecosystem. By establishing a robust Islamic economic ecosystem from upstream to downstream, the stakeholders and key drivers of Islamic economy are expected to have a much greater opportunity to improve business processes both in terms of quantity and quality. It is also important to stimulate the emergence of innovation and motivation of these economic actors.

Elements that make up the Islamic economic ecosystem are contained in the interaction of the supply side and demand side. There are 4 groups of economic actors which form the side block of Islamic economic supply products and services, namely the halal industry cluster, commercial financial cluster, social finance cluster, and community cluster. The interaction on the supply side represents a strong support of industrial activity in the real sector coming from industrial sectors in commercial and social finance clusters, including the participation of the Islamic economic community. Therefore, the development of the Islamic financial sector must be in line with the needs of strengthening the real sector, especially the halal industry and Islamic businesses in order to create sustainable synergy with domestic and global demand.

Fig.25. The Islamic Economic and Financial Ecosystem



Finally, the government alone cannot achieve sustainable development without any collaboration from other parties. The agenda in minimizing the financing gap and creating a robust circumstance of sustainable financing based on Islamic principles needs to be enhanced and disseminated to all stakeholders. Collaboration and synergy between all parties and elements in the Islamic economic ecosystem are the engine of global Islamic finance growth.

Islamic banks are generally optimistic about the future of the industry over the next 10 years. There is, however, a recognition that in the areas where Islamic finance is well-established, it may be difficult for growth much to exceed that of the general economy. For very high overall growth rates to be sustained, growth will have to come from areas where Islamic finance is relatively new, and from those where, despite a long-term presence and a dominantly Muslim population, it continues to represent a small proportion of the overall financial sector.

In some cases, the growth of Islamic finance is inhibited by prescriptive banking laws containing provisions devised for conventional banking but which are inappropriate for Islamic banking. Restrictions on the ownership of physical assets are one obvious example. This requires a commitment by government to remove unnecessary obstacles to Islamic banking, though it does not imply more than a "level playing field" policy. There is also some fear that governments keen to help their economies recover from the COVID-19 pandemic will try to direct the activities of the banking system in ways which may impede the system's long-term health.

More positively, there is a clear demand from the industry for the implementation (and practical application) of international standards. Some of these are regulatory standards; others are transactional standards, such as standard documentation for interbank transactions. These will also ease cross-border business and the ability of the larger banks to establish operations in new markets.

As Islamic finance grows in a jurisdiction, development of a full infrastructure for it becomes significant. This includes other aspects of Islamic finance, such as capital markets and Takaful, as well as central bank policy instruments and possibly centralized Shariah governance arrangements.

Islamic banks recognize the need to respond to and adopt the innovations in technology that are transforming financial services, though they start from very different bases not only in their own operations but in the national infrastructure available. Only a handful of banks, however, see themselves as challengers, using technology to implement new business models or to surpass established banks. More commonly, respondents speak of the need to keep up with technology, with the implication that they fear being overtaken, possibly by larger conventional rivals. This will be a particular issue for small Islamic banks, and it is possible that the process of consolidation through mergers and acquisitions, already visible in some jurisdictions, will spread more widely. Such a process may also be driven in part by the continuing regulatory drive towards strengthening the resilience of the financial sector following the global financial crisis, which has led to more demanding standards for capital and liquidity in particular.

The boundaries between technological innovation and product innovation frequently blur, especially where the issue is focused on customer needs, which are often not expressed in traditional banking terms. However, there are some points where banks are clearly seeking new transaction forms in Shariah terms, including Islamic capital market products and Shariah-compliant alternatives to conventional derivatives. This, however, opens broader questions about the direction of Islamic finance, views on which were not directly canvassed in the survey.

In recent years, sustainability has become a more and more important topic in the financial world and indeed in business more generally. Some Islamic banks have clearly embarked on the process, which many recognize will be a long one of trying to build sustainability into both their operational practices and their core business strategies, notably the areas in which they are willing to advance finance. For others, while the ethical dimension is clearly important to them, sustainability is expressed more through a distinct set of programmes and activities rather than fully integrated into business strategy. For others, it does not seem to have impinged at all. However, there is no sign that banks expect investor and customer pressure for sustainability to abate and, even if they are not impelled in that direction by the ethics of Shariah, Islamic banks are likely to need to respond to that external pressure.

Conclusion and Recommendations

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The first two parts of this survey, covering the Islamic banking industry's confidence index, risk dashboard and related issues, were inevitably dominated by the current COVID-19 pandemic. The pandemic still continues, and even once elements of normal life return, its economic effects will be felt for a much longer period. Indeed, macro-economic concerns were dominant in the minds of Islamic banking officials. These will affect some jurisdictions more than others, with those dependent on hospitality, tourism or oil revenues likely to be particularly hard-hit.

Given the circumstances, it is hardly surprising that levels of confidence about the future have fallen. However, it is surprising and heartening to see that Islamic banks still maintain a relatively optimistic outlook. This may be attributable to hopes for a relatively early end to the pandemic, but also to the vigorous measures taken by governments and central banks to inject liquidity into their economies, to calm market volatility, and to provide continuing stimulus – measures which may be considered generally successful.

However, these measures cannot be continued indefinitely. There are major doubts about the speed at which they can, or will, be tapered down, and about the impacts of tapering, particularly on the ability of bank customers to repay their financings and on asset prices. Concern about the former is likely to underlie the heightened concern of Islamic banks about credit risk. Liquidity risk also remains a significant concern and may be intensified as liquidity support is withdrawn, along with the concessions that some Regulatory and Supervisory Authorities (RSAs) have given in relation to liquidity ratios.

In addition to its economic impacts, the pandemic has impacted Islamic banks' operations. It has accelerated the move to digitalisation and, in particular, to mobile banking, that was already under way. This will have exacerbated challenges for which some banks already considered themselves underequipped. The scale and nature of these challenges will vary by jurisdiction, depending among other things on the digital infrastructure, on regulations, and on the competitive position of Islamic banks in that jurisdiction. However, at very minimum, no Islamic bank can afford to be materially behind its competitors in this respect, whether those competitors are conventional or Islamic.

The pandemic has also forced Islamic banks to operate differently, with staff often having to work remotely. This has heightened an already growing concern about cybersecurity and the ability of technology infrastructures to support future ways of banking. It has also caused banks to think again about their contingency plans, since the pattern of disruption seen in the pandemic, particularly with movement limitations over a long period may not have been considered in past planning.

The third part of this survey was different from past surveys in that it invited respondents to look further into the future, and also includes a number of expert views on what that future might hold.

A number of common themes emerged.

One, unsurprisingly, is technology. For the longer term, a greater range of technologies will come into play than for the immediate COVID-19 recovery period. Some technologies that currently appear promising will no doubt fail to deliver and some novel technology-based business models will prove unsuccessful or will be confined to relatively small niches. Conversely, new technologies or models will emerge. Smaller banks in particular will find it difficult to pursue all possible lines of technology; they will need to keep watching briefs, and be ready to form strategic alliances or to buy in those technologies that they cannot develop themselves. The risk here is that Islamic banks, being a generally relatively small presence in global terms, will find themselves losing ground to their larger competitors.

Another common theme is a reassertion of Islamic finance's position as based on fundamental values, sometimes articulated through the Maqasid Shariah. This contrasts with considering it as purely rule-based, an approach which can easily be seen as negative and restrictive. This aligns with an increased global interest in value-based finance, whether this is articulated in terms of the UN SDGs, or ESG, or environmental concerns, or in some other way (which is very likely to overlap with these). At present, while some banks are very committed to values of these kinds, for others they are not central to their business strategy. This is something that may well need to change in the coming period, partly in response to customer desires, but also to maintain the distinctiveness of Islamic banking in a competitive world.

One of the strongest themes, pervading the individual articles as well as the responses to the survey, is the need for Islamic finance in any jurisdiction to be considered as an ecosystem. This ecosystem includes Islamic banking, capital markets and Takaful, but also financial safety nets, macro-economic tools, public awareness, Shariah scholarship and the development of human capital. Any strategy for its development needs to consider all the parts of the ecosystem, but recognising that they will need to be put in place at different times and will develop at different rates.

The Islamic finance ecosystem can and should also be considered at an international level. At present relatively few Islamic banks are truly international, though capital market instruments cross boundaries much more readily. However, it is in the best interest of Islamic finance to create at least some substantial multinational firms. This will involve addressing some of the barriers that exist partly, though not exclusively, as a result of differing regulatory approaches. Clear support emerged for good international standards, consistently implemented and applied. This will also benefit the emergence of Islamic finance in those jurisdictions where it is at present low representation, where regulation is written around conventional banking, and where authorities do not have the resources to create their own alternatives. The international Islamic finance standards bodies still have some way to go before their standards carry the same weight as those of bodies like the Basel Committee.

Recommendations

While authorities cannot sustain current COVID-19 economic interventions indefinitely, they should seek to taper them in a way which does not impose shocks or undue burdens on the banking system.

Islamic banks should adopt prudent provisioning strategies, recognising that, as government support programmes are withdrawn, further business failures and individual defaults are likely to emerge.

Islamic banks should plan for an accelerated pace of digitalisation, and mobile banking in particular, bearing in mind the need at least to keep pace with competitors. For some banks this may mean buying in technology, possibly including acquisitions or alliances with technology firms.

Islamic banks should revisit their operational risk management and contingency planning in the light of the experience of the pandemic. They should, however, recognise that future disruptive events are unlikely to be identical to the current one and be imaginative in their scenario planning.

Islamic banks need to embrace the trend towards value-based finance and both to articulate and to implement within their core strategies the values that make them distinct, especially in areas such as sustainable development.

Authorities need to consider the development of Islamic finance within their jurisdictions in ecosystem terms, and strategies need to consider how and when each aspect of the ecosystem should develop.

In those jurisdictions where there is no national strategy for Islamic finance, Islamic institutions should themselves come together to propose strategic initiatives with help, where appropriate, from relevant international bodies.

Strategies should, in appropriate areas, be based on international standards, and national bodies should be encouraged to become active members of appropriate international institutions.

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