Q&A

Seven Questions on Islamic Finance

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Although still a small share of global finance, Islamic finance has grown rapidly over the past decade and is projected to continue to expand. The growth of Islamic finance presents opportunities to improve access to finance for the large underserved Muslim populations, and for small- and medium-sized enterprises, opportunities to facilitate investment in public infrastructures and to promote financial stability. However, for the potential to be realized and to safeguard financial stability, a number of challenges will need to be addressed. In their IMF Staff Discussion Note (SDN 15/05), entitled "Islamic Finance: Opportunities, Challenges and Policy Implications," the authors discuss the macroeconomic and financial stability implications of Islamic finance and the policy options. This article provides brief answers to seven commonly asked questions about Islamic finance, drawing on the findings of recently completed analytical work.

Question 1. What is Islamic finance and why does it matter?

Islamic Finance refers to the provision of financial services in accordance with Shari'ah Islamic law, principles, and rules. The main tenets of Shari'ah as applied to finance are: the prohibition of interest; excessive uncertainty and gambling; risk sharing; the requirement that finance supports real economic activities; and the adherence to ethical standards.

The Islamic finance industry mainly comprises banking and the Sukuk or Islamic bond market which account for 80 percent and 15 percent of total Islamic financial assets, respectively. The balance is accounted for by equities, investment funds, insurance (Takaful), and microfinance. Islamic finance is growing rapidly in terms of assets and geographical reach, although the assets are concentrated in Southeast Asia and the Middle East, particularly the Gulf Cooperation Countries (GCC). The Islamic banking sector is now systemically important in a dozen countries and Sukuk is increasing its global reach to include issuers from advanced, emerging, and developing economies (Figure 1).

The growth of the Islamic finance industry offers important potential benefits. It can facilitate financial inclusion by increasing access to banking services to underserved Muslim populations; the risk-sharing characteristics of Islamic financial products can facilitate access to finance by small- and medium-sized enterprises (SMEs); and the asset-backed nature of Sukuk makes them suitable for infrastructure financing that can help spur economic development, including creating an enabling environment for private sector investment. Moreover, the requirement to finance real economic activity can reduce leverage while the risk-sharing features enhance the loss absorbency of capital.

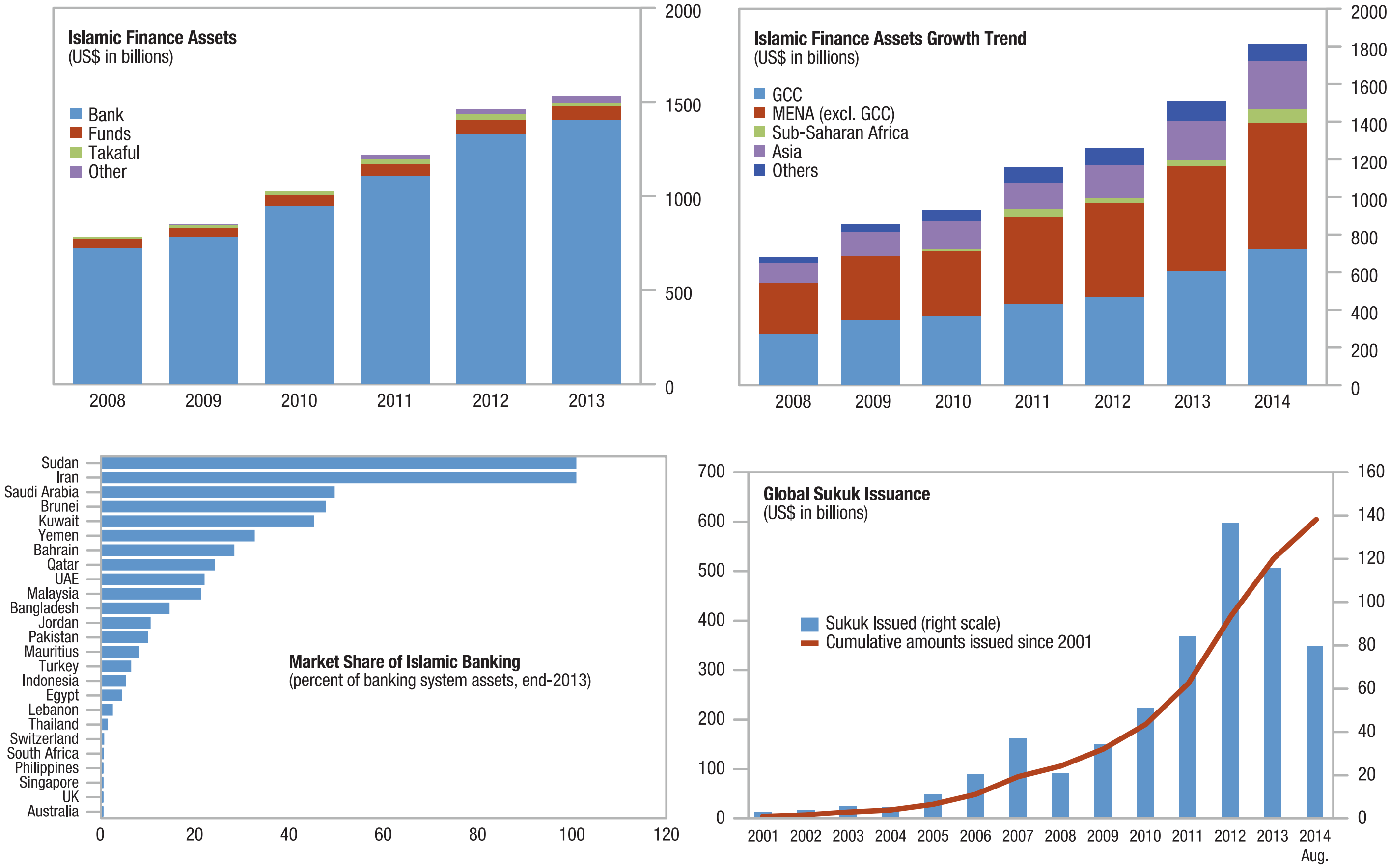
However, to realize the potential and to safeguard financial stability, countries need to adapt their regulatory, supervisory, and consumer protection frameworks to the specificities of Islamic finance; to develop Shari'ah-compliant financial markets and monetary instruments; and to build an enabling environment for Sukuk market development.

Question 2. What stability risks are unique to Islamic banking and what changes are needed to regulatory frameworks to safeguard financial stability?

Islamic financial transactions are structured differently from conventional products because of the need to comply with Shari'ah principles. Unlike conventional banks, Islamic banks are funded by current accounts that do not attract interest or by profit-sharing investment accounts (PSIA) where the investment account holder (IAH) receives a return that is determined, after the fact, by the profitability of the underlying financing and the IAH bears losses, if any. On the assets side, transactions include sales with a profit markup and deferred payments, leases, partnerships, or joint ventures. Additionally, to facilitate the investments, Islamic banks are permitted in some jurisdictions to establish subsidiaries of non-financial corporations in their groups, resulting in conglomerate corporate structures.

Consequently, in addition to standard banking risks (such as credit, market, liquidity, and operational risks), Islamic banks also face unique risks such as the displaced commercial risk (DCR) whereby shareholders may forego a part of their profits to provide competitive earnings to IAHs, equity

Figure 1:
Overview of Trends in the Islamic Finance Industry



investment risk stemming from partnership-like financing, rate of return risk in a context of dual systems where lower earnings may lead to customer flight, and Shari'ah compliance risk. Other standard banking risks such as operational, group risks, concentration, and liquidity risks could also be more heightened because of the complexity of some contracts; corporate structures that include a myriad of non-financial corporations; and underdeveloped liquidity infrastructure and safety nets. PSIAs also raise unique consumer protection issues because of inadequacies in disclosures and the asymmetric treatment of PSIA as investors without shareholder rights.

Therefore, to safeguard financial stability, there is need for further regulatory clarity and consistency, through greater adoption of Islamic standards developed by Islamic standard setting bodies. Countries with Islamic banks need to adopt a cross sectional approach to supervision of Islamic banks, avoid treating profit-sharing investment accounts as pure deposits while enhancing disclosures and corporate governance for the PSIA, strengthen Shari'ah governance structures, and build supervisory capacity. There is also a need to develop supporting financial infrastructures, including Shari'ah-compliant financial safety nets and appropriate resolution frameworks.

Question 3: How does Islamic banking affect monetary policy conduct given the prohibition on interest and what reforms are needed?

Monetary policy formulation and implementation are challenging in the presence of Islamic finance because of the scarcity of Shari'ah-compliant monetary policy instruments, the under development of money and interbank markets, and inadequate understanding of the monetary transmission mechanism. Shari'ah-compliant central bank facilities are also limited, reflecting the difficulty in designing market-based instruments for monetary control and limited Sukuk issuance. The shortage of Shari'ah-compliant high-quality liquid assets (HQLA) also reduces the collateral available for liquidity management and may also affect the smooth functioning of the payment systems. Therefore, a key priority

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will be to bolster the supply of Sukuk and develop Shari'ah-compliant monetary policy instruments.

Question 4. What needs to be done to deepen the Sukuk market?

Although the Sukuk market has registered rapid growth in value and the issuer base has broadened, the markets for Sukuk are still neither deep nor liquid, and most issues of Sukuk are asset based and not asset backed. Issuance also takes place without a comprehensive strategy to develop the domestic market.

National authorities should, therefore, develop the necessary infrastructure, including developing securitization and trust laws, promoting true securitization, clarify legally the investor's rights—particularly in defaults—and promote standardization of contracts. Regular sovereign issuance, and at different maturities, is critical for deepening the market and establishing a yield (or Sukuk) curve that could provide a benchmark for corporate Sukuk. Increased sovereign issuance should also be underpinned by sound public financial management (PFM), and attention should be given to the accounting and statistical treatment of Sukuk instruments, which are currently largely overlooked in existing international standards.

Question 5. What are the tax implications of the growth of Islamic finance?

Islamic finance raises a number of taxation issues that call for policy attention at both national and international levels. The favorable treatment of debt in most tax systems relative to equity can disadvantage Islamic finance. Secondly, Islamic finance involves a series of transactions that could attract value-added, stamp, and other sales taxes that could put Islamic finance at a disadvantage relative to conventional finance. Therefore, particular attention is needed to ensure that tax systems guarantee a level playing field and that the system does not create incentives for international regulatory arbitrage.

Question 6: Does Islamic finance require changes to macroprudential policies?

Most macroprudential policies are applicable to Islamic banks with some modifications. The countercyclical capital buffer framework, conservation buffers, leverage ratio, dynamic provisioning, and sectoral risk weights could help in mitigating credit risks. Also, profit equalization reserves (PER) and investment risk reserve (IRR) can serve as countercyclical reserve buffers. However, given the business model that includes investment, modifications are needed to risk metric and stress tests for identifying and monitoring risks. Sectoral concentrations and liquidity risks also deserve greater attention because of the requirement to underpin all transactions with real economic activity and also the underdeveloped nature of Shari'ah-compliant financial markets and safety nets.

Question 7. What has prompted the IMF to focus on Islamic finance and what is the agenda going forward?

The IMF's interest in Islamic finance is not new. In the early 1980s, the IMF initiated a program of research on the theoretical underpinnings of an Islamic financial system, the operations of Islamic banking, and the conduct of monetary policy within an Islamic system. The IMF also played a key role in the establishment of the Islamic Financial Services Board in 2002. Where relevant, the IMF has been providing policy advice (Article IV consultations and its FSAP assessment) and technical assistance (TA) to strengthen the regulatory framework and monetary operations and to develop the Sukuk market.

However, with the growth of the industry, demands from member countries for policy advice and technical assistance have increased and the evolution of and innovations in the industry also present new opportunities and challenges. So to ensure coherence and consistency in our policy advice, the IMF formed an interdepartmental working group on Islamic finance to undertake analytical work on the macroeconomic and financial stability implications of Islamic finance. The IMF also established an external advisory group which helped to identify policy challenges facing the Islamic finance industry and facilitated coordination with those international institutions involved in establishing standards for the industry. The findings are summarized in the Staff Discussion Note (SDN 15/05) issued on April 6, 2015, entitled "Islamic Finance: Opportunities, Challenges, and Policy Options."

To foster policy dialogue on issues raised in the SDN, the IMF and the G20 presidency jointly organized a seminar on Islamic finance during the 2015 IMF-World Bank Spring Meetings entitled "Islamic Finance: Unlocking Its Potential and Supporting Stability." The seminar was a kickoff event for a global conference on Islamic Finance that will be held in November 2015 in Kuwait. In the interim, a series of working papers that underpinned our policy conclusions will be published and consolidated into a book. The IMF will also continue regular policy dialogue with our member countries, our financial stability assessments, our technical assistance, and training.

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set to become tighter because of the impact of the normalization of the U.S. monetary policy. The recent declines in potential growth estimates for most EMEs are also likely to be a drag on business investment going forward. Moreover, investment ratios are still relatively low in some emerging market regions, particularly in Latin America and the Caribbean, so boosting private investment remains a policy priority.

In light of our results on the size and persistence of financing constraints, especially for smaller firms, business investment in EMEs would benefit from further deepening domestic financial systems, strengthening capital market development, and promoting access to finance—of course, subject to sufficient safeguards to ensure financial stability. Strengthening financial infrastructure and legal frameworks, and enhancing capital market access to funding for small and mid-sized firms would be positive measures.

More generally, and beyond the scope of our study, structural reforms to boost productivity could help unlock private investment and output growth. The design of a policy agenda of structural reforms is a difficult task and entails country-specific considerations, but in many emerging markets, the efforts to improve infrastructure and human capital, strengthen the business climate, and foster competition are key priorities.

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