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Islamic finance 2017: State of the art and outlook for the future

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Question

How is the Islamic finance sector developing, where are investments being made? Are conventional investors (i.e. investors in conventional financial instruments such as bonds, equities, etc. including sovereign wealth funds, state pension funds, etc.) moving into the Islamic space? What have various authorities suggested as potential directions for future development of the sector?

Contents

1. Overview
2. Composition of the industry
3. National markets
4. Conventional investors and Islamic banking and finance
5. Outlook for the future
6. References

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1. Overview

The Islamic finance industry is composed of four sectors: banking, sukuk (bonds), equity and funds, and takaful (insurance). The banking sector dominates the industry with approximately 75% of all Islamic financial assets under management (Dubai Islamic Bank, 2017a: 38). Islamic financial industry assets are domiciled predominantly in Gulf Cooperation Council (GCC) countries (USD 922 billion), Southeast Asia (USD 473 billion), and Middle East excluding GCC countries (USD 453 billion). In non-Muslim majority countries, in Europe and the Americas, Islamic finance maintains a presence but remains marginal. Interest in Islamic finance among conventional investors appears to be limited.

In 2016, the Islamic finance industry experienced a year of slowdown after almost a decade of two-digit growth, mostly due to an unfavourable political and economic climate (notably due to low oil prices), rate depreciation in some of the key markets, and natural maturation of the industry (IFSB: 2017, DIB: 2017a). Islamic finance is developing predominantly in Muslim-majority countries, most importantly in Malaysia, GCC, and Iran. Experts predict a slowdown in the growth of the industry, a decrease in profitability, and potentially a decline in the quality of assets. Slower growth is expected in maturing markets such as the GCC and Malaysia, while growth is hoped to accelerate in some non-core, newer markets such as Europe, Russia, CIS, and Africa, as well as in Iran which will be opening to the global economy thanks to the recent lifting of sanctions (S&P, 2017; DIB, 2017a, Thomson Reuters & Dinar Standard, 2016).

Key opportunities for the development of Islamic finance sector include:

- Demographic trends;
- Lifting of international sanctions on Iran;
- Initiatives such as Saudi Arabia's Vision 2030 and China-Pakistan Economic Corridor (CPEC);
- Super-abundance of capital (increasing per capita income and wealth of Muslims).

Key challenges include:

- Lack of standardization and unified regulatory environment;
- Low levels of public awareness;
- Low oil prices;
- Uncertain political and economic environment.

The *sukuk* sector, where issuance is still time- and resource-intensive, is not expected to expand greatly in the upcoming years, although so-called green *sukuk* is seen as a new promising field of development. *Takaful* and sharia-compliant pension funds, despite their potential (mostly due to demographic changes), are not expected to grow in 2018 either. The application of sharia-compliant solutions in the FinTech sector and SME funding are seen as promising directions for development.

2. Composition of the industry

The Islamic finance industry is composed of four sectors: banking, sukuk (bonds), equity and funds, and takaful (insurance). The Islamic banking sector, which experienced "reasonable

levels” of growth (IFSB, 2017: 3), holds the majority of sharia-compliant assets. The sukuk market has recovered after three difficult years, while both takaful and Islamic equity and funds managed to perform well.

Table 1 : Islamic financial assets by sector (2016)

Sector	Share in Islamic finance assets
Islamic banking assets	72-78.9%
Sukuk	15-17%
Islamic investment funds	3-4%
Takaful	1-2%
Microfinance	1%
Other	4%

Sources: Dubai Islamic Bank, 2017a: 38; IFSB, 2017:8; Thompson Reuters: 2016.

Banking

In terms of assets under management (AUM), the Islamic finance industry continues to be dominated by **the banking sector,** in spite of the fact that with a year-on-year growth rate at 6% it was its slowest growing sector (Thomson Reuters, 2016b: 58). Islamic banks and conventional banks with Islamic windows hold roughly 75% of all Islamic financial assets. Out of those, ca. 60% belong to full-fledged Islamic banks (Dubai Islamic Bank, 2017a: 38; Thomson Reuters, 2016b: 54-55).

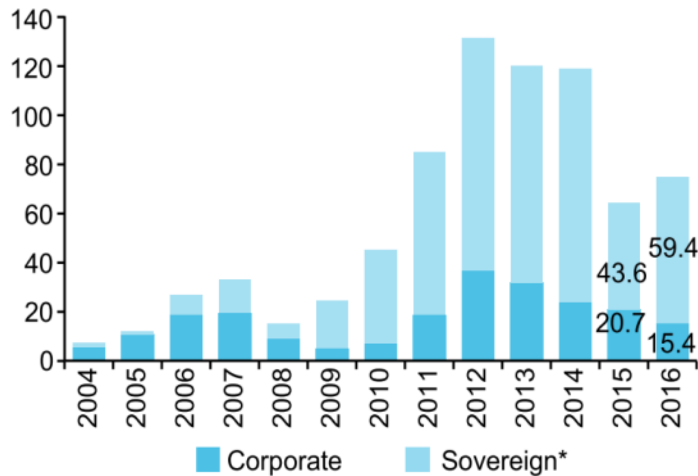
In general, in 2016 Islamic banks experienced “reasonable levels” of growth of their assets, financing, and deposits, and their market shares increased in 18 jurisdictions, decreasing marginally or remaining unchanged in further 13 (IFSB, 2017: 3). At the same time, regional composition of these assets changed. The Iranian rial’s depreciation was the main reason behind the 2016 drop in the MENA (excluding GCC) Islamic banking sector’s assets by USD 66 billion, down to USD 541 billion. Conversely, in the GCC and Asia, Islamic banks’ assets grew, in spite of both regions also experiencing currency depreciations. At the end of 2016, the GCC and Asian shares of total Islamic financial assets increased to 42% and 22% respectively, while MENA excluding GCC decreased to 30%. Despite these changes, 88% of Islamic banking industry’s assets remain to be held in jurisdictions with a systemically important Islamic financial sector (according to IFSB classification, see Section 3).

Sukuk (Islamic bonds)

After three years of decline in the volume of issuances, in 2016 the **sukuk market** rebounded, expanding by 6%, although it still has not regained its pace of growth from the post-financial crisis period of 2009-2014 when its Compound Annual Growth Rate (CAGR) stood at almost 20% (IFSB, 2017: 15). New issuances, the majority of which originated in Malaysia (50.6%), Indonesia (12.1%), and UAE (10.5%) amounted to USD 75 billion, bringing the volume of all outstanding sukuk to ca. USD 320 billion. With only 21% of new issuances being corporate, the

market was driven by issuances from sovereigns,[1] especially those looking forward to patch their budgets hurt by low oil prices (IFSB, 2017: 3, Dubai Islamic Bank, 2017a: 40-41).

Figure 1: Global Ṣukuk Issuances – Sovereign and Corporate (2004–2016) (USD billion)



Source: IFSB, 2017: 16.

*Includes all government-related entities (GREs), multilateral development banks (MDBs) and international organizations (IOs).

Sovereign issuances, which grew in volume by 36.4% compared to 2015, originated from 16 OIC (Organisation of Islamic Cooperation) countries, including debuting Jordan and Togo. Over half (50.8%) was issued by Malaysia, followed by Indonesia (14.7%), UAE (8.1%), Saudi Arabia (6.7%), and Turkey (5.1%).

Unlike the sovereign sukuk market, the corporate market experienced a persistently low number of issuances, which compared to 2015 declined by 25.7%. This is believed to be a result of a mixture of unfavourable socio-economic and political environment and complexity and burdensomeness of the issuance process itself (IFSB, 2017: 3). Corporate issuers originated from 9 countries, including debuts from Kuwait, Oman, and Germany (the only non-OIC jurisdiction on the sukuk map), although just over half (50.2%) were based in Malaysia and further 18.3% in UAE. The biggest corporate sukuk issuances of 2016 were by IDB (USD 1.5 billion), Dubai's DP World (USD 1.2 billion), and Emirates Islamic Bank (USD 1 billion) (IFSB, 2017: 18).

In terms of issuances by sector, while the plurality of issuances was by governmental (42.9%) and financial (31%) services, infrastructure-linked (power and utilities, transportation, and telecommunication) issues soared up to 16.7%, and real estate accounted for 4.1%. Most issuances (49% compared to 40% in 2015) were asset-based (mostly based on *ijarah*[2] or

[1] Including multilateral organizations such as IILM and IDB and government related entities.

[2] Sharia-compliant leasing contract.

wakalah[3]). Debt-based structures (like *murabahah*[4]) decreased sharply from 52% in 2015 to 35% of all issuances in 2016. The remaining 15% (up from 8% in 2015) were PLS (profit-and-loss sharing) structures (although this increase is entirely attributable to Malaysia). Less than 1% of sukuk issuances in 2016 were based on new, hybrid structures (Thomson Reuters, 2017: 30). Outside of the Malaysian market, where a variation of structures and maturities could be found, all but one issuances have maturity marks under 10 years.

Equity and funds

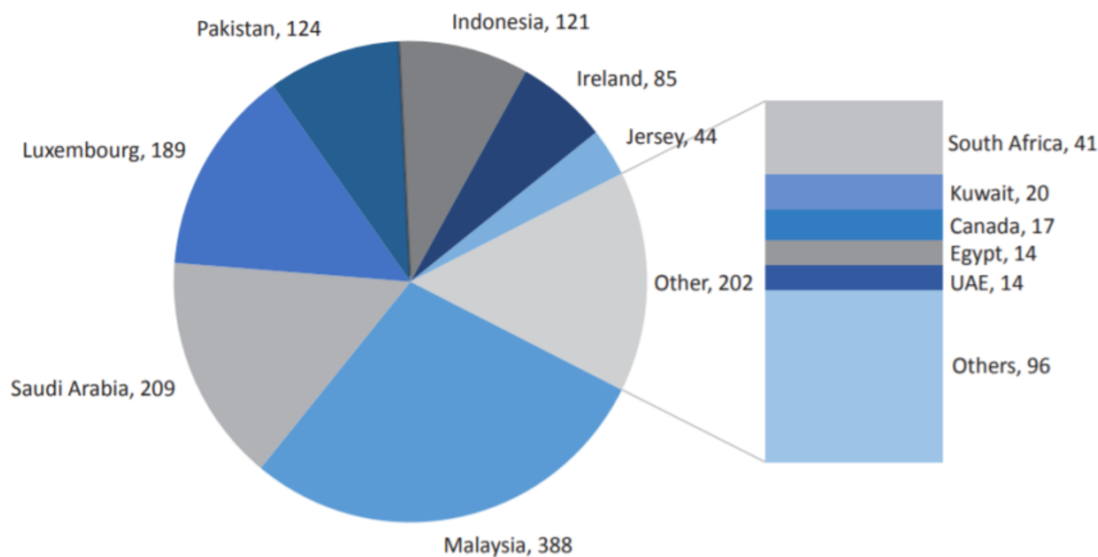
Compared to the sukuk market, **Islamic equity and funds** remain niche sectors, despite performing relatively well over the past year. Price movements of sharia-compliant stocks are correlated with those of conventional equities[5] so in 2016 Islamic equities experienced similar challenges resulting from changes in the political and socio-economic environment (both globally and locally). At the same time, and unlike in the past, returns generated were lower than those brought by conventional equity: the Dow Jones Global Index (DJ) generated a return 2.4 percentage points higher than that of the Dow Jones Islamic Market World Index (DJ Islamic) (13.6% versus 11.2% respectively). IFSB attributes this to the particular composition of both indices: Sharia-compliant equity is more exposed to healthcare and consumer goods and services sectors as opposed to better-performing infrastructure and finance (IFSB, 2017: 3, 23). Nevertheless, on a 10-year horizon (2006-2016), the performance of DJ Islamic tops that of DJ Global index, generating over twice as high return (40.1% versus 17.5% respectively) (IFSB, 2017: 3).

Figure 2: Number of Islamic Funds Domiciled by Country at the end 1Q2017

[3] An agency contract.

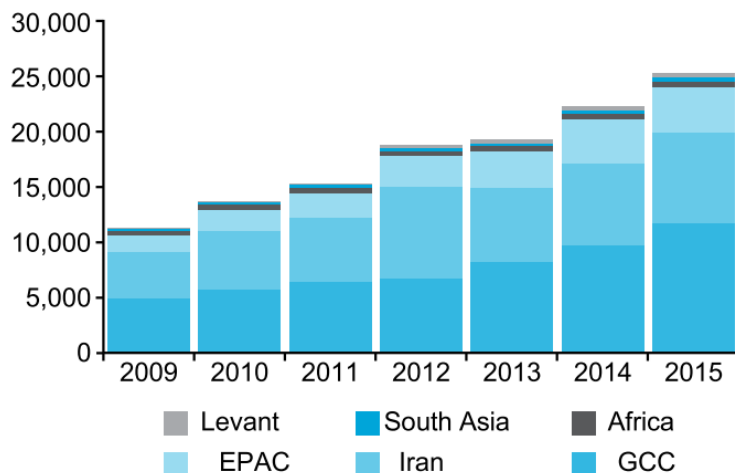
[4] A mark-up sale or cost-plus financing, one of the most popular sharia-compliant financial instruments on the market.

[5] Sharia-compliant equity, unlike sukuk, functions as a part of the broader global stock market securities.



Source: MIFC, 2017: 1.

Figure 3 Takaful. Gross Contributions by Country Groups (2009–2015) (USD million)



Source: IFSB, 2017: 28.

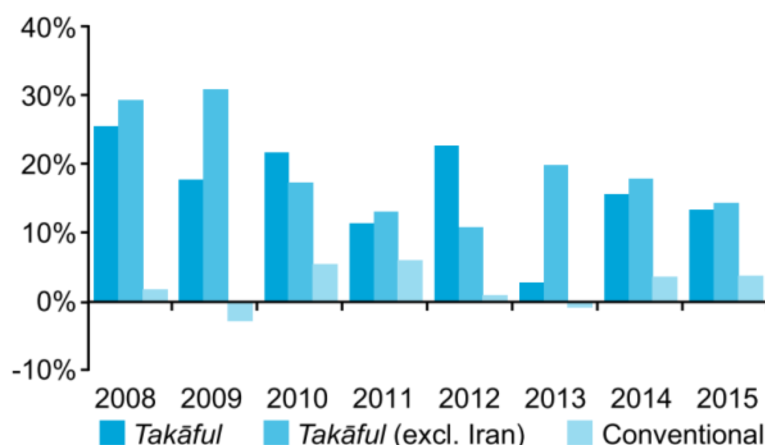
The performance of sharia-compliant equity, in turn, coupled with performance of the sukuk market, influences the performance of Islamic collective investment schemes (ICIS). These comprise 1,535 Islamic funds with ca. USD 70.8 billion (up from USD 56.1 billion as of the end of 2016 and USD 47 billion as of the end of 2008) of assets under management (as of 1Q2017) (MIFC, 2017: 1). Domiciled in 37 jurisdictions (out of which 22 are non-OIC members), they are predominantly concentrated in Saudi Arabia (38%) and Malaysia (29%), followed by Ireland (8%), USA and Luxembourg (5% each). Roughly one third (34%) of the funds have a global investment focus, while further 25% focuses on Malaysia and 21% – on Saudi Arabia (down from 31% in 2015). In terms of asset-class structure, 43% are equity-based (up from 36% in 2015), 25% money market-based (down from 35% in 2015), and finally 12% (up from 10% in 2015) –

commodity-based (the remaining ones being based on sukuk, real estate and mixed allocation) (IFSB, 2017: 25).

Takaful (insurance)

The takaful (so-called "Islamic insurance") industry, despite its huge potential and growing by 12% (in terms of contributions) last year (2015) and by 16% on average between 2008 and 2015, still comprises just 305 operators and windows. Its contributions, coming mostly from GCC (47%), MENA excluding GCC (that is mainly Iran) (33%), and Asia (18%), in 2015 amounted to USD 25.1 billion (up from USD 22.2 billion in 2014) (IFSB, 2017: 3; WB & IsDB, 2017: 106). Still underdeveloped, it is slowly expanding to new jurisdictions (for instance, in 2014 takaful was introduced to Oman and in 2015 Morocco passed takaful regulations) and expanding further in existing markets, mostly in GCC and Africa. New legislation aimed at helping the takaful industry grow was introduced in 2014 in Indonesia and in Pakistan.

Figure 4 Chart 1.4.3 Growth Rate of Premiums in Takaful and Conventional Insurance Sectors (% y-o-y) (2008–2015)



Source: IFSB, 2017: 27.

The majority (71%) of global takaful contributions come from Saudi Arabia and Iran (in 2015 they totalled USD 9.7 billion and USD 8.1 billion respectively), followed by Malaysia, Indonesia, and UAE. However, while in Saudi Arabia and Iran growth rates of contributions declined (mostly due to currency depreciations), UAE saw an increase of 24% resulting from an introduction of a mandatory health insurance (already in force in another GCC country, Saudi Arabia). In ASEAN countries (Brunei Darussalam, Indonesia, Malaysia, Singapore, and Thailand), it exhibited similarly high growth of 22% between 2012 and 2014, mostly due to demographic trends and the overall strong economic performance of their economies (IFSB, 2017: 27; IsDB & WB, 2017: 106).

In terms of takaful business lines, while motor takaful has been suffering from a decline in car sales, family takaful has been expanding in the Southeast Asia, and medical/health takaful – in the GCC (IFSB, 2017: 26-30).

3. National markets

Despite the relatively wide outreach of the Islamic financial industry, in 2015 the majority of Islamic finance assets were domiciled in GCC (USD 922 billion), Southeast Asia (USD 473 billion), and Middle East excluding GCC (USD 453 billion). A further USD 72 billion was held in Europe and the Americas (72.2% of that in Turkey), USD 51 billion in remaining parts of Asia (51% of which is in Bangladesh), and USD 32 billion in Africa (Thomson Reuters, 2016a: 12-13).

Depending on the methodology adopted, different institutions rank various countries differently on their "top Islamic destination" classifications. Table 2 below presents three different rankings prepared by Thomson Reuters, Islamic Development Bank, and Islamic Financial Services Board, based on different methodologies (see notes below the Table). In a ranking based purely on the share of Islamic banking assets in total banking assets, Iran and Sudan (where 100% of financial institutions are sharia-compliant) lead the way. In the other two – more complex – rankings, however, Malaysia is ranked number one.

Table 2 Islamic finance country rankings

Country	Islamic Finance Indicator*	Islamic Finance Country Index (IFCI)**	Islamic Banking Share in Total Banking Assets***
Malaysia	1	1	8
Iran	12	2	1
Saudi Arabia	4	3	4
UAE	2	4	9
Kuwait	6	5	5
Pakistan	7	6	14
Indonesia	9	7	21
Bahrain	3	8	13
Qatar	8	9	7
Bangladesh	11	10	10
Sudan	12	11	2
Jordan	10	13	12
Brunei	14	15	3
Oman	5	16	16
Singapore	15	25	34

Source: Author's compilation based on Thomson Reuters, 2017; Dubai Islamic Bank, 2017b, and IFSB, 2017.

* "Best developed ecosystem for Islamic Finance". "The ranking was calculated according to four criteria: i) financial (e.g. size of Islamic Finance assets and number of Islamic Finance institutions); ii) governance (e.g. regulations for Islamic Finance and disclosure index score); ii) awareness (e.g. number of related news articles, Islamic Finance education institutions, research papers, and events); and iv) social (e.g. value of Zakat and charity and CSR disclosure index score)" (Thomson Reuters, 2017: 56).

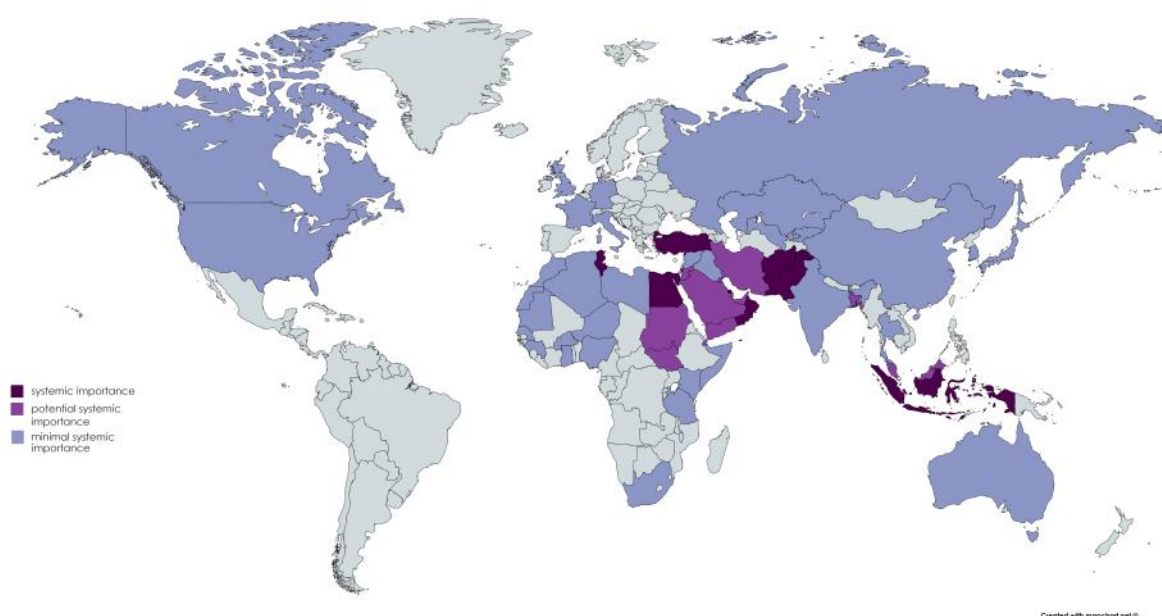
** Variables used for the purpose of IFCI preparation include: i) number of Islamic banks, ii) number of banking and non-banking Islamic financial institutions (including Islamic windows); iii) sharia's supervisory regime; iv) Islamic financial assets; v) Muslim population; vi) sukuk; vii) education and culture; viii) Islamic regulation and law (Dubai Islamic Bank, 2017b: 56).

*** Countries ranked 1-15 have "satisfy the criterion of having a more than 15% share of Islamic banking assets as a proportion of their total domestic banking sector assets, and hence are categorised as systemically important" (IFSB, 2017: 8).

Compared with the previous year, there is no change in IFCI's top 5, although Saudi Arabia and Kuwait dropped slightly in the ranking, while Malaysia, Iran and UAE rose. In the IFI top 5, Bahrain strengthened its position over UAE, while Saudi Arabia and Oman retained their positions.

Over 80% of Islamic financial assets under management are concentrated in 10 countries where oil dependence is crucial to the growth of the Islamic finance industry are predominantly Iran, Saudi Arabia, and Malaysia, with Islamic assets (as of 2016) of USD 560 billion, USD 431 billion and USD 335 billion respectively (Dubai Islamic Bank, 2017a: 40; Thomson Reuters, 2017: 56-57).[6] In terms of comprehensively-balanced development in Islamic finance, DIB believes that it is Sudan, Pakistan, Indonesia, Malaysia, Bangladesh, and Egypt – three of which are countries with highest Muslim populations – that performed particularly well in this realm, better so that Iran and GCC countries (Dubai Islamic Bank, 2017b: 63).

Figure 5: Islamic Finance Markets by Systemic Importance



Source: Author's production based on data from IFSB, 2015: 8 and IFSB, 2017: 8.

*systemic importance means more than 15% share of total domestic banking sector assets in a given country are Islamic banking assets

[6] There are a number of indexes ranking countries with respect to Islamic banking. These include Edbiz Consulting's Islamic Finance Country Index (IFCI) published in Dubai Islamic Bank GIFR, Thomson Reuters' Islamic Finance Indicator (best developed ecosystem for Islamic Finance) and IFSB's list of countries where Islamic finance is systemically important. Other institutions prepare rankings of Islamic institutions or instruments rather than domiciles. The Banker for instance prepares a list of Top Islamic Financial Institutions and all three rating agencies (Standard & Poor's, Moody's, and Fitch) – as well as those specially created for Islamic clients, such as Islamic International Rating Agency – are all publishing their own ratings.

GCC

The GCC region is the domicile for 43.7% of global Islamic banking assets (Saudi Arabia – 20.6%, UAE – 9%, Kuwait – 6.1%, Qatar – 5.8%, Bahrain –1.7%, Oman – 0.5%). While the UAE and Qatar recorded double-digit asset growth rates (10.8% and 12.7% respectively) between 2Q2015 and 2Q2016, Kuwait experienced its lowest pace of growth in three years, and Saudi Arabia's sharia-compliant banking sector saw contraction in deposits by ca. 4.3% in 2Q2016. Bahrain was the only GCC country to see a decline of its Islamic assets share in global banking assets (from 13.5% to 13.3%) (IFSB, 2017: 9-11). With the exception of Oman, which only joined the Islamic finance market in 2012, the remaining GCC countries are securely placed in the top 10 of each of the rankings presented in Table 2, indicating the strength of the Islamic finance market in the region (Thomson Reuters, 2017: 57).

Iran

The Islamic Republic of Iran, whose entire banking system is sharia-compliant, is home to 34 Islamic banks holding assets worth ca. USD 448 billion, or 33% of global Islamic banking assets (IFSB, 2017: 9). It is believed that with significant sanctions relief under the JCPOA (Joint Comprehensive Plan of Action) or "nuclear deal", both its economy and Islamic finance market will grow (see also section "Key Opportunities" in Section 5).

Malaysia

Malaysia, with its numerous Islamic financial institutions, large sharia-compliant assets base, and well developed regulatory framework, as well as high awareness levels, is home to 9.3% global Islamic banking assets and is generally considered the global hub for Islamic finance – something its government has worked on since the implementation of its Financial Sector Masterplan in 2001 (Thomson Reuters, 2017: 57; Bank Negara Malaysia: 2017: 87; IFSB, 2017: 9). Currently (as of 2016), Malaysia's takaful market shows sustained growth with RM 7.5 billion in contributions (up from RM 6.8 billion in 2015), and the total assets of its Islamic banking industry grew by 8.3% in 2016 (a slight slowing in the rate of growth of 11.5% in 2015), accounting for 28% of the country's banking system (or 23.8% if one excludes Development Financial Institutions (DFIs)). The government's aim is to achieve 40% market share by 2020 (IFSB, 2017: 8; Bank Negara Malaysia: 2017: 87; Dubai Islamic Bank, 2017a: 39). In order to reach this goal, during the upcoming two years, the central bank of Malaysia (Bank Negara Malaysia) plans to focus on sustaining sharia-compliant finance industry's pace of growth and facilitation of business diversification, focusing on innovation, development of risk management solutions and talent development (Bank Negara Malaysia, 2017: 87).

Indonesia

Indonesian sharia-compliant banking assets account for 4.8% (2015) of national bank assets and 1.6% (2016) of global Islamic banking industry. Since 2010, the growth of Islamic finance outpaced that of the conventional sector (139% versus 42% respectively) and although it remains less competitive, the government is hoping that Islamic banking assets will account for 6-8% of the country's banking sector by 2020 (if awareness of Islamic finance is improved and "unless structural problems remain unresolved"). Other promising sectors are direct family takaful – according to CIMB Islamic, having an "immense un-tapped potential" – and retail and corporate sukuk, especially in the energy, transportation, and construction sectors (although Indonesian

rupiah devaluation makes issuing sovereign sukuk more expensive for the state) (IFSB, 2017: 9; CIMB Islamic, 2016:11-13, 35-36).

Others

Particularly big improvements in terms of the development of Islamic finance sector were, according to DIB, made by Tunisia, Kazakhstan, Pakistan, and Brunei Darussalam (Dubai Islamic Bank, 2017b: 50-52). This assessment seems to be shared by IRTI (part of IDB) and Thomson Reuters, who in conjunction with various partners dedicated to the first three extensive reports evaluating their current standing and potential for development of Islamic finance.

Tunisia currently is host to only 3 Islamic banks, accounting for ca. 5% of the country's banking business. However, the growing awareness of Islamic finance – enhanced thanks to various training workshops organized in the country – helped Tunisia's Islamic financial assets to grow by nearly 25% during the last year (Dubai Islamic Bank, 2017b: 50).

Kazakhstan, home to one full-fledged Islamic bank (Abu Dhabi's Al Hilal Bank) and a number of non-bank Islamic financial institutions, has been showing "great commitment" to Islamic finance introducing its "Road Map for Development of Islamic Finance by 2020": working on raising awareness of IF, organizing stakeholders' meetings, and engaging with organizations such as IFSB, Islamic Corporation for the Development of the Private Sector (ICD), and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to introduce a new legal framework (Dubai Islamic Bank, 2017b: 51; CIBAFI, IRTI & Thomson Reuters, 2016b: 14).

In **Pakistan,** Islamic finance has been promoted since the 2000s when a dual financial system policy was introduced. Promotion of Islamic finance has been led by three Centres of Excellence (CoEs) for education on IBF (created with support of the State Bank of Pakistan thanks to grants from the UK's Department for International Development) and the introduction of a 2% tax discount for sharia-compliant stocks listed on the Securities and Exchange Commission of Pakistan (SECP), as well as introduction of tax exemptions for sukuk and strengthening of the regulatory framework (Dubai Islamic Bank, 2017b: 51-52; IRTI, IBA CEIF & Thomson Reuters, 2016: 10).

Brunei Darussalam is believed by DIB to be "emerging as a visible player" on the global Islamic finance market, increasing the size of its Islamic financial assets and internal support for the development of the industry in the country. A difficulty for this may come from being overshadowed by its bigger neighbour, Malaysia – a challenge that another state in the region, **Singapore**, also aspiring to become an Islamic finance hub, has not been able to overcome thus far (Dubai Islamic Bank, 2017b: 50,52).

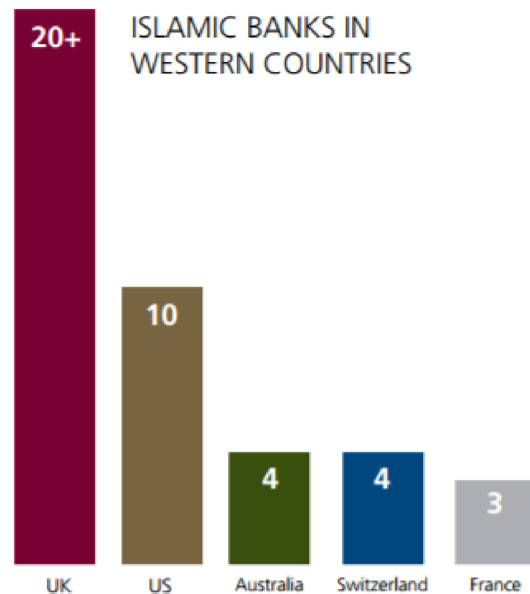
Europe and the Americas

Islamic finance, while present in a number of Western[7] countries, is not as popular there as in the Muslim-majority parts of the world. Some countries, However, the United Kingdom (UK) and Luxembourg, which have been attempting to attract sharia-compliant investors for a number of years, do now host their own Islamic finance markets.

[7] European or North American.

In the **UK**, Islamic finance has been present for over thirty years but truly started growing in the early 2000s when the government amended legislation facilitating its development. Currently, five fully sharia-compliant banks are domiciled on the UK territory and twenty institutions (including fifteen conventional banks) offer sharia-compliant services. UK advertises itself as "the leading Western centre for Islamic finance" (The City UK, 2015). Since 2007, the sukuk market has been growing and sukuk are listed on the London Stock Exchange, which, according to the UK government, is "a key global venue" for its issuance (UK Embassy, 2016: 8). In 2014, the UK government issued a sovereign sukuk, the first one ever by a Western government. One year later, the UK's export credit guarantee department helped finance the purchase of 4 Airbus A380 aircraft by Emirates Airlines by providing a guarantee for a USD 913 million sukuk issued for this purpose (British Embassy Bishnek, 2016: 4-5). Sharia-compliant investments in UK include the Olympic Park, the Shard, and Battersea redevelopment, as well as planned social housing scheme by a Kuwaiti Sharia-compliant bank.

Figure 6: Islamic Banks in Western countries



Source: UK Embassy, 2016: 9.

Another European location working on attracting Islamic investors is **Luxembourg**, advertised by consulting firm Ernst & Young as "the leading non-Muslim domicile for Sharia-compliant investment fund" (E&Y, 2017: 1-4). Indeed, Luxembourg was the first European country to became a member of International Islamic Liquidity Management (IILM) and one of the first Eurozone countries to issue a sovereign sukuk (2014), while its central bank – the first European central bank member of the Islamic Financial Services Board (IFSB) (E&Y, 2017: 2,6).

Regarding Islamic finance development in the Western world in general, the DIB noted that "[d]espite various claims by non-Muslim governments of being global or regional centres of excellence for IBF, the OIC countries remain leaders in terms of incidence of Islamic financial assets. In a list of top 20 countries in terms of Islamic financial assets, the UK is the only non-Muslim country that features significantly. The USA and European countries other than the UK have yet to receive attention and confidence of Islamic investors" (Dubai Islamic Bank, 2017a: 43).

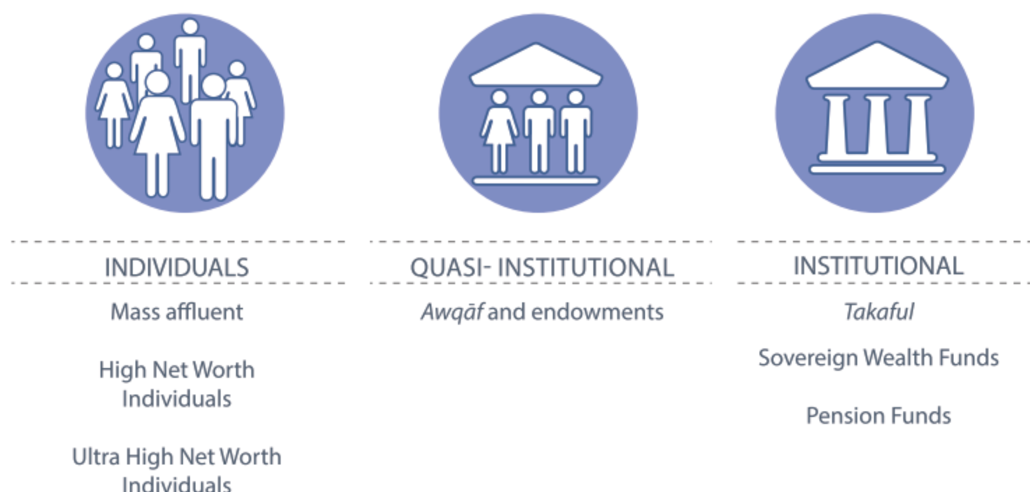
4. Conventional investors and Islamic banking and finance

Ernst & Young identified three main groups that invest in Islamic financial products: individuals, quasi-institutional, and institutional (see Figure 6). The first group can be differentiated by wealth into mass affluent, high net worth, and ultra-high net worth individuals. Mass affluent individuals (with liquid wealth of USD 50-500 thousand) usually invest in short-term, safe, and simple products (e.g. insurance- and annuity-linked ones). High net worth individuals (with liquid wealth

of at least USD 1 million) and ultra-high net worth individuals (with liquid wealth of at least USD 30 million) tend to focus on safe assets and capital preservation (IRTI & UNDP, 2017: 67).

The quasi-institutional group, consisting of *waqfs* (by definition sharia-compliant) and endowments (not necessarily Islamic), seeks long-term capital growth and preservation and fund management. Consequently, they mostly invest in real estate, and to a much lesser extent, equities (IRTI & UNDP, 2017: 67).

Figure 7: Key Investor Profiles in Islamic Finance



Source: IRTI & UNDP, 2017: 67.

Among institutional investors are *takaful* funds, necessarily investing solely in sharia-compliant instruments, but also sovereign wealth funds, and pension funds. Sovereign wealth funds may turn to Islamic finance if they seek ethical investments. They are mostly interested in "sophisticated structured product offerings and exposure to international markets", as well as competitive returns and top-notch service quality (IRTI & UNDP, 2017: 68). Pension funds in turn, by their nature seeking long-term investments, seek international investments on mature markets. However, as noted by IRTI and UNDP, "[a]s awareness of shariah-compliance grows, these funds will be increasingly pressured into allocating more capital to Islamic offerings"; they may turn to Islamic banks for cash deposits and sharia-compliant mutual funds for stable returns (IRTI & UNDP, 2017: 67).

Hardly any detailed data are available on the numbers of investors turning to Islamic finance globally. The scant evidence found suggests that these numbers are small. For instance, although recently a number of sovereign sukuk were issued by non-OIC countries (UK, Hong Kong, Luxembourg, and South Africa) and corporates (e.g. Goldman Sachs and Bank of Tokyo-Mitsubishi), ISFB notes that "sukuk instruments have failed to become a choice for issuers in these markets, and sovereign issuances (if any) in these jurisdictions have largely been symbolic without generating a similar enthusiasm in the other sectors of the jurisdiction, particularly corporates" (IFSB, 2017: 22). DIB believes that "Western banks and financial institutions continue to hesitate getting involved in IBF" due to "heightened Islamophobia" (Dubai Islamic Bank, 2017a: 39).

Table 3: Selected mainstream organizations addressing Islamic finance

Regulatory	Central Banks	Bank of England (UK) People's Bank of China (China)
	Standards Setting Bodies	Bank for International Settlements (Switzerland)
Multilateral	Multilateral Organizations	World Bank (USA) International Monetary Fund (USA)
Banking	Commercial Banks	HSBC (UK) Standard Chartered (UK) Barclays (UK)
Banking	Investment Banks	BNP Paribas (France) Deutsche Bank (Germany)
Insurance/ Takaful	Insurance Providers	Swiss Re Retakaful (Switzerland) Hannover Re Takaful (Bahrain)
Crowdfunding	Equity crowdfunding platforms	Crowdfunder (USA) Crowdcube (UK)
Private Equity	Private equity firms	Texas Pacific Group (USA) Abraaj Capital (UAE)

Source: Author's elaboration based on Thomson Reuters (State of the Global Islamic Economy Report 2016/17, 2016): 64.

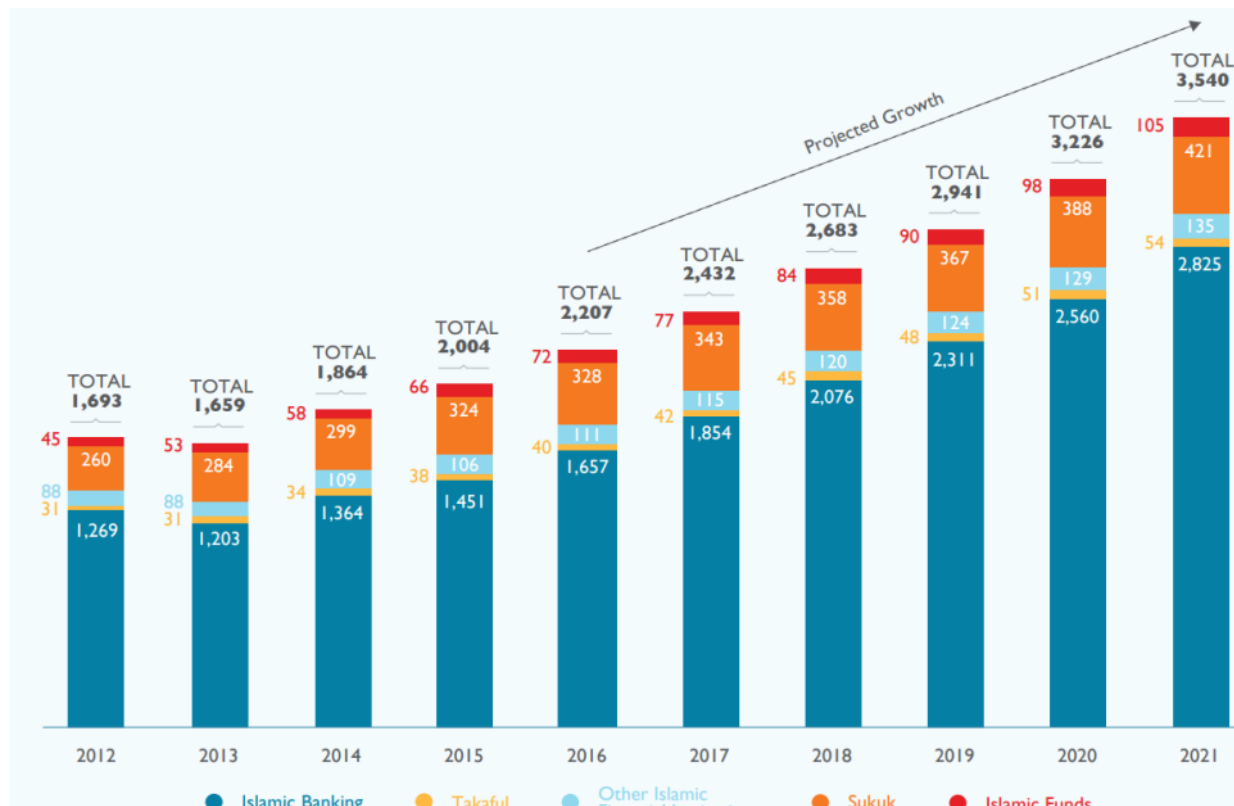
5. Outlook for the future

Overall growth

Experts in Islamic finance predict a slowdown in the growth of the industry, decrease in profitability, and potential decline of Islamic assets' quality, at least in a short term. Dubai Islamic Bank (DIB) has revised its 2016 forecast for Islamic finance industry growth downward, projecting the industry to be worth between USD 3 trillion and USD 4.4 trillion by 2020 (compared to the previous forecast of between USD 3.2 trillion and USD 4.6 trillion). Thomson Reuters provides a similar forecast of USD 3.5 trillion in 2021, and Deloitte projects USD 3.3 trillion by 2020 (Deloitte, 2016: 18; Thomson Reuters & Dinar Standard, 2016: 6). DIB has also revised its prediction regarding the time horizon for the Islamic finance industry to reach the point at which the supply of sharia-compliant financial products meets the demand: previously, they estimated this to happen around 2043, but the 2017 version of the Dubai Islamic Bank GIFR report mentions the year 2052 (Dubai Islamic Bank, 2017a: 39-42). Islamic banks, especially in GCC, are expected to be affected by this forecast slowdown, with profitability deteriorating due to increasing costs of risk and funding (S&P, 2017).

At the same time, DIB expects that this slower pace of growth – which it says should accelerate in the upcoming decade – will be to a certain degree compensated for by expansion to “non-core” markets (Europe, Russia, CIS, Africa) as well as lifting sanctions on Iran, both of which are expected to bolster sukuk market (Dubai Islamic Bank, 2017a: 39-42). S&P singles out especially Morocco and Oman, who entered Islamic finance market only recently (S&P, 2017).

Figure 8: Global Islamic Finance Assets by Sector Growth (2012-2012) (USD billion)



Source: Innovation in Islamic Liquidity Management 2017. Thomson Reuters, 2017: 9.

In the past two years, the Islamic financial services industry – despite performing better than conventional financial market – has experienced a slowdown, growing by 7.0% as compared with 9.3% in 2014 and 7.3% in 2015. The average growth rate between 2009 and 2016 was 13.9% (Dubai Islamic Bank, 2017a; IFSB, 2017: 31). Nevertheless, the Islamic Financial Services Board (IFSB) believes that, under the current economic and political circumstances, the overall performance of the industry can be considered “satisfactory” (IFSB, 2017: 133).

Among the main reasons for the slowdown identified by Dubai Islamic Bank were (Dubai Islamic Bank, 2017a: 40):

- Political conflicts, particularly in MENA but also other Muslim-majority countries;
- Drop in oil prices, detrimental to the sector as 80% of its assets are domiciled in oil-dependent economies;
- Declining enthusiasm of Western investors;
- Maturation of Islamic financial industry in crucial markets (e.g. Malaysia and GCC excluding Oman), prompting a natural gradual decrease in the pace of growth.

IFSB in turn believes that the slowdown was to a large extent caused by exchange rate depreciation in some of the key markets (e.g. Iran, Malaysia, Turkey, Indonesia) which adversely affected the value of global sharia-compliant assets in USD terms (IFSB, 2017: 7).

Sectoral development

The **sukuk** market did grow in 1Q2017 compared to the same period last year, but it is not likely to expand greatly in 2018, as the temporary rebound was caused by a huge number of issuances of GCC governments – something unlikely to happen again soon. It is believed that main reason behind this is nature of the sukuk issuance process, which despite attempts on part of the regulatory bodies remains complex, pricy, and time-consuming. A poster child for favourable regulatory environment is Malaysia, where issuing sukuk is of comparable effort to issuing a conventional bond. Newly (almost) sanctions-free Iran is believed to have a huge potential in the sukuk market development as well (Thomson Reuters, 2017: 63, S&P, 2017). The Islamic Economy Leaders Survey of 172 industry leaders by Thomson Reuters showed that 23% of respondents see sukuk infrastructure financing as the major growth opportunity for the sector.

So-called **green sukuk** – used to secure funding for clean energy, mass transit, forestry, low-carbon technologies, water conservation and other environmentally-friendly investments – is seen as a new promising field of development (Dubai Islamic Bank, 2017a: 43; IRTI & UNDP, 2017: 79; Al Natoor, 2017).

S&P does not expect the **takaful** market to expand in 2018 either, despite its potential for growth in more favourable regulatory environment (S&P, 2017). This potential is underlined by IFSB, who believes that low level of insurance penetration, increasing life expectancy, and high population growth will likely fuel takaful demand both in GCC and Indonesia and Malaysia. This should be helped by the already mentioned introduction of obligatory insurance in Saudi Arabia, as well as changes in legislation introduced in Malaysia and Indonesia aimed at assisting the takaful sector to reach its potential (IFSB, 2017: 30-31). Researchers from Hamdan Bin Mohammed Smart University in UAE expect that due to the presence of Muslim minorities, takaful will also enter markets of the EU (Germany, France, Spain) countries and former Soviet republics (Ukraine, Uzbekistan, Turkmenistan), as well as USA, Canada and Argentina and India and China (Baydoun, Khan, & Fisher, 2015: 46).

> “We believe progress would be aided if regulators acted to create a more supportive regulatory environment, while scholars, MLIs, and lawyers worked together to achieve standardization. What's more, universities could provide the necessary training and knowledge to create the next generation of Islamic finance professionals. Overall, we believe that, united and more integrated, the industry will become stronger.”
>
> (Standard & Poor’s, 2017)

Sharia-compliant **pension funds** are another promising sector, especially considering future demographic changes in predominantly Muslim countries. Much like the case of takaful, its pace of development depends on political decisions to develop a sharia-compliant pension scheme in a given country or not. Recently (March 2016) Malaysia introduced the largest such scheme in the world: the Islamic Saving Plan, worth USD 24.6 billion. Indonesia has announced plans to follow suit (Thomson Reuters, 2017: 67). Sharia-compliant pensions were seen as the major growth opportunity for the sector by 12% of experts surveyed by Thomson Reuters (Thomson Reuters & Dinar Standard,2016: 20).

FinTech (digital financial technology), although still in its natal stages, is also believed to have potential for high growth (IFSB, Thomson Reuters). IFSB estimates that around 80 companies have already started working in this sector. Those include a platform matching entrepreneurs developing Islamic FinTech ecosystems with investors, a UAE-based zakat-driven crowdfunding platform, a Qatari non-profit crowdfunding platform allowing the establishment of waqfs (endowments) for chosen micro-entrepreneurs, and a start-up in Indonesia that uses Bitcoin in its crowdfunding efforts to support microfinancing (Thomson Reuters, 2017: 65-68). The sector is still relatively new and regulatory issues such as taxation, sharia-compliance, and auditing for underlying businesses still need to be resolved (IFSB, 2017: 94, 120). However, should these challenges be overcome, utilizing FinTech by Islamic finance (e.g. mobile banking technologies) can help to increase financial inclusion among Muslims (22.2% of the world's unbanked are Muslims and the account penetration in the Middle East at 14% is the lowest in the world (Ernst & Young: 2015). One attempt at that is being made by Salaam Bank which is working on "an Islamic finance platform that will give people from the United States to Jakarta, Dubai and London access to Islamic finance options that are technologically innovative while creating a bank beyond borders" (World Bank in: IFSB, 2017: 129-132). The role of FinTech in boosting financial inclusion was also underlined during 2016 Global Islamic Economy Summit in UAE. Twelve percent of experts surveyed by Thomson Reuters pointed to fintech and crowdfunding as the major growth opportunities for the Islamic finance sector (Thomson Reuters & Dinar Standard, 2016: 20). A survey of Islamic banks' customers in GCC countries conducted by Ernst & Young in 2015 showed that user-friendly digital banking is expected and valued by customers. Three quarters (73%) would be willing to change their bank for a better digital experience and a majority declared they would increase their payment (71%), credit facilities (57%), credit card (57%), and savings (51%) usage is their online banking experience was "convenient, simple, and accessible" (Ernst & Young, 2015: 36). Digital transformation, although facing challenges such as regulatory environment, technology shortcomings and limited digital skills, would be therefore highly beneficial for the banking sector.

> "The future of Islamic banking clearly lies in developing a completely segregated Islamic banking model rather than a dual banking model built on hybridisation of Islamic and conventional banking. (…) Given the importance of Muslims as a main stakeholder group on the demand side, Islamic banks should focus more on acquiring businesses from Muslims rather than focusing on non-Muslims, as suggested by some Western advisory groups."
>
> "IFCI ranking implicitly suggests that the countries with large Muslim populations are the future frontiers for growth in IBF. Therefore, it is absolutely imperative for the Islamic banking groups based in the Middle East and the Far East to expand their businesses into these countries."
>
> (Dubai Islamic Bank, 2017: 38, 67)

Another important field in which a new approach is urgently needed (IFSB, 2017: 119) – and in which FinTech can and already is playing a role – is **SME financing**. SMEs' need for financing was illustrated by IFSB using an example of Dubai, where "SMEs represent nearly 95% of all establishments in the Emirate accounting for 42% of the workforce and contributing around 40% to the total value of Dubai's economy. [However,] approximately 70% of SMEs have had their applications for funding from conventional banks rejected and loans to SMEs account for just 4% of outstanding bank credit in the UAE" (Dubai Financial Services Authority, "Crowdfunding: SME Financing through Lending" quoted in: IFSB, 2017: 199). Along similar lines, Islamic Economy Leaders Survey of 172 Islamic Economy industry leaders by Tomson Reuters showed that while

60% of businesses operating in Islamic economy long-term expansion, working capital or trade finance, only 49% of respondents (operating in Islamic economy) using sharia financing most of the time. The same survey showed that 16% of respondents saw increased SME growth initiatives as the major growth opportunity for the sector (Thomson Reuters & Dinar Standard, 2016: 20).

The role and situation of SMEs was one of the main points discussed during of the 2016 World Islamic Economic Forum (WIEF) in Indonesia and 2016 Global Islamic Economy Summit organized in UAE. One of the ongoing initiatives in this field is an agreement between IDB and central bank of West Africa's CFA- franc zone to set up a USD 100 million Islamic find aimed at providing financing for SMEs (Thomson Reuters, 2017: 67).

FinTech instruments and platforms may in turn prove useful in the development of Islamic **impact investing**. Initiatives like that are already taking place, for instance in the shape of the already mentioned crowdfunding platforms providing microfinancing for entrepreneurs or IDB's Awqaf Properties Investment Fund (APIF) supporting residential and commercial projects. In view of Thomson Reuters, the sector is "ripe for further development" (Thomson Reuters, 2017: 67). Support for social development was seen as the major growth opportunity for the sector by 15% of experts surveyed by Thomson Reuters (Thomson Reuters & Dinar Standard, 2016: 20).

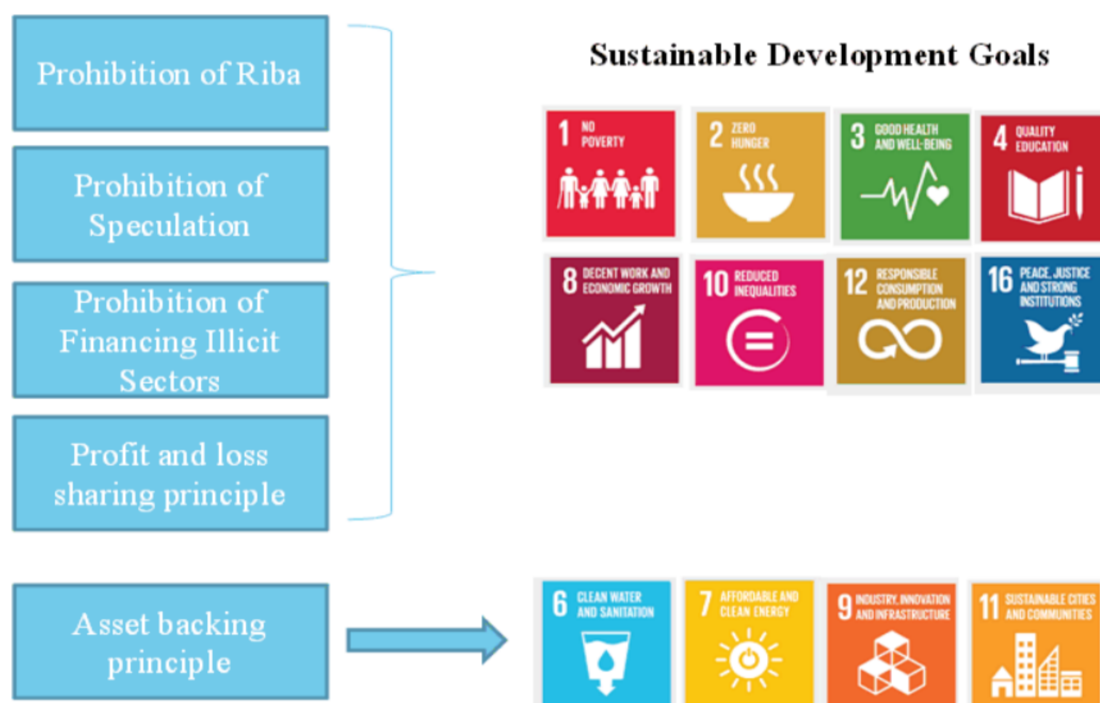
"Sharia-compliant crowd-funding can fill the gaps witnessed by micro-finance lenders and can be a force for good in the uplift of society's neediest worldwide. Challenges to the growth of crowd-funding include the absence of regulation in most jurisdictions where it can make the largest difference; variations in laws across jurisdictions that make cross-funding difficult; investors' fear of losing their money; and the possibility of unregulated or unscrupulous platforms blowing up."
(GIES, 2016: 67)

Islamic finance may also be able to contribute towards achieving the **Sustainable Development Goals (SDGs).** A number of institutions, including Standard & Poor's Ratings Services, IDB, IFSB, and the World Bank, have expressed a belief that Islamic finance "is very relevant" for the cause (*Global Report on Islamic Finance. Islamic Finance: A Catalyst for Shared Prosperity?*, 2016): 2) and the 2015 UN Sustainable Development Summit focused on the role of Islamic Finance in implementing the SDGs. A World Bank – IsDB joint report argues that Islamic finance "can play a significant role in helping achieve the twin development objectives of ending extreme poverty globally by 2030 and promoting shared prosperity by raising the incomes of the bottom 40 percent of the population" (IsDB & WB, 2016: 2) An IsDB report argues that Islamic finance possesses "strong potential in promoting financial stability, financial inclusion and shared prosperity, and infrastructure development which will set an enabling environment for timely implementation of SDGs" and that "Islamic finance principles, if applied into the financial system, could "minimize the severity and frequency of financial crises" (IsDB, 2015: 4).

Stakeholders agree that Islamic Finance can contribute both through promotion and application of its underlying principles (such as profit and loss sharing) and its instruments (such as sukuk, zakat, waqf, or qard hassan) (Damak, Volland, Heriard Dubreuil, & Blume, 2016; IsDB, 2015; Zarrouk, 2015).

Figure 9: Islamic Finance Core Principles and UN Sustainable Development Goals

Islamic Finance Principles



Source: S&P, Islamic Finance Could Aid Modestly in Achieving Sustainable Development Goals, 2016: 4.

Nevertheless, some point out that Islamic finance's capacity in this area is still underdeveloped "due to the industry's small size and the issues it has yet to resolve to unlock its global potential" (Damak et al., 2016: 2). A World Bank working paper argues that "[t]he role of the Islamic financial industry in supporting the SDGs will depend on the extent to which stakeholders can influence its direction" since "a more effective role for Islamic finance (…) would require the supply of an innovative mix of products, adequate governance of Islamic finance intermediaries, and a supportive legal and regulatory framework" (Ahmed, Mohieldin, Verbeek, & Aboulmagd, 2015: 30).

Opportunities

Opportunities for the development of Islamic finance include the following:

- Demographic change;
- Lifting of international sanctions on Iran;
- Initiatives such as Saudi Arabia's Vision 2030 and China-Pakistan Economic Corridor (CPEC);
- Super-abundance of capital (increasing per capita income and wealthiness of Muslims).

Demographics

As of 2010, there 1.6 billion Muslims around the world, the majority of whom (61.7%) lived in Asia-Pacific region, almost one-fifth (19.8%) in MENA, and 15.5% in Sub-Saharan Africa. According to the Pew Research Center, by 2050 this total will reach 2.76 billion, meaning that Muslims will form 29.7% of world's population. While most Muslims will still reside in Asia, their share will decline to 52.8%. At the same time, number of Muslims in Sub-Saharan Africa will increase to 24.3% (MENA's share will remain approximately the same) (DeSilver & Masci, 2017). Two phenomena relevant for the development of Islamic finance will develop simultaneously. Firstly, change in the number of young Muslims (aged 0-29), which will increase in absolute terms although decreasing as percentage of the overall Muslim population. Secondly, the number of Muslims aged 60+ will increase both in absolute terms and as a percentage of the Muslim population (nearly doubling from 7% to 12% between 2010 and 2030 (Lugo, Cooperman, O 'Connell, & Stencel, 2011: 18).

Currently, roughly 2.5% of world's Muslims are believed to be clients of the Islamic finance industry (Thomson Reuters, 2017: 77). In general, according to DIB, the number of Muslims interested in becoming clients of Islamic financial institutions may be in the region of 100 million people (Dubai Islamic Bank, 2017a: 43). According to Thomson Reuters, currently it is Millennials "asserting their values" who are the driving force behind the Islamic economy, including Islamic finance. In a study on young Muslims' behaviours online they found that young men and women were equally engaged in social media interactions relating to the Islamic economy, although men were more likely than women to engage in topics relating to Islamic finance (Thomson Reuters, 2017: 19, 77).

Changing demographics will impact not only demand for Islamic banking products, but also for takaful and sharia-compliant pension schemes, as well as other sectors of Islamic economy (e.g. halal foodstuffs, modest fashion, halal pharmaceutics) (IFSB, 2017: 30-31). Focus on financial inclusion "will change the focus of IBF and its concentration in terms of incidence of Islamic financial assets. While at present, Islamic financial assets are by and large concentrated in the GCC countries and Malaysia, a successful financial inclusion policy will bring countries like Indonesia, Pakistan, Bangladesh, Turkey and Egypt into central focus" (Dubai Islamic Bank, 2017a: 43).

Political and economic trends

Lifting of international sanctions under the Joint Comprehensive Plan of Action on Iran, one of the key Islamic finance markets, opens its economy to the world. For instance, a number of Iranian banks – all of which are Islamic – have been reconnected to the global transaction network SWIFT. The country, whose financial sector is 100% sharia-compliant, is believed to become more involved in the global Islamic finance industry; indeed, at the beginning of 2017 it took chairmanship of IFSB. As it returns to the global market, it is hoped to become "a key market for growth", especially for the sukuk market (although it does need to review its legislator standards) (Dubai Islamic Bank, 2017a: 42-45).

Similarly promising for sukuk is the announcement of the Vision 2030 programme by Saudi Arabia, which struggles to diversify its economy. The country's public investment fund is to increase to USD 2.2 trillion. Privatization efforts by Kuwait and Bahrain can help fuelling the Islamic financial industry as well (Thomson Reuters, 2017: 66). Moreover, DIB believes that

clean energy initiatives in GCC countries will help to expand the green sukuk market (Dubai Islamic Bank, 2017a: 44).

Finally, the China-Pakistan Economic Corridor (CPEC), aimed at enhancing cooperation and geographical linkages between the two countries, may provide growth opportunities for the industry, which is already present (and growing) in the countries which the project encompasses (Dubai Islamic Bank, 2017a: 43).

Super-abundance of capital

"Super-abundance of capital" was identified by Thomson Reuters as one of the high impact issues on its "issues and opportunities map" for Islamic finance (Thomson Reuters: 2017, 53). Rising per capita income and wealthiness of Muslims was in turn identified by DIB as one of the major factors contributing to the growth of the industry (Dubai Islamic Bank, 2017a: 36).

Challenges

- Lack of standardization and unified regulatory environment;
- Low levels of public awareness;
- Low oil prices;
- Uncertain political and economic environment.

Standardization and operational challenges

The need for standardization of contracts and practices is underlined by virtually all experts in Islamic finance (IsDB & WB, 2016; Iqbal, 2016; S&P, 2017). Although standard-setting bodies (such as IFSB) have been working on developing regulations, standards and supervisory networks, sharia is still interpreted differently across Muslim world and Islamic markets, resulting in investors' lacking certainty and clarity. Lack of common sharia rulings and legal frameworks additionally prevents the industry from integrating and growing into a truly global one (S&P, 2017; Thomson Reuters, 2017: 70). What is more, as Thomson Reuters argues based on the result of their Islamic Economy Leaders Survey, monetary policy formulation and implementation (18%), underdeveloped safety nets (17%), and central bank governance changes are seen by respondents as major challenges for the development of the industry, illustrating "limitations on sector growth imposed by monetary policy formulation" (Thomson Reuters, 2017: 22, 70).

> "Numerous institutions have looked at Islamic finance and the sukuk market and eventually walked away, rather than go through all the steps required for issuance" (S&P, 2017)
>
> "Harmonisation of the various pillars of the Islamic economy is the new imperative" (GIES, 2016)
>
> "The growing market shares and rising domestic systemic importance of Islamic finance underscores the importance of developing strong regulatory frameworks for prudential regulation and supervision in Islamic finance jurisdictions, supported by proactive stress testing and an enhanced set of capabilities for macroprudential surveillance." (IFSB, 2017:1)

Public awareness

In the already mentioned survey by Thomson Reuters, low levels of public awareness come as number one challenge for the industry development in the eyes of Islamic economy leaders (Thomson Reuters, 2017: 22, 70). Need for raising awareness is mentioned by IDB and WB in their joint Global Report on Islamic Finance (IsDB & WB, 2016: 73), and underlined by IFSB and CIMS Islamic in their country reports.

"Lack of understanding is the biggest hurdle to Islamic banking growth in Kazakhstan" (CIBAFI, IRTI & Thomson Reuters, 2016b: 15)

"The first challenge that the Islamic banking industry in Pakistan faces is the lack of public awareness about the objectives, underlying principles, and the operations of Islamic banking and finance" (IRTI, IBA CEIF & Thomson Reuters, 2016: 78)

"Our retail banking consumer survey reveals that awareness campaigns are necessary to increase Islamic financial inclusion." (CIBAFI, IRTI & Thomson Reuters, 2016a: 12)

"Closing the gap between theory and practice is the most important issue facing Islamic banks (…). Nowhere is (…) a gap between aspiration and reality more apparent than on the asset side of the balance sheets of Islamic banks." (IsDB &WB, 2016: 68-69)

Low oil prices

Low oil prices have been pointed to as one of the major reasons for below-expected performance in 2016 of the Islamic finance industry, which remains concentrated predominantly in oil-exporting countries. However, DIB believes that "the worst is over and the crude oil prices are going to settle between a more favourable US$50 to US$70 range in the years to come" (Dubai Islamic Bank, 2017a: 40).

Uncertain political and economic environment

Continued uncertainty in global markets resulting from Brexit, Donald Trump's presidency and the political situation in Europe may negatively affect performance of the global financial industry, impairing the Islamic financial industry as well. At the same time, ongoing political conflicts in the MENA region will continue to prevent Islamic finance from developing to its full potential in the region. Moreover, as noted by the DIB, "[t]he emergence of Islamic State of Iraq and Syria (ISIS) has given birth to a crisis that has engulfed not only the Middle East but its adverse effects on anything to do with Islam in Europe" – including Islamic finance (Dubai Islamic Bank, 2017a: 39, 44).

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