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Development Trends of Islamic Finance Worldwide

Alisher Eshimov
researcher
2120101a@mail.ru

Abstract. The Islamic finance industry resiliently grew by 17% in 2021, reaching nearly US$4 trillion in total assets. The growth was evident across sectors including Islamic banking, Sukuk, Islamic funds, and other financial institutions. Notably, Islamic banking, comprising 70% of assets, expanded due to government support, operational efficiency, and strong demand. Net income surged by 290%, while average return on assets also increased. The rise of fully digital Islamic banks globally and responses to the LIBOR transition, such as Malaysia's MYOR-i and Oman's Islamic money market instruments, highlighted industry innovation. Efforts to enhance sustainability, governance, knowledge, and awareness through the Islamic Finance Development Indicator (IFDI) underscore industry progress, positioning Islamic finance for continued growth and innovation.

Keywords. Islamic finance, industry growth, total assets, resilience, sectors, Islamic banking, Sukuk, Islamic funds.

Introduction

In a world marked by rapid economic transformations and financial innovation, the phenomenon of Islamic finance has risen as a beacon of ethical resilience and global significance. Grounded in the principles of sharia law, Islamic finance presents an alternative framework that intertwines financial activities with ethical values, social justice, and sustainability. What began as a modest financial undertaking confined to Muslim-majority nations has evolved into a dynamic and multifaceted global industry that transcends cultural, religious, and geographical boundaries. In this article, we embark on a comprehensive exploration of the intricate and multifarious development trends that have propelled Islamic finance to the forefront of contemporary finance, reshaping conventional notions of banking, invstment, and economic systems along the way.

At its core, Islamic finance is more than a mere financial system; it is a manifestation of ethical convictions and social principles rooted in centuries-old Islamic teachings. The bedrock of Islamic finance lies in its adherence to ethical conduct, fairness, and social responsibility, all grounded in

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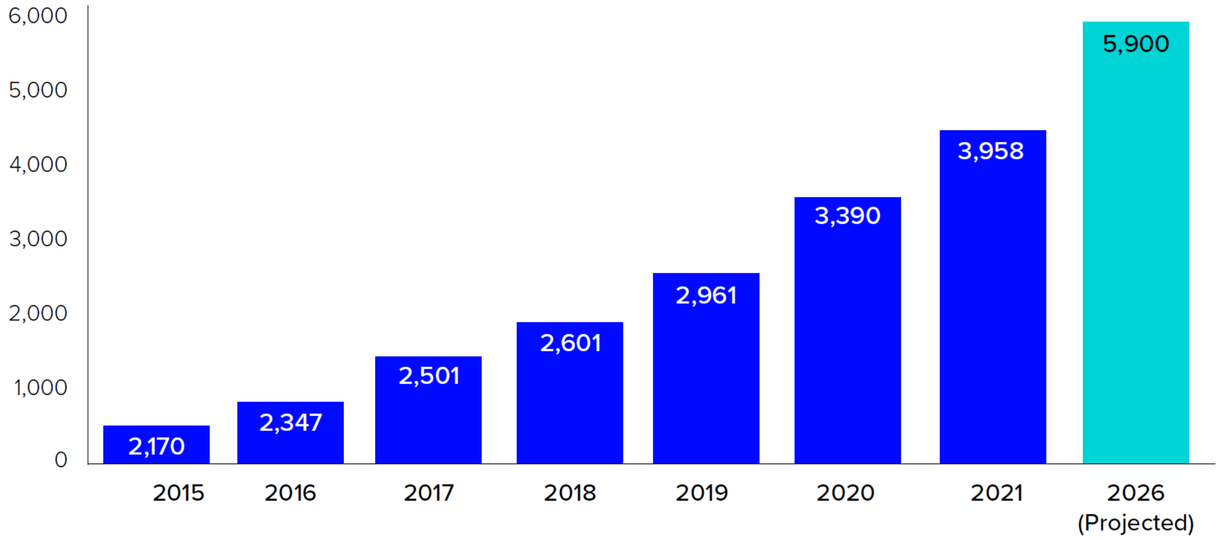
sharia law. This ethical compass guides the industry to shun exploitative practices such as interest (riba), uncertainty (gharar), and gambling (maysir), fostering a financial landscape where transactions must be backed by tangible assets and imbued with principles of fairness, equity, and accountability. The principles of Islamic finance not only set it apart from conventional finance but also underscore its overarching goals of fostering economic equilibrium and enhancing the well-being of individuals and communities

In 2020, during the initial year of the pandemic, the global Islamic finance sector demonstrated resilience by witnessing a 14% increase in total asset size. However, it was the subsequent year that showcased even greater strength, with a growth of 17%, surpassing pre-pandemic levels and propelling assets to reach the milestone of $4 trillion.

From the moment the first vaccine was administered to a 90-year-old British individual on December 8, 2020, the Covid-19 vaccination marked the turning point that set the world on the path of recovery in 2021.

As the severity of the virus abated due to widespread vaccinations, economies progressively reopened, leading to an enhanced state of the Islamic financial industry's well-being.

Islamic banking, the largest sector within the Islamic finance industry with 70% of its assets, experienced relief as credit loss provisions eased, resulting in a substantial increase in net income. Three primary factors contributed to this growth: some banks received extended government support for pandemic-affected sectors, a few achieved operational efficiencies through measures like branchless banking and partnering with FinTechs, and there remained a consistent high demand for Islamic banking services. Notably, the most significant expansion occurred in non-core Islamic finance regions, indicating the emergence of new markets alongside the maturation of more established areas. Tajikistan (84%), Burkina Faso (27%), and Ethiopia (26%) stood out in terms of Islamic banking growth. Overall, the global Islamic banking sector expanded by 17% to reach $2.8 trillion.



Source: IFDI 2022

Picture 1. Islamic Finance Assets (2021, US$ Billion)

The Sukuk sector, the second-largest in terms of assets, saw a 14% growth in 2021, reaching $713 billion in outstanding sukuk. New issuances surged by 9% to a record $202.1 billion. Noteworthy was the rise of long-term sukuk with durations of five years or more, reflecting a shift towards a longer post-pandemic perspective. Sovereigns and quasi-sovereigns remained prominent in new issuances. Additionally, they continued to lead in ESG sukuk issuance, which reached a new peak of $5.3 billion in 2021. Saudi Arabia, Indonesia, and Malaysia took the lead in this segment, which is expected to continue growing as ESG investments become more mainstream and GCC demand increases, particularly to finance green and sustainability-oriented projects.

Islamic funds, ranking as the third-largest sector, exhibited impressive growth of 34%, amassing assets under management worth $238 billion in 2021. However, this sector's presence is less widespread compared to banking and sukuk, with a notable 81% of the total global Islamic funds originating from Iran, Saudi Arabia, and Malaysia. Money market and equity were the primary asset classes, while exchange-traded funds (ETFs) gained momentum, witnessing increased availability in various countries. In a parallel trend to sukuk, ESG funds marked a significant milestone in the advancement of Islamic finance in 2021. Notably, Malaysia's Employee Provident Fund (EPF), a major holder of Islamic funds, announced its intention to transition into a sustainable investor with a fully ESG-compliant portfolio by 2030 and achieve a climate-neutral portfolio by 2050.

Other Islamic financial institutions (OIFIs), encompassing financial technology firms, investment companies, financing entities, leasing and microfinance organizations, as well as brokers and traders, grew by 5%, accumulating assets worth $169 billion. Noteworthy asset growth occurred in countries such as Kazakhstan (44%), Egypt (38%), and the Maldives (31%). A significant focus within this sector is financial technology (FinTech), particularly for Saudi Arabia, which aims to nearly triple the number of its FinTech firms from 82 to 230 by 2025.

Takaful, the smallest segment in the Islamic finance industry, reported a robust 17% growth, resulting in holdings of $73 billion in 2021. This sector is undergoing consolidation within the Gulf Cooperation Council (GCC) countries to enhance efficiency and cost reduction. Furthermore, significant regulatory changes in Southeast Asia are expected to strengthen governance in Indonesia and Malaysia while potentially opening doors for new market entrants in the Philippines.

Despite the challenges of the second year of the pandemic, the Islamic finance industry demonstrated resilience, achieving substantial growth that propelled its assets to nearly US$4 trillion in 2021, marking a 17% increase compared to the 14% growth observed in 2020. The collective net income reported by Islamic financial institutions globally also tripled, surging from US$10.5 billion in 2020 to US$32 billion in 2021, reflecting improved performance, particularly among Islamic banks.

After the tumultuous events of 2020, economies began to recover in 2021. However, the Islamic finance sector faced yet another trying year, as markets cautiously resumed operations and countries cautiously reopened their economies. The progress was hampered by successive waves of the Covid-19 virus, including the Delta and Omicron variants, which disrupted global supply chains and transportation, leading to renewed lockdowns and safety measures. Despite these challenges, 2021 concluded on a more positive note, as widespread vaccinations prompted nations to ease pandemic-related restrictions.

Additionally, a surge in global demand for petroleum outpaced supply, owing to OPEC+ production limits established in a late 2020 agreement. Consequently, crude oil prices rose throughout 2021, with the spot prices of Brent and West Texas Intermediate (WTI) crude ending

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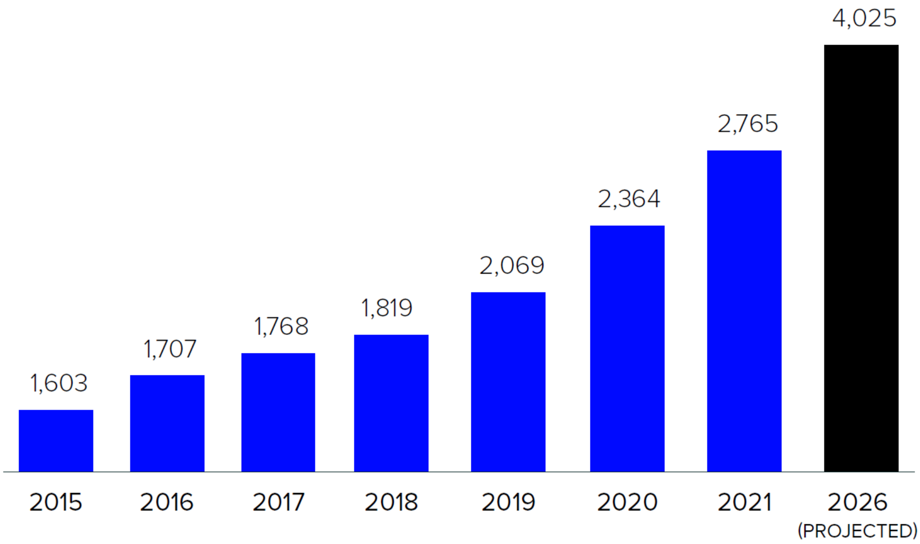
the year at US$77.78 and US$75.21, respectively, compared to US$51.09 and US$47.62 at the start of the year. This alleviated financial pressures on Gulf Cooperation Council (GCC) economies that rely on oil revenues.



Source: IFDI 2022

Picture 2. Islamic Banking Assets Growth (2015 - 2021, US$ Billion)

Islamic banking took the lion's share, comprising 70% or US$2.8 trillion, of the total Islamic finance assets in 2021. The Gulf Cooperation Council (GCC) holds a commanding 43% of global Islamic banking assets, followed closely by the broader Middle East and North Africa (MENA) region at 40%. Remarkably, this sector witnessed a robust growth of 17% in 2021 compared to the end of 2020. Among countries, Tajikistan (84%), Iran (45%), Burkina Faso (27%), and Ethiopia (26%) emerged as the significant growth markets.

Moreover, the Islamic banking sector demonstrated enhanced performance, evident in the remarkable 290% global growth in net income and higher average return on assets, largely attributed to reduced provisions for credit losses in 2021 as compared to the preceding year. Islamic banks also displayed prudent financial decisions, focusing on upscale clientele, and benefited from extended government support for sectors impacted by the pandemic. Furthermore, operational efficiencies were garnered by several banks through strategies such as branchless banking and strategic partnerships with FinTech companies.

The continued surging demand for Islamic banking is underscored by emerging trends, setting a trajectory for the industry to achieve a remarkable US$4.0 trillion by 2026.

A clear indication of the ongoing demand for Islamic banking lies in the notable shift of conventional banks towards conversion. A prime example is Faysal Bank in Pakistan, which intends to relinquish its conventional banking license by the conclusion of 2022 and commence operations as a fully-fledged Islamic bank in January 2023.

Furthermore, the process of consolidation is poised to fortify the Islamic finance sector. Kuwait Finance House (KFH) is in the advanced stages of acquiring Bahrain's conventional Ahli United Bank, marking a pivotal step forward. This consolidated entity will ascend the ranks of the world's most significant Islamic banks and simultaneously become Bahrain's largest bank following its merger with KFH's Bahraini subsidiary.

In addition, Kuwait's Gulf Bank is also contemplating a potential conversion to Islamic banking. This decision aligns with the bank's trajectory towards merging with Al Ahli Bank, as evidenced by the Memorandum of Understanding signed by both parties in August 2022. This scenario underlines the ongoing demand for Islamic banking in Kuwait, where its Islamic banking assets of US$134 billion establish it as the world's sixth-largest sector, according to IFDI assessments.

The scope of conversion transcends individual institutions and extends to entire banking systems. Afghanistan's central bank, following the emergence of a new Taliban-led government in August 2021, announced plans in May 2022 to transition towards an Islamic banking framework. Similarly, Pakistan's Federal Shariat Court has directed the government to ban riba (interest) by the end of 2027, signifying a pivotal stride towards fostering more extensive growth in Islamic finance within the country.

In 2021, Islamic banking had a presence in 76 countries, and this figure is poised to expand with the licensing of Australia's inaugural Islamic bank, Islamic Bank Australia, granted by the Australian Prudential Regulation Authority in July 2022. Notably, the bank's digital nature is a strategic maneuver aimed at appealing to the tech-savvy Muslim population within the country. This trend mirrors similar digital banking endeavors in non-Muslim majority nations like Germany and the UK. The latter, a former EU member, introduced Nomo, the world's pioneering international digital Islamic bank created by Kuwait's Boubyan Bank Group. Consequently, the UK's oldest retail Islamic bank, Al Rayan, closed its final physical banking branch in August 2022, redirecting patrons to its digital app. Similarly, the US witnessed the launch of the Shariah-compliant neobank, Fardows, in July 2021.

Anticipated industry growth in 2023 is set to reshape the landscape of Islamic banking in several countries with limited Islamic banking institutions. Notably, the Philippines' Bangko Sentral ng Pilipinas (BSP) has unveiled plans to facilitate Islamic banking units (IBUs) and in June 2022, issued a preliminary circular outlining revised minimum capitalization requirements for conventional banks housing Islamic banking units. Recent reports in August 2022 indicated that discussions are underway between two conventional banks and the central bank regarding the establishment of IBUs.

In Central Asia, sanctions-affected Russia is gearing up to legalize Islamic banks within four of its states, as per the State Duma Committee on Financial Market. In North Africa, the burgeoning demand for Islamic financial offerings, notably housing finance, in Algeria has prompted numerous conventional banks to open Islamic windows, including Banque National D'Algérie, Banque Extérieure d'Algérie, and Banque de Développement Local. The Algerian Islamic finance sector is poised for expansion, with the imminent introduction of takaful products to complement Islamic banking services.

The gradual elimination of LIBOR, commencing on January 1, 2022, marked the initiation of its replacement with Risk Free Rates (RFRs). In response, Malaysia's central bank took a significant step by introducing the Malaysia Islamic Overnight Rate (MYOR-i) in March 2022. This pioneering move by a central bank introduced a transaction-based Islamic benchmark rate, with MYOR-i being founded on commodity Murabaha. The intention behind this initiative, as perceived by Bank Negara Malaysia, is to stimulate the growth of Islamic financial products within the nation. Furthermore, the development of additional instruments based on the MYOR-i framework is currently underway.

In a parallel development, Oman has revealed plans to introduce Islamic money market instruments, as outlined in its Financial Stability Report 2022, aimed at fulfilling the liquidity requirements of local Islamic banks. This initiative serves to align Islamic banks with conventional counterparts.

The topic of liquidity for Islamic banks is garnering heightened attention across the GCC region. Notably, Qatar introduced treasury sukuk in October 2022 as an enhancement to its T-bills framework. While the UAE, at the time of writing, had not incorporated treasury sukuk into its domestic T-bills offering that debuted in May 2022, the country did implement liquidity standards for Islamic banks in January 2022 as part of its broader regulatory framework for banks.

In conclusion, the Islamic finance industry exhibited remarkable resilience in the face of the challenges posed by the pandemic, with its total asset size soaring by 17% in 2021, reaching close to US$4 trillion. The sector's growth was evident across all its key sectors, including Islamic banking, Sukuk, Islamic funds, and other Islamic financial institutions. Notably, Islamic banking, the largest sector with a 70% share of total Islamic finance assets, witnessed substantial growth, driven by factors such as extended government support, operational efficiencies, and sustained demand. The sector's net income saw an impressive surge of 290%, while its average return on assets also increased.

Moreover, the industry experienced notable expansion through the emergence of fully digital Islamic banks, as seen in Australia, the UK, Germany, and Malaysia. Several countries are poised to join the Islamic finance landscape, such as the Philippines and Russia, which are introducing measures to accommodate Islamic banking institutions. The transition from LIBOR to Risk Free Rates (RFRs) prompted innovative responses, with Malaysia introducing the Malaysia Islamic Overnight Rate (MYOR-i) as a transaction-based Islamic benchmark rate, and Oman and Qatar introducing Islamic money market instruments and treasury sukuk, respectively.

The industry's progress is further underscored by efforts to enhance sustainability, governance, knowledge, and awareness, as reflected in the Islamic Finance Development Indicator (IFDI). As the sector continues to evolve and respond to changing market dynamics, it is evident that Islamic finance is not only maintaining its momentum but also carving out new paths for growth and innovation in the global financial landscape.

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