Islamic Finance 2021-2022: Toward Sustainable Growth

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This report does not constitute a rating action.

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Key Takeaways

- We expect stronger sukuk issuances and expanding market shares amid the modest recovery of core Islamic finance economies to boost Islamic finance assets by around 10%-12% over 2021-2022.
- Although the pandemic offered the possibility of more broad-based and transformative growth, the industry has not yet fully unlocked the opportunities inclusive standardization affords and increased its share of sustainable finance activity.
- Coordination between the different stakeholders is key to the industry leveraging the opportunities related to the energy transition for core Islamic finance countries and wider social challenges.

S&P Global Ratings believes the global Islamic finance industry will grow by 10%-12% in 2021-2022 after slowing to 10.6% in 2020 (excluding Iran). Growth of Islamic banking assets in some Gulf Cooperation Council (GCC) countries, Malaysia, and Turkey and sukuk issuances exceeding maturities explain this performance. Islamic finance grew rapidly in 2020, albeit at a slower pace than in 2019, despite the double shock from the pandemic and the drop in the oil price. We have excluded Iran from our statistics this year owing to the extreme volatility of the country's currency in the parallel market (as disclosed by the Central Bank of Iran), which makes comparison with last year's numbers or any forecasts less meaningful.

Although we expect a modest recovery for most core Islamic finance countries in 2021-2022, we think that the sector will expand against the backdrop of continued standardization and integration. Over the next 12 months, we could see progress on a unified global legal and regulatory framework for Islamic finance that the Dubai Islamic Economy Development Center (DIEDC) and its partners are developing. Depending on the outcome and its adoption, we believe that such a framework could help resolve the lack of standardization and harmonization that the Islamic finance industry has faced for decades.

We may also see more frequent issuance of dedicated social Islamic finance instruments and green sukuk as the industry leverages its alignment with environmental, social, and governance

(ESG) values. This would help tackle the aftermath of the pandemic and support the agenda for core countries' energy transition. We expect such processes will remain slow, however, given the additional complexity related to these instruments and the core Islamic finance countries' slow implementation of policies to manage the energy transition.

Growth In 2020 Slowed To About 10%, And This Level Of Growth Will Likely Continue In 2021

The Islamic finance industry continued to grow in 2020, although more slowly than in 2019. The industry's assets expanded by 10.6% in 2020 versus 17.3% in 2019 when growth was supported by higher-than-expected sukuk issuance (see chart 1).

We now believe that the industry will continue to expand by 10%-12% in 2021-2022.

- We expect economic recovery in core Islamic finance countries, although some countries' GDP growth will be lower than what we have observed historically (see chart 2).
- We expect financing growth in Saudi Arabia to remain strong, fueled by mortgages and by corporate lending as the country implements some of its Vision 2030 projects. We also expect some growth in Qatar supported by investments related to the upcoming World Cup, and to a lesser extent the United Arab Emirates (UAE) where the Dubai Expo is likely to help boost economic activity. Malaysia and Turkey will also continue to grow, although Turkey's growth will be at a slower pace and driven primarily by public sector participation banks.
- On the sukuk front, S&P Global Ratings forecasts total sukuk issuance of about $140 billion–$155 billion this year. This compares with a drop in issuance to $139.8 billion in 2020 from $167.3 billion in 2019. We expect an increase in the volume of issuances this year as liquidity remains abundant, corporates and sovereigns come back to the market, and new issuances exceed maturing sukuk. In the first quarter of 2021, issuance volumes were up by 1.4% in total and 22% if Sukuk re-openings (issuances under existing structures) are excluded. The additional challenges related to compliance with Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards in the GCC has slowed some issuers, though.
- Although their contribution to the industry remains small, we also expect the takaful and the fund sector to grow this year. We continue to see the takaful sector expanding at 5%-10%, while the funds industry might see some growth as investors chase yields.

Downside risks exist, however, chief of which is the COVID-19 pandemic and whether it will be brought under control.

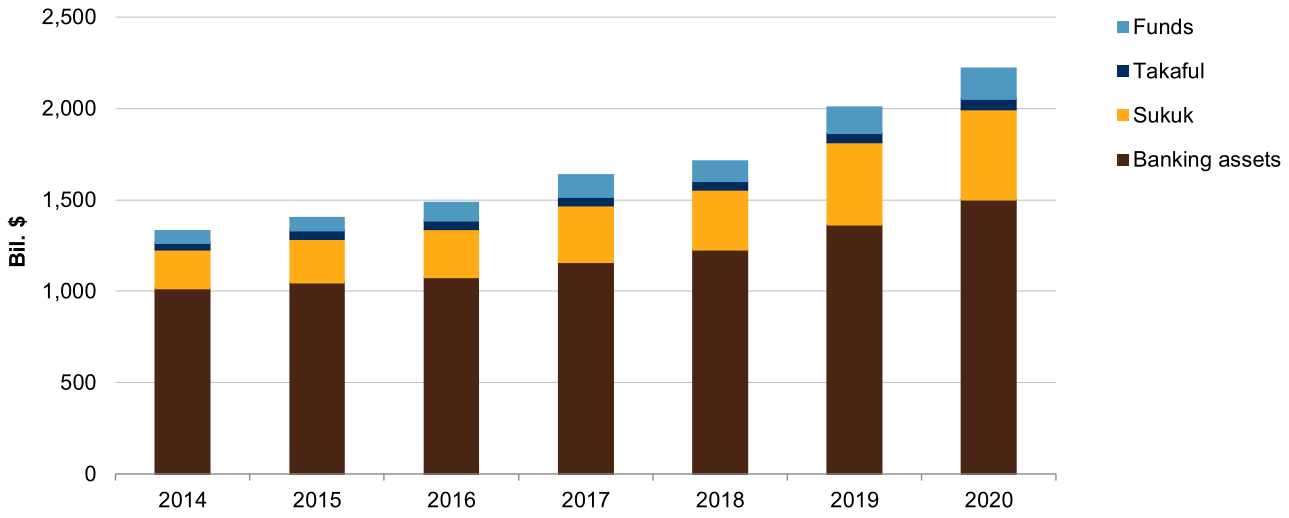
S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves,

we will update our assumptions and estimates accordingly.

Overall, we believe a 10%-12% growth rate for the industry (excluding Iran) over the next two years is achievable. The pandemic offered the possibility of a more broad-based and transformative growth, but the industry has yet to fully unlock opportunities related to standardization and increase its contribution to sustainable finance. Coordination between the different stakeholders will be a key factor of success to leverage the opportunities related to the energy transition for core Islamic finance countries and its social angle.

Chart 1

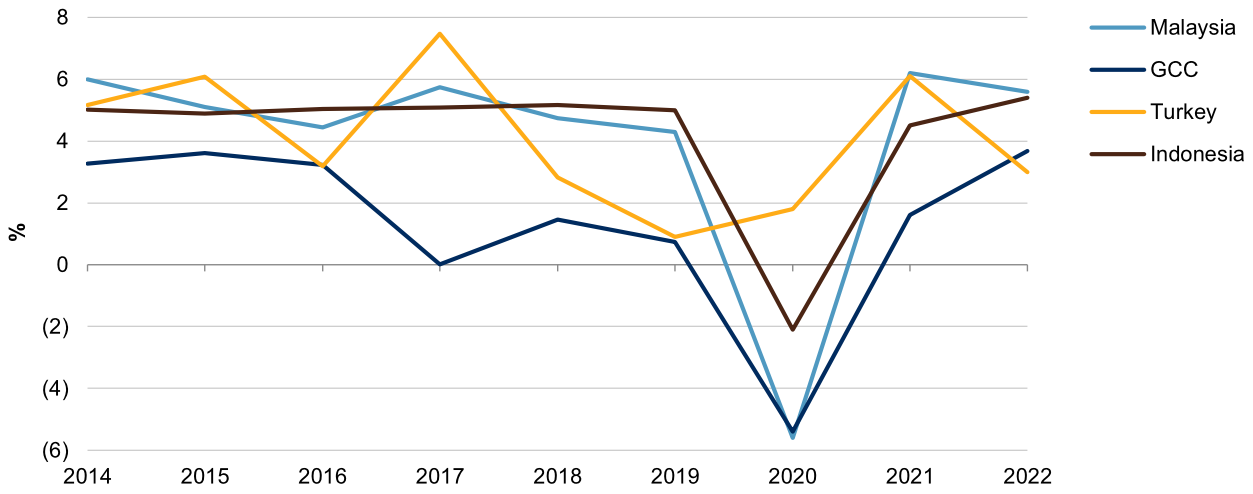
A $2.2 Trillion Industry That Will Continue To Expand...



Source: Central Banks, IFSB, Eikon, S&P Global Ratings

Chart 2

...Helped By The Recovery In Core Markets And Volume Of Sukuk Issuances
GDP growth



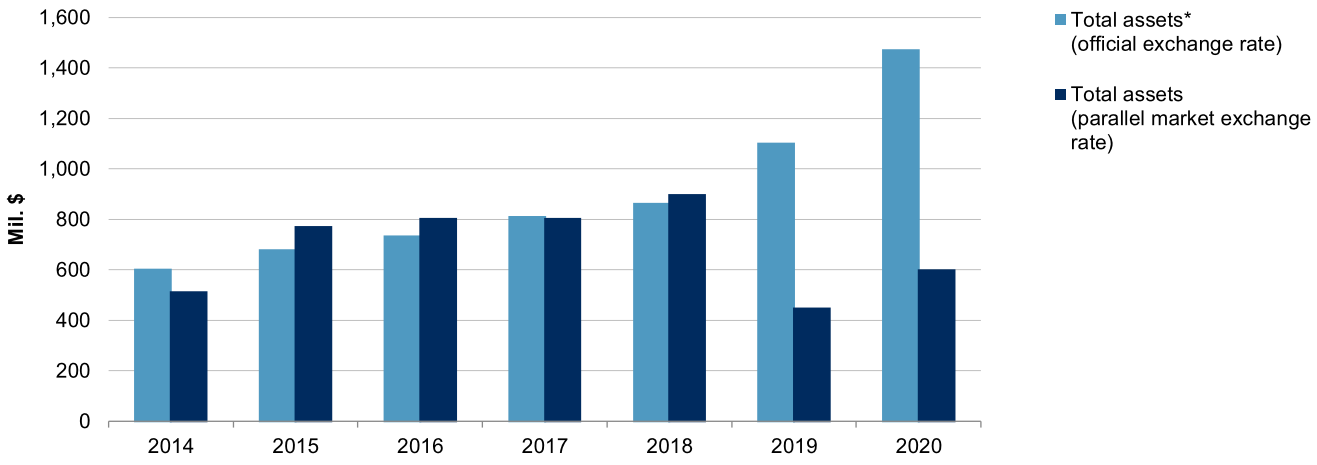
GCC--Gulf Cooperation Council.

Why Did We Exclude Iran From The Calculation Of The Industry Assets?

The country's currency has reportedly declined significantly in value versus the U.S. dollar, even though the official exchange rate remains fixed. This results in about $900 billion valuation discrepancy. Using the official exchange rate, the figures reported by the Central Bank of Iran (CBI) show total assets of the banking system (including nonbank institutions) at $1.47 trillion as of Feb. 7, 2021. However, the parallel rate as reported by the CBI for 2018-2019, and assuming it has not changed despite market sources pointing to a depreciation, shows a total asset of $598 billion at Feb. 7, 2021 (see chart 3). Therefore, given the potential disruptive impact of these numbers on the overall credit story of the industry, we excluded them for this year.

Chart 3

Impact Of Foreign Currency Exchange Rate On Total Assets Of Banks And Nonbank Credit Institutions In Iran



*Assets of banks and nonbanks credit institutions. Source: Central Bank of Iran.

The Social Angle Of Islamic Finance Is Not Sufficiently Visible

COVID-19 has caused a significant slowdown in core Islamic finance markets and a spike in unemployment. While the Gulf's predominantly migrant population structure has led to population shrinkage, and some governments' support packages have helped to absorb some of the shock, several stakeholders have lost a portion of their income.

There are dedicated Islamic finance social instruments. However, their use has remained somewhat less visible in the current environment. We have seen a handful of social sukuk issuances. The Islamic Development Bank (IDB) issued a $1.5 billion sustainable sukuk in 2020 and another $2.5 billion one in 2021. The IDB disclosed that the proceeds of the second sukuk will be used to finance green (10%) and social development projects (90%). This sukuk was allocated predominantly to Middle East and North Africa investors (around 60%) and central banks and official institutions (78%).

Malaysia issued its "Prihatin" sukuk, which is akin to a war bond. This sukuk has a low periodic distribution rate payable to the investors, and the government used the proceeds to help restart

the economy. More recently, Malaysia has also issued a $1.3 billion sukuk, including a sustainability tranche. The sukuk was 6.4x oversubscribed. The proceeds will reportedly be used to fund social and environmental projects as part of the government's agenda to fight climate change and build a more sustainable and inclusive economy.

These and other Islamic finance instruments could help make an even bigger impact if they are leveraged properly. Moreover, these types of innovative instruments targeting social needs may appeal to other local or foreign investors with ESG objectives. They show that the pandemic has presented an opportunity to put the social element back into Islamic finance and demonstrate the social aspect of the Sharia goals, Maqasid. We expect to see more of these instruments in the medium term.

Green sukuk is another area of opportunity, owing to the energy transition, in line with the developing green agenda in many core Islamic finance countries. As with social sukuk, although we expect to see some activity around green sukuk, we don't see it as a game changer. We expect the energy transition will take a long time to materialize in the GCC and Malaysia, and as such, expect to see sporadic recourse to green sukuk. It remains to be seen if greater standardization of these instruments or their greater contribution to economic recovery will accelerate their development.

Will Inclusive Standardization Eventually Happen?

In 2020, unlike what some market participants expected, the overall volume of sukuk issuance dropped to $139.8 billion from $167.3 billion in 2019. That's despite the sharp drop in the oil price and the significant increase in financing needs of core Islamic finance countries. These issuers have instead tapped the conventional markets, where it is easier and quicker to get the funds.

Sukuk instruments remain more complex and time consuming for issuers than conventional bonds. What's more, some jurisdictions' adoption of AAOIFI standards, has already caused some difficulties for sukuk issuers in early 2021, particularly those with hybrid structures that combine a commodity murabaha with tangible assets. In the past, the tangibility ratios of these structures were complied with on a best-efforts basis once the transactions were issued. With the adoption of the AAOIFI standards, compliance became an obligation throughout the lifetime of the transaction. The challenge issuers are facing is how to implement AAOIFI standards without changing the credit characteristics of the transaction.

There are indeed several risks related to obligation of compliance with the tangibility ratio throughout the lifetime of the transaction. One of the risks pertains to the reasons for a potential noncompliance and if it is related to a partial loss, for example of the underlying assets. This returns investors' exposure to the residual asset risks that were in the past mitigated by the restriction of the exposure to a total loss scenario. The risk of having one asset destroyed is certainly higher than having several destroyed at the same time.

The second risk is related to prepayments on some assets and if the issuer does not have sufficient unencumbered assets. This risk is more relevant for corporates (and mainly smaller ones) and would make access to sukuk even more difficult for them.

Another risk is related to dissolution of the transaction before its maturity if the tangibility ratio is not respected, which is one of the strategies implemented by issuers to comply with this requirement. Here again, corporates might face a higher risk of default because some of their debt might suddenly become immediately repayable. This raises the necessity of a critical review of some of the existing standards, and the adoption of an inclusive approach taking on board the views of all the stakeholders. The process would ultimately lead to the standardization of the full

spectrum of sukuk (from fixed-income-like instruments to equity-like ones) factoring the requirements of regulators, sukuk issuers, and investors.

Standardization here includes both aspects of sukuk: sharia interpretation and legal documentation. It is when sukuk issuance becomes comparable with conventional instruments from a cost and effort perspective that it will find a prominent place on the radar for issuers and investors.

More Defaults To Come

Some corporates will also suffer from the current economic environment. However, this risk has not yet fully materialized on banks' balance sheets because of the regulatory forbearance and liquidity support measures implemented in many countries. The extension of these measures in most countries has further delayed the materialization of credit risk. We believe these extensions have likely delayed an increase in default rates among corporates and potentially of sukuk issuers in the next 12 months, especially those with low credit quality or business plans that depend on supportive economies and market conditions. We see pressure on real estate developers, given the drop in real estate prices in the GCC and building risks in the commercial real estate sector. Similarly, companies related to aviation, tourism, travel, and hospitality--sectors that have been severely hit by COVID-19--will take several quarters to recover to prepandemic levels.

We have already seen some sukuk restructurings in 2020, such as by PT Garuda Indonesia, which extended the maturity of its sukuk by three years after getting the approval of more than 90% of the sukuk holders. We expect to see more requests for extensions or restructurings among sukuk issuers in 2021, along with higher default rates. These instances will test the robustness of the legal documentation used for sukuk issuance and could strengthen the case for the documentation to be standardized. Defaults will also test the robustness of the insolvency regimes, which some core Islamic finance countries have strengthened recently, including countries in the GCC. If investors can get clarity on their financial recourse mechanisms because of these events, this would probably outweigh the negative impact on market sentiment.

A Unified Global Legal And Regulatory Framework Is Being Created

Over the next 12 months, we expect some progress on the unified global legal and regulatory framework for Islamic finance that the DIEDC and its partners are developing. DIEDC embarked on this project with the Islamic Development Bank, the United Arab Emirates Ministry of Finance, and several other advisors in 2020. The project's stated objectives include providing a global legal benchmark for Islamic finance, reducing regional differences in product offerings and practices, providing legal protection to all parties involved, and developing an international dispute resolution framework.

Depending on the outcome of the project, issuers may benefit from a speedier and more streamlined process to tap the Islamic finance market. Investors may also gain greater clarity on sukuk resolution in the case of default. This could make the industry more attractive to new players.

Fintech Will Enhance The Industry's Resilience

COVID-19 has demonstrated how the capacity of a company or a bank to shift its business online is critical for its continuity. For Islamic banks and sukuk, higher digitalization and fintech

collaboration could help strengthen their resilience in more volatile environments and open new avenues for growth. The industry is partially there, and digitalization is now taking a prominent place among decisionmakers' priorities. Getting banking services digitally, issuing sukuk on a digital platform using blockchain technology, and enhancing cyber security will be the three main factors that would help the resilience of the industry.

A prerequisite for fintech's ability to enrich the Islamic finance industry is the provision of an adequate physical infrastructure and the implementation of the necessary supervision and regulatory framework. That is why several regulators and authorities in the GCC and elsewhere have launched incubators or specific regulatory sandboxes where fintech companies can test innovations.

Related Research

- Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years, May 3, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021
- Islamic Finance 2020-2021: COVID-19 Offers An Opportunity For Transformative Developments, June 15, 2020
- Islamic Finance And ESG: Sharia-Compliant Instruments Can Put The S In ESG, May 27, 2020

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