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Webinar: The Impact of COVID-19 Pandemic on Islamic Banking (30 April 2020)
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Webinar: Kesan PKP Terhadap Kontrak Pekerjaan dan Perbankan di Malaysia (Impact of the MCO on Work and Banking Contracts in Malaysia) (14 May 2020)
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Webinar: COVID-19 from the Perspective of Islamic Theology and Spirituality  
(9 July 2020)  
*Muhammad Fakhrurrazi Ahmad*

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(IAIS Malaysia, 28 July 2020)  
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Online Research Camp for Academic and Policy Research  
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Webinar: Managing Shariah Non-Compliant Risk in Financial Institutions  
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Book Review

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COVID-19: Reshaping the Future Direction of Islamic Finance

Mohammad Mahbubi Ali*

As the COVID-19 pandemic intensified worldwide, lockdowns designed to restrict movement became the preferred mechanism to reduce infection rates in most countries. Imposing such movement control orders, however, necessitated the cessation of many economic and business activities, including the restriction of travel between borders.

This measure has impacted the general public, small and medium-sized enterprises (SMEs), and the global economy as a whole. In October, the International Monetary Fund revised its World Economic Outlook for 2020, forecasting that the world would experience an economic slump of up to -4.4 per cent, a further 1.4 per cent decline compared to the April 2020 forecast.

As the global economy braces itself for an economic downturn and prolonged recession, the Islamic finance industry finds itself caught up in events. For example, S&P Global Ratings forecasts that the Islamic banking sector will suffer a drastic drop in revenue in 2020, recording only low single-digit growth as a result of government measures to contain the COVID-19 pandemic. In Malaysia, Islamic banks are now experiencing lower financing margins resulting from the slashing of the Bank Negara Malaysia (BNM) base rate to 1.75 per cent per annum, lower fee-based income due to lesser demand for certain banking services, slower financing growth, and a drop in investment returns due to a capital market slump. The government’s six month moratorium on loan and financing repayments, which has been extended for targeted customers, will further deepen the decline in profits seen by the Malaysian Islamic banking industry for the year 2020.

The pandemic has also exposed Islamic banks to an increase in Non-Performing Financing (NPF) and Gross Impaired Financing (GIF) due to a high number of business closures and rising unemployment rates. In Malaysia, S&P Global Ratings estimated that levels of NPF would increase to 1.7-1.8 per cent of outstanding financing in 2020, compared to 1.5 per cent as of 31 December 2019.

Apart from credit risk, the pandemic might also expose Islamic banks to an increase in liquidity risk due to massive withdrawals from depositors. This is particularly true since depositors might now have to start withdrawing their savings to sustain their livelihoods. Concomitantly, new depositors might prefer to place their funds in safe-haven assets, such as gold.
Apart from Islamic banking, COVID-19 has also hit the Islamic capital markets, mainly the stock and sukuk markets. A study by Badar Nadeem Ashraf, titled “Stock markets’ reaction to COVID-19: Cases or fatalities?” revealed that 64 countries over the period January-April 2020 experienced a negative correlation between global stock market returns and confirmed cases of COVID-19; as the number of COVID-19 cases escalated, stock market performance slumped.

The global stock market started its decline on 20 February 2020, reaching its lowest level on the 16 March, and only beginning to recover on the 7 April. The 16 March crash (called Black Monday II) recorded a decline of up to 12-13 per cent, being the largest drop and fastest fall in the global stock markets since the Wall Street Crash of 1929. The stock market then demonstrated an uptrend in April, only to endure a second crash in October 2020. This was mainly due to the sudden exponential spread of COVID-19 and uncertainty surrounding a vaccine. These stock market crashes marked the beginning of an economic and financial recession, which is anticipated to be the worst crisis in financial history post the Great Depression (1929-1935).

In particular, the Islamic stock market was severely hit by COVID-19 in 2020. The Dow Jones Islamic International Titans Index ceaselessly declined from 5,283.50 in February to 3,756.63 by the end of March. However, DJ Islamic Index re-entered a bull market, gradually increasing from 3,756.63 to 6,141.32 by early September. Information technology and healthcare are the two main drivers of equity market performance, contributing around 29.6 per cent and 18.3 per cent respectively to S&P Global BMI Shariah.

According to S&P Global Ratings, the volume of sukuk issuance in 2020 is forecasted to drop by up to 40 per cent, with a total sukuk issuance of approximately USD100 billion as compared to USD162 billion in 2019. This is because many large companies have reduced their capital expenditures and prefer to penetrate bank financing instead.

The Islamic insurance sector has also been exposed to the adverse impact of the COVID-19 outbreak. The industry is expected to face lower contribution income, a larger volume of claims in certain areas, as well as liquidity and solvency challenges in 2020. The Allianz Insurance Report 2020 projected that global premium income will decline significantly, standing at -3.8 per cent (life -4.4 per cent; P&C -2.9 per cent). However, RAM Ratings believes that the Islamic insurance industry will recover in 2021, with an estimated global premium growth of up to 5.6 per cent.

Nevertheless, the coronavirus crisis does offer new opportunities for Islamic finance. As the world reacts to the COVID-19 pandemic, adjusting to the new normal of social distancing, reduced physical interaction has become a priority. The Islamic finance industry is therefore being forced to explore new avenues and
alternatives to in-person banking and physical exchange when conducting daily operations. This is particularly true since the World Health Organization (WHO) has recommended the use of contactless payment, without the physical handling of banknotes. Accordingly, COVID-19 has marked the rise of digital money to mitigate the transmission of the coronavirus via paper money. The adoption of digital finance and financial technology (fintech) is becoming indispensable to the industry post-COVID-19. Ayman Sejiny, CEO of ICD (Islamic Corporation for the Development of the Private Sector) IDB said: “Covid-19 has led us to accelerate the digital transformation that was already underway prior to the pandemic”.

For Islamic finance, the adoption of fintech can lower transaction costs, expedite the execution of Shariah contracts, minimise operational and Shariah non-compliance risks, strengthen transparency, and facilitate standardisation. Nevertheless, the new shift toward fintech and digitalisation in Islamic finance operations challenges traditional fiqh requirements. For example, how should Islamic jurisprudence recognise offer and acceptance, as well as automatic possession, via smart contracts? And how should shariah scholars deal with new asset classes (crypto and digital) and new forms of currency (digital and e-money)?

Apart from the emerging trend towards digitalisation, COVID-19 has also necessitated reconsideration of Islamic social finance instruments and socially responsible investment (SRI) in order to address the adverse effects of the pandemic. For example, the Islamic Development Bank (IDB) issued USD1.5 billion of sustainability sukuk on 19 June 2020, with the proceeds being used to assist 57 member countries in meeting the cost of fighting COVID-19. On 22 September 2020, Malaysia issued Sukuk Prihatin of up to RM500 million (approximately USD121.5 million) to finance the country’s economic stimulus packages and COVID-19 recovery plan. Likewise, Indonesia’s government raised USD2.5 billion in June 2020 in order to fund the fight against COVID-19. Following the success of a sovereign cash, waqf-linked sukuk of IDR50.8 billion (USD3.46 million) in March 2020, the Indonesian government issued another on 19 October 2020 to finance economic recovery both during and post COVID-19.

The shift towards digital finance, social finance, and socially responsible investment during the COVID-19 pandemic has presented Islamic finance with the opportunity to reinforce its commitment to responsible finance (that is, beyond profit), brotherhood and cooperation, and the development of a community-oriented, entrepreneur-friendly environment.
Notes

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