



ESSAYS ON ISLAMIC FINANCE: REGULATOR'S PERSPECTIVE

BY

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Abstract

The objective of this essay is to discuss the current issues on Islamic finance. Hence this essay covers a wide range of issues in Islamic banking and finance. Some of the issues discussed entail the strategic partnership among countries towards the achievement of a sustainable growth of Islamic financial system. In addition to this, the essay also discusses the role of Islamic finance in the global financial stability, regulatory issues in Islamic finance, development of Islamic financial market in Malaysia, issues related to credit risk management and takaful. Based on the essay, Islamic banking and finance system has progressed tremendously in the past few decades, however it still faces some challenges. Therefore, the sustainability and further development requires the need for a vibrant competitive and Islamic financial institution, development and harmonized legal framework and the linkages between industry players.

ملخص الدراسة

إن الهدف من هذه المقالات هو مناقشة عدد من القضايا الراهنة في المصرفية الإسلامية. وبناء عليه، فإن هذا المقالات ستغطي العديد من المجالات المتعلقة بالمصرفية الإسلامية. بعض هذه المقالات تناقش انشاء استراتيجيات شراكة بين الدول من اجل تحقيق نماء مستمر في النظام المالي الاسلامي. بالإضافة إلى ذلك، هذه المقالات أيضا تناقش دور المصرفية الإسلامية في استقرار الاقتصاد العالمي، والقضايا التشريعية في المصرفية الإسلامية، وتطوير سوق المال الإسلامي في ماليزيا، القضايا المتعلقة بإدارة مخاطر التمويل والتكافل. لقد أسهمت هذه المقالات في تطوير المالية والمصرفية الإسلامية بشكل ملحوظ في ماليزيا خلال العقود الماضية. على الرغم من ذلك، لاتزال المصرفية الإسلامية تواجه العديد من التحديات. وعليه فإن التنمية المستمرة تتطلب المزيد من التناغم والنسج مابين المشرعين القانونيين وبين رجال الأعمال وأهم العاملين في الصيرفة الإسلامية.

APPROVAL PAGE

The dissertation of Muhammad Ibrahim has been approved by the following:




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DECLARATION

I hereby declare that this dissertation is the result of my own investigation except where otherwise stated. I also declared that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institution.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

Islamic finance can be described as the financial system that is free from prohibited activities as indicated in the Holy Qur'an. The chief of the prohibited activities is Riba, which signifies interest or a positive increment on loan as reward for waiting. The Islamic financial system thus constitutes a quest for the financial system by Muslims which serves as a platform to carry out their financial activities in a manner that does not violate the principles of Shari'ah. Basically, Islamic banking lay much emphasize on profit and loss sharing business model. This model is highly value loaded because, it facilitates the allocation of financial resources to the most productive sector of the economy and ensures that those with viable business idea have access to financial resources in order to benefit the society.

Efforts to eliminate Riba from every transaction activities by the Muslims scholars and stakeholders started in the 1970; however, practical efforts were taken in the 1980s with the introduction and emergence of Islamic banking system in countries in the Middle East and Few countries in Southeast Asia. Islamic banking system that started as a modest form of financial contract has now evolved to become a complex one.

The contemporary Islamic bank has achieved tremendous progress in the past few decades. With a record of 20 percent annual growth, Islamic finance is regarded as the fastest growing financial segment globally. This unique financial system has not

only been accepted in the Muslims countries but also in non-Muslims countries. Standard and Poor estimated the total Shariah compliant assets to be in aggregate of \$1trillion with more than 1,100 institutions offering Islamic Financial Services. Islamic financial system has achieved growth in banking sector, non-banking sector, Insurance and capital market. The most striking development is the success recorded in the Sukuk market in recent years. Sukuk issuance still attracts investors despite the retrenchment of investment in structured finance following the recent global financial crisis. Currently, Islamic financial system evolved from just commercial banking operation and Takaful to the innovation of products such as syndication, trade finance, equity, private equity and structured products. According to the Governor Dr. Zeti Akhtar Aziz, (2010), the total assets of sukuk is currently estimated at \$130 billion with an annual growth of 40 percent

The attraction and support for the Islamic financial system has been attributed to its huge potential for the real sector of the economy and some advantages it possesses. One of the main advantages of financial system based on Islamic principle is that, it helps in facilitating the raising of equity and risk sharing in project and venture finance through the principle of musharakah and mudharabah.

The future is bright for the growth of Islamic financial system based on the opportunities opened by the unsustainability of the current economic system that is widely associated with instability and financial crisis. Islamic financial system thus remained and acknowledged by scholars and regulatory authority as a viable alternative to the current system. There is need for further consolidation of its product, structure and regulatory framework for Islamic finance to be well positioned to provide solution to the current system. This thus call for the need for the standardization of the Shariah ruling on product permissibility, enhancing regulatory

framework, cross border trading, leverage on information technology and ensure improvement in transparency.

Though, a lot of studies examining various dimensions of Islamic financial system have been explored both conceptually and empirically by scholars and regulators, there is still need for more studies and information dissemination due to the dynamic nature of this fast growing financial segment. This study therefore aims at contributing to the literature of Islamic studies by providing valuable information regarding the development of the practicing and market condition of the various Islamic financial products from the regulatory perspective.

The remaining of this essay is thus organized as followed: Chapter two comprises of Institutional structure of Islamic finance whereby discussion is focused on the evolution of the structure of Islamic finance and its relationship with financial stability. Chapter three discusses the contribution of Islamic finance to global financial stability while chapter four focuses on the regulatory issues in Islamic finance. The discussion in chapter five and six will focus on the emerging trend in Islamic finance and issues in risk management respectively. The last chapter will therefore present the conclusion and recommendation part.

CHAPTER TWO

INSTITUTIONAL STRUCTURE OF ISLAMIC FINANCE

2.1 Merger between EONCAP Islamic Bank and Hong Leong Islamic Bank¹

First and foremost I would like to express my gratitude to Almighty Allah for His grace of making it possible for us to witness the merger between Hong Leong Islamic Bank and EONCAP Islamic Bank. I would also like to thank the organizers for inviting me today, a day that is full of historical moments whereby both banks would unite to become a single entity.

It is my pleasure to be here this evening to witness the merger between EONCAP Islamic Bank and Hong Leong Islamic Bank. Today we are seeing the first merger of Islamic banks in Malaysia. This is indeed a significant milestone. Properly structured, this merger would create synergy from the strengths of both banks and further instill dynamism into our Islamic banking industry. Vibrant, competitive and efficient Islamic financial institutions can play the critical role to effectively intermediate and allocate funds within the economy. I hope the newly merged entity would give birth to a more robust and solid entity, one that is better able to meet the increasingly challenging, competitive business, and operating environment.

¹ Keynote address at the Launching Event of Merger between EONCAP Islamic Bank and Hong Leong Islamic Bank Kuala Lumpur, 10 November 2011

2.1.1 Changing Landscape of the Malaysian Financial System

The Malaysian financial system has undergone remarkable changes over the years. A series of reforms has taken place in the aftermath of the late 1990s Asian financial crisis. The crisis has resulted in bold transformation that involved the restructuring, consolidating, and rationalising of the banking system. We were never shy or hesitant to introduce the fundamental changes that would benefit the country and the industry. These reforms have served us well. The domestic banking system has been transformed beyond recognition from one that was highly fragmented with 71 institutions prior to the crisis, to eight domestic banking groups. But the consolidation reform of the industry was not done in a vacuum. The consolidation of the industry was reinforced by considerable efforts towards strengthening corporate governance and risk management capabilities of the financial institutions, as well as nurturing of human capital in the industry. Today the banking industry is more resilient, diversified and competitive. This was amply proven when our financial system was essentially unscathed by the recent financial crisis. I regard the merger that we are witnessing today as a continuation of what we had started years ago and I expect this process to progress and market forces would determine on how the structure of the industry would look like in the future.

The reform measures that we had carefully instituted over the years had enhanced the operating, legal and regulatory framework that serves as a solid foundation for the development of our Islamic finance industry. Over the last five years, Islamic finance has recorded significant double digit growth rates. Market share of Islamic banks increased from 8.2 percent in 2001 to 22 percent in September 2011, while for takaful, market share increased yearly from 6.8 percent in 2006 to the current 13.6 percent. While these numbers are encouraging, we should not be satisfied

with the achievements. We need to work harder and find new avenues for the Islamic banking industry to grow further.

One area is the Islamic financial markets. Our Islamic financial market in particular has performed very well. The Malaysian Ringgit sukuk accounts for about USD94 billion (RM291.4 billion) or two thirds of the global sukuk outstanding. But more importantly, it has an international dimension with an outreach to international investors through raising of multi-currencies sukuk both by Malaysian and non-Malaysian issuers. Malaysia also now has the world's most active secondary sukuk market. The volume of secondary market trading of Government Investment Issues, Islamic Bills, and Islamic private debt securities has exceeded RM500 billion so far for this year. The annual volume of Malaysian Islamic interbank money market transactions has also now exceeded RM1.5 trillion on an annual basis.

I am very encouraged by another development - the diversity in the structure of our Islamic financial instruments. This development is critical as it shows the industry's responsiveness to innovation in meeting the market's changing needs and sophistication. Our Islamic Profit Rate Swap market, though relatively small at less than RM3 billion in terms of annual turnover, has solid growth potentials given the growth of the Islamic banking system's balance sheet. I am happy to note that EONCAP Islamic Bank and Hong Leong Islamic Bank are among the top players in this market segment.

In terms of Shariah governance - which is the backbone of the Islamic finance industry - we have significantly enhanced our capacity from only 4 Shariah advisors in 1983 to more than 140 Shariah advisors now. This is a tremendous achievement and a reflection of our success in building capacity in Shariah related matters. The Shariah governance framework that was introduced recently is breaking new barriers

in promoting transparency. The framework provides clarity and accountability on the role of the board, senior management and Shariah committee members on Shariah matters. Consequently, as a result of new expectations, internal Shariah compliance functions require revamps to meet the objectives of the framework. In its entirety, Islamic financial institutions and Shariah committee members have to internalise the four key expectations of the framework – oversight and accountability, independence, competency and confidentiality.

These achievements that I had mentioned have enabled Malaysia to set a strong foundation in Islamic finance and enable the country to play a more prominent role internationally. We did this proactively in 2009, where additional liberalisation in the Islamic financial sector was introduced aimed at strengthening international linkages and promoting greater regional financial integration. More Islamic banking licenses were granted. More foreign-owned Islamic financial institutions are now operating in Malaysia offering more products and instilling more competition. In future, to expand its growth, potential Islamic financial institutions have to evolve from being domestic-centric to one that has the ability to venture into cross-border businesses.

2.1.2 Higher Expectations on Newly Merged Entity

With emergence of this new merged entity, our expectations on them would naturally be enhanced. The newly merged entity will have a stronger capital base and would be ranked as the fourth largest domestically. At the global front, it is expected to be ranked among the top 50 Islamic financial institutions in terms of the Shariah compliant asset size – a significant jump from individual rankings of Hong Leong Islamic Bank and EONCAP Islamic Bank which are currently at the 68th and 72nd

position, as reported by The Banker Magazine in its latest list of the world's top 500 Islamic financial institutions.

With stronger capital base come stronger financial capacity, human capability, operational flexibility and more product offerings and competitive pricing. In particular, the merged entity has an added flexibility to optimise on the overall strength of the merging banks to offer more distinctive and innovative product range. For it to be successful, the product offering should be more diversified, and of high quality and serves a wider range of customers. Indeed, in product development, there are many new frontiers to be explored within the Shariah framework to provide better value to customers. To fully reap this potential, the merged entity should be given greater operational flexibility within the group structure, to chart its own growth and strategy.

I also believe that the merged entity would be in a better position to contribute further to Malaysia's financial inclusion agenda. The financial inclusion agenda is an integral part of an inclusive growth process, as it allows various segments of the economy to have access to financial services. The success of the agenda requires active involvement of many different stakeholders. Financial institutions with specialised skills and knowledge are among the key stakeholders. For this, the merged entity with extended delivery channels of more than 300 branches and over 1000 self-service terminals has better ability to expand its customer outreach nationwide. With greater management focus on this agenda, this merged entity can make greater stride to contribute to this important national agenda.

Finally, on human capital management, we should expect that at the onset, adequate emphasis is given to ensure seamless assimilation and collaboration of staff from both entities. It is crucial for the new entity to address potential challenges

arising from the rationalisation of its manpower needs. Necessary action plans on training and retraining of staff need to be identified and resolved. These are critical elements that would support the overall business strategy and contribute towards building a solid team for the merged entity.

2.1.3 Concluding Remarks

In conclusion, it is our hope that the merger between EONCAP Islamic Bank and Hong Leong Islamic Bank is another important step to further strengthen the innovation and competitiveness of the industry. It is our expectation to see Hong Leong Islamic Bank emerge as a more effective and progressive Islamic bank, with strong presence in the domestic financial landscape and be among the early players to expand Islamic banking business beyond our shores. I wish both banks all the best in their effort for full integration.

I believe that the merged entity would become a strong partner in the country's aspiration towards shaping Malaysia as a vibrant Islamic international financial centre. I pray for the banking group every success in this endeavour.

2.2 Partnership between Malaysia and Turkey on Islamic Finance Corporation²

I have the honour today to welcome distinguished guests to the Business Seminar organised by Bank Negara Malaysia, held in this beautiful and historic city of Istanbul. The theme "Malaysia and Turkey: The New Silk Route in Islamic Finance - Strategies for Collaboration, Cooperation and Smart Partnership" was chosen as a

² Opening remarks at Business Seminar on Islamic Finance Istanbul, Turkey, 29 September 2011. (*"Malaysia-Turkey Islamic Finance Cooperation: New Solution - Preferred Partner"*)

reflection of our desire to strengthen economic and business ties for the mutual benefits of both countries. The emergence of the 'Silk Route', a term coined by Governor Dr Zeti in 2006 opens up exciting prospects for countries and businesses. The new 'Silk Route' not only carries traditional trade of goods and services of old but also manufactured goods, technological innovation and know-how, portfolio flows, private equity investment and mobility of human capital and knowledge. Today, Islamic financial products and services are truly 'new' additions to this trade.

Let me first express our heartfelt appreciation to His Excellency Tun Dr. Mahathir Mohammad for accepting our invitation to speak at this event, sharing his thoughts on Islamic finance. Tun Dr. Mahathir needs no introduction. Among his many achievements was the time he steered the country during the 1997 - 98 Asian crisis. His unorthodox policies then have become mainstream now. Under his leadership, Malaysia experienced modernisation and economic prosperity, a development most profound for my generation. That modernisation included the early development of Islamic financial system. From the seeds planted during Tun Mahathir's time, we are now seeing the maturing of the Islamic financial system in Malaysia that is innovative, competitive and increasingly internationalized. What was once a novelty has become an alternative means of conducting business. We owe this very much to Tun Dr. Mahathir's foresight and wisdom. Not many people today realised that one of the first actions that Tun Dr. Mahathir took when he came to office in 1981 was to set up a National Steering Committee to implement Islamic banking in Malaysia. The report of this committee on the viability and strategy of the Islamic banking was the impetus for the creation and robust development of the Islamic financial industry in Malaysia. The rest they say is history.

2.2.1 Global Economic Challenges and Islamic Finance

The world is transforming and its transformation is way beyond what we had seen before. This is an era of radical change, new rules are being formulated, standards and best practices that were in vogue hardly 5 years are now considered insufficient. It is changing at a scale and speed we had never experienced before, that require us to accelerate our own pace of transformation, to enable us to survive and prosper under this 'new normal' operating environment. The world is currently faced with wide-ranging challenges that include among others - excessive indebtedness, at household businesses and at sovereigns. Many are grappling at finding the solutions to overcome the complex issues facing them today. Some of the problems look uncannily similar to what we had faced in the 1990s, but the solutions might be different this time. But whatever that solution might be, we must never discount any probable answers including unorthodox measures. Experience during the Asian Financial Crisis had shown that unconventional measures could very well be the future best practices. But then, yesterday's solution may no longer be adequate to address today's challenges. Therefore, we must endeavour to search for new alternatives and embark on new ventures that could mitigate the contemporary issues and challenges confronting us. And this is where Islamic finance can fit in and play a meaningful role.

As an objective, we need to build the foundations for a stronger and more inclusive global economy with sustainable growth and greater shared prosperity by all. This objective is in fact fundamentally in line with the role and relevance of Islamic finance. Islamic finance emphasises on attainment of socio-economic goals espoused on Shariah objectives. It emphasises on a strong linkage to productive economic activity to generate legitimate income. It also emphasises on accountability, fairness

and transparency. All these reflect the fundamental values propagated in Islamic finance that could serve as a stable and resilient form of financial intermediation. When Islamic finance is applied in an appropriate and structured manner, it has a strong prospect to serve as a contributor to a sustainable global economic growth and financial stability.

The infrastructure already established in Islamic finance today is ready to serve as an effective intermediary for the conduct of global business including promoting greater intra-regional trade not only within Asia but between the various regions of emerging markets. With more than 600 Islamic financial institutions that now operate in more than 75 countries, growing at an annual rate of about 15 per cent, Islamic finance can be a platform to strengthen economic ties between East and West Asia in trade and investments flows. The sukuk market in particular, has evolved as an important avenue for international fund raising and investment activities, generating significant cross-border flows. Sukuk issuances have grown in diversity and sophistication. The diverse sukuk structures of Ijarah, Istisna, Murabahah, Musyarakah and Mudharabah have expanded to form hybrid sukuk which include exchangeable and subordinated sukuks, thus increasing its usability and compatibility to fund various forms of financing. For example, huge amount of funds could be raised, via sukuk, for the purpose of financing large infrastructure projects. It is this substantive advancement in Islamic finance that we believe greater business and investment ties could be built upon to enhance economic relationship between Turkey and Malaysia.

2.2.2 Turkey-Malaysia Vast Growth Opportunities

For Turkey and Malaysia, a productive partnership could be created when both parties are able to harness the strengths of each other. Turkey is Malaysia's eighth largest trading partner among the OIC member countries, has had a significant growth in terms of its trade with Malaysia, which has expanded at an annual average rate of 22.4 percent since 2006. While the volume of trade and investment between the two countries is still relatively small, where Malaysia's trade with Turkey accounts for 0.3 percent of Malaysia's total trade and Malaysia's investment in Turkey totalled to USD56.2 million as at end-2010, the figures also reflect the enormous opportunity for further growth. Turkey's Prime Minister The Honourable Recep Tayyip Erdoğan, during the recent visit by the Malaysian Prime Minister to Turkey, has suggested a leadership aspiration for trade volume between Malaysia and Turkey to grow from USD1.3 billion to USD5 billion. With commitment and hard work, this target is certainly not impossible to achieve. I believe with a Strategic Framework Agreement that is planned to be signed later this year between our two Governments would further strengthen cooperation between the two through identification of important areas where we could focus and work on.

Opportunity to enhance trade and financial linkages between Turkey and Malaysia is immense. Collaboration between the two countries could be in many forms; for instance Turkish investors and financial institutions could use Malaysia as a gateway to the Asean region. Malaysian financial community could use Turkey as a base to Central Asian region and Europe. In the area of Islamic finance, Malaysia is committed to be a partner with Turkey to further promote the business prospect in this country. Malaysia being an Islamic financial hub in Asia is willing to share with Turkey our 30 years of experience in developing its Islamic financial industry and our

knowledge and insights in operating an Islamic financial system that runs parallel with its conventional counterpart.

2.2.3 Potential Turkey-Malaysia Partnership in Islamic Finance

There are vast opportunities for Turkey-Malaysia bilateral cooperation, however let me mention five key areas of possible cooperation that could increase cross-border activities between our two countries. These are in the area of sukuk issuance, promoting cross-border activities, Islamic fund management, partnership in innovation and in education and research.

Firstly, in the area of sukuk issuance, we welcome Turkish financial and business community to use Malaysia's comprehensive and tested infrastructure with its extensive investor's network as a platform to raise funds such as sukuk and Islamic syndication financing. The multi-currency sukuk market in Malaysia is well developed and active with over 60% of the outstanding sukuk in the world originating from Malaysia. There is also the opportunity to list the sukuk on Bursa Malaysia, the Malaysian bourse, which has emerged as the largest exchange for sukuk listing in the world. This gives the listed sukuk greater profiling, visibility and transparency in the global bond market. Collaboration in issuance of sukuk would indeed benefit Turkey, as Turkey's aggressive diversification of its industrial base and services sectors will require huge financing needs that could be partially met through the Islamic financial markets. Large infrastructure projects such as building the Bosphorus shipping canal, the new railway lines and highways might require funding via issuing sovereign sukuk as an alternative source of funding. The extensive privatisation in basic industry - transportation, communication and banking - would also offer the corporates and alternative source of financing that is competitive and innovative.