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Islamic Finance: Malaysia's Growing Role

Over the course of the last four decades, Islamic finance has evolved from a market with one institution in a single country in 1975, to one with more than 300 institutions operating in more than 75 countries today. Analysts estimate that total assets in the Islamic finance market are between US$750 and US$800 billion as of July 2009, and may exceed US$1 trillion in 2010.[i] Among Asian countries, Malaysia's role in Islamic finance is unique.

Since the 1970s, Malaysia has constructed a detailed plan to domestically develop Islamic finance into a full-fledged dual banking system by 2020.[ii] The enactment of the Islamic Banking Act of 1983 enabled the founding of the first Islamic Bank in Malaysia. Since then, numerous financial institutions have joined Malaysia's Islamic finance market. As of year-end 2008, Malaysia had 17 Islamic Banks that focus on Islamic products and services. In addition, other financial institutions such as commercial banks, investment banks, and finance companies participate in Islamic finance activities.

This *Asia Focus* report explores the topic of Islamic finance and highlights Malaysia's role in developing the Islamic finance market. It should be noted that given the recent growth of the global Islamic finance market, publicly available data is relatively scarce and difficult to verify.

An Overview of Islamic Finance

Islamic finance is based on the application of *Shari'ah,* or Islamic law, to banking. One of the main principles of Islamic finance is that of shared risk/shared reward, in which both profit and loss are shared between the bank and its customers.[iii] In addition, *Shari'ah* prohibits interest-based transactions because interest (*riba*) is considered to be an unjust instrument of financing under Islam. For instance, instead of applying interest on home purchases, an institution following Islamic banking practices will purchase a property and sell it to a buyer at a profit; the buyer then pays the amount back over time in installments.

The five pillars of Islamic finance are:[iv]

- No application of interest
- No uncertainty or speculation
- No financing of companies in certain sectors (e.g., weapons, pork, gambling)
- Profit and loss must be shared
- Financial transactions must be backed by tangible assets

One key element of Islamic financial transactions is the value placed on trust and transparency between bank and customer. Contracts are designed to be straightforward so that each party involved in the transaction clearly understands what is being exchanged. As a result of this culture of transparency and the five pillars noted above, risk exposure is limited in both investing and lending. Proponents of Islamic finance assert that this banking model promotes financial stability both through its technical restrictions and its socially conscious orientation.

This conservatism also helps provide insulation from some of the risks commonly faced by conventional banks. Islamic financial institutions have relatively conservative investment portfolios and funding patterns—namely, limited exposure to complex financial instruments and stable deposit-based funding. As a result, Islamic finance has managed to weather the current global financial crisis with few disturbances.

Malaysia's Position

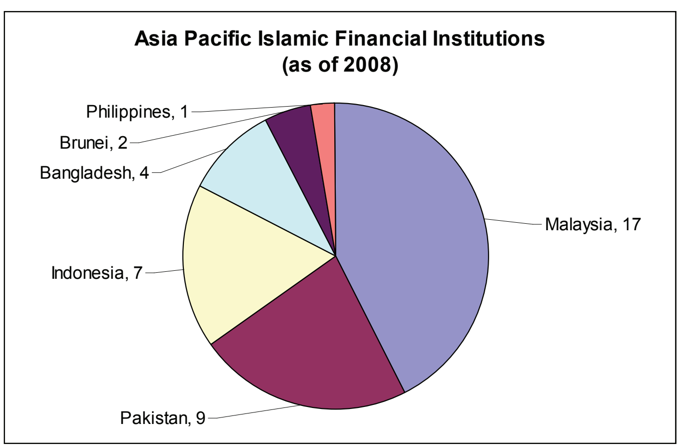
Along with Iran and Saudi Arabia, Malaysia is one of the key players in Islamic finance. Total Islamic banking assets in Malaysia are estimated at US$68 billion (or 17.5% of total Malaysian banking assets) as of June 2009, and have been experiencing an average annual growth rate of 18-20% since 2007.[v] Malaysia's most recent Ten-Year Financial Sector Master Plan articulates the government's goals to serve as a catalyst for growth in the field. In support of these goals, the government has taken steps to liberalize its financial sector, including plans to increase the cap on foreign investment in local Islamic banks, investment banks, conventional insurance and *takaful* (Islamic insurance) operators from 49% to 70%. The Chair of the Malaysian Securities Commission has noted that 87% of securities listed on the Malaysian stock exchange, accounting for 65% of total market capitalization, were *Shari'ah*-compliant as of April 2009.[vi]

In August 2006, the government launched the Malaysia International Islamic Financial Centre to promote Malaysia as a regional hub for Islamic finance in Southeast Asia. Malaysia has thus emerged as a major player in the field, announcing its intention to cooperate with the Islamic financial centers of Bahrain and Dubai to jointly develop the global Islamic finance market.[vii] In fact, Malaysia and Dubai recently signed an agreement on cross-border marketing and distribution of Islamic funds.[viii] In addition, Malaysian financial institutions have already begun gaining a foothold in Southeast Asia through investments in a number of banks across the region. For example, in December of 2008, Malaysia's largest lender, Maybank, finalized its acquisition of Indonesia's sixth largest banking institution, Bank Internasional Indonesia.

Regulatory Environment in Malaysia

Islamic finance in Malaysia is regulated by the country's central bank, Bank Negara Malaysia (BNM), and the Malaysian Ministry of Finance, which are directly involved in the supervision of domestic Islamic financial activities. Islamic banking windows are permitted in conventional banks, as are subsidiaries that function solely to facilitate Islamic financial transactions. Under the Malaysian dual banking system, conventional and Islamic financial institutions operate adjacent to one another in the market.[ix] According to the BNM annual report for 2008, Malaysia had a total of 17 Islamic Banks in operation as of year-end 2008.[x] As part of the government's liberalization plans for the Malaysian financial sector, BNM announced in April 2009 that it would issue up to two new licenses for Islamic banking.

The Malaysian Islamic Banking Act of 1983, established to govern Malaysia's Islamic financial practices, is enforced by separate *Shari'ah* boards in both the BNM and the Securities Commission through centralized oversight. Locally adopted Basel II capital requirements and international accounting standards are being applied to domestic Islamic financial transactions, though adoption has been somewhat inconsistent.



Source: *Asian Banker Research*, 2008. Figures do not include licenses issued in late 2008.

Sukuk Market

Within the field of Islamic finance, investment comprises a significant portion of business, as evidenced by the burgeoning *sukuk*, or Islamic bond, market. First issued by the government of Malaysia in 2002, a *sukuk* is a *Shari'ah*-compliant asset that offers investors asset coupon profit returns instead of compound interest. The principle bond type is the asset-backed *ijara*, which employs a sale and leaseback structure that relies on asset revenues to pay back investors. While global *sukuk* sales declined from US$27 billion in 2007 to US$12 billion in 2008, new corporate and government *sukuk* issuance is projected to surpass US$45 billion in 2009.[xi] Malaysia is currently the world's largest market for *sukuk*; Malaysian ringgit-denominated *sukuk* accounted for 60.7% of global outstanding *sukuk* as of year-end 2008.[xii] Commerce International Merchant Bankers Islamic, a subsidiary of Malaysia's second largest financial services provider, has been the top underwriter of *sukuk* sales since 2007, with a domestic market share of 39.4% and a global market share of 16.1% as of July 2008.[xiii]

Risk Management

As the field of Islamic finance continues to grow, institutions looking to participate face a number of risk management challenges. These challenges include human capital constraints, quality assurance, standardization of regulations, and corporate governance.

Human Capital Constraints

The scarcity of *Shari'ah* scholars is often cited as the most significant obstacle to the growth of Islamic finance. These specialized professionals, highly trained in the verses of the *Quran*, must assess and approve each financial transaction, product and service with respect to its adherence to the principles of *Shari'ah.* Given that there are only 30 to 40 such qualified individuals in the world, developing new financial products and services becomes increasingly difficult, as each must pass the test of the bank's *Shari'ah* supervisory board. An additional challenge lies in the fact that most *Shari'ah* scholars sit on more than one supervisory board, raising questions about information confidentiality and potential conflicts of interest. Finally, some critics have voiced concerns as to whether *Shari'ah* scholars have the requisite technical financial background to evaluate the products presented.

Quality Assurance

Another significant challenge is maintaining quality assurance based on transparency in the face of substantial growth. Banking practices premised on *Shari'ah* require that both risk and return are disclosed to market participants before a transaction takes place; yet, as the size and scope of Islamic finance continue to increase, personalized banking relationships built on the open exchange of information become more difficult to manage. In fact, Standard & Poor's has warned that financial disclosure practices of Islamic financial institutions often do not meet the standards of global best practices.[xiv] Some analysts maintain that incomplete disclosure could hinder the growth of Islamic finance in the future.

Standardization of Regulations

During the past year, international institutions such as the Islamic Financial Services Board (IFSB) based in Kuala Lumpur have spearheaded global initiatives to standardize Islamic financial transactions. The IFSB is the global standard-setting body for Islamic finance, capital markets and insurance. A number of banks are trying to institute common financial reporting standards by appointing *Shari'ah* scholars from both the Gulf Cooperation Council and Malaysia to serve on *Shari'ah* supervisory boards. Yet, with a number of variations in regulations across markets and countries, standardization remains a significant challenge for practitioners, regulators and depositors.

Corporate Governance

As the Islamic finance market becomes larger and more complex, corporate governance at financial institutions participating in the market becomes increasingly important. The Bahrain-based Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990 to govern global Islamic financial banking practices. However, it lacks an enforcement mechanism to support its recommendations. Since AAOIFI standards are voluntary, their adoption rate is relatively low. Fewer than 10 of the 56 Member States of the Islamic Development Bank have agreed to abide by the AAOIFI's established standards of practice.

Looking Ahead

Product diversification will be a key element in the expansion of Islamic finance across the globe. It is widely believed among market participants that diversification will develop from issuance and trading of *sukuk*, *takaful*, project finance, derivatives, private equity, retail banking, and real estate products.[xv] Such diversification will be tailored to the risk profiles as well as the investment and financing needs of both new and existing customers. Remittances present another opportunity for potential growth. Nearly 200 million labor migrants send a global aggregate of US$300 billion per year back home to their families.[xvi] This represents a substantial untapped market in which Islamic financial institutions are beginning to play a role. Despite the current global economic downturn, analysts estimate that remittance flows will only experience a 5-8% decline in 2009.[xvii] Given the value placed on trust in *Shari'ah*-based transactions, Islamic financial institutions may have the ability to appeal to remittance senders as an affordable, secure conduit for the transmission of these funds.

As the number of Islamic financial institutions continues to increase, differences in the application of *Shari'ah* to banking transactions become a more salient issue. Countries like Malaysia, looking to establish themselves as regional hubs of Islamic finance, face competing priorities of continuously innovating products and services designed to meet the needs of a growing client base while maintaining the transparency of each transaction. Regional cooperation will continue to play a significant role in ensuring consistency across jurisdictions, and in confronting the effects of the global financial crisis. Although Islamic financial institutions have fared relatively well to date, they may, like conventional banks across the globe, experience similar declines in asset quality, revenue and growth in the near term as a result of the crisis. Though many opportunities exist to further expand the Islamic finance market, continued focus on risk management practices and regulatory standards will be essential to the realization of sustainable growth.

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