



Recent Development of Islamic Finance Viewed at KLIFF2017

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The author attended the Kuala Lumpur Islamic Financial Forum¹ (KLIFF) held in Kuala Lumpur, Malaysia on 3-4 October 2017 and learned the recent development of Islamic Finance. Islamic finance is a financial form based on *Shariah*², or a *Shariah* compliant finance. The KLIFF that I attended this time is a forum where business persons, regulators and supervisors engaged in Islamic finance, and *Shariah* scholars discuss recent performance of Islamic finance and its future development. The author would like to feature here the points that interested him in the discussion.

1. The recent developments of Islamic financial market

(1) Islamic banks

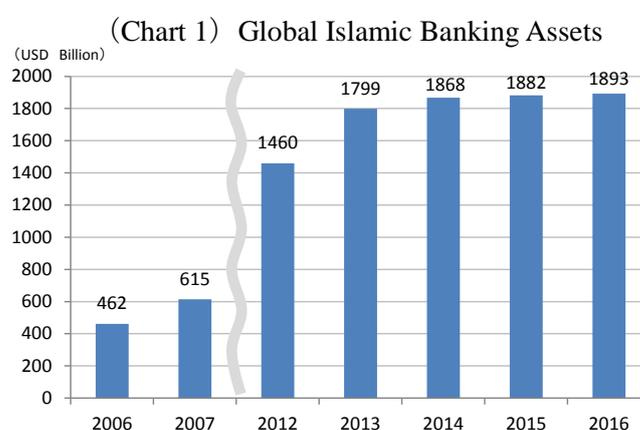
The Deputy Governor of Bank Negara Malaysia (Central Bank) touched in his keynote speech the global development of Islamic banks and their prospects. Islamic banks refer to those that engage in *Shariah* compliant financial transactions³.

¹ The Forum is organized by the CERT Company that has engaged in training and consulting business in Islamic finance. This year's session is the 14th of the series.

² *Shariah* is an Islamic law mainly derived from the Quran, the Islamic holy bible, and Prophet Muhammad's actions called "sunnah", and the codes widely regulate the behaviors from the public administration to personal behaviors of Muslims.

³ Islamic banks offer Islamic deposits on which they do not pay any interest, but instead, they pay dividends on the profits from investment in *Shariah* compliant businesses. According to *Shariah*, it is regarded that money (currency) is just a means to store values and does not by itself create any value (interest) in any activities other than commercial and production activities.

The global Islamic financial assets amounted to \$1.9 trillion in 2016, quadrupling from the level of 2006 (\$0.46 trillion)⁴ (Chart 1). Also in the Islamic financial centers, the presence of Islamic banks has been increasing year after year. Islamic banks used to offer financial services mainly directed to household, including *Murabahah* (cost plus loan) and *Ijar* (leasing). However, he stressed, that in line with the recent rapid growth of fintech such as crowdfunding and P2P transactions⁵, they are required from now on to build a new business model that promotes loans and investment to SMEs (especially those of start-ups) and supports *haral economy*⁶. In fact, interest in fintech is very strong also in Islamic financial world, and it seemed that the consciousness that they need to digitalize the existing financial services and actively utilize the high technology such as IoT⁷ and big data is as strong in Islamic financial business as in conventional⁸ banking industry.



(Source) Islamic Financial Services Board

(2) Sukuk market and its challenges

In the Session on Sukuk (Islamic bonds)⁹, the CEO of Cagamas¹⁰, the National Mortgage Corporation, spoke on the present situation and challenges of the sukuk market. He told that it is necessary to diversify issuers as about 80% of the issuers in the current sukuk market are

⁴ Aggregates of Islamic bank assets, sukuk, Shariah compliant funds, and takaful (Islamic insurance).

⁵ A P2P (Peer to Peer) transaction means a one-on-one transaction directly made on the web network without going through a server.

⁶ Industries authorized by the tenets of Islam, representative of which is a halal food industry.

⁷ IoT (Internet of Things) is a scheme that connect and mutually control various things on the internet.

⁸ “Conventional” transaction means in this context a traditional (ordinary) financial transaction that is worldly conducted, rather than the Shariah compliant financial transactions.

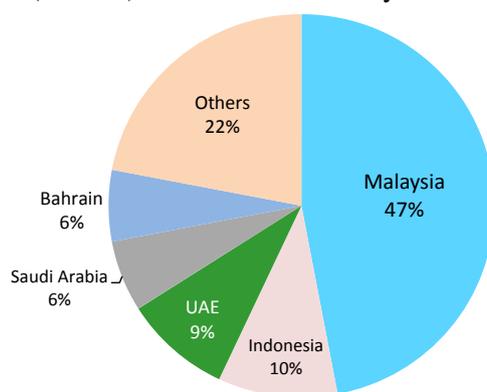
⁹ Bonds issued in compliance with the Shariah. While avoiding the accruing of interest rate that is forbidden by Islam, it instead realizes the same economic function as the conventional bonds by paying to investors profits or fees that accrue from the actual properties or their transactions.

¹⁰ The Cagamas has issued RMBS backed by the conventional mortgage loans and sukuk backed by Islamic compliant mortgage loans. As the external rating agency (RAM) gives the Cagamas an AAA rating, the sukuk issued by the Cagamas have attracted strong demands from institutional investors such as domestic pension funds, government investment funds and Islamic financial institutions.

accounted for by those in the regions and countries with many Moslem population such as Asia (Indonesia and Malaysia) and GCC¹¹ (Saudi Arabia, UAE, etc.) (Chart 2). He also pointed out the need to diversify the investors as the market has not attracted many foreign investors from countries other than those where Islamic finance has already become popular.

The Cagamas is discussing to issue a sukuk denominated in dollars and backed by assets of Islamic compliant mortgage loans. By denominating it in dollars, he said, it intends to minimize the foreign exchange risks and meet the needs of foreign investors in advanced economies as well.

(Chart 2) Issuance of Sukuk by Issuer in 2016



(Source) Bank Negara Malaysia

(3) Islamic capital market

The Managing Director of Development and Islamic Markets of Securities Commission Malaysia discussed the development and outlook of the Islamic capital market (ICM) in Malaysia. In the Malaysian ICM, the government of Malaysia took a leading role to implement various policy measures such as preferential taxation on the issuance of sukuk and codification of Shariah standards¹² so that the ICM does not fall behind the conventional finance. As a result, he added, not only Malaysia has grown to have the largest sukuk market in the world in the past decade, but also domestically the size of the ICM has caught up with the size of the conventional money market in the last 20 years.

On the other hand, he referred to the slowness of the ICM in catching up with the conventional financial industry in which the ESG investment¹³ has seen a rapid growth. According to the Islamic religion, such actions are thought right as to give something as charity to the socially vulnerable like the needy and handicapped. In spite of its affinity to ESG investment, a gap has been spreading in this area between the Islamic finance and conventional

¹¹ Stands for Gulf Corporation Council which consists of Saudi Arabia, the UAE, Bahrain, Qatar, Kuwait, and Oman.

¹² Represents standards to evaluate the eligibility under Shariah of Islamic financial transactions in general,

¹³ Investments that emphasize the environmental and social aspects as well as corporate governance.

finance and a sense of crisis has been developing within the SC. In this context, the Managing Director emphasized the following areas as three key priorities for further promoting a sustainable development of the Islamic capital market: (i) sustainable and responsible investment (SRI), (ii) investment in infrastructure projects through PPP (Public Private partnership) and other initiatives (project sukuk and shariah-compliant investment funds, etc.), and (iii) promotion of waqf funds (discussed below). He expressed the SC's hope to more popularize green sukuk incorporating these factors and shariah-compliant investment funds.

2. Utilization of waqf in Islamic finance

Waqf is a kind of zakat (charity) that represents actions to donate a portion of one's income to charity projects and the like or contribute to the public services to fill their administration costs. Zakat is an act to give part of one's income to the needy people, and it is included as one of the five pillars of Islam¹⁴ required for Muslims under the Islamic religion. Waqf is utilized for construction of mosques and their administration and maintenance, and support for the needy.

As noted above, ESG investments have been accelerated in the conventional finance, and Islamic finance industry also plans to promote investment and loans based on waqf which has an affinity to ESG¹⁵. During the course of panel discussions, some cases were introduced such as the waqf sukuk issued for a sheep breeding industry in New Zealand¹⁶, waqf fund to finance Larkin Sentral Terminal project, a bus terminal in Johore Province in Southern Malaysia¹⁷. The new types of Islamic finance of waqf sukuk or Islamic investment funds related to waqf will further increase in the time to come.

3. Dana Gas Problem

The Dana Gas problem is a case where Dana Gas, a gas company headquartered in Sharjah of the UAE, declared its mudarabah¹⁸ sukuk (due in September 2017) invalid just before the day of maturity and urged to exchange it with a new sukuk on the ground that the original sukuk was not Shariah-compliant from the time of its issuance. As the exchange was proposed between the original sukuk (US\$700 million) that was deemed as not compliant with Shariah and the new

¹⁴ Five pillars of Islam consist of Shahada (confession of Faith), Salat (Prayer), Sawm (Fasting), Haji (Pilgrim to Mecca), and Zakat (Charity).

¹⁵ "Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance" Bank Negara Malaysia, 20 July 2017

¹⁶ This is a scheme to donate sheep meat to the needy during the id al-adha (feast of sacrifice of Islam). Sheep are to be slain in the way compatible with the Shariah. Charity is also made at various places for the sake of sheep skin and sheep wool other than sheep meat.

¹⁷ Waqf fund that uses a trust account was adopted for groups of low income earners or single mothers to reduce or exempt the user fees on shops in the bus terminal.

¹⁸ It is a scheme where a provider of funds (depositor or investor) provides funds to a bank, which in turn invests the collected funds in a business operator to implement a project. The profits (and losses) from the business are distributed to the business operator, bank and fund provider according to a predetermined proportion.

sukuk¹⁹ that was practically rescheduled with reduction or exemption of obligations and extension of maturity, it has provoked a massive protest from the creditors of the old sukuk (esp. institutional investors).

This problem is not confined to the fact that Dana Gas used the ineligibility under Shariah to avoid the default on its sukuk. As the sukuk was issued in the UAE while the documents related to its transactions were based on the British laws, judgments have been divided among Shariah scholars on which country's law should be applied to this case. This problem drew very strong interests at the KLIFF, and most of the free discussion time with Shariah scholars was devoted to the questions and answers on this problem.

As the problem of the Dana Gas sukuk is related to the mudarabah sukuk that is not in the mainstream of transactions, it is not regarded that the court ruling will directly affect the transactions of all kinds of sukuk. However, if the ruling comes up with an extreme content, investors will also demand higher risk premiums on the existing sukuk in other schemes, which is concerned to affect adversely the future issuance of sukuk. Also there have been views that there is a problem with asking ulamas (Shariah scholars) the judgment of legality of often-complicated Islamic financial products in addition to interpretation of them under Shariah. A possibility cannot be denied that, taking advantage of this problem, the ways to assess Islamic financial transactions under Shariah are reviewed and revised. It is worth watching the development of the trial.

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¹⁹ In addition to an extension of maturity, yield has been reduced.