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Corresponding author. E-mail: mohd_zain_othman@rhbislamicbank.com.my

GLOBAL ISLAMIC BANKING AND FINANCE INDUSTRY: THE WAY FORWARD

Jamelah Jamaluddin
RHB Islamic Bank, Kuala Lumpur, Malaysia.

ABSTRACT

The Islamic finance industry is experiencing rapid growth compared to other banking sectors, in spite of the challenges and turbulences facing the industry. However, more efforts need to be put in place in order to move forward. Strengthening the regional and international integration strategy by means of information, infrastructures and professionals sharing; harmonising the regulatory and Shariah frameworks; applying internal best practices while simultaneously bonding cross-border relationships - should be advocated. In addition, prioritisation of standard-setting bodies is vital to establish a sound regulatory system which can promote the growth of the Islamic financial system immensely.

1.0 Introduction

The Islamic financial industry's ascent towards prominence in the midst of a highly competitive environment that is constantly subject to change and development is notable. The industry has progressed in leaps and bounds underpinned by essential fundamentals of financial infrastructure that continue to support its sound expansion. This paper highlights four main aspects on the way forward of Islamic finance i.e. (1) the platform for regional and international cooperation and implementation of an integrated strategy for Islamic finance; (2) development of national Islamic financial markets with a regional and global integrated perspective; (3) development of institutional investors and strengthening the legal infrastructure; and last but not least, (4) priorities for standard-setting organisations.

(1) Platform for Regional and International Cooperation Implementation of an Integration Strategy for Islamic Finance

In order to ensure the sustainability and the soundness of the Islamic banking system, some prerequisite elements have to be adhered to such as (a) transparent corporate governance practices; (b) well-defined financial architecture; (c) enabling legal infrastructure; (d) effective regulatory oversight; and (e) adequate market discipline.

Essentially, considerations of investors' needs and objectives sought from Islamic instruments are immensely important as these not only form the basis of any investment decision, but also the capital flows obtained come from investors. In view of this, the following aspects are highlighted as key areas that are part of an ever-changing environment:

i) *Infrastructure and Services:* Emphasis is placed upon the effectiveness of distribution channels, regular market outlook, liquidity and flexibility of retail clients, minimum investment required and updated real-time performance.

ii) *Competitiveness and Performance:* This is subject to a comparison of Islamic funds with the conventional funds, efficient global investment markets, reasonable fees, stable returns and success factors of Islamic funds.

iii) *Product Development and Marketing:* Diversification, major innovation and product development of equity and venture capital funds, as well as branding and marketing in an international context to be addressed.

iv) *Identifying f\Factors that Differentiate One Instrument Over Another*: Focus should be directed towards good track records of fund managers, competitive fees, competent advisory boards and the domicile country.

v) *Returns from Islamic Instruments vs. Conventional Products:* Investors are looking for competitive returns from Islamic products, which are comparable to conventional products. The Dow Jones Islamic indices provide ready benchmarks to calculate absolute returns.

Globalisation of the Islamic Finance System

At the international level playing field of the Islamic Finance System, several perspectives are essential. The diversification and sophistication of products and services should be addressed by screening the latest market demands. The widening of capabilities and industry coverage will be achievable through strong and highly capitalised industry players. Therefore, by strengthening information sharing among global Islamic Finance professionals and human talent management, a highly qualified pool of talent can be produced. In order to harmonise the regulatory and *Shariah* framework, application of the internal best practices as well as bonding the cross-border relationship should be advocated simultaneously. In addition, an effective supporting system is required for the structure side, whereby it does not merely allow the recording and processing of transactions per se, but covers holistic aspects of the industry.

(2) Development of National Islamic Financial Markets with a Regional and Global Integration Perspective

The Malaysian Islamic Capital Market is in an evolutionary stage with rapid growth since the 1980s. Islamic Private Debt Securities debuted in Malaysia in 1990, which saw the issuance of Shell MDS Sdn. Bhd. valued at RM140 million. Via the Islamic Capital Market (ICM) guidelines as well as the ICM Master Plan; the Securities Commission (SC) of Malaysia has strategically outlined prospective areas of development and growth. The ICM has progressed significantly and formed an integral part of a broader capital market landscape in Malaysia.

The framework has been underscored in order to enhance the intermediation process of the ICM, with much focus placed on market and product development through the introduction of innovative, competitive and a wider range of securities as well as a sustainable tax and legal framework; mobilisation of Islamic assets held by Islamic institutions through securitisation to enhance liquidity and provide new sources of income; increasing the awareness at the domestic and international levels; and promoting the international harmonisation and standard setting to enhance cross-border linkages as well as to accelerate the country as an investment destination.

Prior to the inception of the Islamic debt market, most financing needs were provided for by the banking sector. As a result, there was a limitation of funding sources by banks. However, as the Islamic debt market developed more sources of funding become available, hence reducing the dependency on banks for financing purposes. The emergence of structured products such as asset-backed securities to cater for sophisticated financing requirements has led to an increase in superiority to deliver the financing needs of infrastructure projects. This will provide an avenue for more efficient and effective allocations of savings into investments, thus enhancing value and maximising returns to investors.

A wide array of Islamic concepts via various structures are available to to ICM for it to cater to the different needs of financing i.e. *Istisna, Ijarah, Musharakah, Mudarabah, Murabaha* etc. Lower cost of financing is achievable due to high demand on *Shariah*-compliant and ethical investment instruments as well as the availability of a larger pool of investors. Furthermore, alternative modes of financing are available via ICM, with investors having the choice of investing in the long term and *riba* free financing, in asset-backed securities; liquid assets; real estate; and non-real estate related assets.

Nevertheless, as an intermediary, the ICM continues to face challenges which cause its progress to be slowed down. The lingering effects of the 1997/98 Asian Financial Crisis has reduced international competitiveness and dampened the recovery process in capital market activities mainly in South East Asia (Malaysia, Indonesia, and Thailand). The capital markets are in dire need of increasing funding demands of issuers, investment and intermediation needs of consumers, and also employment and knowledge development. In addition, heightened global competition for business and investment remains a pressing issue. Although tremendous efforts have been made to ensure the success of ICM in Asia, much room for improvement still exists as the ICM is still at its infancy stage compared to the conventional capital markets. Emphasis should be given to the level of compliance with the *Shariah* Ethical Code of Conduct which is the ultimate divergence between the Islamic and the conventional counter party.

Studies have shown that the Asian ICM market is vibrant with much room for growth. The reasons for this include:

(a) Strong liquidity in the Asian region driven by capital inflows and negative real interest rates. The total foreign exchange reserves of Asian countries is estimated at USD2.3 trillion.
(b) Rarity value of Islamic bonds will ensure robust demand.
(c) Demand in high-grade investment papers from regional banks have kept high-grade dollar credits well supported over the past few years.
(d) Growing participation from insurance companies and pension funds coupled with the fact that fund managers have been given continuous liberalisation of foreign exchange administration rules.
(e) Robust and sustainable growth momentum in the Asian region.

The recent geographic distribution of the Islamic Development Bank's USD1.0 billion *sukuk* reflects a move away from its reliance on the Middle East. In fact, for the first time, for a GCC promoted *sukuk*, Far East investors outstripped investors from the Middle East –

Far East 35%, Middle East 32%, Europe 26% and Supranational 7%. Hence, the investment trends have undergone an evolutionary phase whereby many potential new markets have been discovered, the reasons being:

(a) Asia – Arab investors awash with liquidity from petrodollars are now shifting their focus to Asia due to the region's revived economic growth.
(b) China – It has the largest population in the world and Muslims constitute 3% of the country's total population i.e. 38 million compared to Malaysia with about 15 million Muslims.
(c) Brunei – It issued its first short-term government *sukuk ijarah* to pave the way for the development of the Islamic Capital Market although the government did not really need the money.
(d) Indonesia – It has the highest population of Muslims in South East Asia. Before a *sukuk* is issued the Government will have to amend the law on State Debt Securities or the law on State Treasury. Indonesia's current capital market is not deep enough to support infrastructure investment needs as the country would have to access external sources of funding.
(e) Russia – It is proposing conversion to Islamic banks.
(f) USA – It is now allowing Islamic banks to operate in the USA.
(g) Europe – Successful closure of the 1st Islamic Euro-dominated German Anglo-Anhalt *Sukuk* will be the catalyst for development of *sukuk* in Europe. (Germany is the 2nd largest Muslim populated country in Europe after France)

(3) Development of Institutional Investors and Strengthening the Legal Infrastructure

a. Development of Institutional Investors

Development of institutional investors begins with building investor confidence through market discipline. Three key areas to enhance the development of institutional investors include risk management, corporate governance and financial transparency.

The first aspect is the development of institutional investors through risk management. The Islamic industry is evolving with various elements such as awareness, monitoring, quantification and integration. Awareness is in the form of implicit management, informal and reliance on individuals. The next element is monitoring. Monitoring requires a clear vision and a set of goals such as, risk parameters, policies and procedures as well as the need for basic hedging to be established. Quantification and integration comprise active management, performance measurement, projections, RORAC (return on risk-adjusted capital) and improved governance.

The second aspect is the development of institutional investors through effective corporate governance which is necessary to establish the confidence of all shareholders and stakeholders that consist of the government and regulatory environment, investment community, business environment and financial community. To attain effective corporate governance, it involves external and internal audits, measurement and accountability, communication and disclosure.

The third aspect is the development of institutional investors through transparency. Transparency requires presentation that allows users to easily decipher financial and nonfinancial information; uniformity in regulatory standards across markets and industries to enable comparability. For consistency, it requires the application of accounting standards consistently from period to period and accuracy of information that is the true and fair presentation of the company's financial position vital to stakeholders. When transparency is established, it leads to the robust growth of institutional investors.

b. Issues Arising between Legal and *Shariah* Compliance

There are several issues arising between legal and *Shariah* compliance. Firstly, it is the issues in legal recognition. The legal definition of banking and financial services may not recognise Islamic banking and financial transactions due to their nature as trade and investment – no legal recognition of banking and financial institutions. It is also the issue about application of general laws of the country to Islamic financial transactions, which has a possibility of potential conflicts, constraints and adverse legal effects.

Secondly, it is the taxation issue. The nature of Islamic transactions as trade and investments may attract higher taxation, especially when taxation laws do not recognise Islamic banking and financial transactions. This will result in higher costs of operation for Islamic institutions. Furthermore, there is an inability to compete on a level playing field with conventional banks.

Thirdly, it is the judicial issue. There is an issue of jurisdiction for the hearing of Islamic banking and financial cases in civil courts. Therefore, decisions are made based on civil/common law and not *Shariah* law. The court's decision may not necessarily reflect Islamic legal principles; instead it may even contravene Islamic principles. The lack of substantive laws on Islamic banking and financial transactions may exacerbate the problem.

c. Strengthening the Legal Infrastructure: *Shariah* Compliance Governance

To strengthen the legal infrastructure requires legal and *Shariah* compliance governance. *Shariah* compliance gives emphasis to due diligence and is a requirement in making *Shariah* related decisions. It also exercises *ijtihad* (fundamentals of *Shariah* decision-making), that include: clear understanding of the financial markets, instruments and market behaviour – to make informed decisions; strong efforts in terms of due diligence, sound methodologies, approaches that are holistic and balanced; qualified personnel with good knowledge, skills, experience and exposure, sincerity and accountability, independent and have integrity in decision-making.

Shariah compliance governance involves well-defined operation procedures; processes and systems (e.g. IT) that facilitate correct implementation of the *Shariah* rulings and decisions. Last, but not least, are the reporting and accounting policies/models that support *Shariah* compliant behaviour and governance.

(4) Priorities for Standard-Setting Organisations

It is very important to establish a sound regulatory framework in order to enhance the performance of the financial institution. Therefore, the roles of the regulators have to be that of enablers to support the system. The following are the roles of the regulators:

a) To review the legal and regulatory framework which will allow capital market development thereby providing the basis for sound institutional practices;
b) To offer a change of attitude, i.e. the changes that rationalise the relationship of various economic sectors and the allocation of limited resources that will encourage the development of capital markets;
c) To privatise large public sector holdings in order to release new assets for market dealings which will lead to an increase in the financing of activities via the capital market;
d) To develop complementary markets, such as the futures market, to provide alternative sources of investment;
e) To establish a linkage with major markets; e.g. for the listing and eventual trading of shares of major companies and high-rated international bond issues;
f) New developments within markets in which the changes offer new challenges and exert new pressures on the institutional structure of the financial system;
g) Firm monetary policy which plays a major role in stabilising capital markets; and
h) Liberalisation, which stimulates competition and speeds up product development.

2.0 Standard Setting Organisations and Roles in the Islamic Financial System

Standard setting bodies and other interested international organisations play a crucial role in the promotion and development of the Islamic financial system. Priorities should include (i) promoting good corporate governance and transparency to strengthen market discipline; (ii) consumer education and protection; (iii) supporting research and development in the areas which are critical for financial stability within the Islamic financial system; (iv) conducting forums for regulators and interested stakeholders to discuss and share their experience and expertise; and (v) promoting innovation and diversity in the Islamic financial industry.

The standard setting organisations are as follows:

a) Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI), which prepares accounting, auditing, governance, ethics and *Shariah* standards for Islamic Financial Institutions. It also organises seminars on key regulatory and *Shariah* issues and has planned a Certified Islamic Public Accountant programme for accountancy education.
b) Islamic Financial Services Board (IFSB), which serves as an international standard setting body of regulatory and supervisory agencies. It has issued guiding principles on corporate governance risk management and capital adequacy standards for Islamic Financial Institutions.
c) International Islamic Financial Market (IIFM), which aims to ensure the continued growth of Islamic banking and finance as a viable alternative to the conventional financial system.
d) Liquidity Management Centre (LMC), which seeks to develop an active secondary market for short-term *Shariah* compliant treasury products so as to facilitate effective liquidity management.
e) Islamic International Rating Agency (IIRA), which is primarily concerned with rating of sovereigns, entities and issues particularly in Islamic countries to assess *Shariah* compliance.

f) Arbitration and Reconciliation Centre for Islamic Financial Institution, which aims to settle financial and commercial disputes between financial and commercial institutions that have been chosen to be compliant with *Shariah* to settle disputes.
g) Bank for International Settlement (BIS), which fosters international monetary and financial cooperation and serves as a bank for central banks. It also has issued guiding principles on corporate governance, risk management and capital adequacy standards for Islamic Financial Institutions.
h) International Accounting Standard Board (IASB), which is committed to develop high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements.
i) International Association of Deposit Insurance (IADI), which aims to contribute to the stability of financial systems by promoting international cooperation and to encourage wide international contact among deposit insurers and other interested parties.
j) General Council of Islamic Banks and Financial Institutions, which focuses on the media and awareness, information and research, policies and strategic planning and Islamic financial products.

3.0 Conclusion

With the growth engine in motion, Islamic banking is expected to expand and will not be confined to just a niche market but is set to be the mainstream banking in the near future. The key growth drivers include continuous product innovation, infrastructure and regulatory improvement.

To compete on a global scale, Malaysian Islamic banks will have to converge in their banking practices. The stage is set for Malaysia to play an active role in promoting regional financial services to meet the financing needs of companies bearing the following features:

a) A variety of effective and innovative financing instruments and structures.
b) Proper infrastructure/framework in place to support financing via the bond market.
c) Enhanced liquidity - with the increasing number of players there is a larger appetite for quality investments.
d) Increased sophistication of capital market participants to invest in a range of debt securities.