

# **ISLAMIC BANKING AT CROSSROADS: ISSUES AND CHALLENGES**

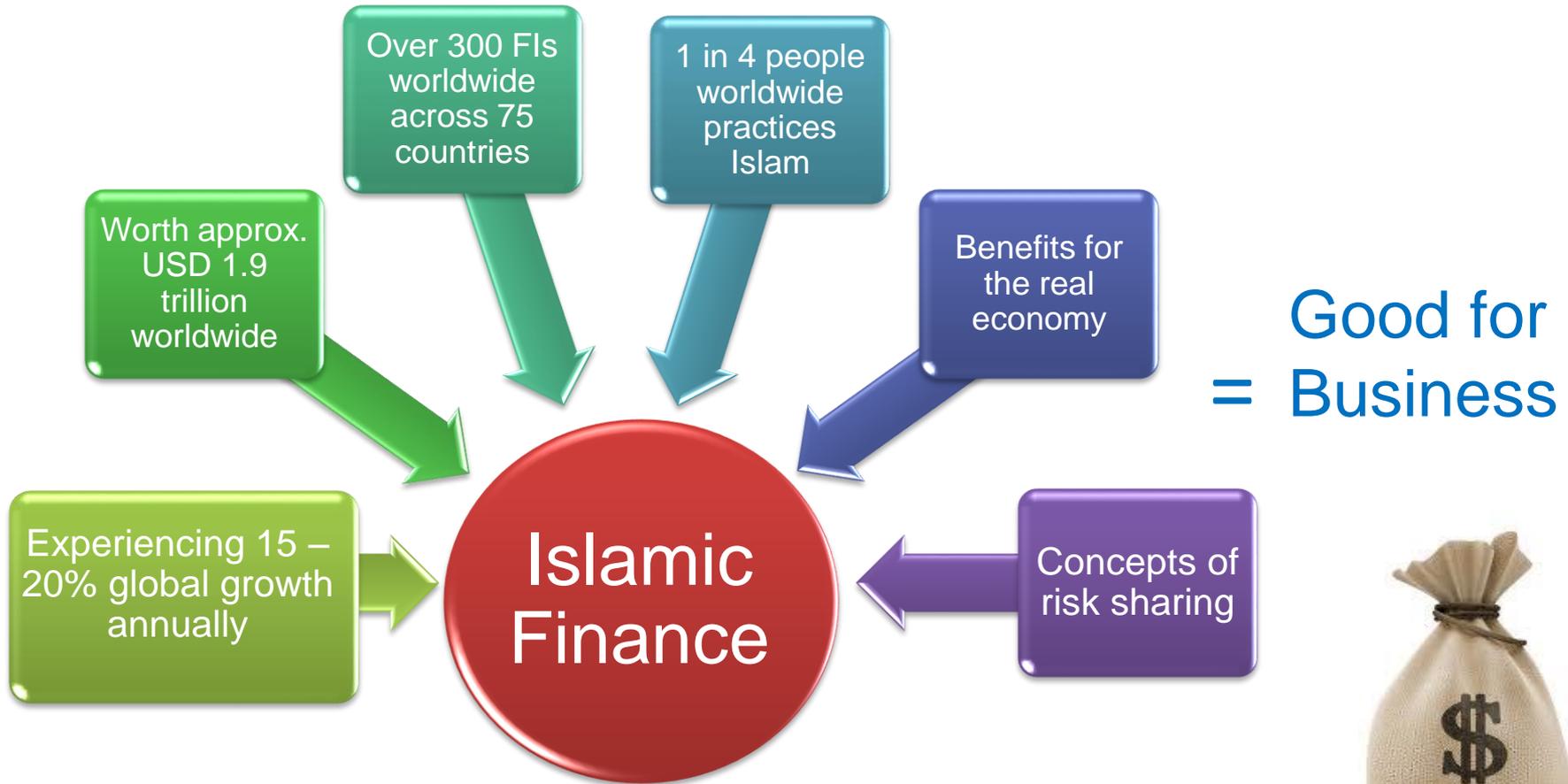
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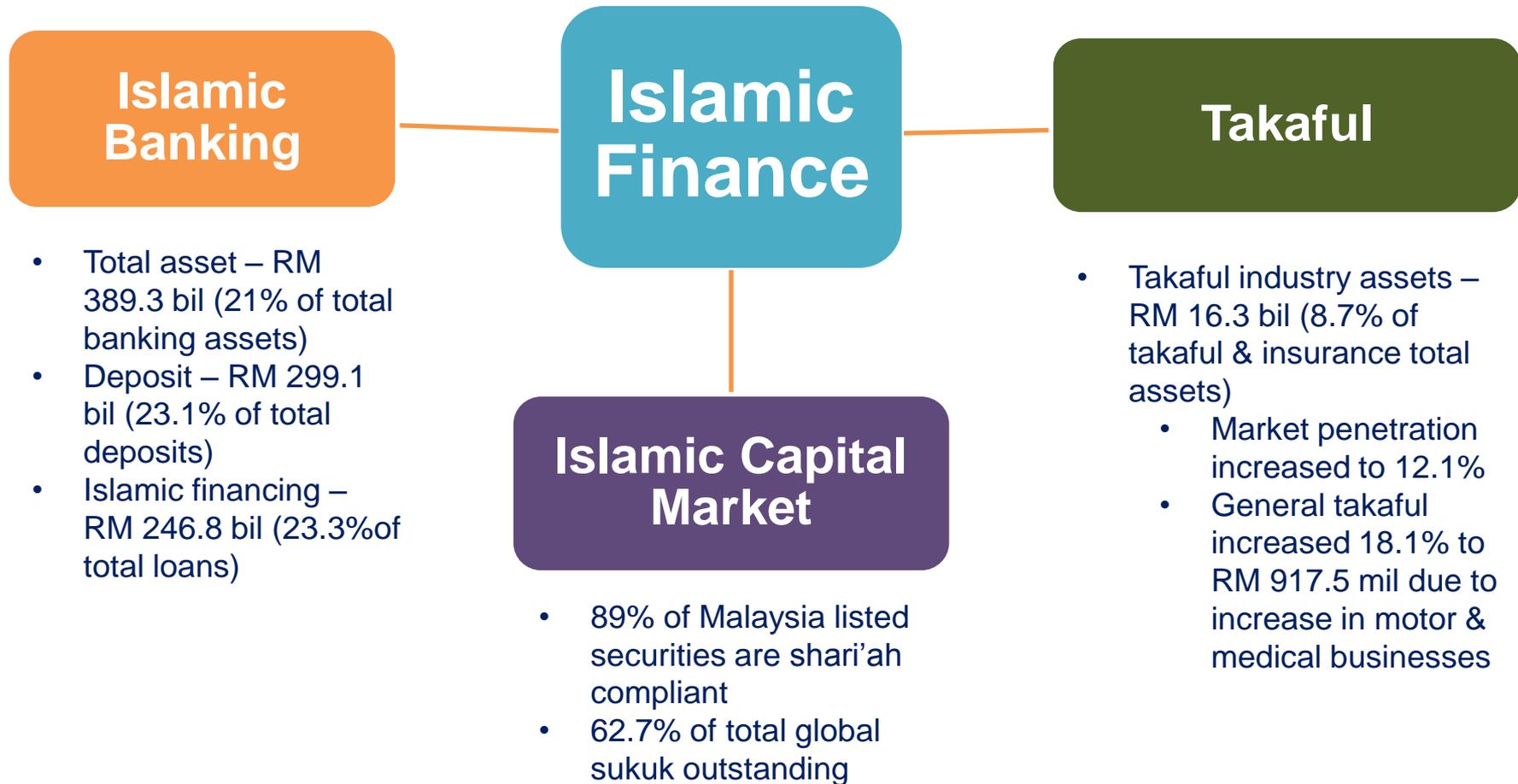
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# Importance of Islamic Finance



# Components of Islamic Finance



# Anatomy of Islamic Finance

- Interest-free [usury = interest]
- Idle savings are disallowed
- Lawful returns on investment
- Capital is not costless
- Real sector connectivity
- Risk sharing
- Islamic ethics: transparency
  - accountability
  - mutual consent
  - no profiting from others' ignorance
  - no ambiguity
  - no bribery
  - no gambling
  - no short-selling

# Shari'ah Mu'amalat Rulings

- The Principle of Permissibility (outside a negative list of prohibitions)
- The Principle of Mutual Consent
- The Role of Maslahah (of benefit to the community at large)
- Balance in the Terms of Contracts: Equivalence in the rights and obligations of contracting parties
  - \* Contracts which comport injustice are prohibited
  - \* Devoid of coercion, fraud, mischief, etc.
  - \* Informed decisions
  - \* Transparency in all transactions
  - \* No short selling

# Attributes of Islamic Finance

- **All financial instruments and transactions must be free from the following prohibitions:**
  - 1) ***Riba*** (usury = interest)
  - 2) ***Rishwah*** (corruption / bribery)
  - 3) ***Maysir*** (gambling)
  - 4) ***Gharar*** (ambiguity)
  - 5) ***Jahl*** (ignorance, i.e. taking advantage of it)

# Prohibition of *Riba*

- *Riba* = Increment or Increase
- Prohibition in the Torah, the Bible, and the Qur'an
- Islamic stance:
  - \* No matter how small or large the amount or the rate
  - \* Regardless of the purpose (consumption or investment)
  - \* Be it of short-term or long-term nature
  - \* Regardless of price levels (real or nominal)

**[In the Islamic order: interest is not rationalised as reward for saving; saving is a reward in itself; financial reward only for risk taking through investment of savings; savings must not lie idle]**

# Financing Modes

- Mark-up (*Murabaha*)
- Profit sharing (*Mudharabah*)
- Profit and loss sharing (*Musharakah*)
- Leasing (*Ijarah*)
- Deferred sale (*Bai' Bithaman Ajil*)
- Agricultural financing (*Bai' Salam*)
- Working capital (*Istisna*)
- Personal loan (*Tawarruq*)

**All hinge on real sector connectivity and some risk sharing**

# Conventional vs Islamic Banking

## CONVENTIONAL

**Customer deposits are loans to the Bank**

**Bank lends money to Customer for, say, buying a property**

**Borrower pays interest and principal to Bank**

**Bank pays interest and principal to Depositor**

## ISLAMIC

**Customer deposits represent investment of capital**

**Bank buys a property and lease it to Customer**

**Customer pays lease rentals and purchase price for the property over time to Bank**

**Bank makes capital repayment with profits to Depositor**

# Conventional vs Islamic Products

## CONVENTIONAL

- Home Loan Fixed Rate
- Home Loan Floating Rate
- Auto Loan
- Personal Loan
- Working capital
- Short-term Facility
- Long-term Facility
- Bond
- Insurance

## ISLAMIC

- *Murabaha Home Facility*
- *Ijarah Home Facility*
- *Murabaha Car Facility*
- *Tawarruq Personal Facility*
- *Istisna Facility*
- *Bai' Salam Facility*
- *Ijarah Facility*
- *Sukuk*
- *Takaful*

# Risky Business

- Asset price risk and commercial risk (real sector link) in addition to credit risk
- Rate mismatch risk (fixed rate assets vs floating rate liabilities)
- Liquidity risk (limited supply of liquid assets)
- Shari'ah non-compliance risk
- Legal risk

# Some Troubling Questions

- Disconnect between theory and practice?
- Practising distorted versions of *Murabaha*, *Mudrarabah*?
- Is *Tawarruq* in sync with Shari'ah rulings, in spirit or letter?
- Benchmarking on interest rate: *riba* through the backdoor?
- Very little risk sharing in practice?
- How come IB financing largely debt-based, not equity based?
- Why is *Musharakah* not the main driver?

# Delicate Balancing Exercise

- Balancing the demands of the market place with the dictates of the Shari'ah to build market share
- Short selling
- Circumscribed role of derivatives
- Space for debt-based financing
- Equity participation: SS and DD considerations
- Balancing debt with equity
- Shari'ah-compliant or Shari'ah-based
- Leverage

# Forms of Islamic Banking

- Wholesome Islamic Banks
  - Malaysia: BIMB (1983) 10<sup>th</sup> in the world; Bank Muamalat (1999)  
KFH (2005), Asian Finance Bank (2005), Al-Rajhi (2006)
- Islamic Windows
  - Malaysia: 21 banks with windows (1993)
  - Nigeria: windows prior to full-fledged Islamic bank
  - Ethiopia: windows only
  - Bangladesh: windows disallowed (1991)
  - Qatar: windows closed down (2011)
  - Deutsche Bank, UBS, Credit Suesse
- Islamic subsidiaries
  - Malaysia: 2002 (8 domestic; 6 foreign-owned)

# Malaysia's Role in Islamic Finance

- Malaysia is playing a catalyst role.
- Malaysia is the world's second largest Islamic finance hub in terms of assets.
- Malaysia by far is the largest source of sukuk securities.
- Strong government support: e.g. creation of Malaysian Islamic Financial Centre (MIFC), Secretariat for Islamic Financial Services Board (IFSB), Secretariat for the International Islamic Liquidity Management Centre (ISLMC).
- Conventional banking still dominates (80%) but IB market share continues to grow in Malaysia
- Islamic banking is inclusive: on average, non-Muslims account for >40% of the IB clientele; for some IBs the ratio is as high as 60%.

# Profile of Islamic Banking in Malaysia

- Dual banking system in place.
- Conventional banks dominate the industry [27 / 16].
- Islamic subsidiaries [11] outnumber wholesome IBs [5].
- Islamic banks account for one-fifth share of the market.
- Conventional bank deposits have fallen from 92.5% in 2007 to 80.4% in 2012.
- Islamic subsidiaries account for 77.2% of Islamic deposits and 83.1% of Islamic financing in 2012.
- Subsidiaries are more aggressive than wholesome banks: share of wholesome IBs in Islamic banking in terms of deposits, financing and assets has been declining.

# Industry at Crossroads

- IBs still stuck in the initial phase: product differentiation with Shari'ah compliance.
- IBs competing with conventional banks, with hardly any competition among themselves.
- Risk-averting rather than risk sharing, with *Musharakah* taking a very low profile.
- Prospects of moving up the value chain with innovation are impaired by the dominance of Islamic subsidiaries of conventional bank.
- Chances are that CBs will come up with new products which IBs would modify with Shari'ah compliance.
- Shari'ah compliance adds to costs.
- Dual banking system skewed in favour of conventional banks: CBs can do what IBs can but not vice versa.
- For IBs, it's like playing soccer in a rugby field!

# The Way Forward

- Graduating from Shari'ah-compliant products to Shari'ah-based products.
- Need for a “niche market” strategy rather than “head-on competition” with conventional banks.
- IBs are no lenders, so the term “banks” is a misnomer, if not an oxymoron.
- Balance between debt-based and equity-based financing
- Specialised Islamic finance houses the way to go?
- Do Islamic subsidiaries meet Shari'ah criteria? Conflict of interests?
- Islamic subsidiaries of conventional banks to quit retail Islamic banking?
- Wholesome IBs to reclaim the turf?

THANK YOU

***TERIMA KASIH***