Islamic Finance in Asia

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A growing river of money seeks investment consistent with Islamic religious principles

Three races are now underway on the topic of Islamic Finance and Asia.

Firstly, there is a race among financial markets to get their share of a fast-growing (15 percent or more a year) business. Secondly, just as important, there is a race to see how much business Islamic finance products can attract against competition from conventional forms particularly in Muslim-majority countries.

The third race is between varying interpretations of shariah law to determine how far down the road of exotic products -- hedge funds, options and derivatives -- Islamic finance can honorably go while adhering to the spirit of the law. The Gulf countries tend to follow stricter interpretations than Malaysia. The region is often referred to as the GCC states, the six members of the Gulf Cooperation Council - Saudi Arabia, Kuwait, United Arab Emirates, Qatar, Bahrain, Oman.

A recent Euromoney Seminar on Islamic Finance in Kuala Lumpur provided a good background in all these races - but also drew attention to the fact that Islamic Finance is still something of a specialized sideshow attracting its own players to discussion but remaining outside the ken of conventional finance.

The most important hub of Islamic finance is the Gulf, partly because it has a stronger history of links between religion and finance and partly because its huge capital surpluses have created a demand by its financial intermediaries for Islamic products in other jurisdictions, not necessarily Islamic ones. Overall there are estimated to about US$70 billion worth of sukuk (the main form of traded Islamic security) outstanding though only about 25 percent of that is listed and trading is very modest.
Dubai is the main centre for listing and trading followed by London. However, Malaysia is now probably the fastest-expanding center, having moved from purely domestic listings to international ones, with the government raising US$600 million with a sovereign sukuk and allowing foreign Islamic finance institutions easy access to the domestic market, which encouraged the entry of GCC players and created much cross-fertilization.

It is the sheer rate of growth of Islamic finance and the possibility that its share of global finance will continue to increase rapidly which is pushing Tokyo, Singapore and Hong Kong to try to grab a piece of the action. At the very least they need to be able to offer shariah-compliant products to rich GCC investors, and perhaps even sell the concept of sukuk to local, non-Muslim investors.

However all this is easier said than done. Of the three Singapore clearly has the best opportunity. Its proximity to the Malaysian market and to Indonesia, its links (partly due to oil trading) with the GCC and even its local Muslim population are helpful. It has changed its banking and tax laws to ensure that Islamic products are treated in the same way as conventional debt securities (even though they supposed to be different in principle) and also put them under the same regulator. The Monetary Authority of Singapore is able to provide clarity on tax and regulatory matters for Islamic asset management.

Singapore has attracted more Middle East banks and its large REIT market is also attractive to Islamic investors who look for regular returns from real assets. Even so, Malaysia is likely to lead the region as originator of Islamic products.

Next is Tokyo. Even this seemingly ever-parochial financial centre has now come up with action by its Financial Services Agency to accommodate Islamic finance institutions, in particular by changing firewall regulations to allow financial institutions to engage in asset trading (the essence of shariah-compliant finance) through subsidiaries. Japan, which has long been behind the Asian Bond Market Initiative - designed to encourage the issue and cross border trading of local currency bond issues - now aims to bring sukuk bonds into this framework. The Japan Bank for International Cooperation is looking to do con-financing involving Islamic and conventional financing tranches. And Islamic-compliant equity funds focused on energy and environmental issues are being aimed at GCC investors.

Well behind in the race is Hong Kong, which has only very recently appeared to recognize the existence of Islamic finance and the need to make special
arrangements for it. It is making a few attempts at a quick start, but these largely come from a government which seems ill at ease with Islamic issues and is simply desperate to be seen to be doing something to boost the territory’s international trading role after years of ignoring anything that was not China-related. Its Airport Authority has suggested it may make a sukuk issue and a tiny Islamic Index Fund which tracks the Dow Jones China Islamic Index, comprised of mainland and Hong Kong companies deemed to be shariah-compliant. Such vehicles can doubtless attract some smaller investors but the larger ones can pick and choose between individual companies on the compliant list.

Hong Kong has yet to get to grips with a fundamental tax problem – the city taxes profits arising locally but not interest – as well as various regulatory issues if its is to become an originator of sukuk issues, or even a trading location. It may also need to look at how, if at all, it will vet shariah compliance. Will it set up a board of shariah experts, or just leave that to issuers? For sure there is potential GCC and other Muslim demand for shariah-compliant investments in China and elsewhere in East Asia. But that may be more easily filled with equity investments. Shariah-compliant equities are easy – almost anything qualifies which does not profit from alcohol, gambling, entertainment, pork or usury or have financial ratios showing over-reliance on debt funding.

For sure, GCC countries, already over-stocked with North American and European assets, are increasingly looking to fast-growing Asia and to currencies which seem likely to appreciate. However, with or without sukuk, this is easier said than done given that most of these countries have their own foreign surpluses and high domestic savings rates. The big GCC investors’ preferences anyway have been for big equity purchases.

The next issue is whether there is much interest among non-Muslims in Asia in Islamic finance products. Promoters say that sukuk financing provides profit sharing opportunities unavailable in debt finance. They note too that so far at least no Islamic finance institutions have been badly hurt by the global credit crisis because they do not engage in the leverage, hedging and derivatives trading which has proved so costly to western banks. Sukuk products, they say, deserve some place in a portfolio and as secondary trading develops that will become more accepted. Likewise takaful – the Islamic version of insurance based on mutual principles and profit sharing and will become a more significant buyer of shariah-compliant assets.

However, working against these aspirations are a number of factors. Firstly, that the sukuk concept is little understood outside relatively small circle both domestically and
internationally. *Sukuk* itself comes in different forms depending on type and duration of transactions – *murabaha, mudaraba, musharaka and ijara*. Much public education of non-Muslims (indeed of most Muslims as well) will be needed before they are going to be prepared to buy in a major way.

Disputes about shariah compliance are a barrier to trading. (Some Gulf institutions have declared that a majority of Malaysian issues are not, by their standards, compliant and thus cannot be included in portfolios. Kuwait Finance House had to get special treatment from Malaysia’s Bank Negara to conform to Kuwaiti interpretations.)

Big arguments are also currently raging about whether it is possible to create Islamic products which mirror the derivative products of conventional finance. This in turn reflects a wider debate over whether shariah compliance is simply an exercise in legal manipulation in interpreting the words of the Koran to create Islamic equivalents of conventional products, or whether it is a key part of a very different economic philosophy and thus its promoters should be emphasizing its differences, not trying to mirror systems based on usury and gambling.

The philosophy, indeed theology, behind Islamic finance may also be alien to many Asian investors who like to gamble and hope that some luck will make them rich quickly. *Islamic finance abhors gambling and views return on investment as something to be shared.* There is as yet also a lack of common auditing and regulatory standards for Islamic products. The various markets are edging towards standardization but it is a slow process.

How long the Islamic finance growth momentum can continue will depend on two principle factors. First is the duration and scale of the surpluses of the GCC countries (and Malaysia) which have been Islamic finance’s mainspring. That is largely an issue of energy prices. So long as oil holds above about $75, surpluses will continue to be so big that GCC countries will continue to grow their financial muscle and use it to promote shariah-compliant products.

But either way it’s a very un-Islamic gamble to bet on either oil being for long at $150 or falling to $50. Any early collapse of the oil price could indeed create trouble for supposedly conservative Islamic financial institutions in the GCC in particular. Huge inflows of money have had to be invested—much of is directly or indirectly in very ambitious construction projects as in Dubai and Qatar which could prove investment black holes when the price pendulum swings.
The other issue is whether the populous Islamic states will show more enthusiasm for Islamic finance. Indonesia is to issue sukuk to attract GCC capital but has only very recently changed laws to accommodate Islamic instruments in its domestic markets. Pakistan’s history of Islamic finance goes back 20 years but has been scarred by scandals and poor regulation so only now is it again beginning to gain some local traction. In Bangladesh it is virtually non-existent.

Despite Islamic finance’s claims to be more socially responsible than conventional finance, there is no Islamic equivalent of the Grameen Bank. Indeed promoters of Islamic finance themselves admit that at present it is appealing more to a few very rich investors (as in the GCC) than to the average man in the mosque.

However, if Islamic banking can take root among the masses in fast-developing parts of the Islamic world it must surely have a bigger global future. At a time when most of the rest of the world is headed toward zero population growth, the Islamic world mostly continues to show higher than average birth rates. Demography could be the ultimate determinant of Islamic hopes, but first the ummah (Muslim community at large) needs to be convinced that the system is more beneficial in this world as well as the next.

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