AN OVERVIEW OF ISLAMIC BANKING AND FINANCE IN ASIA

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Abstract

The Islamic finance industry has grown substantially in Asia over the last 2 decades. The Muslim populations in different Asian countries, especially in Southeast Asia, are increasing. Rapid Muslim population growth and improving living standards may enhance the popularity of Islamic finance as a keen alternative to conventional financing mechanisms. In addition, investors from the Middle East and Asia are increasingly seeking to invest in products that are in line with their religious beliefs.

The governments and financial authorities in several Asian countries have played active roles in promoting the development of Islamic financial markets in line with the efforts to boost investments and achieve sustainable funding to enhance economic growth by tapping the huge liquidity from oil- and commodity-producing countries.

The ethical character and financial stability of Islamic financial products may increase their attraction. Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) with a risk profile that appeals to wider ethically conscious investors.

Given that in Islamic banking returns on investments are based on underlying economic activities and/or assets that structure the contractual relationship between transacting parties, it is possible to use the asset-based nature and risk-sharing aspects of Islamic finance for greater integration with the real economy and to improve the overall economic balance between the real and the finance sector.

**Keywords:** Islamic banking, Islamic finance, Muslim finance, Muslim banking, sukuk, mudarabah

**JEL Classification:** F3, G2
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1. INTRODUCTION

The concept of Islamic banking and finance originates from the aspiration to remove Riba (usury) from the Islamic community. The Quran prohibits Riba. Despite differing views on the concept of Riba in the pre-Islamic era and the present time, Islamic scholars have sought to design and implement Riba-free (usury-free) banking since the early 1950s. The first Islamic institutions that offered widespread Islamic banking services date back to the 1960s, when Islamic banks started to appear in countries with a large Muslim population.

Muslim thinkers and bankers have made substantial progress both theoretically and practically in the fields of Islamic money, banking, and insurance in the five decades since the emergence of the first Islamic financial institutions. They have discussed theoretical issues concerning the principles that should guide Islamic financial systems and their distinction from those of other financial systems. Such discussions have rotated around the main differences between economic systems due to their views on the universe, the purpose of creation, and the mission of humankind. Islam places high significance on the position of humankind and views it as the axis of creation and as the proxy of Allah on Earth. The difference between an Islamic economic system and secular economics lies in the former’s emphasis on social justice in the economic domain. All the values governing the Islamic economic and banking system are extracted from the Quran. Significant attempts that Muslim economists have made in the last half century include designing a Shariah²-based financial and banking system while maintaining the standards of efficiency and stability.

In this chapter, the first section provides an overview of Islamic banking and finance by presenting the principles, characteristics, and features of an Islamic financial system. Section 2, which is the core of this chapter, describes the growing Islamic banking and finance sector in Asia by highlighting the current status, challenges in the capital market, regulatory environments, and recent developments in the issuance of infrastructure Sukuk.

2. OVERVIEW OF ISLAMIC BANKING AND FINANCE

The transformation of Islamic economic and financial systems started in the late 19th century when protests against the payment of interest gained momentum. In the 1890s, Barclays Bank opened a branch in Cairo to finance the construction of the Suez Canal (Kettell 2010). The establishment of an interest-based bank in a majority-Muslim country aroused some opposition and led some jurists to declare in 1903 that the interest paid to depositors in the post office contradicted Islamic rules and values.

Islamic scholars designed alternatives to conventional banking by extracting Shariah-compliant contracts. Due to the high demand for Shariah-compliant banking services, many Islamic banks were established in the Middle East and parts of Asia, including Malaysia (1963), Bangladesh (1983), and Indonesia (1991). The foundation of the Islamic Development Bank (IDB) in 1975 as a regional development institution had the goal of promoting the economic development of Muslim countries and providing Shariah-compliant finance.

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¹ The Holy Quran, Albagharah, verses 29–30.
² Sharia, Islamic Sharia, or Islamic law is the religious legal system governing the members of the Islamic faith. It derives from the religious precepts of Islam, particularly the Quran and the Hadith.
The Islamic Financial Services Board (IFSB) is an international institution that designs and publishes Shariah-compliant standards aiming to enhance the health and stability of the Islamic financial service industry, including guidelines for the banking, insurance, and capital markets. The activities of the IFSB complement the measures and activities of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors. The IFSB, which is based in Kuala Lumpur, was officially inaugurated in November 2002 and started operation in March 2003.

Islamic capital markets have experienced substantial growth. Securities with the backing of Islamic assets are known as Sukuk. These securities have appeared in various structures in Malaysia, Indonesia, Iran, and other Islamic financial centers. Private corporations and international organizations such as the IDB, the World Bank, and governments are among the issuers of Sukuk, including the governments of Indonesia, Iran, and Malaysia. A number of high-profile non-Muslim Asian jurisdictions, including Singapore and Hong Kong, China, have also now issued sovereign Sukuk (ADB–IFSB 2015). Several funds based on Shariah-compliant shares emerged during the boom years of the 1990s (Iqbal and Mirakhor 2007).

Since the early 2000s, the global Islamic capital market has been growing in depth and size across jurisdictions, with numerous entities across sectors raising capital in ways that comply with Islamic principles. Today, the global Islamic capital market is a multisector segment that includes holistic financial instruments, including Sukuk Islamic equities, Islamic funds, and other Islamic structured products, such as real estate and investment trusts (REITs) and exchange traded funds (ETFs). The Islamic equity sector has firmly established itself in key global bourses and jurisdictions, and the world’s major financial index providers, such as Dow Jones, Standard & Poor’s, and the FTSE, all have Shariah-compliant equity listings, which have allowed the Shariah-compliant equity and fund markets to blossom. As an example, the Dow Jones Islamic Market indices cover market capitalization of more than $10 trillion in over 40 countries. These developments have enhanced the attractiveness of Islamic financial markets as an asset class for investment (ADB-IFSB 2015).

In the following, we will briefly discuss the principles, characteristics, and features of Islamic banking and finance to clarify the differences from conventional banking and finance practices.

2.1 Principles of Islamic Financial Systems

An Islamic economy is supposed to reflect the principles of the Islamic worldview and morality. Islamic jurists and scholars extract Shariah laws and the values of an Islamic economic system from the Quran and the performance of the Holy Prophet and Imams. The main Shariah rules with regard to banking and finance include the following (Moosavian 2007):

1. Money does not have any intrinsic value and is used merely as a medium of exchange and a tool for preserving and assessing the value of goods, services, and properties.
2. Emphasis should be on activities in the real economy and on the sharing of risks and rewards.
3. Socially destructive activities, such as trading alcoholic drinks, betting, and gambling, are prohibited.
4. Riba (interest) is prohibited.
5. Gharar (ambiguous and risky transactions) is prohibited.
2.2 Characteristics of Islamic Financial Systems

The prohibition of Riba results in the immediate disappearance of bonds and the debt market in an Islamic economic system. Most jurists believe that debt instruments, such as bonds for which the issuer guarantees the nominal value, are not tradable in an Islamic market, even though interest may be absent. The main reason behind the prohibition of conventional debt and bond markets in Islam is the notion of ownership in conventional bonds. Bonds are securities in the form of debt; however, Sukuk indicates ownership of an asset (i.e., an infrastructural project). Sukuk can increase in value when the assets increase in value, but there is the possibility of a decrease in value. The sale of Sukuk is the sale of the ownership of the assets backing them, whereas the sale of bonds is the sale of debt.

Except for participation contracts (see the endnote and the next subsection for more information), the assets of an Islamic financial intermediary are connected to other assets. This basket of assets has interesting features. First, it includes a vast range of maturities from short-term business finance to mid-term rent contracts. Second, these assets have low risks, since their yields are directly related to predetermined cash flows. Finally, predetermined cash flows and fixed maturities make these securities suitable alternatives for conventional fixed-return bonds. Such securities will also be attractive in conventional financial systems. Recent developments in mortgage-based securities (MBSs) in conventional financial markets show that a dynamic and efficient market can develop on the basis of real assets. In essence, an asset-based security market has replaced the debt market in an Islamic financial system. This market assumes a vital role by providing liquidity for the financial system.

Financial derivatives construct the second important market. Muslim jurists have so far been of the opinion that conventional derivatives include the element of Gharar (ambiguous deal) and therefore are prohibited in Shariah. Gharar means the ambiguity and ignorance that prevails with regard to the price and delivery time of the assets that back derivatives such as forwards, futures, options, and swaps. However, some financial derivatives, such as futures and options for the subordinate sale of shares – which insure shares against price reductions, have gained permission from jurists for trading in the Iranian capital market (TSE 2010, 2012).

In asset pricing, the representation of lender payoffs under put-call parity permits the identification and exact valuation of all the constituent components of asset-based Islamic finance as balance sheet identities within the standard Black–Scholes–Merton (BSM) framework of capital structure-based option pricing theory (OPT) (Black and Scholes 1973; Merton 1973, 1974). Jobst (2007) showed how to derive the fair market price of Islamic lending transactions if the underlying collateral conforms to a lognormal asset process. In particular, Jobst (2007) characterized the implicit interest rate of Islamic lending as a result of the premium payments (i.e., periodic rental payments) that the lender receives in return for the call position on assets that the borrower holds in Islamic finance.

The role of financial intermediation and the dependency of an Islamic financial system on Islamic banks are clear. They are also in line with the empirical evidence that highlights the role of financial intermediaries in less-developed capital markets. In a nutshell, an Islamic financial system will be similar to a bank-based one for the following reasons:

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3 Islamic banks’ asset-side contracts consist of two groups: participatory contracts, which are based on profit and loss sharing; and debt-creating modes, which are based on fixed charges.
A) Due to the prohibition of Riba and debt papers, the debt-based capital market will be non-existent. Therefore, financial intermediation will take the form of direct financing via Mudarabah\(^4\) and participation contracts.

B) In the absence of a debt market, there will be a demand for the development of asset-based security markets to increase the liquidity of bank assets. Financial intermediation can play a vital role in this development via the introduction and accumulation of financial instruments through the securitization and enhancement of credit during the life cycle of assets.

C) Since risk-shifting violates the basic principles of Sharia law, derivatives remain controversial in Islamic finance. In particular, Sharia scholars still do not readily accept derivative trading due to its often speculative and unfunded nature (Jobst and Solé 2009). The unavailability or restriction of the derivative market will increase the pressure on financial intermediaries to offer sharing and mitigation of risks.

2.3 Features of Islamic Banks and Islamic Banking Contracts

The features of Islamic banking include:

A) The relationship between the bank and its customer is not one between a debtor and a creditor; rather, it means sharing risks and rewards.

B) An Islamic bank keeps separate accounts for its own capital and deposits to avoid mixing its own share of profits with those belonging to depositors and distributes them proportionately according to the profit-and-loss-sharing agreement.

C) Unlike conventional banks, Islamic banks do not offer cash loans; rather, they grant facilities based on either Islamic contracts with uncertain returns, such as participation (Musharakah), Mudarabah, Muzaraah,\(^5\) and Musaghat,\(^6\) or contracts with certain returns, such as Murabahah,\(^7\) sale on installments, and

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\(^4\) A partnership contract between the capital provider (Rabb-Al-Mal) and an entrepreneur (Mudarib) whereby the capital provider contributes capital to an enterprise or activity that the entrepreneur will manage. They share the profits that the enterprise or activity generates in accordance with the percentage specified in the contract, while solely the capital provider bears the losses unless the losses are due to the entrepreneur’s misconduct, negligence, or breach of contracted terms.

\(^5\) This is another Shariah-compliant contract based on which one party (Muzare) delegates a piece of land to the other party (Zare or agent) to cultivate it, and later they share the crops in agreed-upon proportions. Muzaraah is a financing instrument in agriculture and the bank always takes the role of the Muzare. Therefore, a bank can enter a Muzaraah contract only when it possesses land or production factors or a combination of the two. A Muzaraah contract terminates when the parties divide the crops and the bank takes its share.

\(^6\) This is a contract between the owner of an orchard and an agent who grows and harvests the products against a certain share. The bank is always the owner and can make an agreement with legal or real entities to work as the agent in their orchard. The agent takes the responsibility to grow, take care of, and harvest the products, which the bank and the agent will later share based on the Musaghat contract.

\(^7\) This is similar to the sale of an installment contract but has a wider range of applicability. Based on Murabahah, the bank informs the applicant about the full price of properties and services and then adds a certain percentage as the profit. The applicant should make either bullet or balloon payments upon maturity. In accordance with the application, banks may purchase raw materials, spare parts, tools, machinery, installations, land, and other goods or services required by firms or residences, durable goods, and services for households. They can transfer these items to the applicant via a Murabahah contract. To ensure repayment, it is necessary for the banks to take sufficient collateral.
Ijarah.\textsuperscript{8} Deals in the real economy form the lion’s share of Islamic banking activities, with the bank purchasing the merchandise for customers and selling it to them against cash or gradual payments with an agreed profit.

D) Islamic banks are multi-purpose institutions. They perform the roles of commercial, investment, and development banks. Based on its resources, an Islamic bank is involved in short-term operations just like a commercial bank or participates in medium- and long-term investments just like a development bank or a non-bank financial institution.

E) Islamic banks are supposed to contribute to the development of the whole society. Although making a profit is important, it is not the main objective of finance in Islamic banking. An Islamic bank stresses the realization of socio-economic goals without any violation of Shariah law.

F) Islamic banking is based on shares. To mobilize funds, Islamic banks receive term deposits with uncertain interest rates and then, on behalf of depositors, consolidate these funds with their own resources to offer facilities to applicants based on contracts with either certain or uncertain profits. Eventually, they share the realized profits in accordance with the agreement between the bank and the depositors.

G) An Islamic banking system is supposed to comply with high moral values.

H) In addition to the existing audits conducted in conventional banks, an Islamic supervisory board usually audits Islamic banks to ensure their compliance with Shariah law while absorbing funds and making investments; however, this may differ across countries.

Islamic banks are financial intermediaries that receive deposits and act like conventional banks in offering interest-free services, including opening current accounts, issuing letters of credit, holding valuable objects, transferring funds, issuing letters of guarantee, deposit boxes, and other services that they offer against payment of fees (Khan 2000).

We can divide Islamic bank contracts into two groups: a) liability-side contracts and b) asset-side contracts. Liability-side contracts contain two sub-groups: i) Qarz (zero-interest loans); and ii) Wakala (agency contracts). The Shariah legal framework defines a Qarz as a temporary transfer of ownership to the borrower that must not incur any interest burden, stated in the terms of the contract. However, non-stipulated compensation of the lender is accepted and expected. In Wakala contracts, the bank acts as an agent of the depositor against a certain fee. To avoid the principle–agent problem, a bank’s capital is pooled with its depositors’ savings. It is important to mention that depositors in Islamic banks are like shareholders, who are legally entitled to withdraw their money capital out of an account.

On the asset side, the structure of Islamic contracts centers on the notion of profits and refers to the financing of real assets. The statutory classification of Islamic credit facilities contains two categories: participatory modes, which are based on profit and loss sharing; and debt-creating modes, which are based on fixed charges. The revenue of an Islamic bank generally consists of “fees and commission” and “trade income.”

\textsuperscript{8} An agreement made by an institution offering Islamic financial services to lease to a customer an asset that the customer specifies for an agreed period against specified rental. An Ijarah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijarah contract.
Islamic banking activities do not recognize “interest income.” The participatory mode contracts are:

I. Musharaka (sharing)
II. Civil partnership (involving a joint enterprise)
III. Legal partnership (buying equities)
IV. Mudaraba (the bank provides the capital and the other side provides labor)
V. Muzaria (the bank provides the land and the farmer provides cultivation)
VI. Musaqat (the bank provides an orchard and the farmer provides labor)

Participatory activities are “high-risk” ventures, and they divide the loss in accordance with the ratio of the capital invested.

The debt-creating modes belong to a “low-risk” category and normally create debt when applied by Islamic banks. Once a lawful permitted transaction creates debt, there can be no stipulated increase in the amount of debt. However, it is possible to discount it at spot market rates. These contracts include:

I. Murabaha (a cost-plus sale with a spot or deferred payment)
II. Installment sale (a Murabaha of goods on installment)
III. Joa’la (a Murabaha of services with a deferred payment)
IV. Salam (a forward purchase)
V. Istisna’a (an order to manufacture)
VI. Hire purchase (buying and leasing with the final transfer of the property to the lessee)
VII. Bay’ al-Dayn (the sale and purchase of an outstanding debt)
VIII. Qarz al-Hasan (a zero-interest loan)

3. ISLAMIC BANKING AND FINANCE IN ASIA

Asia is an important part of the global economy as well as the Islamic financial system. Asia is the home to the largest portion of the Muslim population in the world. A majority of the population in many Asian countries are Muslim, including Pakistan (96.4%), Bangladesh (86.3%), Indonesia (87.2%), and Malaysia (61.4%). In some other Asian countries, the Muslim population is a minority but still sizable. In India, 14.2% of the population or 172 million people are Muslim.

Presently Islamic banking and Sukuk dominate the Islamic finance market in Asia. According to the IFSB (2015), the total size of the Islamic finance sector in Asia in 2014 amounted to more than $419 billion or an estimated 22.4% of the global Islamic financial assets, of which 48.6% ($203.8 billion) was Islamic banking assets, 44.93% ($188.4 billion) was outstanding Sukuk, 5.5% ($23.2 billion) was Islamic funds, and 0.93% ($3.9 billion) was Takaful (Islamic insurance), which was small but growing.

In Asia, Islamic banking and finance have experienced rapid growth and development. Table 1 shows a breakdown of the Islamic finance segments by region and compares the size of Islamic banking assets in Asia with that in other parts of the world.
Table 1: Breakdown of Islamic Financial Segments by Region
($) billion, 2014 YTD*

<table>
<thead>
<tr>
<th>Region</th>
<th>Banking Assets</th>
<th>Sukuk Outstanding</th>
<th>Islamic Funds AuM</th>
<th>Takaful Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>203.8</td>
<td>188.4</td>
<td>23.2</td>
<td>3.9</td>
</tr>
<tr>
<td>GCC</td>
<td>564.2</td>
<td>95.5</td>
<td>33.5</td>
<td>9.0</td>
</tr>
<tr>
<td>MENA (exc. GCC)</td>
<td>633.7</td>
<td>0.1</td>
<td>0.3</td>
<td>7.7</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>20.1</td>
<td>1.3</td>
<td>1.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Others</td>
<td>54.4</td>
<td>9.4</td>
<td>17.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Total</td>
<td>1,476.2</td>
<td>294.7</td>
<td>75.8</td>
<td>21.4</td>
</tr>
</tbody>
</table>

* Data for banking and Takaful as of 1H2014; data for Sukuk and funds as of 3Q2014.

Note: AuM stands for assets under management. We use Takaful contributions as a basis to reflect the growth in the Takaful industry. The breakdown of Islamic funds’ AuM is by the domicile of the funds.


The Islamic banking assets and financial products in Asia are much larger than those in Europe and North America, largely due to the Malaysian Islamic finance marketplace. Malaysia is one of the global leaders in Islamic financial services and held an estimated 10.0% share of the global Islamic banking assets at the end of 2013. Comparatively, Indonesia, Pakistan, and Brunei Darussalam have smaller shares, but their growth and regulatory developments in recent years have enabled them to expand their volume of Shariah-compliant banking assets. As of the end of 2013, Malaysia contributed 70.5% of the regional Islamic banking assets ($135.5 billion), followed by Indonesia (9.5%, $20.2 billion) and Pakistan (5.3%, $10.2 billion) (ADB-IFSB 2015). Figure 1 shows the share of global Islamic banking assets by country, including Asian countries.

Figure 1: Share of Global Islamic Banking Assets (2014)


Among majority-Muslim countries, banks have designed numerous securities over the last two decades to finance governments, provide the required capital for manufacturing firms, and enforce the monetary policies that central banks have introduced. Shariah-compliant securities that usually receive their licenses from Shariah councils are recognized as Sukuk. The Malaysian government Investment Issue (GII) as well as Ijarah papers issued in Brunei Darussalam, Indonesia, and
Pakistan are among the securities that fall into this category (Ghazavi and Bazmohammadi 2011). The Brunei Darussalam government issued its first Sukuk–Ijarah in 2006. In 2008, the Indonesian government started to raise funding using a Shariah-compliant Sukuk–Ijarah for the first time, the so-called Sukuk Negara. In 2002, Malaysia reached a further significant milestone when the Malaysian government issued the first global sovereign Sukuk, raising $600 million. With this issuance, it became an international benchmark for the issuance of global Sukuk. The Luxembourg Stock Exchange and the Labuan International Financial Stock Exchange in Malaysia listed the Sukuk issue. Further sovereign issues have since occurred in the global capital market (Azis 2007).

Like Malaysia, several other Asian countries – including Bangladesh, Brunei Darussalam, Indonesia, and Pakistan – have both Islamic and conventional banking systems. Both approaches have contributed significantly to the deepening and widening of the financial sector through the use of innovative financial instruments that offer new ways of mobilizing resources for both public and corporate sectors.

As of 2013, 66% of the globally outstanding Sukuk originated in Asia (ADB-IFSB, 2015). Malaysia has maintained its dominance in Sukuk issuances over the years globally and continues to be the leader in global Sukuk issuance. Malaysian new Sukuk issuances accounted for 68.8% of the global primary Sukuk market share at the end of 2013, followed by Indonesia (4.68%), Pakistan (0.37%), and Brunei Darussalam (0.33%). Among other economies that have issued Sukuk in Asia are Singapore, Kazakhstan, and Hong Kong, China, which are seeking to diversify their funding options following liquidity constraints in international markets (Figure 2).

**Figure 2: Sukuk Outstanding in Asia (2013)**

![Sukuk Outstanding in Asia (2013)](image)

Note: Asia in the above figure is limited to Asian members of the Asian Development Bank (ADB).

For instance, on 28 May 2015, the Government of Hong Kong, China issued a $1.0 billion 5-year Sukuk priced at a rate of 1.894%. This was the second Sukuk that the government had issued, with the first taking place in September 2014. The government said that the Sukuk follows the Wakala structure, in which one-third of the assets are based on units in a Hong Kong, China building and the remainder are in Shariah-compliant commodities (ADB 2015). In 2012, the Development Bank of Kazakhstan issued a Malaysian ringgit (MYR)-denominated Sukuk program in Malaysia.
worth MYR1.5 billion. This transaction represents the first ever Sukuk issued outside of the Commonwealth of Independent States (CIS). The transaction also represents the first issuer from the CIS region to tap the Malaysian market. The Kazakh Parliament approved changes allowing the Ministry of Finance to issue its first sovereign Sukuk amounting to $500 million to finance road construction in 2011. Kazakhstan stands as the second CIS major oil producer and requires significant investment for exploration activities and the construction of infrastructure projects (KFHR 2013).

As for the finance side, Islamic financial instruments, such as Sukuk, have financed a wide range of social and physical infrastructure as well as corporate investments, and they are becoming increasingly important for driving growth in the region. The growing market of Islamic finance in Asia could be an appropriate source for different sectors, including: (i) infrastructure financing; (ii) government fiscal and revenue expenditure financing; (iii) corporate and retail financing; (iv) ethical investment solutions for corporate and retail investors; (v) trade financing for international trade; and (vi) Islamic insurance services.

### 3.1 Challenges of the Islamic Capital Market

The development of secondary financial markets is vital for the expansion of primary markets. Savers have different preferences with regard to the liquidity and risk of their portfolios. The faster savers can liquidate or transform their assets and the fewer the risks involved, the more likely they are to hold long-term securities. When Islamic banks are able to issue various securities with either certain or uncertain returns to finance real economic activities, investors will show a greater interest in Islamic financial products when the security markets are sound and well developed.

Islamic bonds traded along with conventional papers, such as stocks and options, in financial markets help Islamic banks to diversify and distribute risk and manage the liquidity of their portfolios. Moreover, as Islamic banks are necessarily involved in financing and investment in the real economy, the existence of commodity markets may assist the transparency and reduction of costs for Islamic banks and improve the efficiency of Islamic financing systems (Mirakhor 1992).

A pressing challenge is the lack of liquid and active secondary Sukuk markets in key Islamic finance domiciles, which limits investors’ ability to trade Sukuk instruments. To date, in Asia only Malaysia and Iran have a fully functioning Islamic money market with an active secondary market that is very effective in addressing the domestic Islamic financial market’s liquidity management issues (IFSB 2015).

### 3.2 Regulatory Environment for Islamic Banking and Finance in Asia

An IMF survey on the legal, regulatory, and supervisory frameworks for Islamic banking and finance shows that some Asian countries, like Kazakhstan, apply a single integrated regulatory framework to all banks with references identifying provisions applying only to Islamic banks. Some other Asian countries, like Indonesia and Malaysia, follow a mixed approach; that is, they adopt a similar regulatory framework for areas that are applicable to Islamic and conventional banks, but they issue separate guidelines and regulations for areas that are specific to Islamic Banks (Kammer et al. 2015).
Specialized standard-setting bodies in different Asian countries have developed specific Shariah-based standards. Here we present some of the regulatory frameworks from the selective Asian economies.

The Islamic Financial Services Act 2013 (IFSA) is a Malaysian law that has been in effect since 30 June 2014. The IFSA lays out the regulation and supervision of Islamic financial institutions, payment systems, and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah and of related, consequential, or incidental matters. In supporting the aspirations of the Act, Malaysia’s central bank, Bank Negara Malaysia, is currently developing several standards for key Islamic contracts that set out the Shariah and operational requirements of a particular contract. Among other things, the Act distinguishes investment accounts from Islamic deposits and prohibits principle and profit guarantees on investment accounts (IFSB 2015).

The IFSA offers a new dimension to the regulatory framework for Islamic finance, as it accords greater prominence to the Shariah contracts in Islamic finance transactions. The statutory foundation for a contract-based regulatory framework in the IFSA has enabled the issuance of Shariah standards that define the underlying Shariah principles that Islamic financial institutions have adopted and support the effective application of Shariah contracts in offering Islamic financial products and services. This represents a significant step forward in aligning legal and regulatory principles with Shariah precepts and can serve as a useful benchmark for evolving more comprehensive regulatory frameworks globally that promote greater legal and operational certainty in Islamic finance. More importantly, it develops the contract-based regulatory framework in a manner that facilitates the next level of Islamic banking business, transcending financial intermediation to include real economic sector participation. Such a distinctive regulatory approach seeks to realize further the value proposition of Islamic finance as the industry advances towards a new level of maturity and sophistication (IFSB 2015).

In India, the world’s second most populated country, the Reserve Bank of India, the country’s central bank, has begun a review of regulations on Islamic banking. The Reserve Bank of India has established an internal committee consisting of senior central bank officials amid calls for the re-evaluation of Islamic banking regulations in the country (ADB–IFSB 2015).

Hong Kong, China’s Legislative Council passed the Loans (Amendments) Bill 2014 in March 2014, enabling the government to raise money through alternative bonds, such as Sukuk (ADB-IFSB 2015). The Philippines are expected to enter the global Takaful industry in the near future, as the Insurance Commission of the Philippines is formulating Takaful regulations to enable Takaful services in the country (IFSB 2015).

In January 2014, the State Bank of Pakistan (SBP) prepared its Strategic Plan for the Islamic Banking Industry of Pakistan 2014–2018. The plan focuses on the initiatives necessary for improving the public perception of Islamic banking and promoting it as a distinct and viable system to address the financial service needs of the public in general and the business community in particular. Acting to this plan, the SBP, in collaboration with stakeholders, will keep its focus on the following key areas/objectives to facilitate and catalyze stable and distinct growth of Islamic banking in Pakistan: i. enabling policy environment, ii. Shariah governance and compliance; iii. awareness and capacity building; and iv. market development. The functional strategies and action plan for achieving objectives in each area have undergone development in consultation with the Islamic banking institutions and their Shariah advisors, SBP Shariah Board members, academics, internal SBP departments, the Securities and Exchange
People expect that, with the implementation of this strategic plan, Pakistan’s Islamic banking industry will grow prudently and distinctly with the enhanced acceptance and confidence of the general masses contributing to the economic development of the country (SBP 2014).

Although the Islamic banking and finance regulatory framework is well developed in some Asian countries, the regulatory and supervisory frameworks in many jurisdictions do not yet cater to the unique risks of the industry. Although Islamic banks appear to be well capitalized, the implementation of the Basel III Accord will involve challenges. For example, further clarification will be necessary from national regulators regarding the instruments that are eligible for treatment as additional Tier 1 and Tier 2 capital. Furthermore, the scarcity of Shariah-compliant high-quality liquid assets (HQLA) will make it difficult for Islamic banks to satisfy the Basel III liquidity coverage ratio (LCR) requirement. Therefore, it is important that national authorities use the leeway that the Basel standards give to grant highly rated and tradable Sukuk HQLA status and take steps to deepen local Sukuk and money markets. Safety nets and resolution frameworks remain underdeveloped. Very few countries with Islamic banking have a full-fledged Islamic deposit insurance scheme with premiums invested in Shariah-compliant assets.

### 3.3 Recent Developments in the Issuance of the Infrastructure Sukuk

An important and growing segment in Islamic finance in Asia is the market for infrastructure Sukuk. Recent ADB (2017) estimates put the infrastructure financing needs of developing Asian economies at $26 trillion for the 25 years from 2016 to 2030, which equates to $1.7 trillion per year. In many less-developed countries in Asia, the lack of proper infrastructure is one of the major obstacles to development. The use of cross-border financing and investment through Islamic finance (i.e., Infra-Sukuk) can help to widen the investor base and lower the cost of financing for the development of infrastructure in Asia.

**Figure 3: Infra-Sukuk Issued by the Domicile of the Issuer (2012Q1–2015Q3)**

![Infra-Sukuk Issued by the Domicile of the Issuer (2012Q1–2015Q3)](source: Nik-Musa (2015).)

Sukuk have played an important role in infrastructure financing for public and private projects. More than 10 different countries issued a total of $73.1 billion infrastructure Sukuk between 2002 and 3Q2015. Issuances from Malaysia (61%), followed by Saudi Arabia (30%) and the UAE (7%), dominate the global infrastructure Sukuk market (Figure 3). Malaysia’s Economic Transformation Program (ETP) will accelerate its spending plans with the issuance of Infra-Sukuk to meet its economic and socio-economic targets by 2020 (Nik-Musa 2015).

In the following, we briefly highlight two examples of Sukuk issued in Malaysia for financing infrastructure projects. The first example is the financing of the PLUS highway project (Table 2), which was the single largest ringgit-denominated Sukuk issuance and the single largest Sukuk issuance globally in any currency (Nik-Musa 2015).

<table>
<thead>
<tr>
<th>Table 2: Example 1: PLUS Highway in Malaysia Financed by Infra-Sukuk</th>
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<td><strong>Issuer</strong></td>
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<td>Sector</td>
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<td>Profit Rate</td>
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<td>Purpose of Issuance</td>
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Note: PLUS: Projek Lebuhraya Utara-Selatan Berhad; MYR: Malaysian ringgit. 
Sources: Zawya, IFIS, and KFH Research.

The second example relates to the financing of a Malaysian mass rapid transit (MRT) project through the first Sukuk with fixed-income assets listed on Bursa Malaysia for retail investors. The debut issuance of the ETBS (Exchange Traded Bond and Sukuk) was oversubscribed by 1.61 times (1,424 applications representing MYR484 million in value). Members of the public were able to purchase this Sukuk via application forms or the automated teller machines (ATMs) of participating banks. The landmark transaction was part of the initiatives under the Capital Market Masterplan 2 to facilitate greater retail participation in the bond and Sukuk market and intended to make a wider range of investment products available to the retail segment (Nik-Musa 2015).

<table>
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<th>Table 3: Example 2: Mass-Rapid Transit (MRT) Project in Malaysia Financed by the ETBS (Exchange Traded Bond and Sukuk)</th>
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</thead>
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<td><strong>Issuer</strong></td>
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<td>Purpose of Issuance</td>
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</tbody>
</table>

Note: MYR: Malaysian ringgit; ETBS: Exchange Traded Bond and Sukuk. 
4. OUTLOOK

The Islamic finance industry has grown substantially in Asia over the two last decades. We can expect the growth of Islamic banking and finance to continue, with the following underpinning factors:

(i) The Muslim populations in different Asian countries, especially in South East Asia, are increasing. Rapid Muslim population growth and improving living standards may enhance the popularity of Islamic finance as a keen alternative to conventional financing mechanisms. In addition, investors from the Middle East and Asia are increasingly seeking to invest in products that are in line with their religious beliefs. Surveys have suggested that half of the Muslims worldwide would opt for Islamic finance if given a reliable alternative to conventional services (KFHR 2013).

(ii) The governments and financial authorities in several Asian countries have played active roles in promoting the development of Islamic financial markets in line with the efforts to boost investments and achieve sustainable funding to enhance economic growth by tapping the huge liquidity from oil- and commodity-producing countries.

(iii) The ethical character and financial stability of Islamic financial products may increase their attraction. Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) with a risk profile that appeals to wider ethically conscious investors. Islamic finance has been put forward as a viable alternative financial system (KFHR 2013).

(iv) Given that in Islamic banking returns on investments are based on underlying economic activities and/or assets that structure the contractual relationship between transacting parties, it is possible to use the asset-based nature and risk-sharing aspects of Islamic finance for greater integration with the real economy and to improve the overall economic balance between the real and the finance sector.

Overall, the outlook for Islamic banking and finance in Asia is bright, given that the region is home to more than 60% of the world’s Muslim population, as well as Asia’s growing middle class, and has strong economic and financial fundamentals. In addition, a combination of strong political support, a large investor base, and generous tax incentives are enticements to further Islamic finance in Asia.
REFERENCES


