Muhammad bin Ibrahim: Contemporary issues in Islamic finance and equity-based financing

Keynote address by Mr Muhammad bin Ibrahim, Assistant Governor of the Central Bank of Malaysia, at the Conference on Contemporary Issues in Islamic Home, Personal and Auto Financing, jointly organised by the International Islamic University Malaysia (IIUM) Institute of Islamic Banking and Finance (IIiBF), the Bar Council Syariah Law Committee (SLC) and the Consumers Association of Penang (CAP), Kuala Lumpur, 2 April 2010.

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Thank you for inviting me to this seminar and for giving me the opportunity to speak on contemporary issues in Islamic finance. I shall attempt to touch on some issues that, to my mind is important. I will also touch on the subject of equity-based financing, a topic that has attracted a lot of discussion lately. But I must remind you that I'm not a scholar, nor am I an expert on Islamic finance.

What I will offer is my experience in dealing with the promotion and development of Islamic finance in Malaysia over the last 10 years and the general experience of over 25 years with the conventional financial system. Therefore, my focus and emphasis would be purely from a practitioner point of view, experience that comes from the need for pragmatism in translating shariah principles and rulings into public policy, development initiatives and formulation of framework on regulation and supervision for the Islamic finance industry.

I would try to provoke some questions on some issues that have attracted attention lately. While the issues would not be exhaustion but I will attempt to give a different dimension on the matters raised.

Development of Islamic finance

Islamic finance is now the fastest growing segment in the global financial industry. Notwithstanding the global financial crisis, Islamic finance has shown strong growth. The size of assets under management may very well exceeded USD1 trillion. Islamic finance has maintained an average growth rate of 15–20% per annum. New areas of business continue to show encouraging progress. Islamic Mutual Funds is growing at average of 23% per annum. The Takaful industry is growing at 13% per annum. Islamic finance has attracted a lot of attention. It is no more peripheral to the conventional banking system but has grown from being a novelty to be a viable and attractive alternative to the conventional banking system.

Giant banking and insurance groups are now very much interested in Islamic finance as a way to growth their business. Five years from now, the data that I am showing you could very well change in terms of numbers and structures.

Interest in Islamic finance is no longer limited to Muslim nations and Muslim communities. The world realizes the economic clout of 1.5 billion people is a market that cannot be ignored. The Islamic finance market offers an enormous potential for future growth. Long established financial centers such as London, Hong Kong, Tokyo and Singapore have already begun the first steps to enhance their respective centers into vibrant Islamic financial centers.

Opportunities in Islamic finance

This would raise several implications and opportunities for the development of Islamic finance. The increased competition where non-traditional players will enter the industry bringing with them superior system, management skills, established R & D and risk management system with proven track record globally will spur growth or at least maintained at an already phenomenal growth in Islamic finance.

There will be more innovative products, new concepts and new structures, as the new players bring with them new value proposition to attract or entice their customers. Demand will grow for services related to Islamic finance in the areas of consultancy, accounting, trust, shariah, legal advice and IT services.

New shariah concepts will emerge and this will require scholars to rethink some of the structures that had been well established. In addition, new demand for standardization and harmonization of shariah standards would intensify as cross border transactions increases. This will also result in an increase in demand for financial products that can be sold between markets.

Malaysia's Islamic financial industry

Malaysia is well positioned to take on this competition. The path for the development of Islamic finance started as far back as 1983. From the building of the foundation of legal, regulatory and shariah framework, the Islamic Banking Act (1983) to the formation of the first Islamic bank and Takaful Company to instituting Islamic windows concept for banking institutions and encouraging competition amongst the Islamic financial institutions in the nineties (1990s), to establishing key infrastructures and institutional arrangements such as the Shariah Advisory Council and the Islamic Money Market, we are on a mission to be the center for Islamic finance.

Today we have a comprehensive system for Islamic finance but as you would expect, because of competition and the fast changing pace of the banking industry, we must continue to strive to maintain the lead in this industry. There are a few pre requisite to maintain this competitive edge. It is the ability of the industry to meet the evolving and discerning needs of the users of Islamic finance and the ability to meet those needs in a timely and comprehensive manner. The solutions to customer needs must be as innovative and competitive as any other alternatives offered by the financial market.

The shariah aspect of the products must be recognized and accepted by the majority of players practicing Islamic finance. The supply and ability to attract and retain talent, not only in shariah area and Islamic finance, but also those who are conversant in IT, legal, accounting, risk management and communication.

The next level of development will probably entail the enhancement of linkages between various centers, be it in the financial markets, credits or investment of funds. The various Islamic finance centers operating around the globe must operate as one! We should allow a diversified number of players to operate in our market. Recognising the benefits of foreign competition and presence, we have announced a further opening of the Malaysian financial system to new players.

Islamic banking market share in terms of asset vis-à-vis total banking asset as at the end of 2009 is 19.6% (2000: 6.9%) including DFIs. This data is very close to our target of 20% by the end of 2010. Domestic Islamic banks accounted for about 85% of market share in Islamic banking sector. Annual growth rate of Islamic banking assets was 20.8% per annum for the years 2000 to 2009. For takaful, the market share, although still small, it has shown significant progress of 7.9% and 11.09% in terms of asset & contribution respectively. Annual growth rate of takaful assets was 24.2% per annum (2000–2009). Total financial assets had also increase significantly. The Islamic sukuk is larger than the conventional PDS.

What are the factors that contributed to the development of Islamic finance in Malaysia? One of the factors is a comprehensive legal, tax, accounting, regulatory and supervisory framework and this are well articulated and generally known. Let me attempt a few additional factors that might not be that well appreciated. It is the willingness of the players and the developers of Islamic finance to explore new initiatives. When we embark into this journey during the early 1980s there was no precedent to follow. We did not wait until we were 100% sure or until we were sure we could tackle all the possible issues that might arise. Some might say that this is a “trial and error” method. But history has taught us that many break through ideas and solutions originated from this approach. The willingness to try new things and the ability to move on should an idea doesn’t work is an important attribute. It pays over the long run.

The willingness to use existing resources that had served the financial system well is another contributing factor. Malaysia has already in place an efficient custodian, payment and settlement system, the principal dealership system, the real time gross settlement system and the process of tendering of government securities. All this has a proven track record of being effective and efficient. We avoid “reinventing the wheel” because it is costly, time consuming and risky if we create an entirely new approach. We adopt and adapt with the existing system so long it does not contravene any shariah principle or requirement.

Willingness of shariah scholars to practice ijtihad is another contributing factor. The courage to set a precedent and the resolve to agree to a new concept never done before. For example, in the establishment of shariah parameters and centralization of shariah rulings and the creation of financial instruments that the Central Bank used to mop up liquidity from the financial market on a daily basis.

The forward looking plan of our various institutions of higher learning to offer courses in Islamic finance related subjects that have enable a steady supply of talent and workforce to the industry.

Equity-based financing

Let me touch on the subject of equity-based financing. This subject has captured the imagination of many especially within the academic circles. Some even went to the extent of saying equity-based financing is the heart and soul of Islamic finance. This is a point that will invite a lot of comments and a subject of endless conversation. In practice, somehow, bankers are not into this.

In Malaysia and in the Middle East, however, more than 70% are debt-based financing. Why is this so? Let me discuss this point with greater detail.

For the benefit of those who are less familiar, in a nutshell *Mudharaba* is a profit sharing and loss bearing concept where the Financier provides financial investment in a business and the Entrepreneur provides expertise in running the business. The financier gets to share profits and absorb loses and the entrepreneur have a share of the profit

Musharaka is where both Financier and Entrepreneur commit to invest financially in a business. In both cases, the profits and losses are shared according to ratios that both Financier and Entrepreneur agrees prior to the venture.

In practice, these financing concepts can cover several aspects. Banks invest in a business venture with an entrepreneur and receive profit/loss sharing (e.g. in a corporate banking transaction). Depositors invest in a Bank and earn profit/loss sharing (e.g. when consumers want to open a mudharabah account).

Banks invest in a business venture with an Entrepreneur and then finance the product of the business venture to consumers (e.g. Bank enters into partnership with Entrepreneur to build houses and sells the house to consumer thru a financing package). The structure seem quite established and generally accepted. Yet since 2006, despite equity-based transaction has become more popular, it only constituted only 2% of total financing.

In fact, in our effort to motivate the industry to engage in more equity-based financing, a specific guideline dealing with mudharabah and musyarakah was issued on 21 September 2007. From our observation, we need a lot of room for improvement in this particular area.

Sales based contract remains significant portion of financing – around 50%, 30% being *Ijarah*. A large proportion of Islamic finance domestically is therefore debt or asset based financing.

Why the industry did not focus more on equity based financing? Should Islamic banks which are relatively small in size take this major shift in direction? A new direction not just for Islamic banks, but a new direction in the way Islamic finance should develop forward. Is there an impediment? If so – what is the impediment and is it something that we can solve? Or is it a natural phenomena?

Are players in the industry not aware of the benefits? Or are they aware of the benefits, weighed it against the potential risks and decided not to pursue this strategy because of business and operational reasons?

First let's analyze the potential benefit. For example, a Bank enters into a joint venture with a housing developer. The financing of the project in the form of equity can yield a lucrative return when the development is completed and then sold. Margin for profit upon sale can be high, as Bank enters into the development at the earliest chain of production.

The Bank can still provide financing for the home purchasers, the difference this time – the homes are the Bank's own asset. Those are direct impact; there are positive impacts in other key areas as well.

What happens to the profit from sales and financing? It gets channeled back to Depositors (giving them higher returns on the deposits). This concept would, completely, according to equity-based financing proponent, move Islamic banks away from mimicking conventional products and would truly operate as the shariah had wanted it. Is this true, are there any other factors to be considered?

In terms of risk assessment, such a transaction will necessarily inject greater market discipline among industry players. This business model is premise on a few fundamental assumptions. The Bank and its staff will have to be good at risk assessment, due diligence, assets valuation, good at project financing and management, a good landlord, skillful in project monitoring and have the necessary expertise on specific areas such as construction, agriculture, manufacturing, fishing and other industries. Under this model, the banks created are very specialized with a set of expertise that they are not trained and possess. Its an entirely new "ball game".

Currently 71%, the bulk of financing in Islamic finance is fixed, only 29% is on a floating rate. In conventional, only 26% is fixed. This gives rise to the issue of mismatching. For as long as source of funds for Banks is floating and its asset gives fixed return, the risk of funding cost being more expensive than income is a very real possibility. Rate of Return Risk and DCR will become a challenge to overcome.

Would an equity based approach significantly remove such risk? Most likely, it is an area of where the practitioners can develop and explore. Or whether the benefits of equity-based financing would outweigh the risks associated with the obviously higher risks posed by the structure.

The shift from asset based financing to equity based financing does not mean that Islamic banks will operate without any risks. Whilst the risk of mismatching between floating and fixed will be greatly reduced, it does also mean that Islamic banks will be taking the unprecedented step of actually owning the assets for which they are financing.

So the question then is – should Islamic banking be the conduit for this sort of financing model? When the business climate is good then the answer is yes – but in an environment where certain sectors decline significantly such as the property market, it could adversely impact Islamic finance institutions, that could that suddenly finds itself saddled with assets that it cannot sell. There are ways to minimize such inventory risk – but we are making a big assumption here that ALL Islamic banks will behave rationally at all times.

Although clearly *Mudharaba* and *Musharaka* should be in the Islamic Bank's toolbox, in taking a wholesale view to move towards asset based financing – it is imperative to look at the overall implication of such a shift. For the purpose of discussion, let's consider for the moment that the entire economy is premised on asset based financing. We must ask ourselves, in that scenario – would a financial system purely based on profit from equity based financing be necessarily more efficient than one based on asset financing or debt? Does it benefit the entire *Ummah*? Consider this possibility – who would have better information on business climate – the Entrepreneur, the Bank or the Client? Remember the asymmetry of information?

A shift from the debt based financing to equity based financial system does not, necessarily lead to a better equitable outcome to society; instead, if not properly implemented it could cause uneven benefits to various stakeholders. The reason is that in the new system the risk-averse Clients will be crowded out of the market, allowing the risk-taking individuals to gain the most from a profit-sharing system because they have better access to information. The costs may outweigh the benefits.

Let us now analyze the Business and Bank's perspective and the client's perspective. Here we are talking about the potentially real issues – the practical aspects that Banks, Entrepreneurs and Clients will face. Firstly, in terms of information asymmetry, banks will need to have perfect information on the Entrepreneur. This cuts both ways – Clients of the Banks will need to have perfect information on the Banks as well. Banks will need to keep detailed records and then reveal such information to their Client and Entrepreneur. Of course we need transparency – but when transparency requirement start to conflict with giving out information to your competitors (perhaps in conventional banking), then this could have a serious impact on competitiveness.

Requirement for information will certainly result in an increase in costs – which is then passed on to customers, potentially causing services to be more expensive. This could result in Islamic Banks losing its competitive edge. We should also question what is the expertise of the Bank? Would the Bank possess sufficient expertise to invest in a business venture? If it does not have the expertise or take an active role – then the Bank is merely financing the business venture. That is no different from debt based financing.

Now let's take a closer look at the Client's perspective. Firstly, if the Bank is operating on purely equity based financing – return on deposits will be based on the Bank's performance. Now how many of us here invest our life savings in the stock market? Because that is essentially a rather crude way of presenting an example of what a pure equity based financing system may bring. It is of course possible for the authorities to guarantee your deposit in the Islamic Bank a depositor choose to "invest" – but this would no longer be in the spirit of *Musharaka* and *Mudharaba*.

But another point that needs to be considered is this. Are banks the best entity to provide equity-based financing. Would it be more suitable for a joint venture company, a partnership or a private equity funds to undertake this venture? Shouldn't we develop these market-based institutions to be the conduit for such an endeavour. Since market-based institutions do not have the fiduciary responsibility to depositors.

Should we leave the banks which were created to play an intermediary role to continue to perform the function which they are good at. Wouldn't the financial stability aspect be a consideration on whether banks are allowed to venture into equity-based financing? Shouldn't we expand an entirely new Islamic finance industry that specialises in equity-based financing?

I asked plenty of questions that I don't have ready answers but I hope enough to force you to ponder into thinking this issue from a multiple dimensions. The good news is we are at a stage of growth in terms of product and service in Islamic finance. That means innovation is still the driving force behind the industry progress. The questions posed today is not meant to deter nor to direct in which direction we ought to be moving – but to provoke new thoughts in moving forward.

The fact of the matter is that debt based financing is generally accepted and approved by Shariah scholars and currently forms an integral part of Islamic finance and its structured was tested in our legal system. These instruments have been adopted by the IDB and many Sovereigns to finance infrastructure investments, to promote trade and to meet liquidity needs in Muslim countries. In other words, debt-based financing has been successfully deployed to bring economic benefit to fellow Muslims.

There is no doubt that Equity based financing needs to be considered and its usage encouraged. At the same time we must do so with the full knowledge of its full consequence on the entire financial system stability as it currently stands. Perhaps splitting hairs on whether we should focus more on asset based or equity based financing pales in comparison to other issues, such as encouraging mutual recognition on diversity of thoughts and ideas in Islamic finance, enhance the inter linkages between Islamic financial centers, so that economies that have surplus funds could be channel to economies that are short of funding and that those excess funds could be invested in productive manner.

Perhaps, we should be patient in developing Islamic finance, moving forward. Patience does have its own virtue. I remember the days when the financing for purchases of houses are purely based on murabahah concept, but now we have musyarakah mutanaqisah, a structure that is very close to equity-based type of financing structure.

Conclusion

Malaysia since 1983 has established a comprehensive Islamic financial system. We have suitable legal, tax, shariah, regulatory and supervisory framework institutions and the right talent to bring Islamic finance to the next level of development. If there is a gap – we are in a position to fix that gap.

But the world as you know it has never remained static, the agility and the commitment to change would determine the ability of Malaysian Islamic financial system to remain competitive and relevant. On that note, I wish you all the best and I am confident this forum will make a tremendous contribution to the overall growth in Islamic finance.