

ASIA: FUTURE PROSPECT FOR ISLAMIC FINANCE



Growing potential in Asia's economies supports expansion of Islamic finance, with a robust growth prospects, unique demographics, strong political support, and large investor base. The region's efforts towards greater integration, including financial integration, provide a solid growth for a strong Islamic financial industry and provide confidence to tout Asia as the future leader for Islamic finance.



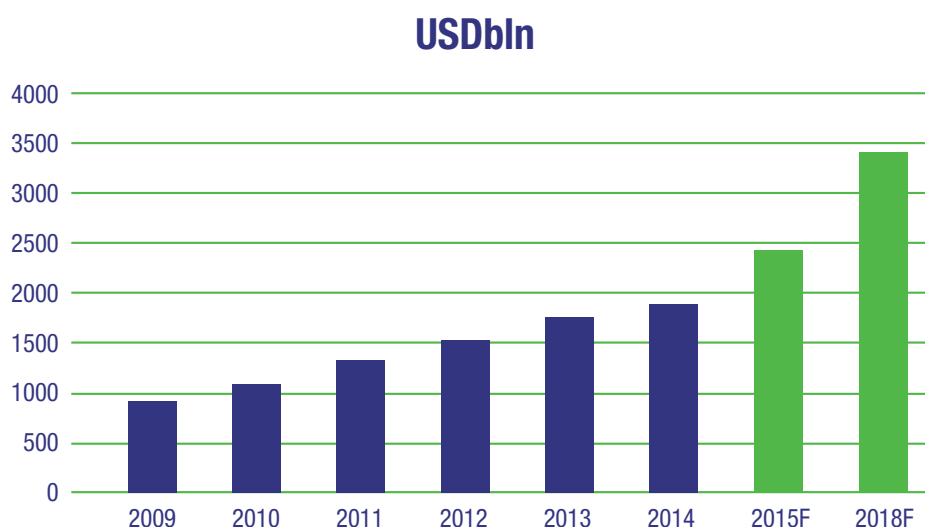
Asia: Future of Islamic Finance

In just four decades, Islamic financial system has evolved into a comprehensive financial system of its own: ranging from banking, capital market, to takaful sectors.¹ In the past five years between 2009 and 2014, the Islamic financial industry has experienced robust expansion, recording a 17.3% Compounded Annual Growth Rate (CAGR).² To date, total global financial assets of the Islamic financial industry is estimated to be around USD2tn and is estimated to surpass USD3tn by 2018.³

By geographical dispersion, expansion has been concentrated in emerging markets

such as the Gulf Cooperation Council (GCC) countries and parts of Asia, especially South East Asia. Discussion on Asia's growth prospects is fairly entrenched around South East Asian Muslim-majority countries such as Malaysia, Indonesia and Brunei; with strong potential growth in banking, capital market and takaful sectors to support the growing economic activities.⁴ Apart from the South East Asian Muslim-majority countries, it also centres on large and populated Asian economies such as China and India, as well as dynamic hotspots such as Singapore, Hong Kong and Japan.⁵

Total Islamic Finance Assets (2009-2018f)



Source: ISRA

¹ ISRA

² IFSB Stability Report 2015

³ ISRA estimates

⁴ MIFC

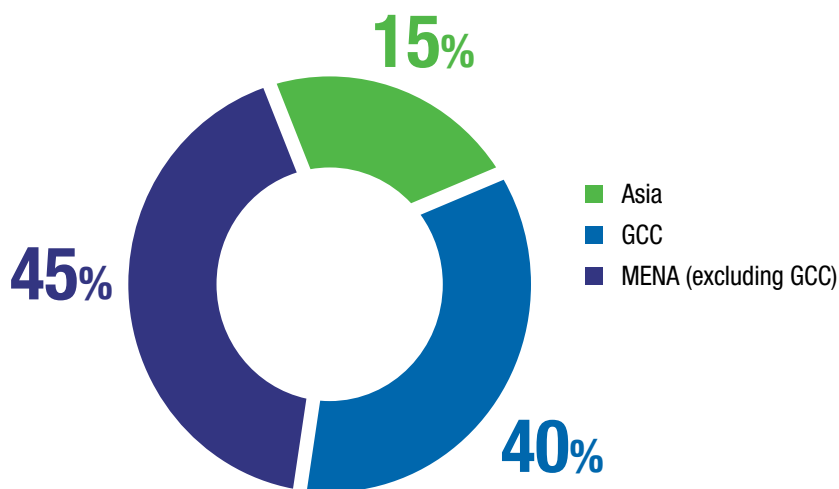
⁵ MIFC

Geographical Dispersion of Islamic Finance

Overall, Islamic finance is now present in majority of the countries offering some types of Shariah-compliant financial products.⁶ Key Islamic finance jurisdictions are GCC and Asian region. GCC region involve countries like Saudi Arabia, the UAE, Kuwait and Qatar whilst the Asian region mainly comprise Malaysia and Indonesia. In these countries, Islamic finance accounts for a sizeable and growing share

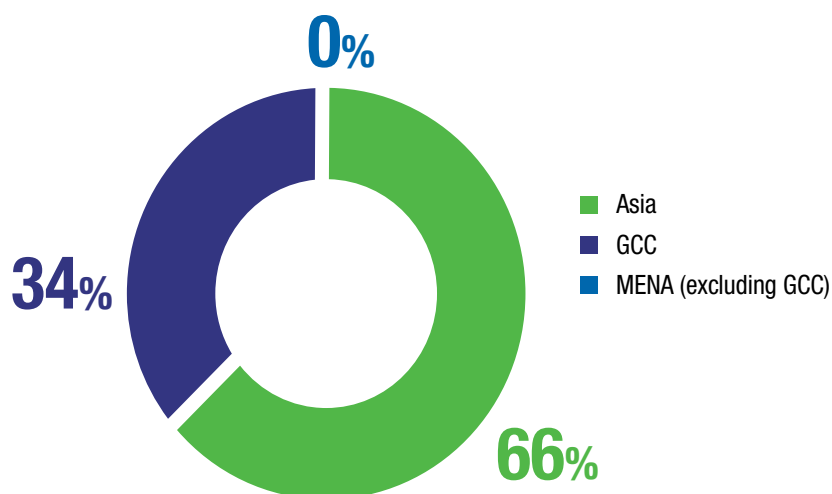
of the domestic banking sector, catering to both large corporate clients and household financing.⁷ Meanwhile, several European countries such as the UK, Luxembourg, Germany and France and the US have become increasingly active in Islamic finance. As well, selected countries in the African and Commonwealth Independent States (CIS) region are either engaging with regulators or exploring the concept of Islamic finance.

Breakdown of Islamic Banking Assets as at 1h2014



Source: Regulatory authorities, Bloomberg, Zawya, Central banks, Individual Institutions, Corporate Communications, IFIS, The Banker, ISRA
 Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions. Takaful contributions are used as a basis to reflect the growth in the Takaful industry.

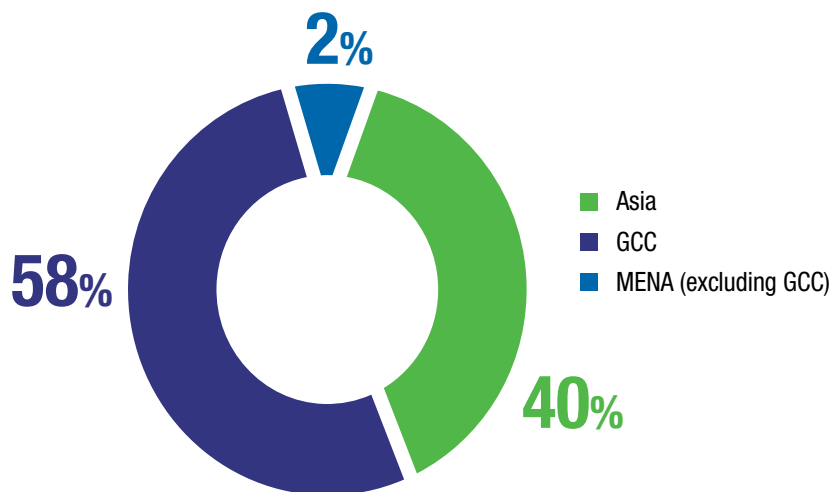
Breakdown of Sukuk Outstanding as at 3Q2014



Source: Regulatory authorities, Bloomberg, Zawya, Central banks, Individual Institutions, Corporate Communications, IFIS, The Banker, ISRA
 Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions.

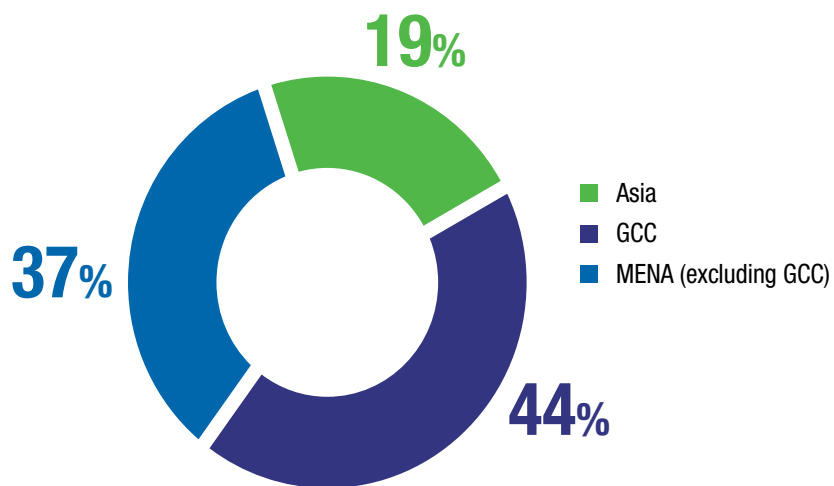
⁶ MIFC
⁷ MIFC

Breakdown of Islamic Funds Assets as at 3Q2014



Source: Regulatory authorities, Bloomberg, Zawya, Central banks, Individual Institutions, Corporate Communications, IFIS, The Banker, ISRA
 Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions. The breakdown of Islamic funds' assets is by domicile of the funds.

Breakdown of Takaful Contributions as at 1H2014

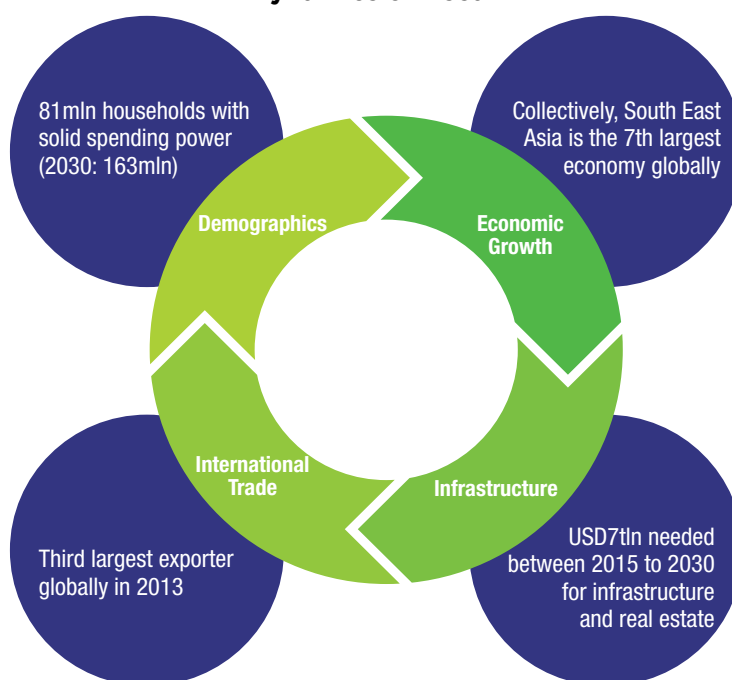


Source: Regulatory authorities, Bloomberg, Zawya, Central banks, Individual Institutions, Corporate Communications, IFIS, The Banker, ISRA
 Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions. Takaful contributions are used as a basis to reflect the growth in the Takaful industry.

Although the MENA region (excluding the GCC region) took the lead for the total asset of Islamic banking for 1H 2014 but the market size in other Islamic finance segments such as sukuk outstanding, Islamic funds and takaful contributions, is comparable between Asia and GCC.⁸ Nevertheless, touting Asia to be the next leader for Islamic finance is a possibility. Of more

importance, Asia is home to more than 60 percent of the world's Muslims with Indonesia being the world's largest Muslim population, home to 12.7% of the world's Muslims.⁹ Moreover a combination of strong political support, large investor base and generous tax incentives are further enticements to tout Asia as the next leader for Islamic finance.¹⁰

Dynamics of Asean



Source: McKinsey Global Institute, Asian Development Bank, Economist Intelligence Unit, ISRA

Developments and Progress of Islamic Finance in South East Asia

Over the past two decades since the Asian financial crisis, South East Asian countries have made positive strides in improving the efficiency and soundness of their financial institutions and in developing money and capital markets.¹¹ The 10-country region is home to economies which vary in terms of size, stages of development and economic structure; and encompassing fast-advancing economies such as Malaysia and Indonesia, developed economy

such as Singapore, small wealthy economy such as Brunei, as well as new frontiers such as Vietnam and Myanmar.¹² It is noteworthy to inform that the South East Asian countries jointly would rank as the world's seventh largest economy¹³, where the region's GDP is expected to reach USD3tn by 2017¹⁴, three times its size from the last decade. Of more importance, the 10-country region plans to launch a single market for goods, services, capital and labour this year, which has the potential to be one of the largest economies and markets in the world.¹⁵

⁸ Islamic Financial Services Board (IFSB), Islamic Financial Services Industry Stability Report 2015

⁹ Wikipedia

¹⁰ <http://www.asiabriefing.com/news/2014/07/asia-future-islamic-finance/>

¹¹ MIFC

¹² MIFC

¹³ "ASEAN Economic Community: 12 Things to Know", Asian Development Bank (August 2014)

¹⁴ "ASEAN's rapid economic growth and future potential", opening address of ASEAN Fixed Income Summit (September 2014)

¹⁵ "ASEAN Economic Community: 12 Things to Know", Asian Development Bank (August 2014)

1. Favourable Demographics and Growth Potential

Looking ahead, the South East Asian economies will play an increasingly influential role in Asia's possible move towards becoming the next global leader for Islamic finance, partly dedicated to its favourable demographics and growth potential.¹⁶ Other important possibilities include the entrenchment of Islamic finance in Muslim-majority South East Asian countries such as Malaysia, Indonesia and Brunei. In Malaysia, Islamic financing assets are

2. Regulatory Efforts

Moreover, the recent regulatory efforts in the region is also a positive sign for the South East Asian economies to play an influential role in Asia's possible move towards becoming the next global leader for Islamic finance. The enactment of Islamic Financial Services Act 2013 (IFSA 2013) in key Islamic finance jurisdiction such as Malaysia, which went into effect in June 2014, has focused to strengthen the development of Shariah matters in the industry.¹⁹ It represented a significant milestone in the development of Islamic finance industry in Malaysia. Failure of an Islamic financial institution (IFI) to adhere to the Shariah-compliant requirements will subject it to criminal and civil penalties.²⁰ Among important feature of IFSA is the distinction and separation between Islamic deposit and Islamic investment product classification in the IFIs' liability side.²¹ While on the asset side, the act clearly draws the distinction of the features of Islamic contracts which are applicable for financing activities into sale-based financing. This include murabahah and ijarah, equity-based which include mudharabah and musharakah, and fee-based contract which include wakalah and kafalah.²² Alongside the legislation of IFSA, Malaysia has also embarked on the issuance of new Shariah standards and their operational requirements, featuring the prevailing and applicable contracts

forecast to account for 40 percent of the banking sector by 2020 while Indonesia, with about 250 mln people, is likely to be the next major market for Islamic financing, with its young Islamic banking sector forecast to grow fivefold from 2011 to 2015.¹⁷ Moving to Brunei, the Sultanate's early entry into the Islamic financial services market has provided it with strong foundation to develop the industry, and carving out a niche for itself as an international Islamic banking centre.¹⁸

and principles in Islamic banking and takaful industry. This initiative marks an important milestone as part of Bank Negara Malaysia's continuous endeavour to enforce and strengthen Shariah compliance culture among IFIs, to enhance the Shariah and regulatory framework in Malaysia, and to create harmonization among IFIs in Malaysia in regard to Shariah-related matters.²³ Furthermore, as part of further promotion of Islamic finance, the country's recent 2016 budget among others include the cutting of taxes on issuance costs of "Sustainable and Responsible Investment" (SRI) sukuk and provision of 20 percent stamp duty exemption to Shariah-compliant loan instruments for home financing.²⁴ Elsewhere in Indonesia, its financial services authority Otoritas Jasa Keuangan (OJK) announced in August 2014 that it was working on a five-year blueprint to develop Islamic finance.²⁵ Amongst others, the blueprint is expected to address pertinent issues such as the lack of scale in the industry, sector consolidation and the role of foreign ownership. In November 2014, the country's capital markets authority signed an agreement with the national Shariah board to move towards the centralisation of Shariah matters related to Islamic finance.²⁶ The streamlining of Shariah standards at the national level is expected to support innovation in Shariah-compliant products and to develop a wider pool of Shariah scholars.

¹⁶ MIFC

¹⁷ <http://www.asiabriefing.com/news/2014/07/asia-future-islamic-finance/>

¹⁸ "Brunei Darussalam: Islamic banking earmarked for further growth", Oxford business group (24th January 2013)

¹⁹ www.ifs13.org

²⁰ M. Mahbubi Ali & Syahida Abdullah. Islamic Finance News, 26th March 2014

²¹ Ibid

²² Ibid

²³ Islamic Finance News, 26th February 2015

²⁴ "Malaysia aims to boost Islamic finance with new initiatives in budget", Reuters (25th October 2015)

²⁵ MIFC

²⁶ MIFC

3. Infrastructural Demand

Meanwhile the region's demand for infrastructure investment (it needs about USD60bln a year until 2022²⁷) is likely to spur more sukuk issuances by sovereign and government-related entities. Malaysia housed to almost two-thirds of the global Islamic debt market²⁸ while Indonesia has created a milestone on every global issuance, such as launching an inaugural Wakalah-structure sukuk in 2014 and issued the largest ever single-tranche USD Sukuk in May 2015²⁹. In the

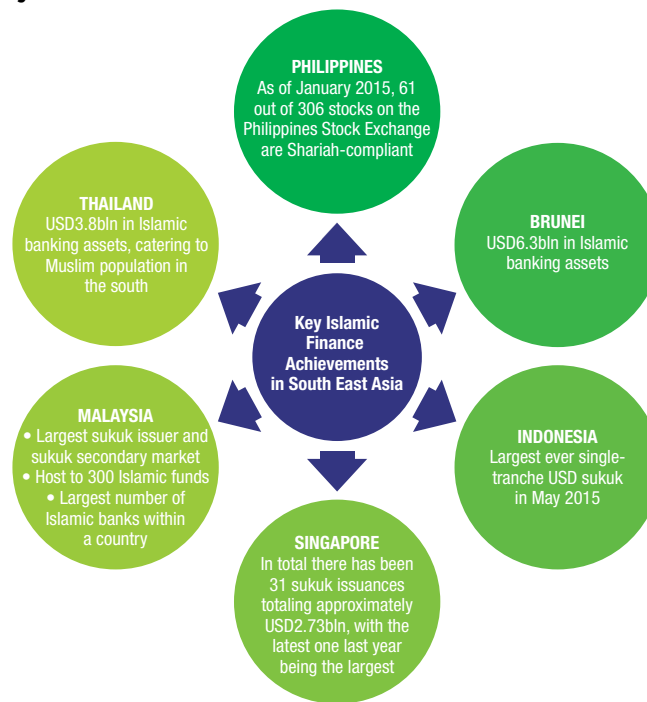
4. Shariah-compliant Financial Services for Minority Muslims

Elsewhere, Islamic finance has a growing presence in countries such as Thailand and the Philippines where the demands for Shariah-compliant financial services are escalating. Developed South East Asian economy such as Singapore has also shown sign to further boost its Islamic finance regime. Islamic banking assets in Singapore have grown by 73% since 2010, and are increasingly cross-border in

National Budget 2015, the Indonesian government has allocated a substantial amount for infrastructure project via government sukuk issuance.³⁰ In Brunei, the Authority Monetary Brunei Darussalam (AMBD) announced the successful pricing of its 82nd issuance of sukuk in 2013, which was worth USD122.5mln at a rental rate of 0.16 percent.³¹ Furthermore, corporate issuers have also tapped the sukuk market to raise funds for the plantation and real estate sector.

nature.³² Since the establishment of its sukuk facility in 2009 by the Monetary Authority of Singapore (MAS), there have been 31 sukuk issuances over the last five years, with total outstanding issuance reaching a high of USD2.73bln in 2014, compared to USD315.73mln in 2009.³³ To facilitate further growth of Islamic finance in Singapore, MAS is working with the industry and other government agencies to provide clarity and certainty in the regulatory and tax treatment for sukuk.

Key Islamic Finance Achievements In South East Asia



Source: IFIS, Zawya, Bloomberg, Eurekahedge, World Islamic Insurance Directory, ISR

²⁷ KKPMG

²⁸ "Malaysia remains leading sukuk issuer", The Star Online (27th September 2014)

²⁹ "Indonesia celebrates listing of largest sovereign sukuk issuance in Dubai, underlining the Emirate's global lead in Sukuk listings at AED 135 billion (USD 36.7 billion)", Thomson Reuters Zawya (13th September 2015)

³⁰ MIFC, 2015

³¹ "Brunei Darussalam: Islamic banking earmarked for further growth", Oxford business group (24th January 2013)

³² "Enhancing Linkages between Asia and the Middle East" – Welcome Address by Ms. Jacqueline Loh, Deputy Managing Director, Monetary Authority of Singapore, at the 6th World Islamic Banking Conference Asia Summit on 3rd June 2015.

³³ "Enhancing Linkages between Asia and the Middle East" – Welcome Address by Ms. Jacqueline Loh, Deputy Managing Director, Monetary Authority of Singapore, at the 6th World Islamic Banking Conference Asia Summit on 3rd June 2015.

Islamic Finance in Other Parts of Asia

Apart from the South East Asian economies, some other Asian economies have also evolved to play an increasingly important role towards the development and progress of Islamic finance. Hong Kong which is known for its skyline and deep natural harbour has been working to become the centre for international financial intermediation between China and the Middle East. With the China market continuing on its rise, Hong Kong is situated as the ideal gateway to channel the renminbi into the Islamic banking sector. As it readies for its goal of becoming a Shariah compliant financing hub for Chinese companies, it recently issued its second sovereign sukuk.³⁴ The Hong Kong Monetary Authority has recently announced plans to sell USD1 bln of five-year sukuk, the same size and tenor as its debut issue in September that drew USD4.7 bln of bids.³⁵ Those notes last yielded 2.06 per cent, almost the same as the rate at issue and about twice the level of the government's similar-maturity non-Islamic securities.³⁶ In addition, the financial hub had passed a tax bill in 2014 allowing the sales of sukuk and levelling the playing field between sukuk and conventional financing.³⁷ China itself which has found more confidence in exploring Islamic finance after Hong Kong has issued its debut sukuk is looking to apply Islamic finance for wide-ranging projects, from hospitals to metro stations.³⁸ In addition, Ningxia, an autonomous region in northwest China where a third of the 6.5 mln population are Muslim, is planning for USD1.5bln sukuk sale.³⁹

Apart from China, another Asian economic powerhouse which is also showing its interest towards Islamic finance is India. The Bombay Stock Exchange (BSE) became India's first stock exchange to launch an Islamic-focused Index, calling it the S&P BSE 500 Shariah Index in 2013.⁴⁰ The Shariah Index will be the first index launched since S&P Dow Jones and BSE announced the strategic partnership, joining a long list of well-known indices around the globe.⁴¹

Similarly, Islamic finance has a growing presence in other Asian countries such as Japan and Korea. For example, with Japan has enhanced its co-operation with key Islamic finance jurisdiction such as Malaysia.⁴² The Japanese government, and its authorities will encourage Japanese enterprises, financial institutions, and investors to engage in Islamic finance-related activities with Malaysia and in turn Malaysia will offer technical assistance to Japan in this field.⁴³ In addition, Japan has also made Islamic finance headlines in the past years with the issuance of USD100mln sukuk al-ijarah, as well as the establishment of a commodity murabahah facility, which was upsized from USD50mln to USD70mln due to demand.⁴⁴ Of more importance, Japan is amending its financial regulations to facilitate Islamic financing.⁴⁵ Moving to Korea, as regulators across Asia build closer ties to the growing industry, South Korea's central bank has joined the Islamic Financial Services Board (IFSB), one of the main standard-setting bodies for Islamic finance, further reiterating its interest towards Islamic finance.⁴⁶

³⁴ "Hong Kong government sells second Islamic sukuk bond to raise USD1.1 bln", South China Morning Post (28th May 2015)

³⁵ "Hong Kong Sharia Finance Goals Elusive as Second Sukuk Readied", Gulf News Markets (29th October 2015)

³⁶ "Hong Kong Sharia Finance Goals Elusive as Second Sukuk Readied", Gulf News Markets (29th October 2015)

³⁷ <http://www.asiabriefing.com/news/2014/07/asia-future-islamic-finance/>

³⁸ "China Readies for Islamic Finance With a Little Help from Gulf", Bloomberg Business (20th April 2015)

³⁹ "China Readies for Islamic Finance With a Little Help from Gulf", Bloomberg Business (20th April 2015)

⁴⁰ "Bombay Stock Exchange Launches Shariah Index", India Briefing (9th May 2013)

⁴¹ "Bombay Stock Exchange Launches Shariah Index", India Briefing (9th May 2013)

⁴² "Malaysia, Japan to enhance cooperation in Islamic finance", Channel NewsAsia (26th May 2015)

⁴³ "Malaysia, Japan to enhance cooperation in Islamic finance", Channel NewsAsia (26th May 2015)

⁴⁴ "A new era for Islamic finance in Asia Pacific", Nortonrose Fullbright (July 2010)

⁴⁵ "Enhancing Linkages between Asia and the Middle East" – Welcome Address by Ms. Jacqueline Loh, Deputy Managing Director, Monetary Authority of Singapore, at the 6th World Islamic Banking Conference Asia Summit on 3rd June 2015.

⁴⁶ "Bank of Korea joins Islamic finance body IFSB", Reuters (28th March 2014).

Overall Progress and Outlook of Islamic Finance in Asia

Asia remains to be the world's fastest growing region, recording a 5.6% growth in 2015.⁴⁷ As at end-2013, the region's Islamic finance assets amounted to approximately USD391.2bn⁴⁸, equalling 22% of Islamic finance assets worldwide. Moving forward the region's Islamic finance assets is expected to grow at a fairly sustained pace, and amount to USD770bn by 2018.⁴⁹ In Asia as a whole, Islamic finance has expanded and served the economy through banking and capital markets.

Moving to key Islamic finance area in Asia - the South East Asian region; recent important developments have taken place in both established and newly established Islamic finance markets in the particular region. These developments are expected to support further expansion of the

industry in this economically important region.

Amidst the recent regulatory efforts in the South East Asian region and overall market developments in Asia, the Islamic finance industry in Asia is well-positioned to benefit from the region's robust growth prospects and increasingly wealthy consumers. Thus far, the industry has successfully mobilised funds via the Islamic banking and sukuk markets. Moving forward, demand will be reinforced by demand for financing from the considerable infrastructure sector, as well as other key real economic activity in the manufacturing and agriculture sectors. Notably, the region's efforts towards greater integration, including financial integration, augurs well for Islamic capital markets; cross-border investments in sukuk and Islamic funds which would support a robust Islamic finance industry.

⁴⁷ Enhancing Linkages between Asia and the Middle East" – Welcome Address by Ms. Jacqueline Loh, Deputy Managing Director, Monetary Authority of Singapore, at the 6th World Islamic Banking Conference Asia Summit on 3rd June 2015.

⁴⁸ ISRA estimates

⁴⁹ MIFC

Disclaimer

The copyright and any other rights in the selection, coordination, arrangement and enhancement of the information in this publication are owned by Bank Negara Malaysia. No part of this publication may be modified, reproduced, published or transmitted without prior permission in writing from Bank Negara Malaysia and the relevant copyright owner.

Although every effort has been made to check the accuracy and completeness of this publication, Bank Negara Malaysia accepts no responsibility or liability for errors or omissions, if any. The information published here is only up-to-date at the time of printing, and is not exhaustive and may be updated from time to time on the website: www.mifc.com. Bank Negara Malaysia appreciates any feedback or suggestion for improvement.

Copyright © 2015 Bank Negara Malaysia.
The MIFC logo is a registered trade mark in Malaysia.
All rights reserved.