

Islamic Finances Growth in Malaysia: The Challenges

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Abstract: Malaysia has recorded 17.3% growth of Islamic finances market between 2009 -2014 (MIFC, 2015a). It has tremendous potential to grow further in future. However, there are a few challenges that need to be resolved. This paper will discuss the challenges and issues that block the development of Islamic Finance in Malaysia and steps taken by the government to minimize the constraints. The understanding of challenges will alert the relevant parties and Government institution to prepare solutions and plans to minimize these challenges.

Keywords: Challenges, Development, Islamic Finance, Islamic Principles

1. Introduction

Since the 1970s, a few of Islamic countries including Malaysia planned to develop Islamic finance, in order to adhere to Islamic teaching and to capitalize wealth from oil production. But only in 1980s, the first Islamic Bank could be established with the introduction of Islamic Banking Regulation. The enactment of the Islamic Banking Act 1983 enabled Malaysia to establish the first Islamic Bank. By the end of 2008, Malaysia had 17 Islamic Banks serving Islamic banking products and services. As of June 2009, the total Islamic banking assets in Malaysia is estimated at USD68 billion (Gearan, 2009). Today, the Islamic finance was extended from banking to insurance (takaful) and capital market (securities and sukuk) (Bank Negara Malaysia, 2016).

Globally, there are more than 75 countries (Islamic and non-Islamic countries) developed Islamic Financial system with estimated USD2 trillion assets (about 1% of the world market), and this is expected to grow to USD5 trillion in the next five year (Mohd Zain, Ishak, Latif & Kadir, 2011). Islamic finance is growing with double digit internationally due to improved industry infrastructure and realistic financial system. Islamic finance is immune to financial crisis, inflation and price distortions (Askari, 2010). There are five principles in Islamic finance; the prohibition of interest (*riba*), profit/loss sharing on investment, no investment on unlawful product/service (*haram*), no uncertainty (*gharrar*) and speculation in contract, and financial transaction must be transparent and based on real assets (Gearan, 2009). Based on these five principles will eliminate risk exposure to investor and lender and to provide financial stability. Bank failures and financial crisis in recent decade will make the Islamic finance becomes the possible alternative financial and economic system for the world.

Islamic finance has big potential to develop further in world financial market. In order for the Islamic finance to grow further in Malaysia and in the world market, there are a few challenges and constraints that need to address. The first challenge or constraint is shortage of qualified Shariah scholar with good knowledge in Islamic finance (MIFC, Aug 2015). Second, the need of standard and harmonizes Islamic finance regulation across the world (Steffensen, 2013). Third, handling liquidity management risk (Steffensen, 2013). Fourth, harmonization of Islamic finance principal and conventional finances regulatory (MIFC, Aug 2015). Fifth, the

lack of public awareness about the beauty of Islamic finance (Steffensen, 2013) and the last one is on an innovation of Shariah compliant products (Saif Al Nasser, 2013).

2. Growth and development of Islamic Finance in Malaysia

Malaysia is Muslim majority population; therefore there is urging to provide Shariah compliance finance products. With the government role, the first Shariah base institution, Lembaga Tabung Haji was set up in 1963 for Muslim to perform Pilgrimage, to participate in investment and economic activities. The success of Tabung Haji was the mind opening of people to suggest the establishment of Islamic Bank. As a result, in 1983 the establishment of Enactment of Islamic Banking Act, and in 1984, Takaful Act created the full pledged Islamic Bank, which is Bank Islam Malaysia Berhad (BIMB) and Syarikat Takaful Malaysia. Since then, with the introduction of “Skim Perbankan Tanpa Faedah” in 1993 by Central Bank, the industry recorded double digit growth 18-20% (Iqbal & Molyneux, 2005). By the year 2015, there are 16 banks and 8 takaful operators offering Islamic finance products, with Islamic Banking assets reached USD65 billion (Bank Negara Malaysia, 2016). Islamic Banks offer a wide range of products for saving, investment and financing. The government also allows foreign banks to operate full-pledged Islamic banks.

With the significance success of Islamic Banking, the government aggressively expands the Islamic Finance into other sectors of Islamic Finance. The Government of Malaysia set up infrastructure, regulation, incentives and Islamic organization to spur further the development of Islamic Finance. The infrastructure established by government was payment, clearing and settlement, custodian, principal dealers, listing on Bursa with authorize exchange status. After the year of 2000, the Islamic Finance industry was extended into capital market, money market, foreign exchange market, commodity market and Bursa Suq Al-Sila. In May 2010, there were 847 listed companies (representing 88%) in Bursa Malaysia with Shariah compliant securities. For mutual fund, there were 156 approved Islamic Funds. Malaysia is the first to set up Bursa Suq Al-Sila, a Shariah-based commodity trading platform (Askari, 2010). Malaysia was also the largest issuer of sukuk (Islamic bond or Islamic private debt securities) with value of USD159 billion in 2014. Sukuk market was growing rapidly due to tax deduction on issuance expenses provided by the government (Bank Negara Malaysia, 2016).

Across the world, similarly there was a big demand on Islamic finance. Currently, there are more than 300 Islamic Financial institutions in more than 75 countries. The industry is estimated to grow 15 to 20 percent annually. With the failure of the conventional financial system, the Islamic Financial system is considered as alternative financial system to provide financial and economic stability. This is because Islamic financial system is based real assets and avoiding speculation and *riba* (Mohd Zain et al., 2011). The government of Malaysia sees this as an opportunity for Malaysia to play the major role to be the provider and center of Islamic Finance. Malaysia is top of international Islamic Finance with the most advanced and comprehensive Islamic Finance system (Askari, 2010). In August 2006, government established Malaysia International Financial Centre, as regional hub for Islamic Finance in Southeast Asia. In 2010, the government introduces Labuan Islamic Financial Service and Securities Act 2010 to enhance the role of Labuan IBFC as a hub of Islamic Finance dealing in Asia. Malaysia also holds collaboration with other countries to harmonize the different in legal, regulatory, system and practice of Islamic finance.

3. The Future Outlook

Locally, the market share of some products of Islamic finance is reaching about 70 percent. There is small space to expand further, but internationally, the market is so vast. South East Asian especially Malaysia, Indonesia and Brunei is considers the next leading area of Islamic Finance growth because Muslim majority area. Indonesia with more than 200 million people is the most prospective market. There are still big market to be tap in Islamic Banking,

Takaful, money market and Islamic capital market (MIFC, 2015b). Asia is the world's fastest growing region, many countries such as Japan, China, Hong Kong and Singapore keen to venture into Islamic finance especially sukuk market.

So far, the Islamic Finance is worth about USD2 trillion or 1 percent of world market. The market for Islamic Finance is big in moving fund from one country to another. The abundance of fund from middle-east countries, the major oil producers, and the need of fund in Asia countries for their development and infrastructure creates demand for financing, investment and financial services. The cross-border investment and financing in sukuk and Islamic fund is the driver of Islamic Finance development (MIFC, 2015b). Sukuk issuance had increased rapidly in 2013 to USD270 billion. The principle of risk-sharing and asset-based financing attracts investors in sukuk market. Islamic finance promotes financial stability in banking sector by eliminating speculation and lowering volatility. For the past of years, the transaction of sukuk was slower due to fall of oil prices (IMF, 2015).

Malaysia, with the most comprehensive infrastructure and regulation, is considered the leader in Islamic Finance especially in Islamic Banking and Sukuk. The total Islamic Finance assets was about USD400 billion (Bank Negara Malaysia, 2016). Malaysia recorded the fastest growth in Islamic Finance. The government plays very important role in developing regulation and infrastructure for the Islamic finance to be more dynamic, competitive and innovative. Malaysia is successfully implementing dual banking system; Islamic and conventional banking system. The system is complementing each other in the economic development of the country.

4. Challenges and Constraints

There are considerable challenges and constraints need to be faced by the Islamic Financial services industry in order to secure a promising future in this industry. Such as:

4.1 Shariah Scholar Human Capital Development

In order to fulfill the expectation of the industry, the highly dedicated and qualified workforce is the key for securing long term competitiveness and steering to high performance and excellence in this industry. The competencies and skills needed in this field are such as Shariah understanding and its application to economic problems and financial transactions. Each financial transaction, product and service must be approved and assessed by these specialized professionals who are well verse in Quran with respect to its adherence to Shariah principles (Gearan, 2009). The research carried out by the Capital Market Regulators Forum, there are 60% of Islamic finance professionals require further training and skill development and another 82% of the countries responded experienced scarcity of talent in the Islamic financial services areas such as Shariah and Takaful (MIFC, Aug 2015). In addition, in Russia, human resources training are one of the most important issues, because the specialists are in need for any necessary changes in the legislation and the preparation of any documents in this industry. The Russian Centre of Islamic Economic and Finance created in 2008 became an educational center for training specialists in the field of Islamic Finance (Savelyev, 2015).

4.2 Accounting Industry Standard

Islamic Finance to have different practice and use of concepts is subject to the nature of Islamic law which allows different interpretations (MIFC, 2015, Aug 28). Number of variations in regulations across markets and countries, the standardization of Shariah practices remain significant challenge for practitioners, regulators and depositors (Gearan, 2009). Key to global growth is the adoption of common standards and the shared understanding of terms used, product objectives, and processes (Steffensen, 2013). Therefore, in order to clear some of the confusion and increase the effectiveness of a nationalized strategy, it needs: (1) to establish a foothold into a number of diverse economies and cultures and, (2) to renew effort to establish country-level Shariah governance (Saqlain, 2013).

4.3 Liquidity Management Risk

In managing liquidity, pricing list and allocating credits, the key player is interest rate. Given that in the Shariah principles, there is no *riba'* (interest rate), the Islamic bank is facing greater management risk than the of similar size conventional bank. This is due to the need of holding higher level of liquidity which leads to negative effect to compete. Furthermore, due to the scarcity of Shariah compliant liquidity instruments and infrastructure may also increase liquidity risk. Therefore, there is a need of risk analysis and risk management tools to provide agents with hedging instruments to hedge against the high volatility in currency and commodity markets (Zaher & Hassan, 2001).

4.4 Legal Framework

Existing Islamic banking regulation are based on conventional banking model. Some product and services of Islamic banking are considered valid from the legal perspective, but their practices are similar to conventional banking in term of pricing and interest rate benchmarking. In practice, the contemporary Islamic banks finance focus more on popular product, a debt financing with risk-free principle, whereas it is supposed to focus on risk-sharing *mudhara* and *musharakah* based on profit-and-loss sharing principles (Ahmadi, 2016). Therefore, there is a need to strengthen the development of Shariah legal system that offer better social value and uphold the risk-sharing spirit in Islamic Finance.

4.5 Public Perception

There are negative perceptions about Islam and Islamic finance around the world due to ignorance and misrepresentation (Steffensen, 2013). In Malaysia specifically, the penetration of Islamic financial industry is low due to lack of awareness and perception toward Islamic financial products and services. The research conducted by Bursa Malaysia 2009 found that there were lacks of awareness of potential investors in Islamic stock market in Malaysia (MIFC 2015a).

4.6 Innovation of Shariah Compliant Products

There is a need to develop innovative, creative and more variations in Islamic products. Furthermore, in order to innovate and securing long term competitiveness in Islamic finance industry, the Islamic financial institutions need to develop strategic leaders who are able to reinvent themselves in this new environment, and also a highly qualified and skilled workforce in the industry is indispensable for innovation (Aziz, 2004).

5. Minimize the Constraints

These are some of the steps and strategy programs taken by Malaysia to minimize the above challenges and constraints. MIFC (Malaysian International Islamic Finance Center) was established to nurture and develop talents and experts in Islamic Finance. And one of many initiatives undertaken by Malaysia was setting up INCEIF (International Center for Education in Islamic Finance) - Global University of Islamic Finance, to provide excellent knowledge, teaching, research and leaderships to produce and train professional Islamic Finance experts. This is the only university in the world that is dedicated on the Islamic Finance (BNM, 2014). The Bank Negara also established Financial Services Talent Council to pool all talents from the financial service industry and academia. The council will identify the shortages of talent and prepare the training program to up skill the industry talent pool (BNM, 2014). These talents are desperately needed by the industry to produce innovative Islamic Finance products, to develop Islamic Finance regulation and international Islamic Finance standard. The talent will lead to support the growth and innovation of Islamic Finance. INCEIF, ISRA (International Shariah

Research Academy) and some other institutions are actively disseminating information about the Islamic Finance through forums, training and education. These are basically to increase the awareness, understanding and positive perception of the public towards Islamic Finance.

Islamic Financial Service Board (IFSB) based in Kuala Lumpur was established to spearhead global standard setting body of Islamic Finance, capital market and insurance. Later IFSB joined Accounting and auditing Organization for Islamic Financial institution (AAOIFI) to collaborate in producing the best practice in development of global Islamic Finance (Mohd Zain et al., 2011). Furthermore, Labuan Offshore Financial Center is upgraded to be the International Islamic Financial Market. This is to stimulate the creation of liquidity of Islamic Financial instruments. Developing local liquidity market is important by increasing Islamic interbank money market and short-term investment products. There is also a need to explore cross-border liquidity risk management (Saqlain, 2013).

6. Conclusion

Islamic Finance with the enforcement of Islamic principles of ethical and moral values plays important role in providing financial stability of the world economic. The system is still at the beginning stage of development that needs to be developed further in term of legal, framework, regulation, infrastructure, and product innovation. The unique system of Islamic Finance must be aggressively promoted and developed. Malaysia, with the most comprehensive system of Islamic Finance, can be further developed to tap the vast market potential of the world. The country needs to overcome all constraints (six constraints from previous discussion) in development of Islamic Finance by developing and providing practical work plan. In international level, there is urgent need to increase collaboration and cooperation between countries that practicing Islamic Finance in order to provide standardize system while maintaining all the Shariah-based principles of Islamic Finance. Islamic Finance should be creative and innovative to come out genuinely Islamic based Finance products rather copying the conventional products. Islamic Finance is not limited to Muslim only but also slowly being accepted by non-Muslim.

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