

# The key driver of Islamic finance – demand and supply

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**Islamic finance plays an important role in nation building and acts as the foundation of a sound economy. It represents an essential component of the financial market side by side with the conventional “riba” based finance industry. It is still early days for Islamic finance as the industry has only been noticed as a serious financial platform in recent years.**

In this article we will not be talking about how this industry has grown quickly from a very low base 10 years ago to US\$1.5 trillion today, how its sukuk market has taken the market by storm, how its insurance and banking sector has taken a bigger share of the market in various jurisdictions across the globe and how many governments are now interested to facilitate the industry from a regulatory and legislative perspective in their countries. Nor would we bother in this article to correct the many misperceptions that some have, that it is a very exotic proposition available only to a select customer segment, how to some it is an enigma or a mysterious phenomenon deep in the realm of religion and how to some it is a fad that will fade away over time.

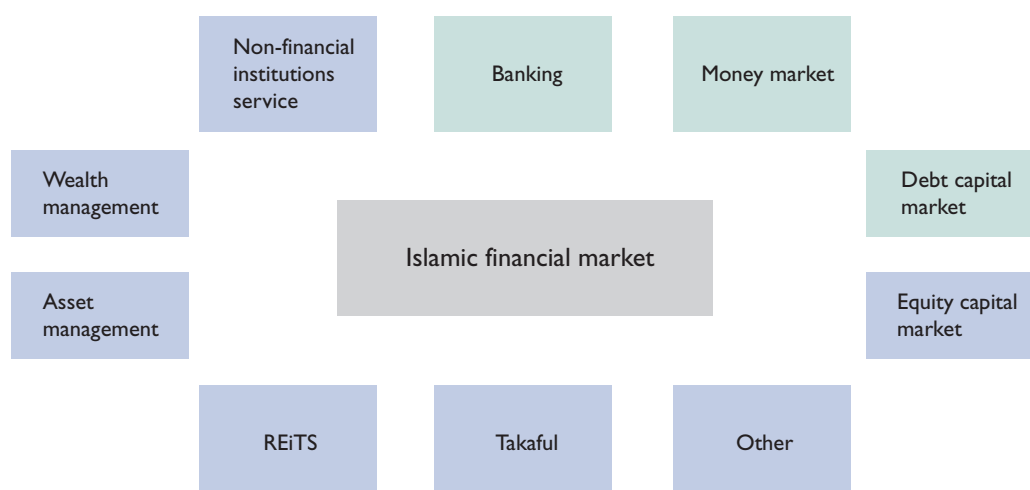
In this article we aim to share with the reader some of our insights on the issues surrounding the developmental aspects of the industry from a demand and supply perspective. In order to have an effective discussion on this subject matter we need to shed some light on the basic and true nature of Islamic finance.

Islamic finance is essentially a set of financial activities that conform to principles found in the Quran (command of God encompassing all aspect of human life) and the Hadith (the words/actions and acknowledgement of Prophet Muhammad) known as Shariah delivered more than 1,420 years ago, which to the surprise of many are the same as contemporary business and economic principles found and practised in today’s modern day business environment. Some even found that the business principles and economic theories expounded and introduced by modern economist and business gurus were already expounded and explained in quite detail much earlier in the Quran and Hadith.

Islamic finance activities include the banking sector, the insurance sector known as Takaful, the debt and equity capital market, the fund and investment management sector and many others as illustrated in Figure 1.

In Figure 1 we highlighted in green to emphasise the existence of the Islamic “banking”, “money” and “debt” markets alongside the other sectors. Islamic finance provides practically all the sectors found in

**Figure 1: Component of Islamic finance industry**



the conventional “riba” based financial market but all its activities are Shariah compliant. Islamic finance are pure commercial transactions that are governed under the ambit of Muamalat (human societal relationship) under Shariah, which provides that everything is allowed unless there is a clear express stipulation in the Quran and Hadith that it is disallowed. What is disallowed in this world can be listed in only five items, as follows:

1. Do not do “riba”. Simplistically it does not undertake activities that charge money on money i.e. the conventional bank’s practice of interest-banking or lending. While Shariah law prohibits interest (or riba) this does not mean that capital is costless in an Islamic system. Islam recognises capital as a factor of production but it does not allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest charge. Any predetermined payment over and above the amount of principal is prohibited.
2. Avoid “gharar”. It does not enter into contracts that contain uncertain terms. Must observe that every contract possesses all its essential elements and that every essential element meets the necessary conditions.
3. Avoid “maisir” or gambling. This cannot be confused with speculation as speculation is fine under Shariah.
4. Do not undertake or facilitate non-halal or illegitimate activities. There are very few things in the world that are illegitimate or non-halal. The impure activities prohibited are very limited such as: financial services based on “riba” (charging money-on-money activities); entertainment activities that are non-permissible according to

Shariah; manufacture or sale of non-halal products (e.g. pork, tobacco-based, alcoholic beverages). It is an exhaustive list.

5. Do not transact on assets that have no value such as idol.

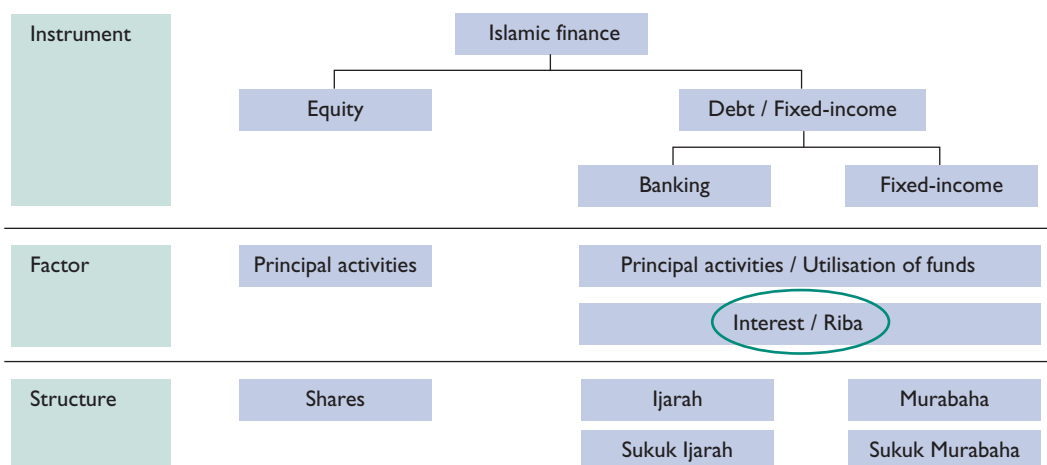
As such, Islamic finance as an industry is very deep and broad. It can serve the financial needs of everyone from all walks of life throughout the world, including large regional corporations, domestic listed companies, entrepreneurial start-ups, high-net worth individuals, pensioners and children. For the purpose of easy reference, the Islamic products and services are defined in the context of “equity” and “debt” as normally used in finance courses as illustrated in Figure 2.

Although making the “equity” side of the universe is a lot simpler by ensuring that the principal activities are Islamic while the legal contracts remain as shares, the “debt” portion is more challenging, Shariah-wise, as the interest lending or “riba” legal relationships are prohibited by Shariah. As a result, Islamic “debt” will become credit obligations under trades or indebtedness arising from trade activities such as Murabaha or Ijarah. The viability and attractiveness of each product and service would be subject to supply and demand in the market driven by Islamic deposits or funds.

### The key driver of Islamic finance

The key driver for the development of any financial market is funds chasing after assets or the marriage between the supplier or provider of funds and the demander or user of funds. Many financial centres in the world have been developed by attracting insurance companies, fund managers, private bankers and deposit-taking financial institutions to set up

**Figure 2: Typical value proposition in Islamic finance**



Source: CIMB Islamic Fixed Income Research

operations first. Once these players and their funds exist in the market all other activities would follow suit such as financing activities, bond issuance, initial public offers (IPOs), private equity investments, etc.

In the Islamic finance industry, it is natural to expect that the key driver in its development would be Islamic deposits or funds chasing after Islamic assets. Typically Islamic deposits and funds demand various forms of Islamic products such as private equity, Islamic IPOs, financing assets, property funds, project finance and many others. The demand for Islamic assets has been quite healthy generally which has led to monumental growth in the industry. However, we can not say the same for the demand of Islamic fixed income instruments over the years. The demand for this type of Islamic investment instruments seems to have suffered with many grouching why there is not enough Islamic bank's participation in the primary sukuk issuances, why is there negligible sukuk secondary market, why is there not enough bilateral or syndicated financing by Islamic banks and many such other grouches.

It is imperative that through the Islamic financial system, Islamic deposits and funds be allowed to accordingly demand for real Islamic fixed income instruments. We would like to emphasise the word "real" in this statement and the reason for this is that most of the Islamic deposits and funds are actually demanding for pseudo Islamic fixed income instruments. Allowing Islamic deposits or funds that have been duly marketed, represented and labelled as "Islamic" to be invested in commodity Murabaha transactions with conventional banks, has changed the true nature of demand in the market, thus creating huge market distortions. Instead of demanding real Islamic fixed income products, Islamic deposits and funds actually demand conventional "riba" based fixed income assets. This is a very strong statement to be made in the Islamic finance industry as it flies against the nature of Shariah itself but it is unfortunately true.

In one of our recent discussions and presentations to a group of more than 30 Central Bankers from the Organisation of Islamic Conference (OIC) member countries, we were asked by one of them who works in one of the Central Banks in the Gulf Cooperation Council (GCC) country, "Why are Islamic banks funding conventional banks?" To most other central bankers present at the closed door discussion it was a very awkward question as most thought it is impossible for an Islamic bank to fund conventional banks and their activities. Some of them even laughed out loud at the very idea. Everyone knows that it is prohibited by Shariah. However, the central banker was very

adamant and serious to know as his central bank through an audit process had discovered that the funding they had provided to all of their licensed Islamic banks had ultimately gone to conventional banks who in turn utilised the fund for conventional "riba" based activities. What made it worse as he explained is that it happened not just in the domestic context but the funding was also channelled directly out of their domestic Islamic finance market into foreign conventional "riba" based markets.

The central banker then asked how we deal with this situation. He was surprised when he was told that it does not happen in Malaysia. The Shariah scholars in Malaysia have never permitted the practice of Islamic banks funding conventional banks as it is against one of the five items that is clearly and expressly prohibited in the Quran, which is the avoidance of "riba". We further explained that this treatment is true for both onshore and offshore Islamic financial businesses in Malaysia irrespective of what Shariah structure is used including the contract of commodity murabaha. This policy restriction has been in existence in Malaysia since the industry started and enforced by the Bank Negara Malaysia (BNM), the entity empowered as the country's central bank and enshrined in the Islamic Banking Act 1983. If a bank utilises Islamic deposit or funds for conventional "riba" based activities, the bank would lose its licence.

The majority of Malaysian Islamic bankers would be appalled to discover that GCC Islamic banks are not restricted to invest in the conventional market and its "riba" based products particularly through commodity murabaha contracts. On the flipside, it is consternation for GCC bankers to be informed for the first time that Islamic banks in Malaysia, as well as Indonesia and Brunei, are not allowed to invest in the conventional market. It is indeed bewildering to know that Islamic bankers from both the GCC and Southeast Asia (SEA) are not aware of each other's true practice. A significant number of GCC Islamic bankers have taken the stance of misplaced assumption towards SEA Islamic bankers and Shariah scholars. The former tends to assume and perceive the latter as conforming or mirroring the GCC practice of commodity Murabaha with conventional banks for the last 40 years or so. Most thought that this is the reason why Malaysia's Islamic finance industry has been very successful. This is in fact very far from the truth.

Moreover, the bulk of SEA Islamic bankers had taken for granted that Islamic deposits/funds should not and cannot be used to fund conventional banks. They presumed that everyone adheres to this

principle and that it is universal practice. On the GCC side, we have encountered some GCC Islamic bankers commenting with incredulity that “if Malaysia does not allow Islamic banks to commodity murabaha with conventional banks then how do Islamic banks survive there?” or “how can you grow without conventional banks?” Some even suggested that such Shariah restrictions are extremely conservative and expounded that “it is impractical!”, “it is impossible as we need conventional banks because they have scale and skill sets!”, “cannot be...I don’t believe you!!” and other such statements of similar meaning. It is funny that these misperceptions exist in this day and age of high-tech information and communication technology.

We have worked in both SEA and GCC markets for the last eleven years and we have always found it maddening how the growth of Islamic “banking”, “money” and “debt” markets have been held back in both regions by these misperceptions. As a matter of fact all Islamic fund management houses are complaining about how small the supply of Islamic fixed income instrument is particularly in the US dollar market. We feel compelled to share this dimension of market happenstance in the interest of the industry’s future development and direction. We hope that with greater knowledge amongst all market players, we can then work towards building a bigger and better Islamic finance industry and allow it to experience the growth it rightly deserve.

Commodity Murabaha with conventional banks has distorted the demand and supply parameters of the Islamic fixed income market – “banking”, “money” and “debt” markets. We would like to enjoin the reader to look at issues from a broader industry perspective rather than product centric. Too often people comment on the Islamic finance industry on a product basis thus getting stuck and losing the bigger picture. Islamic finance is a distinct financial market that is strongly influenced by demand and supply for its growth. There are about US\$1.5 trillion worth of Islamic deposits or funds globally but there are only about US\$100bn debt papers or sukuk assets and US\$700bn banking assets in Islamic financial institutions with the majority of the banking assets in the form of commodity murabaha with conventional banks. This accounts for only half of the total Islamic deposits and funds. Where is the other half?

The industry needs to ensure that Islamic deposits and funds that look for fixed income investment should demand for and be matched with Islamic fixed income investment products. However, the reality is that the bulk of Islamic deposits and funds actually go into commodity murabaha with conventional bank, thus the demand for Islamic fixed income investment product becomes negligible. This ultimately weakens the Islamic capital market and dampens its growth potential. Worse, the incident actually strengthens the conventional “riba” based capital market.

**Figure 3: Differences between SEA and GCC regions**

Item	SEA	GCC
1 Bay al Inah	Yes	No
2 Tawarruq	Yes	Some yes, some no
3 Commodity murabaha with conventional banks	No	Yes. However, some banks are reviewing the practice to include a clause in the contract requiring proceeds from commodity murabaha to only be invested in Islamic activities
4 Commodity murabaha with other Islamic banks or corporates that do Shariah compliant businesses	Yes	Yes
5 Bai’ Al-Dayn	Yes	Some yes, some no
6 Shariah management regulatory framework	Yes	No. Shariah management has been at the sole discretion of individual banks

Note: The last item is not really a Shariah difference but more of how Shariah is managed. It is the key success factor in the Malaysian Islamic financial market. The Shariah management regulatory framework that is anchored by Bank Negara Malaysia and the Securities Commission have become very important as an individual bank cannot criticise each other’s Shariah application, thus creating certainty as required under Shariah. It provides a harmonious environment for the industry that positively intensifies growth. Brunei and Indonesia has their Shariah management regulatory framework in place as well.

## Demand and supply: Fostering Shariah equilibrium

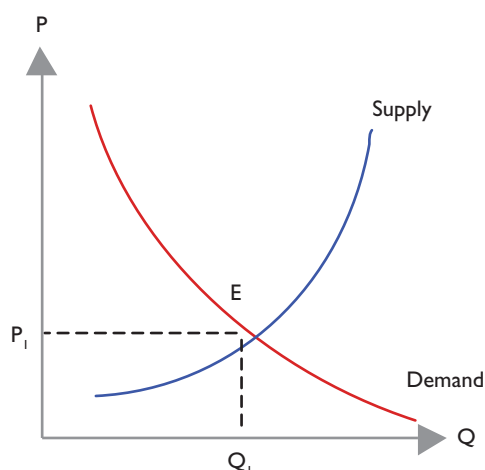
We always hear about harmonisation, standardisation and resolving Shariah differences in Islamic finance product development. As mentioned earlier Shariah is sourced from the Quran and Hadith and since everyone globally accesses the same source, the Islamic finance industry already has a global Shariah standard. When this global Shariah standard is applied in specific jurisdictions the standard would be applied according to local circumstances and parameters as is allowed under Shariah. This leads to differentiation of Shariah application and interpretation between one jurisdiction over another.

Although there are differences between many countries we would like to highlight generically the differences between SEA and GCC regions for the purpose of this discussion. We use these two regions because the countries there have the most active Islamic finance industry.

It is important to understand that the differences are very limited and can be counted on your fingers (summarised in Figure 3).

Shariah scholars always take a view of respecting their peers' opinions being an integral part of Shariah methodology and ethics. As such, we would not find any adverse comments by Shariah scholars against each other for the differences of application. However, at the marketing level of individual banks, particularly for a market that does not have Shariah management regulatory framework, unconstructive disparities between Shariah opinions may occur as bankers start debating in the open in order to try winning customers by saying their structure is more Shariah compliant than the other bank's structure.

**Figure 4: Traditional demand and supply curve**



It can be said that the Islamic finance industry in SEA particularly in Malaysia has attained a “perfect Shariah market” under which all recognised Shariah schools of thoughts or laws is deemed doable as well as enforceable and most importantly where no Islamic funds are allowed to leak out to conventional “riba” based financial market by way of commodity murabaha with conventional banks. This has permitted demand and supply to work its wonders freely to determine which Shariah structure is marketable and viable in the market without bias. Consumer demand determines which Islamic finance product is supplied and how it is structured under Shariah.

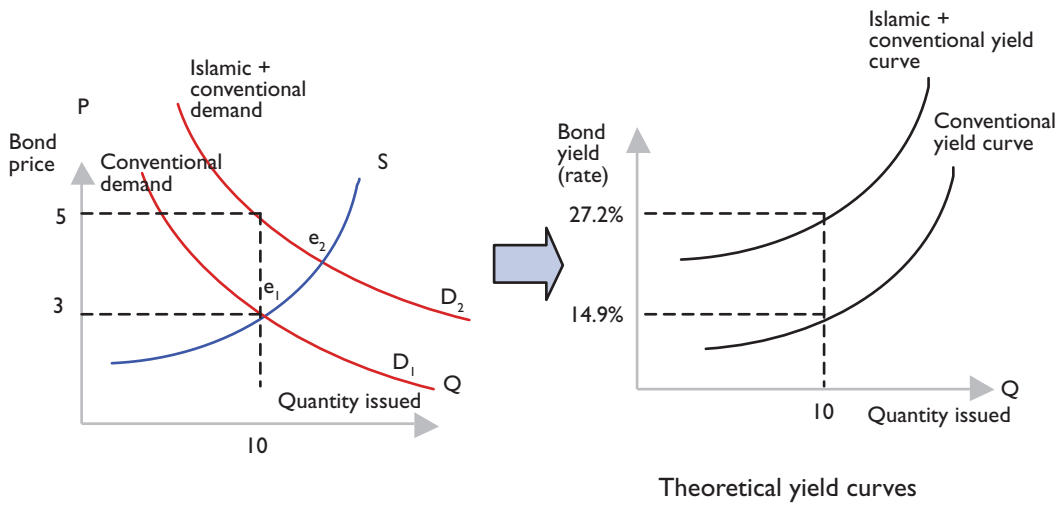
Everyone knows that there is no such thing as strict and lenient rules or conservative and liberal rules under Shariah. There are only one set of Shariah rules based on the Quran and Hadith. Nonetheless, there exist majority and minority views of how it applies. When we look at Islamic finance from this perspective, logically the Shariah structure that is supported by the majority view should command a better market demand and garner better pricing. It also means that for as long as there is a minority view, which is allowed under Shariah, there will always be demand for such minority view's products amongst consumers with the pricing of such product influenced by a much smaller demand.

Theoretically, as illustrated in Figure 4 the higher the price, the more quantity is supplied and the lower the price, the more quantity is demanded. This is the most basic workings of supply and demand theory that one would learn in Economics 101. It is simple logic.

In the real market context, the supply will always be made available at the right demand level. Conceptually the supply of goods will be determined at the equilibrium price, where supply meets demand. What goods are supplied and how much is supplied is harmonised based on its demand level. Nevertheless, if there is intervention in the market such as a price control or business restrictions, then it would lead to the existence of a black market. In this instance, the supply and demand curves will still behave accordingly but incorrectly.

On the same principle, the supply of Islamic financial instruments would also be driven by the demand it gets. In a perfect Shariah market with Islamic deposits or funds chasing only Islamic assets would cause the Islamic fixed income market to have a wider investor base of both Islamic investors and conventional investors, who are neutral in investing into Islamic investment. This would mean the supply and demand curves for sukuk would shift from its conventional curve as illustrated in Figure 5.

**Figure 5: Conventional bonds theoretical demand curve against Islamic bonds theoretical demand curve**



If an issuer plans to issue a US\$10bn five-year zero coupon conventional bond based on the above curve, the present price of the bond or the present proceeds of the bond would be US\$3bn. However, if the issuer decides to issue a US\$10bn Sukuk al Ijarah without periodic payment (i.e. zero coupon sukuk) based on the above curve, the present price of the sukuk or the present proceeds of the sukuk would be US\$5bn. As such, the issuer could raise bigger amount of funds by issuing sukuk despite the same amount payable by the issuer five years later.

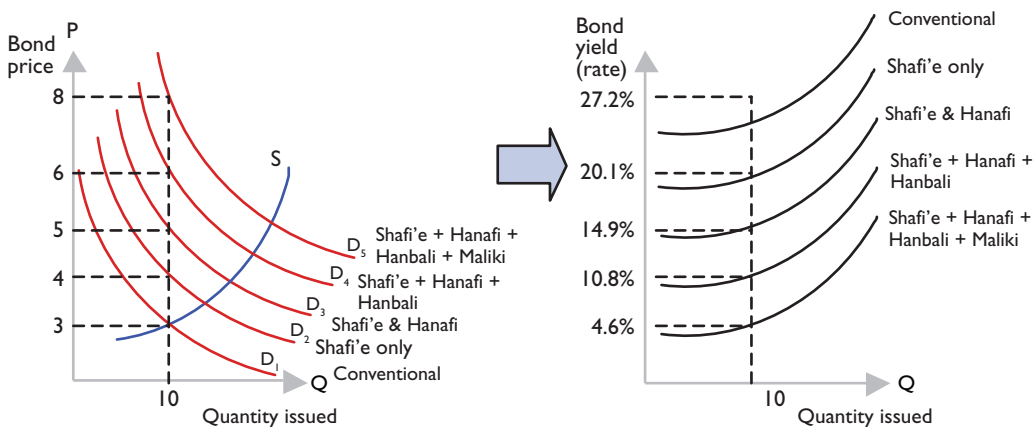
If we translate the above price dimension into yield or rate, the conventional bond yield is 27.2% while the sukuk yield is 14.9%. Therefore, it is cheaper to do sukuk under the above circumstances. These circumstances exist in Malaysia and are the very reason why the Islamic capital market in that

country is the biggest in the world.

Similarly if we apply the above understanding in the context of majority and minority views under Shariah we should derive a consistent conclusion as above as illustrated in Figure 6.

If an issuer plans to issue a US\$10bn five-year zero coupon conventional bond based on the curve in Figure 6, the present price of the bond or the present proceeds of the bond would be US\$3bn. However, if the issuer decides to issue a US\$10bn Sukuk al Murabaha without periodic payment (i.e. zero coupon sukuk) based on the curve in Figure 6, the present price of the sukuk or the present proceeds of the sukuk would be US\$4bn. However, if the issuer decides to issue a US\$10bn Sukuk al Ijarah without periodic payment (i.e. zero coupon sukuk) based on the above curve, the present price

**Figure 6: Theoretical demand curves of conventional bonds in comparison to Islamic bonds that are approved by one mazhab or more than one mazhab**



Note: The above order of Shariah school of thoughts are purely for illustration purposes only and does not really reflect the real demand for Islamic finance products done under any of the Shariah school of laws.

of the sukuk or the present proceeds of the sukuk would be US\$8bn. As such, the issuer could raise bigger amount of funds by issuing sukuk despite the same amount payable by the issuer five years later.

Based on the above figures, the potential issuers would be able to identify the most appropriate Shariah instruments to issue and supply driven by what is most demanded to get the best price and yield. In a “perfect Shariah market” demand and supply forces will determine what Shariah structure is marketable without any bias.

### The way forward: attainment of a perfect Shariah market

Islamic finance industry in most jurisdictions has yet to attain a “perfect Shariah market” status. As a result of this, the demand and supply curve that should exist in the industry, particularly in the Islamic fixed income sector, is missing thus causing systemic weaknesses such as inefficient primary market, lack of secondary market activities, poor pricing methodology and doldrums in Shariah harmony.

Market participants have been unhealthily pre-occupied with an incessant and time-wasting attempt to force the whole Islamic finance industry to accept a structure allowed only in a particular Shariah school of law or only those structures that are fully accepted under all Shariah schools of thought. We get so bogged down with product centric discussion that we lose the big agenda. Some of us are so caught up with our own self importance and belief that we forgot that Islamic finance customers only want the best financial solutions and services with the most optimum benefits. We have totally missed the mark when we ignored the customer’s complain as to why they have not achieved a competitive or better pricing from conventional “riba” based products, or even drastically, why their pricing is worse off than conventional “riba” based bonds, which is currently prevailing in the global Islamic capital market.

By concentrating on demand and supply to bring about the desired Shariah equilibrium we should be able to bring greater development to the Islamic finance industry. To achieve Shariah equilibrium and derive the greatest benefit from the Islamic finance industry for the good of the Ummah and all customers, Muslim and non-Muslim alike, we must strive to attain a “perfect Shariah market” where all Shariah school of thoughts are doable and accepted in the market and no Islamic funds are allowed to leak out to conventional “riba” based financial market by way of commodity murabaha with conventional banks.

### Note about the authors:

The writers are colleagues at CIMB Islamic, the world’s largest sukuk issuer and South East Asia’s largest Islamic bank by branch network. Badlisyah Abdul Ghani, the Executive Director and Chief Executive Officer of CIMB Islamic was voted “Islamic Banker of the Year” in 2007 and 2008 while Shamsun A. Hussain, Director of CIMB Islamic and its Head of Products Management is one of the leading architects of the modern sukuk market.

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