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Islamic Finance: Growth and Prospects in Singapore

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ABSTRACT

Islamic finance has been growing rapidly since its launch in the 1970s. The major market for this industry is typically the Middle East and it is gaining popularity in the UK, USA and Southeast Asia. Malaysia is the leading Islamic finance industry in Southeast Asia while its neighbor Singapore is relatively a new market player. Singapore revised its regulatory framework and tax structure and gradually introduced various Shariah-compliant financial products in the last couple of years. This paper argues that despite having small domestic market and competition from Malaysia, Singapore can still position itself in a niche market in the region. Through its strategy of integrated financial and economic development, Singapore can create new opportunities for Islamic finance and related financial products in the region.

Keywords: Islamic finance, growth, Singapore

1. Introduction

Islamic finance, which dates back to 1975 with the establishment of Bank Faisal in Egypt, is developing at a remarkable pace. The growth of Islamic finance industry has been very strong over the past few years. Currently, there are over 300 Islamic financial institutions in more than 75 countries though they are mainly concentrated in the Middle East and Southeast Asia, but are also gaining popularity in Europe and the United States. It is estimated that the industry will grow at a rate of 15 to 20 percent annually, from current assets of US$300 billion (Al-Salem, 2008).

The importance and potential of Islamic banking prompted the International Monetary Fund (IMF) to facilitate the establishment of the Islamic Financial Services Board (IFSB) (the Islamic equivalent of IMF) in 2002, the idea being addressing the need for a suitable regulatory framework, new financial instruments and institutional arrangements for Islamic finance operations. Recently, the Singapore government has

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also recognized the need for establishing Islamic banking in order to be complete as an international financial centre.

This paper contains four sections. After introductory remarks in section 1, the principles of Islamic finance and types of products and services offered in the industry have been discussed in section 2. Section 3 enumerates the status and prospects of Islamic finance in Singapore. Finally, section 4 concludes the paper.

2. Islamic Finance: Principles and Products

2.1 Principles of Islamic Finance and Advantages

Islamic finance operates under religious beliefs and cultural characteristics of Muslim societies. According to Shariah (Islamic law), the Islamic mode of finance should emphasize profit and loss sharing and prohibit fixed-returns. In other words, any predetermined payment over and above the actual amount of the principal (i.e. interest) is prohibited. The Shariah also prohibits activities related to uncertainty, risk and speculation. A modern interpretation is that interest may be paid only for taking investment risk but not for time value risk-free investment. As such, asset-based lending is allowed under Shariah while paper- or financial-based lending is not. The law also prohibits investment in "un-Islamic" activities, such as lending for constructing a casino or trading of alcohol.

In sum, the guiding principles regarding Islamic finance include the following: (1) any predetermined payment over and above the actual amount of principal is prohibited. (2) The lender must share in the profits or losses arising out of the enterprise for which money was lent. (3) Making money from money is not acceptable by Islamic law. Money is only a medium of exchange, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. (4) *Gharar* (uncertainty, risk or speculation) is also prohibited. (5) Investments should only support practices or products that are not forbidden (or discouraged) by Islam.

There are several advantages of Islamic system which is based on the principle of profit-sharing. First of all, Profit-sharing channels investible funds to the projects with the highest expected profitability as opposed to the interest-based system where funds go to the most creditworthy borrowers whose projects may not necessarily be the most profitable ones. In fact, the 'quest for profit' is the main driving force behind the development of modern businesses and it was clearly reflected in the powerful writings of Adam Smith in *The Wealth of Nations (1776).* Adam Smith argued that even though self-interest is the prime mover of economic activity, the end result is the allocation of goods and services that serves society's collective interests in the best possible manner. If produces offer 'too much' of one product and 'too little' of another, profit opportunities immediately would alert entrepreneurs to the fact and provide incentives for them to change the line of production. In other words, the system based on profitability will ensure 'economic efficiency' leading to optimality in production, consumption, and exchange. Secondly, profit-sharing is more conducive to economic growth, as this would increase the supply of risk capital for investment and greater incentives for undertaking such risks due to expected profitability. Finally, the Islamic

system promotes an 'integrated' economic development as it encourages the use of money for facilitating trade in goods and investment in productive capacity rather than creating money for the sake of money. Such a system is likely to be more stable and is less vulnerable to financial crisis that can be caused by speculative activities.

2.2 Islamic Financial Products

The following is a brief description of Islamic financial products:[3]

i) Profit sharing financial products

- *Musharakah*- all partners participation in terms of equity, investment, management and profit (based on pre-agreed ratio) and loss (based on equity contributions).
- *Mudarabah*- one contributes capital, others provide entrepreneurship. Profit is shared on a pre-agreed ratio.
- *Qard Hasan*- charitable loans free of interest and profit-sharing margins; repayment by installments. Modest service charge is permissible.
- *Wakalah*- a bank is authorized to conduct business on customers' behalf.
- *Hawalah*- an agreement by the bank to undertake some of the liabilities of the customer in return for a service fee. The customer pays back the bank when the liabilities mature.

ii) Advance purchase financial products

- *Murabahah*- a contract between the bank and its client for the sale of goods at a price that includes a profit margin agreed by both parties.
- *Istithna'*- a contract for acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of job completion.
- *Mu'ajjal*- a sales contract that allows purchase with deferred delivery.
- *Ijarah*- a leasing contract under which a bank buys and leases out for a rental fee equipment required by its clients.

iii) Deposit products

- *Wadi'ah*- deposits, including current accounts *(giro wadi'ah).*
- *Mudarabah*- deposit products based on revenue-sharing between depositor and bank, including savings products that can be withdrawn any time and time deposit products.
- *Qard al-Hasanah*- unremunerated deposit products, usually for charitable purposes.

iv) Insurance products

- *Takaful*- Islamic insurance with joint risk-sharing.

[3] Adopted from Imady and Seibel (2006).

3. Islamic Finance in Singapore

3.1 Status of Islamic Finance in Singapore

Islamic finance received attention of the Singapore government in recent years. The following is a brief description of Singapore's recent development in Islamic finance:

i) Regulatory treatment

In June 2006, the Monetary Authority of Singapore (MAS) gave its approval to banks to engage in non-financial activities, such as commodity trading, to facilitate *Murabahah* transactions for clients' investments. Prior to this, banks had been forbidden to engage in non-financial activities such as trading, which is not normally associated with banking and finance. This move shows that MAS recognizes the fundamental characteristics of *Murabaha* - a key form of Islamic financing in the Middle East (Asmani, 2006).

ii) Tax treatment

The Singapore government recognizes that given the nature and structure of Islamic financial products, they tend to attract more tax then their counterparts. The overall policy approach has been to align tax treatment of Islamic contracts with the treatment of conventional financing contracts they are economically equivalent to. In line with this policy, the Finance Ministry announced several changes in the 2005 and 2006 budgets.

In 2005, Singapore waived the imposition of double stamp duties in Islamic transactions involving real estate and accorded the same concessionary tax treatment on income from Islamic bonds that are applicable to conventional bonds.

In 2006, income tax and GST (goods and services tax) applications on some Islamic products were further clarified. The government identified three Shariah-compliant products and ensured that they do not suffer more taxes due to the nature of their structuring. In addition, to level the tax playing field for *Sukuk* (Islamic equivalent of a bond), remission will be granted on stamp duty on immovable property, incurred under a *Sukuk* structure, that is in excess of that chargeable in the case of an equivalent conventional bond issue.[4]

iii) Growth and development of financial products

In July 2001, Maybank, Malaysia's largest bank started Islamic banking in Singapore with the introduction of Singapore Unit Trusts Ethical Growth Fund that complies with the principles of the Shariah.[5] In November 2005, the bank introduced Shariah-complaint online savings account and Shariah-compliant savings cum checking account (Siow, 2005).

[4] Ng, Nam Sim, Executive Director, MAS, Opening Remarks at the IQPC Islamic Finance, Singapore 2006.

[5] Source: Singapore Unit Trusts website www.sut.com.sg/main/fund_sutegf.asp (accessed on 28 May 2008).

In February 2006, the first Shariah-compliant term deposit in Singapore was launched by OCBC Bank. The bank targets wholesale to Muslim companies, financial institutions, mosques and non-profit organizations (Yee, 2006).

Islamic insurance or Takaful has also been successful in Singapore with over S$500 million Takaful funds under management. For instance, HSBC (Singapore) launched Takaful Global Fund in September 1995 while Takaful Sinaran Fund was launched in May 2005. Returns from these funds are not subjected to income tax. There are about S$2 billion Shariah-compliant real estate funds managed out of Singapore.[6]

iv) Islamic equity index

In recognition of increasing interest of Middle East investors in diversifying and tapping the growth opportunities in Asia, the first Shariah-compliant pan-Asian equity index was launched in Singapore in February 2006. This index serves as a benchmark for Shariah-compliant funds investing in Asian equities, and paves the way for the growth of Shariah-compliant funds seeking Asian exposures.

v) IFSB membership

MAS is a member of IFSB. MAS joined the IFSB in December 2003 as an observer member and became a full member in April 2005. MAS currently participates in the Islamic Money Market Taskforce, the Supervisory Review Process Working Group and the Special Issues in Capital Adequacy Working Group.[7]

vi) Education

Another significant move in the development of Islamic finance in Singapore has been the announcement by the Singapore Islamic Scholars and Religious Teachers Association (PERGAS) that some Islamic religious scholars would be trained in banking and finance to assist Singapore's aim of becoming a hub for Islamic finance. PERGAS also mentioned in September 2006 that in order to develop *Asatizah* (religious teachers), it would introduce a Shariah Advisers Training Programme organized jointly with the Kuala Lumpur-based International Institute of Islamic Finance (Venardos, 2006, pp 208-209).

vii) Exchange traded fund

Singapore moved a step forward in the development of its Islamic finance industry with the first listing of a Shariah-compliant exchange traded fund (ETF) on 27 May 2008. Daiwa Asset Management Co. Ltd.'s first ETF offers an investment channel into Japanese companies that fully complies with Shariah investment principles.[8]

[6] MAS, Annual Report 2005/2006.
[7] MAS, Annual Report 2006/2007.
[8] "Singapore's de facto Central Bank sees 'promising growth' in Islamic Finance". Source: Forbes website www.forbes.com/afxnewslimited/feeds/afx/2008/05/27/afx5048208.html (accessed on 28 May 2008).

3.2 Prospects of Islamic Finance in Singapore

Singapore is a relatively new market player in Islamic finance. The domestic market is quite small and there is not sufficient public awareness about Islamic finance. Regionally, Malaysia is leading Islamic finance industry. Yet Singapore has good prospect for positioning itself in a niche market. For instance, as of 2006 there are nearly 227 million Muslims in Southeast Asia, which is about 40 percent of total population in the region.[9] Being a regional financial hub, Singapore could target a big pie of this Muslim community since Islamic finance in Southeast Asia is not as far advanced as in the Middle East despite strong growth potential. For example, Islamic finance in Indonesia is not nearly as well developed as it is in Malaysia with Islamic banks holding only a 0.12 per cent share of the assets in the banking system. The lack of comprehensive and appropriate framework and instruments for regulation and supervision has impeded the development of Islamic finance to its full potential. Indonesia is the world's most populous Muslim nation and Singapore could eye on this potentially huge market.

The Middle East and South Asia could also offer a unique opportunity for Singapore's development in Islamic finance industry. Singapore could attract rich Arabs in the Middle East and Muslims in Pakistan, Bangladesh and India. Besides, non-Muslims could also be educated on Islamic finance products and targeted in the long-run. Singapore's reputation as a stable and open financial hub is expected to play an important role in luring investors in this industry.

In order to strengthen its presence in Islamic finance industry, Singapore has refined its regulatory framework and tax structures over the years. The initiatives include granting of a 5 percent concessionary tax rate for income derived from Shariah-compliant fund management, lending and insurance and re-insurance. The MAS will also be developing a facility for the issuance of Singapore dollar denominated sovereign-rated *Sukuks* in response to the needs of financial institutions conducting Shariah-compliant activities in Singapore.[10]

4. Conclusion

Islamic finance is a relatively new concept in Singapore. Small domestic market and lack of public awareness do not offer strong growth potential for Islamic finance industry within the Republic. Over the years, Singapore revised its regulatory framework and tax structure and introduced various Shariah-compliant financial products. The city-state Republic also faces strong competition from Malaysia in providing Islamic products regionally. However, the country can still find a niche market in Southeast Asia (particularly Indonesia), the Middle East and South Asia given the reputation of being regional financial hub and its overall attractiveness as a business location. Singapore's neutral stance to all religious beliefs and practices and its harmonious development of various race relations within the community at large has further added to its strength. Another important point is worth mentioning. Singapore is

[9] Source: Muslim Population Worldwide website www.islamicpopulation.com (accessed on 31 May 2008).

[10] "Singapore's de facto Central Bank sees 'promising growth' in Islamic Finance". Source: Forbes website www.forbes.com/afxnewslimited/feeds/afx/2008/05/27/afx5048208.html (accessed on 28 May 2008).

pursuing a strategy of integrated development of financial and real sectors as it believes that the two can reinforce each other. Singapore has just completed a free trade agreement (FTA) negotiation with Gulf Cooperation Council (GCC) and this is likely to facilitate trade and investment between two sides. With deeper trade and investment links, there will be greater opportunity for financial integration that could open new promises for Islamic finance and the related products.

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