

Chapter 1: Introduction

Islamic finance is based on *Shariah*, an Arabic term that is often translated into Islamic law. *Shariah* provides guidelines for Muslim life, which include ritual, economics, banking and business (Ilias, 2009). The major prohibitions¹ of the *Shariah* principles distinguish Islamic finance from conventional finance. One of the most important principles is the prohibition of *riba* (translated as interest or usury). While the interest is the main source of revenues in the conventional finance, it is prohibited in Islamic finance as it is regarded as unearned profit (Taylor, 2003).

The growth rate of Islamic finance is estimated at 15% ~ 20% per annum and Islamic assets account for approximately 1% of the global banking assets at US\$450 billion and is expected to reach US\$1 trillion by 2010. As for the *sukuk* market, the total global *sukuk* outstanding is estimated at over US\$ 70 billion (KFH, 2009) whereas the Malaysian *sukuk* accounts for two third of the global *sukuk* outstanding.

Kuwait Finance House (KFH) reported that at least US\$3 ~ 5 trillion will be invested in Asia's infrastructure development over the next decade. Focusing on the East Asia region alone, it is estimated that an amount of US\$165 billion per annum is needed to develop the economy by building infrastructure facilities such as electricity, telecommunication, major paved inter-*urban* roads,

¹ Detail explanation is provided in Chapter 2, Section 2.1

rail network, etc. Currently, an estimated amount of US\$2 trillion worth of infrastructure projects have already been launched and planned from 2008 to 2013 in the Gulf Cooperation Council (GCC) countries. The significant amount of funding requires in developing these projects for the region is expected to give a great leap in positioning Islamic finance in the global market.

1.1 Background of the Study

The economic downturn brought conventional financing to the disputable table which drove governments, investors and issuers to consider alternative methods, leaving the door open for alternative options (International Tax Review (ITR), 2009). The Islamic finance may not be a perfect alternative as the Dubai's economic concern might come to one's mind in conclusion that the world of Islamic finance is not spared from the financial crisis (Taylor, 2010). However, at the peak of the 2008 financial crisis, Islamic finance was relatively less affected by the global financial turmoil than the financial situations in western countries (Taylor, 2010). There was much media coverage on the Islamic finance's bright new footing of development, which emerged as a more equitable and safer alternative to the traditional conventional finance during the global financial crisis.

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 the simple use of money for loans. Such a system is likely to be more resilient and is less vulnerable to the financial

crisis which is caused by excessive speculative activities (Khan and Omar, 2008).

Given the experience of the recent financial crisis and foreign exchange crisis in 1997, Korea also considered Islamic finance as a good innovation in the financial market or a method for re-ignition of its economy. At present, there is no specific legal system for the Islamic finance in Korea, a non-Muslim country, not to mention Islamic financial institutions. According to the 2007 census, the population of Muslims in Korea stands at about 130,000, i.e. 0.2% of its population. The small number of Muslims signifies that it may not be viable to establish Islamic finance in Korea. Islamic finance, however, has gained its footing in the UK with 3% of Muslim population and in the Australia with 1.7% of Muslim population (ITR, 2009; KFHR-GIFF, 2010).

The first effort was made by the Ministry of Strategy and Finance (MOSF) in Korea. In 2009, they designed a bill as an initial step to facilitate foreign-currency-denominated *sukuk* issued overseas. The bill for tax neutrality was put to the National Assembly, but it has been prolonged due to some objections from the legislators. Currently the MOSF continues to make efforts in facilitating tax neutrality for *sukuk*.

Even if Korea is a relatively newcomer to Islamic finance in East Asia, Korea is trying to promote Seoul as a future Islamic finance hub following the ambitions of neighbouring countries such as Hong Kong and Singapore who

attempted to establish themselves as the international Islamic finance hubs (KFHR-GIFF, 2010), thus, raising interest on the part of the researcher to examine the possibility of introducing Islamic finance in Korea and identify the issues and challenges facing the country to establish Islamic finance.

1.2 Objectives of the Study and Research Questions

Islamic finance is rapidly growing based on the rulings of *Shariah* since the 1970s (Khan and Omar, 2008). Non-Muslim countries such as UK, France, Singapore, Australia, etc. have taken important steps to promote Islamic finance (FSA, 2007) and promulgated regulations and laws to facilitate a level play field in their markets with the conventional finance.

The interest in Islamic finance in Korea emerged after the 2008 global financial crisis as the companies was facing difficulties in raising fund through the issuance of conventional bonds. The MOSF and key market players are still passionately pushing for the amendment of the taxation law in order to tap into the Islamic finance market, but such an attempt is confined only to the foreign-currency-denominated *sukuk* issued overseas. Hence, Islamic finance in Korea is still at its infancy stage and more studies are needed to examine the feasibility of its establishment.

This study explores the issues and challenges in introducing Islamic finance in Korea focusing on the *sukuk* market.

The specific objectives of this study are:

1. To explore the legal and regulatory issues and challenges in introducing Islamic finance in order to provide practical considerations to the regulatory bodies and market players;
2. To understand the *Shariah* issues facing the Korean market players relating to the issuance of *sukuk* and propose the potential solutions to these issues; and,
3. To identify the challenges facing the Korean market players in relation to the derivatives so as to mitigate the *sukuk*'s market risk; in particular the currency risk.

This study addresses the following major research questions which are expected to contribute towards a better understanding of the issues and challenges facing the industry in Korea.

1. What are the issues and challenges in introducing Islamic finance in Korea relating to the legal environment including the taxation system?
2. What are the *Shariah* issues facing the Korean market in relation to the issuance of *sukuk*? What are the possible solutions to these issues?
3. What are the problems facing the Korean market players when executing derivatives to mitigate the market risk in the issuance of *sukuk*?

In order to achieve the above objectives and answer the questions, this study adopts the interview method. In-depth interviews were conducted with experts who are involved in Islamic finance in Korea and Malaysia. The interviewees represent the relevant regulatory bodies, key market players and academicians.

1.3 Purpose and Significance of the Study

The review of the extant literature on the introduction of Islamic finance in non-Muslim countries reveals that the main issue and challenge are related to the legal or regulatory framework and taxation system².

Khan and Omar (2009) accredited the growth and prospects of Islamic finance in Singapore to its fast actions in reconciling its related regulation and taxation issues to accommodate the offerings of Islamic financial products.

In America, its regulatory framework was examined to identify the possibility of the establishment and operation of Islamic banking through innovation and regulatory flexibility, thus, enabling the offerings of various Islamic products under the existing regulatory framework (Taylor, 2003)

Islamic finance in UK have advanced considerably by its legislative efforts which reached the authorization of banking for retail and wholesale Islamic

² Detail explanation is provided in Chapter 2, Section 2.5

products, the defining *sukuk* in national law, and the relief of transfer taxes (FSA, 2007; Jessop, 2009).

Given that Islamic finance in Korea is at its infancy stage, the basic principle of Islam and the general understanding of *sukuk* were discussed (Choi, Oh and Park, 2007). Some researchers tapped the taxation matters relating to *sukuk* (Kim, 2008).

This study is unique and different from previous studies in the following aspects:

1. The study concentrates on the feasibility of introducing Islamic finance in Korea and the scope is not only confined to *sukuk*;
2. The researcher obtains views, opinions and suggestions via interviews with regulators, key market players, legal and accounting practitioners and academicians involved with Islamic finance in Korea;
3. The researcher also gathers the professional opinions and the practical suggestions via interviews with regulators, key market players and academicians in Malaysia; and
4. The study analysed the cases from selected countries such as France, Singapore, UK, and USA which have taken important steps in introducing and establishing Islamic finance in non-Muslim countries.

Accordingly, it is expected that the findings of the study would contribute practical ideas to the regulatory body to facilitate the market for Islamic finance in terms of its legal and regulatory framework. This study would benefit both the regulatory body and market players to have a better understanding of the *Shariah* issues involved in *sukuk* and to consider it for a practical implementation.

In addition, the findings would provide the practical insight in building up the *Shariah* Supervisory Board which is an independent body of specialised experts in *Shariah* to supervise the activities of Islamic finance (Lahsasna, 2010).

1.4 Scope of the Study

With regards to the purpose and significance of this study, the researcher concentrates on the following scope of study:

1. Issues and challenges of Korean laws and regulations directly or indirectly relating to Islamic banking business and *sukuk*; and
2. *Shariah* issues that the relevant parties in Korea need to consider when issuing *sukuk*.

1.5 Organization of the Study

The study is organized in the following five chapters:

Chapter 1: Introduction

The first chapter of the study explains the background of the Interest in Islamic finance in Korea. It describes the objectives of the study and research questions, where the needs of Islamic finance in Korea are demonstrated and the objectives of the study are categorized together with the research questions to be answered. This chapter also highlights the purpose and significance of study along with the scope to be covered by the study.

Chapter 2: Literature review

Based on past literatures, this chapter presents detailed discussions on Islamic finance, Islamic banking and *sukuk*. It includes a description of the various types of Islamic deposit and financing. The legal system such as civil and common law is discussed as the role of the legal system is very critical in introducing the new financial system. In addition, the chapter analyses the process of introducing Islamic finance in the selected countries to obtain insight on the potential issues and challenges in establishing Islamic finance in Korea. Finally, *Shariah* issues and risk mitigation relating to *sukuk* issuances are reviewed.

Chapter 3: Research Methodology

The third chapter of the report elucidates the research philosophy and

research methodology employed in the study to achieve the research objectives. This study adopts a qualitative method in gathering the necessary data. The primary data collected in this study is based on semi-structured interviews. The interviewees are selected from regulatory bodies, key market players and academicians in Korea and Malaysia. The interviews focus on professional views, opinions and suggestions in introducing Islamic finance in Korea, which is a non-Muslim country.

The secondary data is obtained by reviewing books, articles and existing websites which are analysed with the findings of the interviews.

Chapter 4: Research Results

This chapter demonstrates the research results derived from interviews and the analysis of the secondary data to construct a final research result. The chapter contains four sections which are the results from the opinions of legal and practical considerations, the views about the *Shariah* issues and the issues relating to risk mitigation.

The chapter analyses the opinions and suggestions of legal and practical considerations for Islamic banking and *sukuk*. The legal environment for Islamic finance through analysing the permissibility of Islamic banking, the definition of *sukuk* in Korean laws and taxations for Islamic banking as well as *sukuk* is discussed. The findings of this chapter show that the legal environment is unfavourable to be on a par when competing with conventional

finance. Hence, the findings highlight that the practical efforts such as the amendment of the Capital Market and Financial Investment Business Act are necessary. As a short-term measure, the results proposed critical ideas to facilitate Islamic finance under the existing legal framework at the initial stage.

As for the *Shariah* issue such as ownership transfer³, the alternative which Korea can take is proposed. The additional considerations to solve any challenge such as currency risk facing market players in issuing *sukuk* are derived and it is suggested that the regulatory body needs to include these matters within its current efforts.

The results also stresses that the lack of awareness in Islamic finance is a major challenge in facilitating the market in Korea. It was found that the effort to create awareness may be parallel with the efforts of legislative or regulatory changes through i.e. alliances or a close working relationship with other well-established countries.

Chapter 5: Conclusion and Recommendations

This chapter concludes with the findings from the study. It also highlights some practical suggestions and insights to the relevant parties in introducing Islamic finance in Korea by exploring issues and challenges relating to legal and regulatory framework as well as certain *Shariah* requirements.

³ Detail explanation is provided in Chapter 2, Section 2.6

Concurrently, this chapter presents the limitations of the study as well as suggestions for future research. Finally, this chapter ends with a practical implication for those who might be able to benefit from this study.