

## **Chapter 4: Research Results**

### **4.1 Introduction**

This chapter analyses and describes the detailed findings from interviews regarding the topic of this study, which is to explore the issues and challenges and to provide insights by introducing Islamic finance in Korea. In this regard, this chapter presents the results of the interview.

Section 4.2 covers the findings on the opinions and discussion of legal considerations in Korea for Islamic finance. In section 4.3, practical considerations of Islamic banking and *sukuk* are dealt with. The next section 4.4 administers the viewpoints on *Shariah* issues. Finally, section 4.5 copes with the risk management relating to *sukuk* issuance as a small subject matter. The chapter presents findings from interviews conducted with the Korean interviewees as well as interviewees from Malaysia based on the established interview guidelines as explained in Chapter 2. However, some interviewees are asked to respond to specific sections dealing on certain guidelines which he or she knows well, e.g. [R3] and [R10].

### **4.2 Legal Considerations in Korea for Islamic Finance**

The first section of the interview guidelines deals with legal considerations and readiness in Korea for Islamic finance, which are most importantly and directly related to law, regulations, environments, and requirements in Introducing Islamic finance.

#### 4.2.1 Permission of deposit and financing of Islamic banking

Table 4.1

##### Permission of deposit and financing of Islamic banking

Respondents	Summary of Opinion
R1_RG	Both deposit and financing of Islamic bank are not acceptable under current laws
R2_RG	Both deposit and financing of Islamic bank are not acceptable under current laws
R4_AC	<i>Murabahah</i> deposit can be acceptable through a different approach. Financing, in principle, may be acceptable.
R5_AC	<i>Murabahah</i> deposit may be acceptable through a different approach
R6_AC	Both deposit and financing of Islamic bank are not acceptable under current laws
R7_PR	Both deposit and financing of Islamic bank are not acceptable under current laws
R8_PR	<i>Murabahah</i> and <i>Ijarah</i> financing seem to be acceptable in bank
R9_PR	Both deposit and financing of Islamic bank are unlikely to be acceptable under current laws

From the summary, overall opinions from the regulatory body and two practitioners regarding the acceptability of Islamic banking are not favourable to be introduced under current laws. Many of the interviewees refer to the Capital Market and Financial Investment Business Act (hereafter, CMFIB Act) as well as Banking Act to give their opinions about Islamic banking deposits. In particular, *Mudarabah* is not likely to be seen as products under the Banking Act of Korea.

As a pivotal basis of unfavourable environment, one of the interviewees pointed out the following;

*Banks can operate their business which is clearly described in the Banking Act. This is because the Korean legal system is a positive system whereby basically the only stipulated business is permissible. [R6]*

One of the clear characteristics in civil law is unequivocal codification (Tetley, 2000) and Korea basically follows the German civil law branch (Graff, 2008). Hence, interviewees firstly tend to find out related codifications of corresponding law for acceptability. Hence, given no manifest articles of laws, the uncertainties in introducing Islamic banking products were discussed here. One of the opinions is as follows;

*Since the character of Mudarabah represents investment rather than deposit in the Korean Banking Act, the Banking Act does not govern such products as Mudarabah. But rather, Mudarabah can be associated with the financial investment instruments of CMFIB Act and it is difficult to interpret Mudarabah as a deposit under the Banking Act. In addition, Mudarabah can be classified into Collective Investment which can be authorized by the bank, but getting approval from FSS is one of the major regulatory obstacles. Moreover, Mudarabah which cannot provide the guarantee for deposited capital bring about conflict with a typical understanding for deposit in the Banking Act which does not stipulate clear definition of deposit but implicit capital protection. [R1]*

According to the Article 3 of CMFIB Act, “financial investment instruments means a right acquired by an agreement to pay, at a specific time in the present or in the future, money or any other valuable thing, with an intention to earn a profit or avoid a loss, where there is a risk that the total amount of such money or similar, paid or payable, for the purpose of acquiring such right may exceed the total amount of money or similar already recovered or recoverable from the right (hereinafter referred to as “investment risk”). The main

categories of financial investment instruments are derivatives and securities such as debt securities, equity securities, and beneficiary certificates”.

The reason that *Mudarabah* can come under the CMFIB Act is because it holds investment character as shown in the CMFIB Act. Furthermore the view of collective investments shows *Mudarabah* deposit as a pooled investment; activities of acquiring, disposing of, and managing in any way such assets as are valuable for investment with money or similar pooled by inviting two or more persons for such investment (CMFIB Act, Article 6).

The problem from such legal environment is similar with the illustration from Australia. Bank deposits must be protected in order to be defined as bank deposits in regulation (Ahmad, Osmani, et al., 2010). If they, however, are defined as investments in a collective investment scheme, they are no more bank deposits (Zaher and Hassan, 2000).

Even though the Banking Act does not explicitly stipulate the definition of deposit, the paper can refer to the Depositor Protection Act, Korea to ensure the opinion of [R1]. According to Article 2 of the Depositor Protection Act, Korea, “the definition of deposit is money which is insured by financial institutions provided for banks have risen by bearing liabilities from unspecified persons in the form of deposits, instalment deposit, instalment, etc. and money which they have raised through money trusts, etc. the principals of which are compensated under Article 103 (3) of the CMFIB Act”.

As an example in order to solve the conflict with the *Shariah* principle of the no-protection of deposits, [R1] suggested the UK's case of Islamic bank authorized by the Financial Service Authority (FSA), whereby FSA created a guideline that customer has an option to choose between deposit protection and *Shariah* compliance (FSA, 2007).

As for the financing, the topics about 'purchase and sales of underlying assets', 'lease financing' and 'purchase of non-operational real estate' mainly were illustrated to opine their opinions. Like deposit, the Banking Act does not include articles for such topics and most opinion turned out to be negative.

*Under the Banking Act of Korea, the financing by purchase and sales basis of underlying asset is not authorized and even lease financing is not acceptable as the business of goods' purchase and sale, possession of non-operational properties are stipulated in the Banking Act. Hence, the products such as Murabahah or Ijarah cannot be acceptable under the current Banking Act. [R2]*

On the opinions from the academicians, more flexible suggestions were provided. For the investment product such as *Mudarabah*, some academicians opined that the practice of investment trust products, which is the business of banks, can be applied to because it also does not guarantee any capital.

On the other hand, one practitioner gave an opinion for financing; since *Murabahah* and *Ijarah* make contracts based on fixed prices (cost + profit, rental fee), these products can be permissible to conventional banks.

## 4.2.2 Needed efforts to facilitate Islamic banking activities

**Table 4.2**

Needed efforts for Islamic banking (Korea<sup>9</sup>)

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	As for the deposit products, demonstration of capital protection is necessary. For the financing, law and regulation need to permit the possession of commodities and properties and lease business and change the definition of business-purpose real estate.
R2_RG	Willingness to amend law/ regulation and policy to support Islamic finance are put first
R4_AC	Tax exemption or relief for purchasing and selling properties. Human resource to operate such transactions.
R5_AC	Foundation for transactions or properties and commodities in terms of law or regulation
R6_AC	Awareness of Islamic finance
R7_PR	Amendment of law with explanation considering religious conflicts
R8_PR	Systematic study in <i>Shariah</i> . Amendment related to financing. Organization readiness of financial institutions. Public awareness to Islamic culture
R9_PR	Facilitating Islamic banking as financing stream

Firstly, most interviewees said that key efforts should be made in terms of laws and regulations to facilitate Islamic banking. As for the deposit, it is stated that the capital protection should be put forward. An alternative for the issue of capital protection was suggested as follows;

*A UK case introducing the concept of the right to choose 'profit-taking and loss-bearing' in Islamic deposit can be considered in order to represent capital protection. [R1]*

---

<sup>9</sup> Hereafter, meaning interviews in Korea.

For the financing, a couple of amendments in laws and regulations were recommended; the legal approval for the transaction of non-financial assets, exemption or relief against taxes followed by transactions of real properties for tax neutrality.

In particular, many interviewees highlighted the awareness and willingness of Islamic finance. The awareness is considered as very important because lacking awareness brings about religious conflicts or misunderstanding. The willingness, especially, seems to be essential factor due to the following reasons;

*Since the Korean legal system is based on the civil law system and is less flexible, the comprehending Islamic finance under the current system is a big challenge. And thus the willingness of policy-makers is most critical. [R2]*

*Benchmarking the case that IFRS (International Financial Reporting Standards) recommended tax law to AAOIFI would be the beginning of efforts to solve related issues and introduce Islamic banking activities. [R8]*

Meanwhile, related to this sub-topic, this study can gather supplementary opinions from interviews in Malaysia.

**Table 4.3**

Needed efforts for Islamic banking (Malaysia<sup>10</sup>)

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	<ul style="list-style-type: none"><li>- Rather than individual approach, the approach in terms of whole system/ aspects is necessary</li><li>- The government's efforts for awareness, strong supports training of Islamic finance</li><li>- Amendment of tax law should be first</li></ul>
S2-AC	<ul style="list-style-type: none"><li>- Building up awareness is important.</li><li>- Efforts of related parties need to reach legislation or guidelines to facilitate Islamic finance.</li></ul>
S3-PR	<ul style="list-style-type: none"><li>- Need of integrated approaches to support Islamic finance; regulatory infrastructure (such as Bank Negara Malaysia for banking, Securities Commission for capital market), Market infrastructure (the number of players and supporters such as <i>Takaful</i>, Law firms or Accounting firms), Educational Infra.</li><li>- Consider all related parties; Islamic entities, conventional entities in terms of cost-benefit</li></ul>
S4-PR	Two main considerations for level playing; namely taxation and ownership. Taxation is about double taxation driven by exchange contract. Ownership is about legal ownership and beneficial ownership, but then again it is related to taxation.

Basically, interviewees from Malaysia recognized that there is a big difference between Islamic banking and the conventional one in terms of contracts.

Firstly, harmonized or integrated approach is necessary under the overall finance-related system. This was supported by the interviewee's illustration of regulatory body;

*For example, when land is involved in a transaction, not only is the*

---

<sup>10</sup> Hereafter, meaning interviews in Malaysia.



*concept of beneficial interest employed, but also the courts understand the Shariah concept of law. Some countries have chosen to give tax-neutrality on an ad-hoc basis rather than changing the acts since it involves regulatory/internal issues. [S1]*

At the same time, awareness by government and related parties was highlighted by most interviewees in line with the harmonization. Practical ideas to create awareness were recommended by the interviewees in Malaysia;

- *Usage of Collaborative agreement with well-established countries like Malaysia, It can be partnership. This helps to increase the awareness for Islamic finance, like the cases of Luxembourg or Hong Kong, through training, conference, etc. to governmental staffs, central bank, financial institutions, etc.*
- *The partnership plays a critical role as a channel of communication for setting up Islamic finance.*
- *Usage of Academic arrangement with universities or training organization. [S2]*

The next notable one is to amend the taxation of transaction of underlying assets for level playing with conventional banks.

In conclusion, before legislative efforts and amendments, the awareness and support from related parties were found to be very critical and successful factors. De facto, misunderstanding can cause conflicts among interested parties and reach a point gradually. On the basis of awareness, harmonization and legal amendments must also be followed according to the opinions; particularly, regarding flexibility of deposit definition, transaction tax for Islamic financing and ownership for level playing.

### 4.2.3 Implementation of Islamic banking activities in Korea in a couple of years?

**Table 4.4**

Possibility of implementation of Islamic banking activities

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	Not easy to implement in a couple of years
R2_RG	Not easy to implement in a couple of years
R4_AC	Chance to implement will increase
R5_AC	Not easy to overcome objective opinions and set up tax neutrality
R6_AC	Not easy to implement in a couple of years
R7_PR	Not easy to implement in a couple of years
R8_PR	Need of 3 ~ 5 years
R9_PR	Not easy to implement in a couple of years

The six interviews with the respondents opined that the implementation of Islamic banking activities in Korea has been negative for a few years.

Some specific reasons are as follows;

*Not attractive from the economic viewpoint, less population of Muslim in Korea, more complicated transaction structure. [R1]*

*Lacking understanding and experts, speedy implementation seems to be difficult. [R6] [R8]*

Meanwhile, [R4] stated positive opinion that the possibility of implementation will increase with legal pace, as the awareness regarding the usefulness of Islamic finance increases.

**Table 4.5**

Possibility of implementation of Islamic banking activities in non-banking institutions

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	Partial possibility open to Islamic banking activities
R2_RG	Partial possibility open to Islamic banking activities
R4_AC	Higher possibility than commercial banks
R5_AC	Difficult to approve before banks
R6_AC	Not easy to implement likewise
R7_PR	Partial possibility open to Islamic banking activities
R8_PR	Partial possibility open to Islamic banking activities

Based on the interviews, Islamic banking activities can be implemented by some non-banking institutions such as capital companies.

[R1], [R2] and [R8] mentioned partial possibility saying that lease financing with *Ijarah* structure might be utilized in special credit financial business companies because of the authorized leasing business.

Article 2 of the Special Credit Financial Business (SCFB) Act states that specialized card financial businesses mean credit card business, facilities leasing business, instalment financing business, and venture capital business.

[R4] suggested that companies under the SCFB Act may provide Islamic banking activities with their authorized businesses when compared to commercial banks.

Based on the interviews, the implementation of Islamic finance in banks does not seem easy to get to a point where the basic products of Islamic banking

come to the market with amendment of laws or widen interpretation of regulations. Unlike commercial banks, however, the special credit financial business companies are able to implement the *Ijarah* principle in their products.

#### 4.2.4 The establishment of *Shariah* Supervisory Board (SSB)

**Table 4.6**

The viewpoint about establishment of *Shariah* Supervisory Board

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	Use of <i>Shariah</i> counselling firm outside or separate dedicated board both can be considered
R2_RG	Not necessarily to set up professional board inside institutions
R3_RG	Need of <i>Shariah</i> scholar
R4_AC	Establishment of association by a regulatory body or a banking sector
R5_AC	Use of <i>Shariah</i> counselling firm outside
R6_AC	Use of <i>Shariah</i> counselling firm outside
R7_PR	Use of <i>Shariah</i> counselling firm outside
R8_PR	Internal board is necessary for persuasive proposal
R9_PR	Use of <i>Shariah</i> counselling firm outside

As shown in Table 4.6, it can be said that a specific entity should be involved regardless of its form to review the *Shariah* ruling. And many interviewees recommended the usage of external *Shariah* professionals.

According to AAOIFI *Shariah* standard 2008, SSB is defined as: a SSB is an independent body of specialized jurists in *fiqh al-muamalat* (Islamic commercial jurisprudence). The Financial Services Authority (FSA) of UK is of the view that the *Shariah* Supervisory Board (SSB) should be built by

organizations to examine if the transaction and products are *Shariah* compliant (FSA, 2007). However, while FSA has made efforts to facilitate a fair environment for level playing, they did not take any religious stance in dealing with conventional and Islamic firms. As such, there is no specific committee or board in FSA (FSA, 2007). Such view concurs with the opinions of the interviewees [R1] and [R2] as follows;

*Screening of regulatory body is not necessary as in the case of UK. However, since the financial institutions must attain Shariah compliance for Islamic banking products, a couple of methods to solve it will be employed; hiring Shariah scholar, alliance, or the use of counselling firm. In particular, if the government amended certain laws, e.g. exemption of double stamp duty, permission of assets transaction in banks, etc., ensuring whether or not the products are Shariah-compliant comes on the table of the regulatory body. [R1]  
[R2]*

From a practical point of view, the result of an interview brought out an idea that an association or a joint board are an efficient alternative in the beginning phase for Islamic finance;

*Considering the cost, a lack of experts and initial confusion, it is recommended that the establishment of a board is led by the regulatory body's initiative or industry-wide until the volume of industry comes to a certain level. [R4]*

The results of interviews in Malaysia are very much similar with the Korean interviews. While interviewees from the regulatory body in Malaysia proposed a long-term contract for the stable *Shariah* opinion, the practitioners suggested the use of external *Shariah* counselling firm for SSB and secretary service as well.

Hence, the overall opinion converges in utilizing a *Shariah* counselling firm, but then again the institution should seek such an appropriate firm given the situation that there is no professional *Shariah* counselling firm too in Korea.

#### **4.3 Practical Considerations of Islamic Banking and *Sukuk***

The second section of interview guidelines deals with the considerations of Islamic banking and *sukuk* from the viewpoint relating to practical needs, which is extracted from literature reviews. The results from this section are expected to provide an in-depth and practical insight into introducing Islamic finance. In particular, in a sub-section regarding the definition of *sukuk* the opinions can give critical reasons to examine whether or not the issuance of *sukuk* in domestic market is possible. It is very important to identify the governing rule relating to the law in Korea. This is partially because Korean laws are based on a positive system of German civil law.

### 4.3.1 The issues of *sukuk* definition

**Table 4.7**

The issues of *sukuk* definition (Korea)

Respondents	Summary of Opinion
R1_RG	<ul style="list-style-type: none"> <li>- As for the asset-based <i>sukuk</i>, where no transfer of ownership, such <i>sukuk</i> can be regarded as debt securities</li> <li>- <i>Sukuk</i> by trust structure can fall into beneficial certificates( hereto, <i>Murabahah</i>, <i>Istisna</i> and <i>Ijarah</i>)</li> <li>- As for the <i>sukuk</i> by <i>Musharakah</i> and <i>Mudarabah</i>, these seem to have both the trait of equity securities and collective investment.</li> </ul>
R2_RG	<ul style="list-style-type: none"> <li>- <i>Sukuk</i> of <i>Murabahah</i> and <i>Ijarah</i> fall into debt securities</li> <li>- <i>Musharakah</i>-based <i>sukuk</i> can be equity securities</li> </ul>
R3_RG	<ul style="list-style-type: none"> <li>- <i>Sukuk</i> representing 'Specified Rate of Return' can fall into debt securities or derivatives-combined securities</li> <li>- <i>Sukuk</i> representing 'Expected Rate of Return' can fall into equity securities or investment contract securities or beneficiary certificates</li> </ul>
R4_AC	- Beneficiary certificates from holistic frame.
R5_AC	- Need of separate definition for Islamic securities
R6_AC	<ul style="list-style-type: none"> <li>- Beneficiary certificates from holistic frame.</li> <li>- <i>Musharakah</i>-based <i>sukuk</i> can be equity securities</li> </ul>
R7_PR	-Equity securities or securities of Asset-Backed Securitization Act
R8_PR	<ul style="list-style-type: none"> <li>- <i>Sukuk</i> of <i>Murabahah</i> and <i>Ijarah</i> fall into debt securities</li> <li>- <i>Musharakah</i>-based <i>sukuk</i> can be equity securities</li> </ul>

As shown in Table 4.7, the matching of *sukuk* definitions based on Korean law does not seem to be simple. The opinions mentioned that debt securities, equity securities, beneficiary certificates, collective investment, derivative-combined securities and asset-backed securities as the definition for *sukuk*. This is obviously to show how difficult it is to define *sukuk*.

From the definition of AAOIFI, *sukuk* represents an undivided share of ownership. In order to issue *sukuk* in Korea, the issuers and financial institutions must firstly review what laws govern financial instruments, *sukuk*. This is because the financial instrument will fail to issue, if the issuer approaches are without any corresponding law. In fact there are 14 types of *sukuk* in AAOIFI *Shariah* standards 2008, but as reviewed in literatures major *sukuk* need to be discussed: sales-based *sukuk* [Murabaha-based, *Istisna*-based], PLS (profit or loss sharing)-based *sukuk* [*Musharakah*-based or *Mudarabah*-based], and *Ijarah*-based *sukuk*.

Firstly, if the study looks into the definition of related financial instruments in Korea with regard to major *sukuk*, the following instruments can be examined; debt securities, equity securities, beneficiary certificate, collective investment scheme and asset-backed securities.

According to Article 2 of the CMFIB Act of Korea, the term debt securities means state bonds, local government bonds, special bonds, corporate bonds, corporate commercial papers (referring to promissory notes issued by a company for raising the funds required for its business), and other similar instruments, which bear the indication of a right to claim the payment. The term “equity securities” in this Act means stock certificates, instruments representing a pre-emptive right, investment securities issued by a legal entity established by direct operation of an Act, equity shares in contribution to a limited partnership company, limited liability company, or undisclosed



association under the Commercial Act, equity shares in contribution to an association under the Civil Act, and other similar instruments, which bear the indication of equity shares in contribution. "Beneficiary certificates" in this Act means the certificates which bear the indication of a beneficial interest in a trust.

As shown in the CMFIB Act, debt securities represent a right of claim, not ownership which *sukuk* defined as the core feature. On the other hand, equity securities represent the indication of equity shares in contribution. Hence, *sukuk* seem to hold on to the features of both debt and equity securities.

Article 229 of CMFIB Act defines collective investments scheme (for the collective investment, first section is referred to) as securities fund, real estate fund, special asset fund, etc. For example, securities fund invests the collective investment property in securities, which shall be no less than 40/100 of the collective investment property. As for the real estate fund is a collective investment scheme that invests the collective investment property in real estate in excess of the ratio 40/100.

Lastly, according to Article 2 of the Asset-Backed Securitization Act, the asset-backed securities refers to the subscription certificates, bond, beneficial certificates and other securities or certificates that are issued pursuant to an asset-backed securitization plan, whereby asset-backed assets means claims, immovable property and other property rights which are the subject matter of

asset-backed securities.

When combining the interviews and taking into account the above laws, it seems to make sense that *sukuk* based on *Murabahah*, *Istisna* or *Ijarah* fall into debt securities, because these *sukuk* have an outstanding feature which is the right to claim fixed profit as well as the ownership. However, when it comes to *Musharakah* and *Mudarabah*-based *sukuk*, it becomes more complicated to define because the definition is confused and can fall among equity securities, beneficiary certificates and collective investment. As for the asset-backed securities, because the securities defined include various securities and are more comprehensive in definition, *sukuk* using the asset-backed securities plan structure under Asset-Backed Securitization Act need to be considered for practice.

Among the reasons why defining *sukuk* is difficult;

*Classification should look through sukuk's individual structure [R3]  
Being classified as beneficiary certificate will be comfortable to market players, but it can be misused with tax avoidance. As such, separate definition is a rational alternative for even tax neutrality as well [R5].*

Referring to *Musharakah* and *Mudarabah* *sukuk*, [R1] gave more detailed opinions to consider;

*From a regulatory view, stricter regulations are needed for the Musharakah and Mudarabah because of the moral hazard form of asymmetric information. Moreover, if the investor protection is considered, sukuk need to be governed under the collective investment instead of the equity securities which is less governed. In addition, since the Musharakah and Mudarabah contract freely profit share ratio, sukuk can be used as the means of tax avoidance. [R1]*

Basically, it is true that *sukuk* can be structured with a variety of concepts, [R3] and [R5], meaning that it is difficult to classify all such comprehensive structures into the conventional finance law system. Hence, as seen in the UK case, UK allowed some specific *sukuk* with debt-featured structures in the market through the introduction of Alternative Finance Investment Bonds (AFIBs) considering the size of market product types (FSA, 2009).

**Table 4.8**

The issues of *sukuk* definition (Malaysia)

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	<ul style="list-style-type: none"> <li>- All fall into debenture from the view of undertaking at maturity date and its substance</li> <li>- <i>Musharakah</i>, if pure profit/loss sharing structure, it may be considered in more detail later</li> </ul>
S2-AC	- Need of separate definition for Islamic securities
S3-PR	<ul style="list-style-type: none"> <li>- Consider economic effect first</li> <li>- e.g. <i>Ijarah</i> can be treated as debt securities</li> </ul>
S4-PR	<ul style="list-style-type: none"> <li>- <i>Sukuk</i> are fixed income certificates</li> <li>- Refer to investment fund or mutual fund for <i>Musharakah</i> and <i>Mudarabah</i>.</li> </ul>

Meanwhile, when the study summarizes the opinion from interviews in Malaysia, the approaches are quite different in defining *sukuk*.

Firstly, the regulatory body's approach is very simple whereby they look at its substance. Hence, they currently define all *sukuk* as a debenture, debt security.

Secondly, opinion, [S2], actually support the opinion of [R5];

*Basically, if they want to set up Islamic finance, a separate space for Shariah contract should be given to the legal system or regulation. Without such efforts, there is nothing to do with Islamic finance. In this case, the market will meet with confusion; what is the Islamic finance? As such, in the beginning, a specific space should be ready for a clear recognition. Then mapping or interpretation will be necessary for level playing in terms of tax neutrality. [S2]*

Moreover, on the same line with [R3], [S3] more specifically mentioned the approach of economic effect.

*Look into “economic effects” about how sukuk function in terms of economic effects. For example, if Ijarah acts like MBS (Mortgage Backed Securities), it will be a bond in conventional view. A good example is the UK case. They brought the concept of AFIBs with economic effects. [S3]*

#### **4.3.2 First effort for the level playing of *sukuk* market with conventional capital market?**

**Table 4.9**

First effort to facilitate *sukuk* market (Korea)

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	- First of all, Amendment of CMFIB Act for home-issuance - Amendment of tax law for issuance at overseas zone
R2_RG	Amendment of tax law and CMFIB Act for home-issuance
R3_RG	Amendment of CMFIB Act for home-issuance
R4_AC	Amendment of tax law
R5_AC	Amendment of CMFIB Act
R6_AC	Amendment of CMFIB Act
R7_PR	Amendment of tax law
R8_PR	Amendment of tax law
R9_PR	Amendment of tax law

Unlike the bill of tax amendment (The Restriction Act of Preferential Taxation)

which the Ministry of Strategy and Finance (MOSF) designed as an initial movement for the overseas issuance of *sukuk*, but for the issuance within Korea the group of interviewees demanded for the CMFIB Act to be amended.

At the same time, the amendment of tax law such as ‘The Restriction Act of Preferential Taxation’ was considered as an effective means. Moreover, the issuance of *sukuk* within Korea seems to be negative;

*Because of political and social issues in introducing Islamic finance. [R1], [R3], and [R5]*

**Table 4.10**

First effort to facilitate *sukuk* market (Malaysia)

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	- Amendment of tax law
S2-AC	- Building awareness
S3-PR	- Tax incentive or exemption
S4-PR	- Consideration of Trust law as well as tax law

From the view of the interviewees in Malaysia, this study can confirm that tax matter plays a critical role in motivating the *sukuk* market, but then again such result is in accordance with the cases of some countries.

Without doubt, the problem of tax is at the centre of discussion which resulted from the opinions of previous sub-sections.

### 4.3.3 Taxation environment and issues about Islamic banking and *sukuk*

**Table 4.11**

Taxation environment and issues

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	<ul style="list-style-type: none"> <li>- Negative current tax environment for Islamic finance</li> <li>- Need of changes: Value added tax (VAT), Acquisition/Registration tax<sup>11</sup> resulted from real assets' transaction and Withholding tax of foreign investor for tax neutrality. In particular, transfer taxes for <i>sukuk</i></li> </ul>
R2_RG	<ul style="list-style-type: none"> <li>- Problem regarding tax deductibility of profit for <i>sukuk</i></li> <li>- Problem of double tax charges such as stamp tax</li> </ul>
R4_AC	<ul style="list-style-type: none"> <li>- Need of changes: Value added tax (VAT), Acquisition/Registration tax and transfer taxes</li> </ul>
R5_AC	Consideration of All taxes related to transfer of assets
R6_AC	<ul style="list-style-type: none"> <li>- Consideration of definition of income from Islamic banking</li> <li>- Acquisition/ Registration tax, Corporate tax, etc.</li> </ul>
R7_PR	Need of changes: Acquisition/ Registration tax resulted from real assets' transaction, tax-deductible
R8_PR	Exemption of corporate tax and VAT related to <i>sukuk</i>
R9_PR	Disadvantage in terms of taxes' kind or tax rates
R10_PR	<ul style="list-style-type: none"> <li>- Negative in tax law</li> <li>- Need of changes in Islamic banking activities: Acquisition/Registration tax<sup>12</sup> resulted from real assets' transaction, double charge of Value added tax (VAT), and transfer taxes</li> <li>- For <i>sukuk</i>: Acquisition/ Registration tax, transfer taxes and VAT. Tax-deductible for <i>Murabahah</i> and <i>Ijarah sukuk</i></li> <li>- Consideration for withholding tax as The Restriction Act of Preferential Taxation for foreign-currency-denominated securities</li> </ul>

From the above opinions, the overall conclusion for tax environment has resulted negatively in Korea. Hence, specific efforts for tax neutrality are

---

<sup>11</sup> Corresponding to stamp taxes such as stamp duty land tax in UK.

<sup>12</sup> See 3

certainly necessary. One of the interviewees, a professional in tax, has explained that Korean tax is unfavourable to Islamic finance;

*Basically, Korean tax law is not likely to consider financial transactions through asset transactions. Moreover, the definition of sukuk under CMFIB Act is not identified in order to distinguish whether sukuk is correspondent to debt-securities or equity-securities. As such, Islamic banking and sukuk in such tax environment will be unfavourable [R10].*

However, he added a couple of alternatives under current limited system;

*As for the Murabahah and Ijarah sukuk, Korean taxation can refer to the case of UK such as Alternative Finance Investment Bonds. However, profit-sharing sukuk requires additional discussions. Specifically speaking, if sukuk structure registers the trust registration and repurchase of the trust asset, the exemption of acquisition tax may be given. For the withholding tax, the article of The Restriction Act of Preferential Taxation for foreign-currency-denominated securities may be applicable [R10].*

In summary, the efforts of both the Islamic banking and *sukuk* in the Korean market are summarized as follows:-

Needs of restricted taxation for

- Acquisition/ Registration tax related to real estate transaction such as Stamp Duty Land Tax in other country
- Value added tax (VAT); e.g. as the case of *Murabahah*-based financing or *sukuk*
- Transfer tax
- Withholding tax particularly for foreign investors
- Profit occurred from Islamic finance (Tax-deductibility)

At the same time, considering only taxation will place a limit on the competition of Islamic finance in Korea. Therefore, in order to build a solid foundation, the definitions relating to Islamic finance need to be preceded by such laws as in the CMFIB Act.

#### 4.3.4 Competitiveness compared to conventional banking and bond?

**Table 4.12**

Competitiveness of Islamic finance

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	<ul style="list-style-type: none"> <li>- From the aspect of investment accounts in Islamic bank, low acceptability to the concept of <i>Mudarabah</i> (Profit sharing and loss bearing)</li> <li>- Financing products may have competitive edge</li> <li>- From capital market, intricate documentations, <i>Shariah</i> compliance may become a obstacle</li> </ul>
R2_RG	<ul style="list-style-type: none"> <li>- Cheaper funding cost is expected relatively</li> <li>- Open to medium corporate with real asset</li> </ul>
R4_AC	Diversification of funding and long-term funding
R5_AC	Diversification of funding
R6_AC	Yes, if the issues of tax are solved
R7_PR	Unfavourable
R8_PR	Firstly, it is up to taxation
R9_PR	Equal competitiveness after amendment of tax
R10_PR	Depending on funding cost after amendment

From the above opinions, certain possibilities seem to open up to Islamic finance. In particular, lots of interviewees identify that Islamic finance brings cheaper funding cost to the Korean market. In other words, Islamic finance has competitiveness against the conventional finance if the Korean



environment creates a level playing place. In fact, negative opinions still keep their background around the same topic called tax matter. Samples of positive opinions are as follows;

*However, since in the typical financing market the funding cost is a core determinant in decision-making, Islamic banking can make full competitive power. [R1]*

*While major large corporate or government linked companies have issued bonds which are dominated by the foreign currency market, sukuk is believed to expand the opportunities in the market; namely medium companies with real assets are also able to issue sukuk. [R2]*

*We need to look at the advantage in Islamic finance. Islamic finance can be a pivotal window for funding. Moreover, Islamic finance allows for cheap financing and long-term capital delivers portfolio effects. [R4] [R5]*

Therefore, initial efforts need to focus on funding rather than both investing and funding.

#### **4.4 Selected *Shariah* Issues**

The third section of interview guidelines administrates considerations from *Shariah* issues relating to *sukuk*. The section does not cope with a huge range of *Shariah* issues. Only two issues relating to *sukuk* are reviewed. One is an issue relating to debt-based *sukuk* and the other is the issue of ownership. Before the issues, the guideline also interviewed a general issue whose concern is related to investment against non-Muslim country.

#### 4.4.1 Dubious concerns against non-Muslim country, Korea.

**Table 4.13**

Dubious concerns against non-Muslim country (Korea)

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	- No issue to Muslim investor - Use of <i>Shariah</i> screening to judge halal
R2_RG	Thought that healthy assets and industry are attractive to Muslim investor
R4_AC	No issue
R5_AC	No issue owing to investment on real assets
R6_AC	Positive in terms of portfolio
R7_PR	Open to gleam concerns
R8_PR	No problem due to good impression
R9_PR	There are a lot of non-commercial real estate too

Under the issuance of *sukuk*, underlying assets must be *Shariah*-compliant, i.e. halal transaction. With this regards, the Muslim investors may have suspicious worries in mind. Most of the interviewees gave positive opinions, namely it is not an issue.

*Of course, Korean companies are involved in the entertainment industry such as online game. It can be viewed to be non-halal. However, the good impression and relationship with Middle East countries can trade off the negative aspects. [R8]*

As specific information;

*As of 2009, about 40% of KOSPI (Korea Composite Stock Price Index) is *Shariah*-compliant from research. [R9]*

Meanwhile, reviewing the opinions from Malaysia, whether it is a non-Muslim or Muslim country no longer matters. Hence, investments depend on a healthy economy, profitability and *Shariah*-compliant assets or business. Therefore, looking at such aspects, the Korean market is believed to be a great and attractive market.

**Table 4.14**

Dubious concerns against non-Muslim country (Malaysia)

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	- As long as the investment is <i>Shariah</i> -compliant, it is not matter, e.g. car industry. - The discipline of supervisory action and auditing will be highlighted
S2-AC	- Economic condition, healthy performance, etc. are matter - Given that typical investments take trips to USA or EU, East North and East South Asia are great alternatives
S3-PR	- It depends on profit, credit, legal jurisdiction, etc.
S4-PR	- Once there are appropriate assets and activities except for e.g. loan, it can be attractive

#### **4.4.2 The issue to debt-based *sukuk*.**

Recently, according to the bill of tax amendment (The Restriction Act of Preferential Taxation) which the Ministry of Strategy and Finance (MOSF) designed as an initial movement for overseas issuance of *sukuk*, the bill was considering *Ijarah sukuk* and *Murabahah (tawarruq) sukuk*.

However, *Murabahah sukuk* have been categorized into a debt-based *sukuk* and thus falls into an issue that debt-based *sukuk* cannot be traded with a typical method in the secondary market for refinance or exit under AAOIFI. However, the debt-based *sukuk* is tradable under the guideline of the

Malaysian *Shariah* Advisory Council as it is considered as financial right.

This guideline will deal with the issue in question.

**Table 4.15**

The issue to debt-based *sukuk* (Korea)

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	- Market players prefer Malaysia interpretation - <i>Ijarah sukuk</i> are supposed to take higher marketability compared to <i>Murabahah sukuk</i> in Middle East.
R2_RG	- Follow Malaysian <i>Shariah</i> ruling for Malaysia investments - Follow AAOIFI for Middle East investments
R5_AC	Follow Malaysian <i>Shariah</i> ruling for trading in secondary market
R6_AC	In terms of issuers, the more advantageous to them, the better regardless of difference of <i>Shariah</i> opinion
R7_PR	No problem because practitioners will shed light on <i>Ijarah</i> based <i>sukuk</i>
R8_PR	Malaysia <i>Shariah</i> ruling is preferred to strict AAOIFI
R9_PR	Malaysia <i>Shariah</i> ruling is proper

**Table 4.16**

The issue to debt-based *sukuk* (Malaysia)

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	The consideration of the investment environment at all point and <i>Shariah</i> due diligence are to be more stressed rather a specific standard is to be supported
S2-AC	Since AAOIFI is a global standard, it is very recommendable that Korea follows AAOIFI
S3-PR	Given the diversification of opinion, as long as it is within <i>Shariah</i> , all are permissible. The opinions and interpretation for <i>Shariah</i> can be diverse among scholars.
S4-PR	AAOIFI standard may be recommendable

Relatively, interviewees in Korea did not make their own opinions about *Shariah*. It might be because that the interview guideline represents the issue of *Shariah* interpretation.

Meanwhile, the interviewees from Malaysia manifested their opinion, because the regulatory body has the *Shariah* Advisory Council and among the interviewees is a *Shariah*-teaching professor. In relation to this, the Korean regulatory body seems to give less attention on the *Shariah* issues.

*From the viewpoint of regulatory body, the regulating transaction due to specific Shariah issue seems to be not appropriate under the secular system. [R1]*

In complying with standards, the Korean interviewees prefer not to be one-sided. Hence, they consider that the standard depends on the investors or on the advantages.

As for the interviewee from Malaysia, they recommended to comply with AAOIFI. The reasons are as follows;

*Korea does not have Islamic schools and this gives them the advantage in choosing opinions and standard. So long as the financing is not limited within Malaysia, AAOIFI is the best choice for Korea. [S2]*

*Safer for both international investors and South East Asia's. [S4]*

In combining both groups, its findings say that AAOIFI is a safer standard for Korea. Moreover, referring to the optional choice and opinions of [S1] and [S3] this can be a burden to the Korean market who is unfamiliar to Islamic finance.

In addition, the idea in terms of products also is valuable. The opinion that the use of *Ijarah* based *sukuk* can be preferred is in accordance with the case of Lahsasna (2008).

#### 4.4.3 Transfer of ownership

Among the issues of *sukuk* is the ownership and asset transfer. The issue can be viewed as an issue of true sale or insolvency remoteness. This guideline aims at examining the possibility of utilizing the Asset-Backed Securitization Act in Korea which is related to the issue.

**Table 4.17**

Transfer of ownership

Respondents	Summary of Opinion
R1_RG	- Coincident with asset-backed <i>sukuk</i> , because Asset-Backed Securitization Act stipulates true sale to achieve bankruptcy remoteness.
R2_RG	Since <i>sukuk</i> have buy-back structure, application is doubtful in terms of true sale
R5_AC	- Applicable to <i>sukuk</i> - Minimize legal uncertainty
R6_AC	Can connect with significant articles in terms of bankruptcy remoteness
R7_PR	Need of providing of bankruptcy remoteness, Need of application
R8_PR	Applicable for some <i>sukuk</i> structures as it is.
R9_PR	Not applicable

Except for [R2] and [R9], interviewees opined that Asset-Backed Securitization Act (ABS Act) can be applicable to *sukuk* products, because ABS Act aims at providing true sale for insolvency remoteness and basically supports the asset-backed structure which is in accordance with AAOIFI *Shariah* standards 17, 2008 (Item 2 and Item 5/1/2).

Article 13 of Asset-backed Securitization Act in Korea defines the method of transfer. This article explains how the asset-backed securitization pursuant to the Act fulfils the true sale requirement. In other words, the following conditions are summarized;

- By means of sale and purchase
- The right to make profit and to dispose of securitization asset goes to the transferee
- Transferor should not have to claim back the securitization assets, and the transferee should not have the right to claim back the price paid
- Transferee should undertake risks associated with the securitization assets

The above legal items unequivocally state the conditions of transfer of ownership and assets. De facto, such conditions seem to be in line with the sale contract of *Shariah* principle whereby all risk related is transferred. With this regard, Rahail (2009) classified the method of transfer such as sale, lease, assignment, novation and declaration of trust in order to review suitability. In the review the advantages of assignment are well-explained relatively with English law; i.e. easy procedure.

Furthermore, the opinion of one interviewee, who is a lawyer [R5], opens up a possibility of the application toward *sukuk*. [R1] also gave some important grounds in his opinion, which is relating to the definition of *sukuk*. Hence, if the study looks into another article of the Act, a specific statement can be found. Asset-backed securities means (ABS Act, article 2)

- Subscription certificates
- Bonds
- Beneficial certificates,
- and other securities or certificates issued pursuant to an asset-backed securitization

The broader definition in the ABS Act may make a solution for *sukuk* issuances in addition to *Shariah* issues which is related to the transfer of ownership. Moreover, if combining with tax under Article 119 and 120 of The Restriction Act of Preferential Taxation with regard to asset-backed securities pursuant to asset-backed securitization plan, the exemption of acquisition tax is granted.

#### **4.5 Risk Mitigation**

The forth section of guidelines aims to review the risk aspects arising from the issuance of *sukuk*; i.e. when *sukuk* issue was denominated by foreign currency. At the same time, this section tried to review risk hedging along with *Shariah* principle. However, in this case the guideline requires in-depth *Shariah* understanding. Hence, the guideline regarding risk hedging is



presented to interviewees in Malaysia only; “When the target business funded by *sukuk* creates revenue in the local market (namely in different currency [KRW] from capital [e.g. USD] repaid), what do you think is an expected issue among parties? The Korean issuer have to use only *Shariah*-compliant hedging?”

Instead, for the Korean interviewees the guideline given was about the competitiveness regarding the risk of foreign exchange rate and interest rate (interest rate was used for quick understanding of interviewees) compared to conventional investment.

**Table 4.18**

Regarding risk of foreign exchange rate and interest rate

<b>Respondents</b>	<b>Summary of Opinion</b>
R1_RG	Implied market risk is the same with conventional
R2_RG	Implied market risk is the same with conventional
R5_AC	As important as conventional
R6_AC	Implied market risk is same with conventional
R7_PR	Implied market risk is same with conventional
R8_PR	Rather, less risk for <i>Murabahah</i> and <i>Ijarah</i> based <i>sukuk</i> in terms of interest rate
R9_PR	Implied market risk is same with conventional

The overall results say that the risk aspects will be the same with conventional investment. However, [R8] gave an opinion that less risk can be expected for *Murabahah* or *Ijarah* based *sukuk* in terms of interest rate, since these *sukuk* basically represent the concept of cost plus profit.

**Table 4.19**

Regarding risk hedging from interviews in Malaysia

<b>Respondents</b>	<b>Summary of Opinion</b>
S1-RG	The hedge will be needed for converting Korean Won into US dollar to avoid currency fluctuation, but the hedge transaction must be <i>Shariah</i> -compliant. The hedging can be achieved through <i>Shariah</i> -compliant cross currency swap.
S2-AC	Different approach depending on situation; e.g. if there is no <i>takaful</i> in the country, Islamic bank can't help but using conventional insurance in certain situation in terms of necessity
S3-PR	If hedging is one item of all the processes and there are not many alternatives, conventional forward contracts can be acceptable in the Korean case. This is because currency is just medium
S4-PR	Basically, the opinion is that unless there is an alternative, they can use conventional hedging market. One thing to be considered is that if an alternative costs high and it can jeopardize the company, the company can go to conventional market for hedging

*It is necessary to hedge currency risk, but through Shariah-compliant methods. However, in Malaysia, sometimes due to the size of the Ringgit currency of Shariah-compliant derivatives market, there have been the cases of the issuances of sukuk with different currency unlike initial intention. A hedging tool may be through Shariah-compliant cross currency swap. [S1]*

As shown in the above, the interviewee from the regulatory body argued that *Shariah*-compliant hedging is required in the case. The recommended hedging tool is similar with an illustration from Ghoul (2008);

*The Islamic Cross Currency Swap is an arrangement between two parties to exchange a series of profit and/or principal payments denominated in one currency for another series of profit and/or principal payments denominated in another currency, based on a notional principal amount, over an agreed period. The arrangement uses Commodity Murabahah transactions as the underlying transactions.*

However, other professionals including the *Shariah* teaching professor gave more flexible opinions. In other words, it is to consider a specific position such as Korea which has not developed any Islamic finance at all. Hence, *Shariah* compliance is interpreted in terms of necessity.

From this section, the findings say that Korean interviewees at least do not think of the risk aspects from *sukuk* to be riskier compared to conventional investment. However, when the Korean issuer issues *sukuk*, there is risk to hedge; particularly the hedging of foreign exchange rate. At the same time, such hedging process is associated with *Shariah*-compliant, since it is *sukuk*. Fortunately, 3 of the interviewees in Malaysia admitted alternatives depending on the situation. Therefore, the Korean derivative market may be considered as an alternative due to the availability and cost of *Shariah* compliant hedging. Nevertheless, *sukuk* issuers need to put the *Shariah* compliant hedging to be considered firstly.