

## **Chapter 5: Summary and Conclusion**

### **5.1 Introduction**

This chapter comprises of five sections. A summary of findings is provided under-Section 5.2. It highlights the issues and challenges in introducing Islamic finance to Korea together with practical insights. The findings and conclusion will be discussed under Section 5.3. Section 5.4 discusses the limitation of study and subsequently Section 5.5 suggests some recommendations for future research. Finally, Section 5.6 ends with some practical implications.

### **5.2 Summary of Findings**

This research set out to explore the issues and challenges and provide practical insights to relevant parties such as the regulatory body, market players, etc. In order to achieve the research objective, the study conducted semi-structured interviews using guidelines with two different groups; one group consists of Korean interviewees who are selected based on their background involved in Islamic finance, e.g. staffs from the Korean Financial Supervisory Service, and the other is a group of interviewees in Malaysia, e.g. staffs in the Securities Commission Malaysia. The results of the interviews provide the professional opinions in tackling the issues and challenges facing the Korean market in implementing Islamic Finance. In particular, the opinions of the Korean interviewees represented well the issues and challenges facing Korea when introducing Islamic finance. The opinions from interviews

conducted in Malaysia provide practical recommendations with global views in terms of the issues and challenges.

### **5.2.1 Legal consideration**

Among the salient features of Islamic finance are the prohibitions of *riba*, *gharar*, and *maisir* which shed light on justice and remove ambiguity (FSA, 2007; Ayub, 2007). These features made a critical distinction between Islamic and conventional finance; e.g. no guarantee of principal in the *Mudarabah*-based savings account and financings through the sales & purchase contracts in Islamic finance.

Firstly, the interviews uncover whether or not the Islamic finance, more specifically Islamic banking, is permissible under the Korean current legal framework.

- The Korean legal system and environment for the Islamic banking operations: The UK's approach to Islamic finance can be summed up as "no obstacle, but no special favour" to facilitate a level playing field (FSA, 2007) and thus UK took practical steps such as the amendments of laws.

Unlike the UK case, it was found that the current Korean legal environment is not favourable for the Islamic banking operations. The main drawback is consistent with the study of Ahmad, Osmani and Karim (2010). Their study pointed out that the absence of a regulatory and legal

framework to support an Islamic banking system is one of the biggest issues. The *Mudarabah*-based deposit conflicts with the definition of deposit in Korea which does not accept the principle of no protection of deposit. The Banking Act of Korea, whose legal system is a positive system, also does not stipulate financings through sales & purchases and leasing.

Hence, defining the products related to Islamic banking is subject to the amendments of the laws such as the Banking Act, the Capital Market and Financial Investment Business (CMFIB) Act and the Depositor Protection Act

- More efforts are needed for the implementation of the Islamic banking operations: Given that the legal tradition of Korea is categorized into German civil law branch (Graff, 2008), the Korean legal system is relatively less flexible compared to common law and thus codifications are very important. Hence, for the distinction with the conventional banking, the Korean interviewees proposed the changes of the relevant laws relating to deposit protection, bank's possession of properties, lease operation, legal & beneficial ownership and tax law.
- Level of awareness: One of the significant findings is the importance of awareness on the basic principles underlying the implementation of Islamic financial system before any changes could be made to the legal

framework. Thus, the effort to create awareness on Islamic finance, specifically the basic principles underlying its operation and products criteria, should be placed before the efforts to amend the legislations. Creating awareness on Islamic finance in Korea can be achieved by utilising a collaborative agreement with well-established countries like Malaysia, or the academic arrangement with universities or with training organizations involved in Islamic finance.

- Possibility of the implementation of Islamic banking activities in a couple of years: Most of the interviewees gave negative prospects about the implementation of Islamic banking operation in the near future. Among the major reasons are low attraction from an economic point of view, small numbers of Muslim population and a lack of understanding.

The findings proposed that the *Ijarah* financing can be implemented under the Special Credit Financial Business (SCFB) Act of Korea. Conventional bank may utilise the existing subsidiaries under the SCFB Act or establish new subsidiaries for Islamic banking. This is similar with the study of Taylor (2003), who found that the savings associations in USA can own properties for Islamic banking if they utilise subsidiaries.

- *Shariah* Supervisory Board: The Financial Supervisory Authority (FSA) of UK advised that the *Shariah* Supervisory Board (SSB) should be built in the organization to audit transactions and products which are *Shariah-*

compliant (FSA, 2007). The finding is not in line with the above view. It was found from the suggestions of both groups that the utilisation of *Shariah* counselling firm is more economic and appropriate as an inception model. The finding also suggested creating a counselling association by banks or a regulatory body considering the lack of experts and initial confusion.

### **5.2.2 The definition of *sukuk* and taxation issues**

As reviewed in the 'Responses to the Questions and Government Conclusions' in consultation paper (FSA, 2009), the definition of Alternative Finance Instrument Bonds (AFIBs) relating to *sukuk* gave rise to some arguments; i.e. whether or not the AFIBs include equity-based *sukuk* and indices-linked *sukuk*. Defining *sukuk* is a big challenge and a very important matter to market players as it affects directly or indirectly other relevant laws such as tax law and regulation. This section focuses on the practical considerations relating to definition and taxation.

- Definition of *sukuk* in Korean law: The interviewees gave a wide range of definitions about *sukuk*; i.e. debt securities, equity securities, beneficiary certificates, collective investment, derivative-combined securities and asset-backed securities.

Having reviewed the cases of UK and USA, *sukuk* are classified into AIFBs in the UK and are defined based on the economic characteristics

and namely the feature of debt-like return is captured. The Collective Investment Scheme does not apply to *sukuk* as *sukuk* need to be traded in a secondary market (FSA, 2009). In USA, *sukuk* are treated as conventional debt securities or asset-backed securities under the applicable 33 Act of Securities and Exchange Commission (Abdullah, 2009).

Combining the interviews with laws such as Capital Market and Financial Investment Business (CMFIB) Act, *sukuk* based on *Murabahah*, *Istisna* or *Ijarah* seem to fall into debt securities under the CMFIB Act. As for *Musharakah* and *Mudarabah*-based *sukuk*, it is likely that more discussions are needed in classifying these *sukuk* under the CMFIB Act.

To facilitate the issuance of *sukuk*, a finding shed light on specific opinions; viz. “look into economic effects or its substance in defining *sukuk*” and “give separate space to stipulate it”. This stressed that the substance of *sukuk* is more important than the form of *sukuk* and a separate definition can be reasonable rather than a far-fetched mapping in defining *sukuk*.

- Important effort needed for the issuance of *sukuk*: It is proposed that CMFIB Act and tax law need to be amended to facilitate the issuance of *sukuk*. The amendments of both CMFIB Act and tax law are considered for *sukuk* issuances within Korea. In contrast, the amendment of tax law is enough for foreign-currency-denominated *sukuk* issued overseas. In

relation to this, the interviewees considered that an effective and efficient way is to govern *sukuk* under the Restriction Act of Preferential Taxation which offers preferential taxation to foreign-currency-denominated bonds.

- Tax environment and issues: The finding revealed that the taxation of Islamic banking and *sukuk* in Korea is unfavourable as Korean tax law does not consider financial transactions through asset transactions. Most opinions proposed the practical considerations of taxation related to the acquisition/registration tax of properties' transactions, transfer tax, the withholding tax of foreign investors, the tax-deductibility of return, etc. to make a level playing field with conventional banking and bonds. The Income Tax Act, Corporate Tax Act, Local Tax Act and Value-Added Tax Act are correspondent to the above taxations.

As for *Murabahah* and *Ijarah*-based *sukuk*, however, it was found that the use of trust registration under the Trust Act may offer exemption on an acquisition tax and also the Restriction Act of Preferential Taxation can be applied in relation to withholding tax of *sukuk* investment. The above finding, which mentioned the existing laws, is in accordance with the opinion of Volke. He mentioned that it is true that the amendment of the tax law is identified by many countries, but it is also true that launching specific products of Islamic finance without amendments to the tax law need to be reviewed as existing laws or regulations without special efforts can be applicable (H.C.Volker, personal communication, 26<sup>th</sup> Jan 2011).

### 5.2.3 *Shariah* Issues

This section summarizes a general issue about the concern of investment in a non-Muslim market because Korea seems to be purely a non-Muslim country. Following this, the finding deals with two *Shariah* issues; i.e. one is an issue regarding the debt-based *sukuk* and the other is an issue relating to the transfer of ownership.

- Concerns of investment in a non-Muslim country: The finding revealed whether the country is a non-Muslim or a Muslim country no longer matters. The decision of investment depends on a healthy economy, profitability and *Shariah*-compliant assets or business.
- The issue of debt-based *sukuk*: Among the debt-based *sukuk* is *Murabahah sukuk*, *Istisna sukuk* and *Tawarruq sukuk*. The AAOIFI *Shariah* standard (2008) clearly describes that “it is not permissible to securitize the debt-based *sukuk* for the purpose of trading”. However, the Malaysia *Shariah* Advisory Council (SAC) allows the trading of debt-based *sukuk*. Such a gap between AAOIFI and Malaysia *Shariah* Advisory Council can cause confusion to the Korean market players who are likely to depend on external *Shariah* opinions.

The results indicated that the Korean interviewees do not prefer a certain standard. As such, when *sukuk* is funded by the investors from the Middle East, the AAOIFI standard is recommended and if the investors are in Malaysia, Malaysian SAC standard is recommended.



Most of the interviews in Malaysia regarded the AAOIFI as an international standard to comply with, even though some of the opinions suggested that as long as it is within *Shariah*, the diversification of opinion should be accepted.

Given that the bill in progress designed by the Ministry of Strategy and Finance (MOSF) supports *Murabahah*-based *sukuk*, the *Shariah* issue relating to the debt-based *sukuk* needs to be reviewed by both governmental body and market players.

- Transfer of ownership: *Sukuk* must represent the true ownership of *sukuk*-holders according to the AAOIFI *Shariah* standard 2008. This requirement is very important especially when the originator faces bankruptcy, because if bankruptcy remoteness is not guaranteed, it cannot be said that the ownership of *sukuk* is transferred to the investors. Howladar (2009) explained that if *sukuk* are not asset-backed, but asset-based, the rating of *sukuk* focuses on the creditability of the originator like conventional bonds (as cited in Bill, 2010).

In relation to the issue, the study interviewed how the issue could be solved under Korean laws. This study found that the Asset-Backed Securitization Act (ABS Act) can be applicable to *sukuk*, because the ABS Act aims at providing a true sale for insolvency remoteness and basically

supports the asset-backed structure.

In particular, the study made a special finding that since the ABS Act covers broad types of securities regardless of whether the securities are subscription certificates, bond, or beneficial certificates, the challenge of defining *sukuk* may be mitigated or overcome. Moreover, the preferential taxation is offered under the Act.

In summary, utilising the ABS Act can be positively considered to increase the feasibility of *sukuk* issuance within Korea.

#### **5.2.4 *Sukuk* and risk mitigation**

When Korean companies issue *sukuk*, the *sukuk* will be issued in foreign currency, i.e. dollar-denominated *sukuk*, as the Korean currency is not the main currency globally. There is a need to consider derivatives to hedge currency fluctuations. This is because the return of the *sukuk* can be based on the Korean Won [KRW] currency. This may be a hurdle to overcome by the issuers, because *Shariah* put some limitations for risk mitigation; i.e. “Do not sell what you do not own”.<sup>13</sup> As such there are less hedging mechanisms in the Islamic capital market.

- Korean interviewees recognized that the market risk of *sukuk* is viewed as

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<sup>13</sup> Sunan al-Tarmizi, kitab al-Buyu', hadith no.1236, vol. 3; Sunan abi Dawud, kitab al-Ijarah, hadith no. 3035, vol. 3.

the same in nature with that of conventional bonds.

The findings were divided into two opinions about the use of *Shariah*-compliant derivatives; the Securities Commission Malaysia argued that the Korean issuers should use *Shariah*-compliant derivatives, and the other interviewees including a *Shariah*-teaching professor gave opinions that the issuers can use the conventional derivatives market depending on the availability of *Shariah*-compliant derivatives in terms of the necessity of *Shariah* view.

- Should the *Shariah*-compliant derivatives be employed, the Korean issuers will face two problems. According to the findings, since the size of *Shariah*-compliant derivatives market is not big enough to cover *sukuk* market, the cost can be higher than that of the conventional derivatives market. Moreover, additional contracts for *Shariah*-compliant derivatives are needed, and thus when the related laws are considered, these additional *Shariah* contracts need to be manifested by a governmental or a regulatory body particularly in terms of taxation.

### **5.3 Conclusion**

Islamic finance industry has grown tremendously and is now not only confined to Muslim-majority countries, but also beyond the traditional boundary into new territories. On the other hand, Korea is a relatively latecomer to Islamic finance. It has begun initiating efforts to introduce Islamic finance with MOSF

proposing changes on tax laws which is still in progress since 2009.

The purpose of this research paper is to identify the main issues and challenges in introducing Islamic finance in Korea and provide practical insights to the relevant parties such as a regulatory body and market players. The interviews were held with professionals who are involved with the Islamic finance to explore significant findings.

The findings of the research managed to reveal the main issues in introducing Islamic finance. The current legal environment to facilitate Islamic finance is not favourable due to the absence of a regulatory and legal framework to support the Islamic banking system. The Banking Act, the Capital Market and Financial Investment Business (CMFIB) Act and the Depositor Protection Act need to be reviewed by the governmental bodies and to make room for Islamic banking products such as *Mudarabah*-based deposit, financings through sales contract and lease. The issuance of *sukuk* in Korea is also a tough assignment. It requires a clear classification of *sukuk* under the CMFIB Act.

Currently, tax environment also does not serve a level playing field with conventional finance. The Income Tax Act, the Corporate Tax Act, the Local Tax Act and the Value-Added Tax Act should be considered to facilitate Islamic finance. These Acts deal with the major challenges of taxation such as the acquisition/registration tax of properties' transactions, transfer tax, the

withholding tax of foreign investors, tax-deductibility, etc.

However, the findings showed the feasibility of introducing Islamic finance within the existing legal framework. *Ijarah* financing can be implemented under the Special Credit Financial Business (SCFB) Act which commercial banks can also utilize through creating subsidiaries. As for the asset-backed *sukuk*, the Asset-Backed Securitization (ABS) Act may be applicable as it is believed that the Act is able to solve the issues of *sukuk* definition and the ownership transfer in introducing *sukuk*. In addition, if *Murabahah* and *Ijarah*-based *sukuk* use a trust structure under the Trust Act and the Restriction Act of Preferential Taxation, then preferential taxation can be applicable.

As reviewed in the case of France, Germany and Singapore, it is believed that the Korean regulatory and tax authorities can take different approaches in introducing Islamic finance. Instead of the sophisticated legislation process, the existing legal framework needs to be reviewed based on regulatory interpretations within the existing legal framework.

Due to a lack of *Shariah* experts in Korea, the use of *Shariah* counselling firms is recommended for the *Shariah* Supervisory Body. In particular, it was found that the AAOIFI standard is recommended for the solution of *Shariah* issues. The opinions of the Malaysian *Shariah* Advisory Council, however, can be used for investment from Malaysia.

The *sukuk* issued by Korean issuers are involved with the *Shariah*-compliant derivatives due to its market risk such as currency risk. *Shariah*-compliant derivatives bring up some challenges; i.e. higher expenses and additional transactions for the derivatives contract which might be ignored by the governmental or regulatory body in Korea. The finding suggested that the market risk may be mitigated with the conventional derivatives as there is no *Shariah*-compliant derivative market in Korea. Moreover, the taxation problems can also result from additional *Shariah* derivatives contracts which need to be included together in the efforts of the government or regulatory bodies.

One of the biggest challenges is the lack of acceptance and understanding of Islamic finance. It is believed that Korea is an attractive place to invest in from the aspects of its health industry. Nevertheless, the lack of awareness makes Islamic finance face tough objections of legal changes which are needed to attract Islamic financing. Therefore, the effort to create awareness should be parallel with the efforts of legislative or regulatory changes through alliances with other well-established countries, etc.

#### **5.4 Limitations of Study**

This study concentrates on opinions gathered from interviews with professionals of the regulatory body, securities companies, a law firm, a university, etc. who are involved in the Islamic finance of Korea. However, even though they are experts in the field, the knowledge and experience in

Islamic finance may have some limitations due to the relatively low interest and the short history compared to other countries such as UK, Singapore, etc. which have launched Islamic finance with their suitable system.

Looking forward, if Korea activates Islamic finance in the market, the study can involve more experienced professionals to get the primary data. At the same time, such data will give delicate opinions to develop the market.

Moreover, this study was undertaken in order to explore the issues and challenges in introducing Islamic finance in Korea. Hence, there is a limitation in applying the results to other non-Muslim country.

### **5.5 Suggestions for Future Research**

This study did not demonstrate enough the issues and feasibility of Islamic finance in the Non-banking institutions of Korea. However, it is believed that such a study can give a good attempt of the feasibility in introducing Islamic finance at initial stage.

From the findings, the study identified the importance of awareness. Hence, future studies can contribute to efforts to increase awareness through in-depth study.

### **5.6 Practical Implication**

This study explored the issues and challenges when introducing Islamic

finance in Korea and managed to identify the practical considerations. With the findings on the issues and challenges, the practical implication of the study is to provide practical insights that a governmental or a regulatory body can consider in their efforts and market players such as financial institutions can review for practical implementation.

At the same time, it is believed that the study regarding *Shariah* issues may give practical insights on the issuances of *sukuk* in Korea.