Islamic Trade Finance
An Opportunity for Malaysia
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<td>SESRIC</td>
<td>Statistical, Economic and Social Research and Training Center for Islamic Countries</td>
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<td>SME</td>
<td>Small Medium Enterprise</td>
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<td>SSFS</td>
<td>Shari’ah-Compliant Financing Scheme</td>
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<td>SWIFT</td>
<td>Society for Worldwide Interbank Financial Telecommunication</td>
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<td>Single Window System</td>
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<td>Uniform Customs &amp; Practice for Documentary Credits</td>
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GLOSSARY OF ISLAMIC FINANCE TERMS

**Principles of Islamic Finance**

*Prohibition of interest (Riba):* The premium (interest) that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension.

(i) Riba al-Fadl: Riba in hand-to-hand or barter exchange.

(ii) Riba al-NasiNas: Riba in money-to-money exchange provided exchange is delayed or deferred and additional charge is associated with such deferment.

*Prohibition of speculative behavior (Gharar):* Uncertainty in contractual terms and conditions is forbidden. However, risk-taking is allowed when all the terms and conditions are clear and known to all parties.

*Ban on financing certain economic sectors:* Financing of industries deemed unlawful by Sharia—such as liquor, pork, and gambling—is forbidden.

*The profit- and loss-sharing principle:* Parties to a financial transaction must share in the risks and rewards attached to it.

*The asset-backing principle:* Each financial transaction must refer to a shari’ah-compliant tangible assets (like real estate) and/or intangible assets like usufruct (e.g., leasehold rights) or services (e.g., toll road concessions).

*Takaful (Islamic Social Solidarity Scheme):* Takaful is an arrangement for joint guarantee, whereby a group of participants agrees to support one another jointly for losses arising from identified risks. Under this arrangement, participants contribute a sum of money as a commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage.

*Retakaful:* A form of Islamic reinsurance that operates on the Takaful model.

*Kafalah:* A contract of guarantee used to provide assurance as to performance or liabilities.

*Wakala (Agency):* A contract whereby someone appoints another to act on his/her behalf for a fee.

*Murabaha:* Trade with markup or cost-plus sale. The purchase of an asset is financed for a profit margin, with the asset purchased on behalf of client and resold at a pre-determined price. Payment could be in lump sum or in installments and ownership of the asset remains with bank till full payments are made.

*Commodity Murabaha or Tawarruq:* A murabahah transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred murabahah, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
**Ijarah:** A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. An *ijarah* contract is binding on both contracting parties.

**Musharaka:** Equity participation contract. Different parties contribute capital and profits are shared according to a pre-determined ratio, not necessarily in relation to contributions, but losses are shared in proportion to capital contributions. The equity partners share and control how the investment is managed and each partner is liable for the actions of the others.

**Mudaraba:** Trustee financing contract. One party contributes capital while the other contributes effort or expertise. Profits are shared according to a predetermined ratio and the investor is not guaranteed a return and bears any financial loss.

**Vocabulary of Islamic Finance**

**Bai’ Dayn:** Debt trading

**Rabb-Al-Mal:** Capital owner/investor. In a Muḍarabah contract the person who invests the capital (the capital owner or financier).

**Sukuk (certificates of ownership):** Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or (in the ownership of) the assets of particular projects.

**Ujrah:** Fee

**Wa’ad:** Unilateral binding promise
Executive Summary
Overview

Islamic trade finance (ITF) offers a meaningful opportunity for Malaysia. ITF can play a substantial role to support trade, foster growth, and accelerate post-pandemic recovery. In addition to its impact on the domestic economy, enhancing ITF can bring benefits to other Organization of Islamic Countries (OIC)-member countries and for the global Islamic finance industry in which Malaysia is an established leader.

This report explores the ITF opportunity by considering:

1. the current state of global trade finance and of ITF,
2. institutions and instruments active in providing ITF,
3. key challenges ahead in expanding ITF and
4. opportunities for expanding ITF in Malaysia. The report includes
5. a set of recommendations for stakeholders in Malaysia and beyond to avail of the opportunity that ITF offers.

While the recommendations are focused on Malaysia, they may also have relevance for other developing economies where Islamic finance is relevant.

The report argues that key strides have already been made – in Malaysia and globally – to establish ITF concepts, products, and structures. The relative under-utilization of ITF is due to challenges related to awareness, promotion, scale, and harmonization. Addressing these challenges, through a set of proposed recommendations, can foster ongoing growth of ITF in service of Malaysia’s development objectives.

Background and Benefits

Although ITF is today a small fraction of the global trade finance market, it has taken root globally and in Malaysia and has potential to grow significantly. Achieving such growth, however, will require addressing a series of barriers that currently limit ITF in Malaysia and beyond.

Conceptually, there is a strong affinity between Islamic finance and trade finance. Islamic finance focuses on real assets and seeks to promote the real economy. The core instruments of Islamic finance, which involve financing tangible assets, have direct applicability to international trade. In practice, ITF is already offered through financial institutions in Malaysia, the GCC, and other key OIC-member countries. It is also offered through multilateral institutions and through Export-Import banks in the largest OIC-member economies.

Trade finance allows for reduced trading costs by eliminating intermediaries that buy goods for cash from exporters and resell them at a higher price to importers. It can also enable participants in international trade to deal with new counterparties that may not initially be trusted due to a lack of track record; to place larger orders with suppliers or request higher volumes of stock, leading to bulk discounts; or to commit to selling larger volumes of merchandise, leading to economies of scale. Furthermore, trade finance can mitigate counterparty credit and performance risk and limit delays in payment.

Trade can play an important role in the recovery and trade finance can be especially helpful for businesses that have suffered during the pandemic. Islamic finance instruments can be a part of the solution, especially in accessing SMEs and segments of the population that have religious concerns regarding conventional finance.
Executive Summary

Current State

International trade has historically grown much faster than global GDP, nearly doubling in the 20 years prior to the pandemic and representing 60 percent of global GDP.\(^1\) Although the pandemic led to a decline in global trade of 9.2 percent in 2020, the setback is expected to be temporary, with continued growth forecasted for 2021 and beyond (WTO, 2020a; WTO, 2020b). It is estimated that 47 percent of global trade relies on bank-intermediated trade finance (QYResearch, 2020). As global trade expands, trade finance is of central importance.

In 2019, the global trade finance market amounted to US$8.94 trillion. Due to Covid-19, the global trade finance market dropped by 14.83 percent in 2020 to US$7.62 trillion but is expected to recover and reach US$10.43 trillion by the end of 2026, growing at a rate of 5.37 percent annually from 2020-2026 (QYResearch, 2020).

The global size of the ITF has reached US$186 billion, less than 5 percent of total estimated trade finance activities by OIC member countries (CIBAFI, 2018b) and a small fraction of global figures. ITF is, however, growing both in scale and in relevance as Islamic finance plays a larger role in OIC countries. The Islamic Trade Finance Corporation (ITFC), a member of the IsDB Group, has been a multilateral pioneer in ITF. Established in 2008, ITFC has 26 member countries (including Malaysia) and approved US$5.8 billion of financing in 2019 (ITCF, 2019). Its relevance to the global ITF market stems from its pioneering role in spreading ITF and its ties to member countries who can avail of and replicate ITCF services.

Islamic banks in the GCC region and beyond are active in ITF – all of the top ten Islamic banks in the GCC offer ITF products. International Islamic banks operating in Malaysia similarly offer ITF products. Islamic banks in the GCC are especially strong in unfunded products and services, such as letters of credit and guarantees.

Malaysia is a leader in trade and is the third-largest merchandise exporter, and also the third-largest merchandise importer, amongst OIC countries. This is despite being the seventh-largest economy amongst OIC members, making Malaysia a leader amongst its OIC peers.\(^2\) Malaysia’s foreign trade reached US$449 billion in 2019, corresponding to 123 percent of Malaysia’s GDP. Malaysia’s foreign trade has more than doubled since 2000. Its largest trading partners are China, Singapore, and the USA, and its largest OIC trading partner is Indonesia.\(^3\) Malaysia’s foreign trade contracted 3.6% in 2020 to US$431 billion, due to the pandemic (MATRADE, 2020).

Analysis of the current state of trade finds Malaysia to a be a leader in international trade as compared to other OIC member countries. It is found that the adoption of trade finance in Malaysia is limited compared to global averages, suggesting significant opportunity for growth of Malaysia’s trade finance industry overall and its ITF industry in particular. Malaysia is well suited to be a global leader in ITF because of its high level of trade activity coupled with its leadership in Islamic finance.

In Malaysia, bank-intermediated trade finance (whether conventional or Islamic) is relatively limited, valued at US$40.2 billion in amount outstanding as at 2020. The vast majority of trade relies on credit terms between trading parties or entails immediate, spot payment. ITF comprises US$12.3 billion, corresponding to 31.4 percent of the total trade finance outstanding market as at 2020. The share of Islamic banking within the total banking market, by contrast, is 41 percent. This suggests significant potential for ITF to grow.

Malaysia’s top ten Islamic financial institutions (IFIs) all offer trade finance products. International Islamic banks operating in the country similarly offer ITF. The EXIM, founded in 1995, offers a range of ITF products.

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1. World Bank data: https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS
2. Data from World Bank and SESRIC.
3. Data from BNM.
based on a range of *shari’ah* structures. Trade finance solutions are provided by both banks and NBFI. Islamic banking and *takaful* companies are licensed under the IFSA. BNM supervises banks and *takaful* companies across their full range of businesses, and also has issued 14 *shari’ah* standards for Islamic contracts.

The Securities Commission (SC), which regulates capital markets, including ECF, and P2P has authorized NBFI that are active in ITF and provide Islamic invoice financing and factoring. In addition to pro-active regulation of Islamic finance (including ITF), Malaysia has adopted other policy measures that enable ITF. These include a National Single Window (NSW), established in 2009, that connected more than 25,000 users and enables over 100 million transactions annually.  

Policymakers have further taken measures to promote the halal industry and halal exports, whose stakeholders often prefer Islamic finance and are likely users of ITF. A Halal Industry Master Plan 2030 was issued by the Government of Malaysia. BNM has directly participated in several halal promotion initiatives, in addition to supervising IFIs active in the sector. Growth in this sector could spur significant expansion of ITF as well.

### Opportunities for Growth

Opportunities for growth include reaching new market segments, embracing digital finance, and being part of the response to the Covid-19 pandemic. Each of these opportunities, if pursued by market actors and supported with enabling policies, can expand the reach of ITF. They can also make trade finance more accessible and inclusive in markets where there are demand for ITF.

To expand ITF in Malaysia and beyond, one key opportunity is to reach new segments of exporters. Such segments include:

1. large public-listed companies which meet SC’s *shari’ah* screens,
2. companies in the agricultural sector, and

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4 Dagang Net Technologies Sdn Bhd (Dagang Net).
Executive Summary

Digital finance is another growth opportunity for ITF. 44 percent of banks in the Middle East region have cited the development and deployment of digital trade and online trade platforms as a strategic priority in the near-term (ICC, 2018). Blockchain, which is able to efficiently capture all the data needed for trade finance, can have a transformative impact.

As the world recovers from the Covid-19 pandemic, supply chains are evolving in ways that can create opportunities for ITF. As companies seek to diversify and regionalize supply chains, new partnerships can be formed and ITF can be an enabler. Governments seeking to support their SME sectors can use ITF as part of their stimulus policy. Doing so can not only support the recovery, but also help trade finance reach segments that have not yet accessed it due unavailability of suitable products and services.

Challenges to Expansion

While opportunities for growth are many, there also remain significant challenges to ITF. These include challenges for both trade finance participants (exporters and importers) and the financial intermediaries that serve them related to awareness, promotion, scale, and harmonization.

It is found that stakeholders perceive complexity to fulfill shari’ah requirements and limited understanding of the contracts are challenges to be overcome. Lack of familiarity is a challenge both for clients of banks and for the banks themselves, as explaining ITF structures can require additional effort. Clients also perceive an absence of key products which they would like, such as supply chain finance. It may often, however, be that the products are available, but the client is not aware of the offerings.

Stakeholders have cited a need for product customization, especially when targeting larger and more sophisticated clients. Prospective clients reported that pricing, flexibility on collateral, and speed of approval are key factors that shape their choice in whether or not to pursue ITF.

A lack of harmonization of shari’ah standards at the global level has also been identified as a challenge. Although BNM provides comprehensive shari’ah guidelines, there remains a perceived need to harmonize structures with international trade finance practices and other Islamic finance jurisdictions.

Regulatory compliance requirements impact IFIs’ risk appetite and business strategy for offering ITF products and services especially for cross-border transactions. Further innovation and digitalization by IFIs can facilitate improvements in risk management processes and reduce the risk exposure arising from ITF.

Recommendations

A set of recommendations are offered as means to enhance ITF in Malaysia and beyond. These include recommendations related to

1. robust regulatory and policy support,
2. enhanced Government and multilateral promotion,
3. strong institutional enablers, and
4. digitization and Islamic FinTech.

Each of these recommendations serves to address the current barriers related to awareness, promotion, scale harmonization, and capacity development.
The table below summarizes the report’s eleven recommendations by category and notes which barriers are most directly addressed by each:

<table>
<thead>
<tr>
<th>Category</th>
<th>Recommendation</th>
<th>Barriers Addressed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory and policy support</td>
<td>Develop a more comprehensive trade strategy, which is not limited to the Halal sector but rather more broad in promoting trade.</td>
<td>Promotion and scale</td>
</tr>
<tr>
<td></td>
<td>Target SMEs to adopt ITF.</td>
<td>Awareness and promotion</td>
</tr>
<tr>
<td></td>
<td>Leveraging on existing platform such as the imSME portal for small business finance to integrate a one stop centre/single window for ITF</td>
<td>Awareness and scale</td>
</tr>
<tr>
<td></td>
<td>Develop an ITF framework for the global Halal sector in partnership with international bodies.</td>
<td>Promotion and harmonization</td>
</tr>
<tr>
<td>Government and multilateral promotion</td>
<td>Allocate funds from the Government of Malaysia to create subsidies and incentives for ITF, akin to its Green Technology Financing Scheme (GTFS).</td>
<td>Promotion and scale</td>
</tr>
<tr>
<td></td>
<td>Raise awareness of ITF in Government and industry-led initiatives.</td>
<td>Awareness and promotion</td>
</tr>
<tr>
<td></td>
<td>Collaborate and engage more closely with multilateral bodies such as ITFC and the Asian Development Bank (ADB) on ITF, especially for SMEs.</td>
<td>Awareness and promotion</td>
</tr>
<tr>
<td>Institutional enablement</td>
<td>Promote dialogue on ITF through institutions such as the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) and International Chamber of Commerce (ICC).</td>
<td>Awareness and harmonization</td>
</tr>
<tr>
<td></td>
<td>Enhance collaboration between practitioners, Shari’ah scholars, and academics to develop innovative and flexible IFI products.</td>
<td>Promotion and harmonization</td>
</tr>
<tr>
<td></td>
<td>Enhance talent development on ITF through leading Islamic finance talent development institutions such as the International Shari’ah Research Academy (ISRA), the International Center for Education in Islamic Finance (INCEIF), and the Islamic Banking and Finance Institute Malaysia (IBFIM).</td>
<td>Scale and harmonization</td>
</tr>
<tr>
<td>Digitalization</td>
<td>Enhance online ITF supply chain financing and explore blockchain technology as global banks increasingly engage with blockchain.</td>
<td>Promotion and scale</td>
</tr>
</tbody>
</table>

Malaysia benefits from being a global leader in both intra-OIC trade and in Islamic finance. It already has an ITF industry on which greater success can be built. Further developing Malaysia’s ITF industry through policy, awareness, and institutional measures can not only support the domestic economy but also have strategic impact on other developing countries. Additionally, enhancing ITF can be another area in which Malaysia has a strong impact on the global Islamic finance sector. Availing of the ITF opportunity will require concerted efforts to attain the envisioned development benefits.
CHAPTER 1

Current State and Potential Benefits of Islamic Trade Finance
Introduction

This chapter explores the current state of trade finance and ITF both globally and in Malaysia. Global trade is found to have grown strongly in recent decades, with long-term growth expected despite the challenges of a global pandemic. Analysis of the current state of trade finds Malaysia to be a leader in international trade as compared to other OIC member countries. It is found that the adoption of trade finance in Malaysia is limited compared to global averages, suggesting significant opportunity for growth of Malaysia’s trade finance industry overall and its ITF industry in particular. The chapter concludes that Malaysia is well suited to be a global leader in ITF because of its high level of trade activity coupled with its leadership in Islamic finance.

1.1 International Trade Supports Global Economic Development

1.1.1. Theoretical underpinnings

Trade enriches trading partners by allowing them to produce more of the goods or services in which they have a comparative advantage. They then trade their respective surpluses, allowing them collectively to consume more than they would be able to in the absence of trade. Where the trade is between nations, the impact of trade can be to create more jobs, attract investment, enable the introduction of new technologies, and offer the domestic populace a more diverse array of goods and services to consume. As such, international trade can support economic development.

1.1.2. Data on world trade

International trade has historically grown much faster than GDP. World Bank data depicted in Figure 1.1 below demonstrates that the share of trade in global GDP grew steadily from 27 percent in 1970 to 61 percent in 2008, at the onset of the global financial crisis. Since then trade has remained roughly 60 percent of world GDP, implying growth in tandem with the world economy over the past decade.

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6 https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS
Global merchandise trade volumes nearly doubled over the past 20 years prior to the pandemic. In particular, world merchandise trade volumes and real GDP both grew 26 percent between 2008 and 2018 (WTO, 2020). Merchandise trade is defined by the WTO as “all types of inward and outward movement of goods through a country or territory, including movements through customs warehouses and free zones.” (WTO, 2020b).
Crises have caused declines in trade. While trade volumes have grown steadily, analysis of the trend lines for 1990-2008 and for 2011-2021 suggest that the rate of growth was higher from 1990-2008 than it has been since 2011. It is further noted that the financial crisis of 2009 and the COVID-19 pandemic both led to sharp declines in trade. In the case of the 2009 financial crisis, the recovery was “V-shaped” in that 2010 volumes were comparable to the 2008 figure.

1.1.3. Recent developments

Trade and geopolitical tensions, coupled with the Covid-19 pandemic, have had a negative impact on global trade. In 2019, the volume of world trade fell (by 0.1 percent) for the first time since the financial crisis in 2008-09. Although the pandemic is expected to reduce global trade by a much more significant 9.2 percent in 2020, the setback is expected to be temporary, with the WTO forecasting growth of 7.2 percent for 2021. This will leave merchandise trade noticeably below its pre-pandemic trend in 2021, as shown in Figure 1.2 by the divergence between the dashed red line (representing the trend) and the dark blue line (representing actual and projected figures).

Several reasons may be cited as contributing to the reduced rate of growth. The earlier years of globalization (1970 to 2008) experienced higher growth rates as the starting point was lower and access to markets was quickly improving. The ASEAN Free Trade Area (AFTA) was adopted in 1992; the EU became a single market in 1993; the North American Free Trade Agreement (NAFTA) was adopted in 1994; the WTO was formed in 1995; and the Euro was adopted in 1999. The reduction of trade barriers enabled trade to grow faster than GDP. Since 2008, by contrast, trade has grown in tandem with GDP as the base level of trade is higher and major new trade agreement are limited. Two crises – the 2009 financial crisis and the 2020 pandemic – have also been seen to negatively impact trade.

Trade growth rates have varied by region. The data in Figure 1.3 provide further detail about growth rates for world merchandise trade volume and real GDP in recent years (WTO, 2020). Notably, the dips in trade and GDP experienced in 2020 were least severe in Asia, and all regions are projected to rebound in both trade and GDP in 2021. China, Asia’s largest economy, began its recovery from the pandemic earlier in 2020 than other countries and regions. Its trajectory shapes the regional figures for Asia overall, dampening both the decline in 2020 and the rate of recovery expected in 2021.

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7 It should be noted that these projections are subject to a significant degree of uncertainty. For example, in April 2020 the WTO was more pessimistic about 2020, forecasting trade volumes to fall by 12.9 percent, and far more optimistic about 2021, predicting a 21.3 percent rise. Likewise, a resurgence of Covid-19 along with other downside risks such as higher unemployment could reduce global GDP growth by 2 to 3 percentage points and global merchandise trade growth by 4 percentage points in 2021. On the other hand, rapid deployment of an effective vaccine could raise GDP growth by 1 to 2 percentage points in 2021, increasing the trade growth by 3 percentage points. See WTO (2020a).
FIGURE 1.3: Merchandise Trade Volume and Real GDP: 2015-2021

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<td>3.4</td>
<td>3.8</td>
<td>1.0</td>
<td>-14.7</td>
<td>10.7</td>
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<td>2.9</td>
<td>0.1</td>
<td>-2.2</td>
<td>-7.7</td>
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<tr>
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<td>1.1</td>
<td>3.7</td>
<td>2.0</td>
<td>0.1</td>
<td>-11.7</td>
<td>8.2</td>
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<td>1.3</td>
<td>2.3</td>
<td>6.7</td>
<td>3.7</td>
<td>0.9</td>
<td>-4.5</td>
<td>5.7</td>
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<tr>
<td>Other regions</td>
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<td>3.5</td>
<td>0.7</td>
<td>0.7</td>
<td>-2.9</td>
<td>-9.5</td>
<td>6.1</td>
</tr>
<tr>
<td><strong>Imports</strong></td>
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<tr>
<td>North America</td>
<td>5.2</td>
<td>0.3</td>
<td>4.4</td>
<td>5.2</td>
<td>-0.4</td>
<td>-8.7</td>
<td>6.7</td>
</tr>
<tr>
<td>South and Central America</td>
<td>-7.6</td>
<td>-9.0</td>
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<td>-2.1</td>
<td>-13.5</td>
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<tr>
<td>Europe</td>
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<td>3.0</td>
<td>1.5</td>
<td>0.5</td>
<td>-10.3</td>
<td>8.7</td>
</tr>
<tr>
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<td>4.9</td>
<td>-0.6</td>
<td>-4.4</td>
<td>6.2</td>
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<tr>
<td>Other regions</td>
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<td>1.5</td>
<td>-16.0</td>
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<tr>
<td><strong>Real GDP at market exchange rates</strong></td>
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<tr>
<td>North America</td>
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<td>3.1</td>
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<td>2.2</td>
<td>-4.8</td>
<td>4.9</td>
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<tr>
<td>South and Central America</td>
<td>2.8</td>
<td>1.7</td>
<td>2.4</td>
<td>2.8</td>
<td>2.1</td>
<td>-4.4</td>
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</tr>
<tr>
<td>Europe</td>
<td>-0.8</td>
<td>-2.0</td>
<td>0.8</td>
<td>0.6</td>
<td>-0.2</td>
<td>-7.5</td>
<td>3.8</td>
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<tr>
<td>Asia</td>
<td>2.4</td>
<td>2.1</td>
<td>2.8</td>
<td>2.1</td>
<td>1.5</td>
<td>-7.3</td>
<td>5.2</td>
</tr>
<tr>
<td>Other regions</td>
<td>4.3</td>
<td>4.2</td>
<td>4.8</td>
<td>4.1</td>
<td>3.9</td>
<td>-2.4</td>
<td>5.9</td>
</tr>
<tr>
<td><strong>Other regions</strong></td>
<td>1.5</td>
<td>2.4</td>
<td>1.9</td>
<td>2.1</td>
<td>1.4</td>
<td>-5.5</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: WTO Secretariat for trade, consensus estimates for GDP.

1.2 Trade Finance is a Core Enabler of Trade

1.2.1 How is trade financed?\(^8\)

Trade finance is a broad concept. At the most generic level, trade finance is synonymous with the “payment arrangements between importers and exporters—from open accounts to cash-in-advance, interfirm trade credit, and bank-intermediated trade finance.” (World Bank, 2011). Where goods or services are exchanged for cash on a spot basis—that is, there is no temporal separation between payment and shipment—no trade finance occurs. Transactions with immediate cash payment have been estimated to cover only 10-20 percent of world trade. Therefore, trade finance—whether through payment terms between the transacting parties or intermediated through a bank—supports an estimated 80-90 percent of global trade (World Bank, 2011).

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\(^8\) The discussion in this section about the fundamentals of trade finance is based on the following sources: (World Bank, 2011); (Trade Finance Global, 2020a) and (BIS, 2014).
Bank-enabled trade finance differs from interfirm trade credit. One way to structure a framework for thinking about trade finance is to separate those payment arrangements that are solely between the trading parties ("interfirm trade credit") from those that involve financial institutions ("bank-intermediated trade finance"). The first category can be further broken down into three forms of trade finance, based on the relative timing of payment and shipment and the party with the greater risk:

i. In open-account transactions, payment occurs after shipment. The exporter ships goods to the importer along with an invoice requesting payment, typically within 30-90 days (of shipment, receipt, or another point in time, depending on the terms). The exporter bears the risk of non-payment. The exporter must finance the receivable using its own balance sheet.

ii. In cash-in-advance transactions, payment occurs before shipment, and perhaps even before the exporter has (in the case of physical goods) produced the traded items. The exporter is then obligated to deliver the goods or services within the agreed-upon period. The importer bears the risk that the exporter will not fulfill its obligations. The importer must finance the prepayment using its own balance sheet.

iii. The third type is a mixture of the two, where the parties take a more structured and drawn-out approach to the timing of payment or shipment. For example, an exporter of heavy machinery could have a financing arm for customers that functions as a captive bank, enabling importers to purchase and finance their imports with the same institution, and giving the exporter a security interest in the goods if the importer does not pay as agreed. Likewise, a well-capitalized importer could have a division dedicated to financing foreign suppliers, with prepayments and deliveries occurring under a set schedule and the importer having rights it normally would not if it were not acting as a financier (e.g., the ability to inspect the exporter's factories to ensure production is on schedule).

1.2.2. Bank-intermediated trade finance

In practice the term "trade finance" is often used to refer to bank-intermediated trade finance. Such trade finance involves a third-party financial institution (and sometimes several) acting as an intermediary between the exporter and importer. The institution could be a bank, a specialized trade finance company, an insurer, a development finance institution or other multilateral institution, or an export credit agency. For the purposes of the current report, these various types of institutions will all be covered within the term “bank-intermediated trade finance.” A 2011 World Bank publication estimated that bank-intermediated trade finance funded 35-40 percent of global trade (World Bank, 2011); a 2020 study by QYR Research suggests that the role of bank-intermediated trade finance may have risen to 47 percent of global trade by 2019 (QYResearch, 2020).

Bank-intermediated trade finance can be divided into several sub-categories based on the degree of funding required from the financial institution:

i. Unfunded trade finance does not involve the financial institution providing funding at the outset, though it may have to provide it at a later stage in certain cases. Examples include letters of credit, various types of guarantees and bonds, documentary collection, and trade credit insurance and political risk insurance.

ii. Funded trade finance involves the financial institution providing funding as an initial matter to one or both parties involved in the trade transaction. Examples include working capital or supply chain financing (ranging from the pre-export stage all the way to the importer's inventory or customer receivables stage), secured pre-export finance, letter of credit refinancing, and factoring and forfaiting.
Chapter 1: Current State and Potential Benefits of Islamic Trade Finance

Trade finance products may be unfunded or funded. Key products provided by bank-intermediated trade finance are shown in Table 1.1 as follows:

<table>
<thead>
<tr>
<th>Type</th>
<th>Name</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unfunded</td>
<td>Letter of credit</td>
<td>Importer’s financial institution guarantees payment to exporter once agreed-upon terms are met (e.g., goods have been shipped or delivered and are in satisfactory condition).</td>
</tr>
<tr>
<td></td>
<td>Guarantee or bond</td>
<td>Importer’s financial institution provides security against demand for advance payments or exporter’s nonperformance.</td>
</tr>
<tr>
<td></td>
<td>Documentary collection</td>
<td>Exporter’s and importer’s financial institutions exchange shipping documents, after which latter pays former, which transmits the funds to exporter.</td>
</tr>
<tr>
<td></td>
<td>Trade credit and political risk insurance</td>
<td>Financial institution protects exporter from non-payment by importer due to default, insolvency, bankruptcy, or force majeure events.</td>
</tr>
<tr>
<td>Funded</td>
<td>Working capital or supply chain finance</td>
<td>Exporter’s financial institution provides financing for raw materials, work in progress, or inventory; importer’s financial institution provides financing for importation, payables, inventory, or customer receivables.</td>
</tr>
<tr>
<td></td>
<td>Secured pre-export finance</td>
<td>Producers of commodities (such as metals, energy, or crops) receive financing backed by cash flow from commodity; also used by commodity trading houses and lenders to commodity producers.</td>
</tr>
<tr>
<td></td>
<td>Letter of credit refinancing</td>
<td>Importer borrows from financial institution in order to obtain a letter of credit, or institution issues a letter and then finances the customer’s debit.</td>
</tr>
<tr>
<td></td>
<td>Factoring and forfaiting</td>
<td>Exporter sells open invoices or receivables at a discount to financial institution; depending on terms exporter may be relieved of risk of nonpayment. Factoring involves short-term receivables while forfaiting involves medium- and long-term receivables.</td>
</tr>
</tbody>
</table>

International trade, rather than domestic trade, is the focus of trade finance. For a variety of reasons, the term trade finance is more commonly used of in a cross-border context. The trading parties are subject to different banking and legal systems; long shipping journeys and border delays due to customs inspections can create working capital pressure and the parties may face foreign currency risk. The importer may be unknown to the exporter, which due to distance and language barriers may find it difficult to establish the creditworthiness or reliability of the buyer. The remainder of this report will focus on bank-intermediated trade finance in support of international trade and refer to it simply as “trade finance” except where specifically noted.

Trade finance provides direct access. Trade finance allows for reduced trading costs by eliminating intermediaries that buy goods for cash from exporters and resell them at a higher price to importers. It can also enable participants in international trade to deal with new counterparties that may not initially

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9 The categorization of “unfunded” vs. “funded” is drawn from the “Guide to Trade Finance.” Trade Finance Global (2020).
10 Adapted from the “Guide to Trade Finance.” Trade Finance Global (2020).
11 Adapted from “Trade Finance during the Great Trade Collapse.” World Bank (2011).
be trusted due to a lack of track record; to place larger orders with suppliers or request higher volumes of stock, leading to bulk discounts; or to commit to selling larger volumes of merchandise, leading to economies of scale. Furthermore, trade finance can mitigate counterparty credit and performance risk and limit delays in payment.

**In 2019, the global trade finance market amounted to US$8.94 trillion.** Due to Covid-19, the global trade finance market dropped by 14.83 percent in 2020 to US$7.62 trillion but is expected to recover and reach US$10.43 trillion by the end of 2026, growing at a rate of 5.37 percent annually from 2020-2026 (QYResearch, 2020).

**Technology is supporting innovation in trade finance.** Technological advances and digital platforms are shortening the application processes for trade finance products by enabling tasks such as risk assessment and collection and authentication of documentation to be completed more rapidly. A few examples of such advances include optical character recognition, radio frequency identification (RFID), QR codes, and blockchains, all of which can help trade participants identify and track shipments. In addition, natural language processing, predictive analytics, chatbots, artificial intelligence, and machine learning can assist in identifying and addressing problems, recognizing trends, predicting demand, and making business recommendations. These technologies can also help automate trading documents and ensure the timely delivery of electronic forms to stakeholders. The integration of blockchain technology with trade finance also enables market vendors to expedite and simplify the invoicing of financial transactions from end to end. The size of the trade finance market is expected to grow as such enhancements in technology improve the efficiency of the business financing cycle (Trade Finance Global, 2021).

### 1.3 Islamic Finance and Trade Finance

**Conceptually, there is a strong affinity between Islamic finance and trade finance.** Islamic finance focuses on real assets and seeks to promote the real economy. The core instruments of Islamic finance, which involve financing tangible assets, have direct applicability to international trade.

**One key principle of Islamic finance is the prohibition on paying or receiving *riba*, which is interpreted to mean all forms of interest.** The prohibition of interest is rooted in the notion that money is to be used as a medium of exchange but is not itself a commodity. Thus “any return must be tied to an asset, or participation and risk-taking in a joint enterprise (such as partnerships). A pure debt security is replaced with an ‘asset-linked’ security, direct financing of a real asset, and different forms of partnerships of which equity financing is the most desirable.” (World Bank, 2015).

**In addition to prohibition of *riba*, there are several other important provisions which may affect financial transactions.** These include the prohibition of *gharar* (uncertainty or asymmetrical information), *maysir* (gambling, speculation), hoarding, as well as trading in prohibited commodities (for example, pork and alcohol). (World Bank, 2015).

**Four basic principles of Islamic finance can be extracted from the various guidelines and provisions:**

1. First, if something is immoral, one cannot profit from it.
2. Second, to share reward, one must also share risk.
3. Third, one cannot sell what one does not own.
4. Fourth, in any transaction, one must clearly specify what one is buying or selling and what price is being paid (Rehman, 2009).
Core Islamic finance structures typically entail the acquisition and trade of real assets, with financial institutions making decisions based on the value of assets and projects. Each of the core Islamic finance contracts described in Table 1.2 below introduces an element of risk-sharing that shifts the financing party’s focus toward the activity being financed. They are inherently well suited to facilitation of trade in goods because their focus is on the value of the assets rather than on the credit of the counterparties.

### Table 1.2: Key Islamic Finance Contracts

<table>
<thead>
<tr>
<th>Name</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Murabaha</strong></td>
<td>The financier takes ownership of an asset (even if briefly) prior to reselling it to the client at a higher price. The sale contract discloses the financier’s cost and profit margin.</td>
</tr>
<tr>
<td><strong>Ijara</strong></td>
<td>The financier leases the asset to the client, maintaining ownership of the asset for the duration of the lease and possibly beyond.</td>
</tr>
<tr>
<td><strong>Mudaraba</strong></td>
<td>The financier and the client form a joint venture, with the former taking investment or performance risk and the latter responsible for managing the project. Profits are shared between the parties, while losses are borne entirely by the financier unless there is wilful neglect by the client.</td>
</tr>
</tbody>
</table>
| **Salam/Istisna’** | The financed party (the seller of a good) receives immediate payment for goods to be delivered in the future. The sale contract must include a known rate, volume, and delivery time. The spirit of salam exchanges is twofold:  
   (1) the parties do everything possible to diminish the amount of uncertainty in the contract, and  
   (2) the seller is engaged in the development or creation of the object of sale, rather than procuring them from someone else, and the advance payment assists the seller in doing so.  

   *Istisna’* is similar to *salam* but typically involves manufacturing. In addition, the *istisna’* purchase price need not be paid in full in advance, an *istisna’* contract can be cancelled by the seller, and a fixed delivery time is not required with *istisna’*.  

   *Salam* and *istisna’* are the only types of Islamic finance contracts that permit the sale of something one does not own.  

| **Musharaka** | The financier (as well as the client) takes equity risk. Both parties contribute capital, with profits shared based on an agreed ratio and losses shared based on capital contributions. |

Source: BNM (2010)
Islamic finance principles are readily applied to trade finance. Currently, many Islamic trade finance arrangements are available in the market to facilitate pre- and post-shipping trade and provide working capital to mitigate trading stakeholders’ risks. For example, one of the most common trade finance products is the letter of credit, which is comparable to a murabaha contract in Islamic finance, as shown in Figure 1.4 and Figure 1.5 below.

**FIGURE 1.4 : Structure of Conventional Letter of Credit**

Note: An exporter in country A sells goods to an importer in country B. The importer asks her local bank to issue a letter of credit in her favour guaranteeing the exporter that payment will be made upon presentation of documents. Payment is also guaranteed by the exporter’s bank (the letter of credit is confirmed). The letter of credit is accepted by the issuing bank and the exporter discounts it to her local bank (obtains a credit). 1. Applies for letter of credit; 2. Sends letter of credit; 3. Confirms letter of credit; 4. Sells letter of credit; 5. Discounts letter of credit/provides cash; 6. Ships goods; 7. Sends documents; 8. Presents documents at maturity; 9. Pays at maturity/provides cash; 10. Credits at maturity. Based on description of the instrument in Amiti and Weinstein (2011), BIS (2014), Niepman and Schmid-Eisenlohr (2016, 2017).

Source: Accominotti & Ugolini, (2019)

**FIGURE 1.5 : Structure of Murabaha Transaction**

1. Applicant asks the IB to import the goods
2. The applicant promises to buy the specific goods as agreed
3. The IB appoints the applicant as the agent
4. The applicant signs the sale contract with the beneficiary on behalf of the IB
5. The IB releases the LC
6. The Advising bank confirms the LC and informs the beneficiary
7. Exporters deliver the goods, and shipping documents are forwarded to the advising bank after the goods are shipped
8. The exporter claims a payment from the advising bank
9. The IB forwards the payment to the beneficiary through the advising bank. The IB sells the goods to the applicant under the Murabahah contract.

Source: CIBAFI (2018b)
A letter of credit can adopt a murabaha structure. With a letter of credit, the importer asks its bank to guarantee to the exporter (via its own bank) that the importer will pay for the goods once received. In a murabaha contract, the Islamic Financial Institution (IFI) agrees to buy the goods on behalf of the importer using cash or a letter of credit, and then sells it back to the importer with a profit margin. In both types of trade finance products, the bank’s creditworthiness replaces that of the importer, ensuring that the exporter will be paid and causing the importer’s financial institution to assume the risk of non-payment. It should also be noted that in a murabaha contract, if the importer defaults on any payments, it generally is not obligated to bear additional charges. The importer pays a fixed price, agreed in advance, above its bank’s cost for the goods, which is permissible in Islamic finance (Al Rajhi Bank, 2021).

Such a structure can be used for significant trade finance transactions. For example, the ITFC, recently signed a US$100 million line of trade finance modeled on murabaha principles with a Japanese bank operating in Malaysia (Trade Finance Global, 2020b). Notably, this transaction also demonstrates the potential for conventional banks to grow their ITF businesses.

Alignment of standards is sought. There has been a push within the ITF industry to agree on aligned trade finance standards and to create more products to address the specific needs of trade finance participants. This includes structures for letters of credit, trust receipts and bills, shipping guarantees, working capital financing, and export credit financing (Trade Finance Global, 2020b). In addition, ITF products and structures are evolving with advances in digitization.

Islamic structures may be preferred by certain stakeholders. Importers and exporters may opt for ITF as it becomes more widely available, as it emphasizes transparent and fair dealing and prohibits elements of usury, uncertainty, and deception. Furthermore, importers may be able to benefit from the prohibition in ITF of compounding late payment charges, early settlement or extension fees, compounding financing rates, and hidden charges (Maybank Islamic Berhad). Exporters may benefit indirectly by the provision of streamlined trade financing terms to importers.

ITF is currently limited in scale. As shown in Figure 1.6 below, ITF currently represents a small part of the global trade finance market, and less than 5 percent of trade finance activities in OIC countries. However, the Islamic trade finance sector is growing, and its market size in 2016 was about US$186 billion (CIBAFI, 2018b).

**FIGURE 1.6 : Global Trade, Trade Finance, and Islamic Trade Finance**

![Source: CIBAFI, WTO, ICD](image-url)
1.4 Trade by OIC Countries and Malaysia

1.4.1. OIC trade remains limited

**OIC trade is less than 10 percent of the world total.** OIC countries’ combined merchandise exports in 2019 were approximately US$1.8 trillion, representing 9.8 percent of the global total, and their combined merchandise imports in 2019 were approximately US$1.7 trillion, or 9.2 percent of the global total. As shown in Figure 1.7 below, in recent years prior to the pandemic, the value of OIC trade fell considerably, even as world trade continued to grow, before rebounding somewhat off troughs (SESRIC, 2020). This has been principally due to falling commodity prices, especially since 2014. According to the COMCEC Trade Outlook (2019) report, the largest export item of the OIC member states consisted of fuels and oils (COMCEC, 2019).

**FIGURE 1.7 : OIC Merchandise Exports and Imports (US$ Trillion)**

Source: IMF Directions of Trade Statistics (DOTS), July 2020. Data coverage: 56 OIC countries, 37 developed countries and 116 non-OIC developing countries.

**OIC GDP is similarly less than 10 percent of the world total.** The relatively low share of world trade represented by OIC nations and territories generally reflects their low share of world GDP. They account for about 8.2 percent of global GDP according to World Bank figures showing a collective OIC GDP of approximately US$7.2 trillion in 2019 as compared to world GDP of nearly US$88 trillion. OIC trade and GDP figures are both significantly below their proportion of the world population. The 57 OIC states contain approximately 1.8 billion people, or almost one quarter of the global population of nearly 7.7 billion. These comparative metrics are illustrated in Figure 1.8 below.12

**Fuels comprise over 40 percent of OIC exports.** Fuels (including petroleum, petroleum products, and natural gas) comprise 42 percent of total OIC exports, whereas fuel exports comprise only 11 percent of the world’s total exports. The percentage of national exports corresponding to fuel is more than half the national total in several large OIC economies, including Nigeria (92 percent), Iran (65 percent), and Saudi Arabia (64 percent) (COMCEC, 2019).

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12 World Bank data, from: https://data.worldbank.org/
Imports, however, are less concentrated on oil. Imports of fuels represent US$239 billion of OIC imports, corresponding to 14 percent of the total OIC import figure of US$1.77 trillion. While fuel is the single largest sector of imports, it is comparable in size to electrical machinery and equipment and parts thereof (US$216 billion, corresponding to 12 percent of total) and machinery and mechanical appliances (US$213 billion, also corresponding to 12 percent of total), the second and third largest import sectors (COMCEC, 2019).

**FIGURE 1.8: OIC Trade, GDP, and Population**

![OIC Trade, GDP, and Population](https://www.sesric.org/oic-ranker.php)

Source: World Bank

Political factors contribute to low OIC trade volumes. International trade is affected by political factors such as treaties, alliances, tariffs, sanctions, and embargos. Iran, the fourth largest OIC-member economy (SESRIC data, 2019), is subject to substantial sanctions and trade restrictions. Between June 2017 and January 2021, Qatar was subject to sanctions by other GCC members. Although some OIC members are members of regional trade blocs (such as ASEAN and the GCC), these trade blocs are smaller in size than the NAFTA or EU regional trade blocs. Lack of membership in these trade unions may contribute to the relatively low volume of trade involving OIC-member countries.

Intra-OIC trade imports and exports exceed US$300 billion. In 2019, intra-OIC merchandise exports were US$325 billion in value and intra-OIC imports were US$331 billion. Intra-OIC exports represented 18.1 percent of total OIC exports and intra-OIC imports represented 18.3 percent of total OIC imports (almost precisely the same proportion) (SESRIC, 2020). Intra-OIC trade is quite limited relative to the world total, but large in absolute terms, amounting to hundreds of billions of dollars annually. The bulk of OIC countries’ merchandise exports to fellow OIC members in 2019 originated in the UAE, Saudi Arabia, and Turkey, while the UAE was the largest importer. The largest participants in intra-OIC merchandise trade are shown in Figure 1.9 below.\(^\text{13}\)

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\(^{13}\) Data from SESRIC. OIC Ranker. Available from: https://www.sesric.org/oic-ranker.php.
FIGURE 1.9: Largest Intra-OIC Merchandise Exporters and Importers, 2019

Intra-OIC Merchandise Exports (2019)

Source: SESRIC

Intra-OIC Merchandise Imports (2019)

Source: SESRIC
1.4.2. Profile of leading OIC trading nations

Among OIC members, trade activity is highly concentrated. The top five exporters (Saudi Arabia, the United Arab Emirates, Malaysia, Turkey, and Indonesia) accounted for 60 percent of merchandise exports in 2019, and the top ten countries accounted for nearly 78 percent (SESRIC, 2020). The top five importers (UAE, Turkey, Malaysia, Indonesia, and Saudi Arabia) likewise accounted for 52 percent of the total in 2019, and the top ten for 72 percent (SESRIC, 2020). This data is illustrated in Figure 1.10 below.

**FIGURE 1.10 : Top OIC Merchandise Exporters and Importers, 2019 (US$ Billion)**

Evolving energy markets may affect OIC trade values. As global energy markets evolve, fossil fuels may face sustained pricing pressures. The value of OIC exports may thus be negatively impacted, as they were in the period 2015-16 when oil prices were relatively low. In addition to the direct impact by which lower oil prices result in lower trade values, lower oil prices could also result in limited of negative GDP growth in key OIC-member countries. Strains on such economies could lead to reduced demand for imports and reduced capacity to export.
1.4.3. Malaysia is a leader in international trade

Malaysia ranks highly amongst OIC countries. Malaysia was the seventh largest OIC economy in 2019 but was the third-largest merchandise exporter (with a 13.1 percent share of OIC exports) and importer (with an 11.4 percent share of OIC imports). Malaysian exports and imports of merchandise in 2019 amounted to about US$238 billion and US$205 billion respectively.\footnote{Data from World Bank and SESRIC (2020).}

Malaysia’s foreign trade is substantial. Foreign trade accounted for 123 percent of Malaysia’s GDP in 2019, according to World Bank data. As a relatively small country, Malaysia is no exception to relying on foreign trade as a stimulus for economic development. Malaysian trade has grown considerably in recent decades, with imports and exports of goods and services together rising from US$207 billion in 2000 to US$431 billion in 2020, an increase of 108 percent. The country’s trade reached US$449 billion in 2019, before declining 3.6% in 2020 due to the pandemic. The Malaysian economy has grown even faster than Malaysian trade, with GDP nearly quadrupling over this period, so the share of trade in GDP has declined considerably, as shown in Figure 1.11 below. Nevertheless, the role of trade in Malaysia’s economy remains significant, and its trade figure of 123 percent of GDP makes Malaysia comparable to sizable open economies such as Switzerland (119 percent of GDP) and Thailand (110 percent).

**FIGURE 1.11: Trade as a Percentage of GDP in Malaysia, 1960-2019**

![Trade as a Percentage of GDP in Malaysia, 1960-2019](chart.png)

Source: World Bank
Malaysia trades both regionally and globally, with China and Singapore as its largest partners. Malaysia’s largest trade partners during 2020 were China (16.2 percent of exports and 21.5 percent of imports), Singapore (14.5 percent of exports and 9.3 percent of imports), and the United States (11.1 percent of exports and 8.7 percent of imports). Indonesia (3.1 percent of exports and 4.6 percent of imports) is Malaysia’s largest trade partner among OIC members, and the only OIC nation among Malaysia’s top ten export and import partners (MATRADE, 2020). Malaysia’s trading partners are illustrated in Figure 1.12.

**FIGURE 1.12: Malaysia’s Export and Import Partners 2020**

![Pie chart showing Malaysia's export and import partners 2020](image)

Source: Matrade
1.5 Trade Finance in Malaysia

Trade finance is under-utilized in Malaysia, supporting only 11.2 percent of trade in 2016. Data from BNM, indicates that only 11.2 percent\(^{15}\) of trade in Malaysia is financed through trade finance in 2016, compared to a total of 47 percent of global trade financed by trade finance. The overwhelming share of Malaysian trade (88.8 percent) was financed through sources other than trade financing (presumably seller-financing, cash, unsecured credit, or other means) (BNM, 2016). Utilizing trade finance could enable larger order sizes (and thus larger trade volumes) by accelerating payments. Trade finance can also enable trade with a larger range of partners, some of whom might not be eligible for seller-financing due to lack of comfort with their credit risk.

Several factors may contribute to the under-utilization. One reason for the relatively limited use of trade finance may be limited awareness of the available products and services. Companies in Malaysia may rely on seller-financing, unsecured credit, or other forms of lending to meet their working capital needs rather than using trade finance structures. Another reason may be that certain key export sectors (including petroleum, palm oil, and rubber) may have well-established international markets with spot payment terms that do not call for trade finance. Utilizing trade finance could enable larger order sizes (and thus larger trade volumes) by accelerating payments. Trade finance can also enable trade with a larger range of partners, some of whom might not be eligible for seller-financing due to lack of comfort with their credit risk.

ITF is under-represented in Malaysia (31.4 percent of total trade finance outstanding in 2020) relative to the market share of Islamic financing (41 percent of total banking in 2020). Further data on the current state of Malaysian trade finance is shown in Figure 1.13 below. Since 2016, the share of ITF amount approved\(^{16}\) within the overall trade finance in the banking system has increased significantly to RM13.8 billion (28.1 percent market share) in 2020 from RM1.8 billion (11.3 percent market share) in 2016. The share of ITF outstanding grew moderately between 2016 and 2020, averaging 2 percent per annum whilst the ITF market share of total trade finance outstanding in the banking system maintained an average 30.5 percent during the period. This is somewhat below the share of Islamic financing outstanding within the overall banking sector (41 percent) (BNM, 2021a).

**FIGURE 1.13 : ITF Amount approved and outstanding in the Malaysian banking system (2016-2020)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount approved (% share of trade finance in banking system) (LHS)</th>
<th>Amount outstanding (% share of total Islamic financing) (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>1.8 (11.3%)</td>
<td>2.2 (10.4%)</td>
</tr>
<tr>
<td>2017</td>
<td>47.6 (10.8%)</td>
<td>53.0 (9.3%)</td>
</tr>
<tr>
<td>2018</td>
<td>48.9 (10.1%)</td>
<td>54.5 (8.8%)</td>
</tr>
<tr>
<td>2019</td>
<td>6.3 (24.9%)</td>
<td>9.0 (21.8%)</td>
</tr>
<tr>
<td>2020</td>
<td>13.8 (28.1%)</td>
<td>50.5 (7.5%)</td>
</tr>
</tbody>
</table>

Source: BNM

---

\(^{15}\) Estimate is based on amount of trade financing outstanding.

\(^{16}\) The data includes trade finance instruments that are reported as on and off-balance sheet items.
Barriers to adopting ITF include lack of familiarity and lack of harmonization. Lack of familiarity is a challenge both for clients of banks and for the banks themselves, as explaining ITF structures can require additional effort. Clients also perceive an absence of key products which they would like, such as supply chain finance. A lack of harmonization of shari’ah standards has also been identified as a challenge. Although BNM provides comprehensive shari’ah guidelines, there remains a perceived need to harmonize structures with international trade finance practices and other Islamic finance jurisdictions. Chapter 3 of this report discusses key challenges for greater adoption of ITF in Malaysia.

Scale is another important factor hindering ITF. For banks to succeed in trade finance, scale and volume can be important. This is especially true for unfunded products such as letters of credits and guarantees, which may have low fee margins yet require banks to take balance sheet exposure in the event of default. IFIs are generally smaller than their conventional counterparts, and Islamic subsidiaries in Malaysia are all smaller than their conventional parents. Stronger promotion practices may be needed for IFIs to compete with conventional ones in offering trade finance.

The data suggest that there is a large scope for growth in Malaysia in the use of trade finance in general, and ITF in particular, by MSMEs and corporates with the right tools, promotion, and policies. Coupled with the large share of trade in Malaysian GDP, the potential growth in the size of the Malaysian trade finance market is considerable. With Malaysia’s international trade valued at US$449 billion in 2019, simply bringing the usage of trade finance up to 23.5 percent -- half the global average of 47 percent (QYResearch, 2020). -- would yield a Malaysian trade finance market of US$106 billion. This is more than double the current market size of approximately US$50 billion. Reaching the global average of 47 percent could result in a market size of US$212 billion, four times the reported market size. Further data on the usage of trade finance products by customer type is shown in Figure 1.14 below. ITF continues to support the trade financing needs of MSMEs and corporates even during the challenging Covid-19 period.

**FIGURE 1.14 : Trade finance amount approved by customer type in RM’ billion (2019-2020)**

<table>
<thead>
<tr>
<th>Year</th>
<th>MSME</th>
<th>Corporate and others</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>4.6</td>
<td>36.2</td>
</tr>
<tr>
<td>2020</td>
<td>8.9</td>
<td>37.6</td>
</tr>
</tbody>
</table>

Source: BNM

The potential for expansion of ITF in Malaysia is even more significant. Even at the reported market size of US$50 billion, raising the share of ITF to match the share of Islamic banking of 41 percent would result in an increase in ITF of US$4.5 billion (to a total of US$20.5 billion) – nearly five times the current figure.
1.6 Malaysia As a Potential Global Leader in Islamic Trade Finance

Malaysia is already an OIC leader in trade, as the seventh-largest economy and third-largest exporter and importer, despite ranking fifteenth in population. In terms of total merchandise trade, it ranks second overall among OIC nations. As shown in Table 1.3 below, in each trade-related category, Malaysia’s share of the OIC total is in double digits, giving it a leadership spot in every case.

**Table 1.3 : Malaysia’s Economic Leadership in the OIC**

<table>
<thead>
<tr>
<th>Category</th>
<th>Malaysia Figure</th>
<th>Malaysia OIC Rank (out of 57)</th>
<th>Malaysia Figure, Share of OIC Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>30.2 million</td>
<td>15</td>
<td>1.8%</td>
</tr>
<tr>
<td>GDP</td>
<td>US$365 billion</td>
<td>7</td>
<td>5.1%</td>
</tr>
<tr>
<td>Merchandise Exports</td>
<td>US$238 billion</td>
<td>3</td>
<td>13.1%</td>
</tr>
<tr>
<td>Merchandise Imports</td>
<td>US$205 billion</td>
<td>3</td>
<td>11.4%</td>
</tr>
<tr>
<td>Total Merchandise Trade</td>
<td>US$443 billion</td>
<td>2</td>
<td>12.2%</td>
</tr>
</tbody>
</table>

Source: World Bank

**Malaysia has also been highly successful in developing its Islamic finance sector.** Despite being home to approximately 2 percent of the global Muslim population, Malaysia accounts for over 20 percent of global Islamic finance assets (IFDR, 2019). According to the IFDR (2019), Malaysia is also consistently ranked as the most developed Islamic finance jurisdiction in the world, far ahead of second-place finisher Bahrain, and took top marks in four of five sub-indicators of Islamic finance development: quantitative development, knowledge, governance, and industry awareness. Malaysia’s Islamic finance leadership as documented in the IFDR is summarized in Table 1.4 below.

**Table 1.4 : Malaysia’s Leading Position in Islamic Finance and Trade Among OIC Members**

<table>
<thead>
<tr>
<th>Category</th>
<th>Malaysia Score</th>
<th>Malaysia OIC Rank</th>
<th>Malaysia Figure, Share of OIC Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Islamic Finance Development Indicator</td>
<td>115</td>
<td>1</td>
<td>n/a</td>
</tr>
<tr>
<td>Islamic Finance Assets</td>
<td>US$521 billion</td>
<td>3</td>
<td>&gt;21%</td>
</tr>
<tr>
<td>Total Merchandise Trade</td>
<td>US$443 billion</td>
<td>2</td>
<td>12.2%</td>
</tr>
</tbody>
</table>

Source: Islamic Finance Development Report

**Malaysia remains the largest Islamic finance market in Southeast Asia.** The Islamic finance industry’s market share of total financing in Malaysia has been growing, as it is projected to reach 41 percent in December 2020, up from 39.2 percent in 2019 (BNM, 2021a.). With the market share of ITF in relation to total trade finance lagging this figure, there is scope for ITF to grow.

17 World Bank data, from: https://data.worldbank.org/
Malaysia is home to leading multilateral and industry-building Islamic finance institutions. These include the IFSB, the IILM, and INCEIF/ISRA. The IFSB is an international standard-setting organization based in Malaysia whose members include regulatory and supervisory authorities, intergovernmental organizations (including the World Bank), and private-sector participants in the Islamic financial industry (including financial institutions, professional services firms, and industry bodies), which collectively operate in 57 jurisdictions. The IILM is another international body based in Malaysia, composed of central banks from several OIC nations and the ICD, that aims to make available Islamic financial instruments to meet the liquidity needs of IFIs (e.g., by issuing sukuk and by developing a secondary market for IILM sukuk). INCEIF is a university established by BNM in 2005 to develop talent for the Islamic financial services industry. INCEIF offers degrees in Islamic finance as well as executive education programs and has thousands of alumni worldwide. Likewise, ISRA, was established by BNM in 2008 to promote and publish research on Islamic finance, including textbooks, journals, and research papers.

Finally, Malaysia enjoys an advanced regulatory system with centralized governance on Islamic finance matters. Malaysia has a comprehensive Islamic finance regulatory framework that covers all sectors of the Islamic finance industry (IFDR, 2019). The Malaysian government and BNM have taken an active role in supporting and regulating the Islamic finance industry in Malaysia. In 1997, BNM established a council of scholars, the SAC to advise it on Islamic religious law matters relating to Islamic finance (BNM, 2010). Over one hundred resolutions of the SAC, along with supporting reasoning, have been published online, several on topics relevant to trade finance.

With strategic support and enabling policies, Malaysia could potentially play a leading role in global ITF. Regulatory bodies in Malaysia have already taken note of the potential for ITF and announced targets to advance the state of the industry. For example, in 2017 BNM aimed for ITF to support 10 percent of Malaysian trade by 2020. It has also suggested the use of trade credit takaful, a form of insurance, for risk mitigation (New Straits Times, 2017). In addition, BNM had initially supported the growth of trade finance through pricing incentives to banks and customers and stamp duty remissions and rebates. As Malaysia has a well-developed conventional banking industry, banks with Islamic subsidiaries could be encouraged to support the growth of ITF.

In conclusion, Malaysia’s high level of trade activity among OIC nations, its well-developed Islamic finance industry, and its robust regulatory structure with decades of experience in Islamic finance all combine to offer Malaysia the opportunity to show leadership in ITF.
CHAPTER 2

Islamic Trade Finance: Institutions and Instruments
Introduction

This chapter covers the institutions that support ITF globally and in Malaysia, followed by a review of the Islamic finance products that have been developed to serve core trade finance needs. It is found that a wide range of institutions including the multilateral organization ITFC, private sector banks, and national export-import banks are active in ITF globally. In Malaysia, it is observed that a wide range of ITF products and services are available, and that the range of offering compares favorably to offerings found in other OIC member countries. Apart from trade finance institutions, the chapter discusses trade promotion organizations focused on intra-OIC trade. The chapter concludes with a discussion of the primary remaining challenges ahead for the ITF market in Malaysia and a key area of opportunity to deepen and strengthen this market.

The ITF market structure includes multilateral, private, and public institutions. Multilateral institutions, serving a development agenda and owned by governments, are able to finance clients in developing countries who otherwise might not have access to trade finance. Private sector banks, owned by shareholders, cater to “bank-able” clients and transactions with lower risk profiles. Export-Import (EXIM) banks, owned by governments, can finance trade in the national interest. EXIM banks can serve sectors that are high priorities for national development. They are able to finance clients who might not have access to financing from private sector banks.

A range of institutions currently support ITF globally and in Malaysia. At the widest geographic level, a number of multilateral institutions have played a pioneering global role. In addition, private sector financial institutions with offerings in ITF are active worldwide, particularly in OIC nations. Focusing on Malaysia in particular, one can see ITF products offered by both domestic and international banks. Government-affiliated institutions such as export-import banks also participate in the ITF market in Malaysia and in a number of other OIC nations, and similar institutions are dedicated to promoting international trade. This section of the chapter will discuss each group of institutions in turn.

2.1 International Institutions Offering Islamic Trade Finance

2.1.1. International Islamic Trade Finance Corporation (ITFC)

The sole multilateral institution fully dedicated to ITF is the ITFC (ITFC, 2019). ITFC is a member of the IsDB Group, a collection of multilateral Islamic finance institutions based in Jeddah, Saudi Arabia that operate throughout the OIC member states. Established in 2008, the ITFC consolidates the trade finance initiatives that existed within the IsDB Group. Malaysia is one of the largest shareholders of ITFC, with over 6 percent of the paid-up capital stock held by OIC member states or entities other than the IsDB.\(^\text{18}\)

ITFC, with 26 member countries, has provided over US$51 billion in international ITF since its creation. It approved US$5.8 billion of financing in 2019, the latest year for which figures are available. As noted in Chapter 1 of this report, the latest available figure for the size of the ITF market is US$186 billion, suggesting the ITFC’s financing activities represent over 3 percent of the global ITF market. Its relevance to the global ITF market stems from its pioneering role in spreading ITF and its ties to member countries who can avail of and replicate ITFC services.

ITFC’s multilateral status and relationships with governments allows it to marshal the public and private sector in support of ITF and intra-OIC trade. The institution has an A1 rating from Moody’s.

\(^{18}\) ITFC: https://www.itfc-idb.org/en/content/what-itfc
which enables it to access funds more readily and cheaply than many governments in the countries it serves. As one demonstration of this ability, 62 percent of the financing the ITFC provided in 2019 came from syndicate partners, comprised of banks operating throughout OIC member states (ITFC, 2019).

**ITFC’s stated mission is to serve as “a catalyst for trade development among OIC Member Countries and beyond.”** This mission is ultimately in service of economic development, given the importance of trade in raising living standards. Toward this end, ITFC currently has three strategic objectives: providing ITF, from ITFC’s own account as well as in cooperation with private-sector banks; diversifying member economies through trade finance; and promoting intra-OIC trade.

**ITFC’s products and services include a range of trade finance offerings.** For example, ITFC can confirm letters of credit, reducing reliance on intermediary banks. It also offers structured trade finance solutions, such as asset-backed financing using a traded commodity (or a receivable from the sale thereof) as collateral. The focus on export commodities to serve as security for the financing arrangement is helpful to commodity producers whose balance sheets preclude access to trade financing on similar terms. Another product the ITFC offers, new for 2019, is salam for trade finance for agricultural products.

**ITFC has thematic programs.** Among the specific thematic programs of the ITFC is the Arab-Africa Trade Bridges Program, which aims to promote trade and investment linkages between Arab and sub-Saharan African nations that are OIC members, with the stated objective of supporting “inclusive and sustainable growth.” The ITFC also has an initiative to increase the efficiency and utilization of ITF in West African nations. In collaboration with other institutions, the ITFC has held a training workshop in ITF for regulators in several countries, furthering the development of public-sector human capital devoted to this field.

**ITFC undertakes trade promotion activities.** In addition to trade financing, ITFC has a trade cooperation and promotion program for intra-OIC trade. This program can take the form of trade promotion activities, trade facilitation, capacity building, and the development of strategic sectors. In 2019, nearly US$4 billion, or about two-thirds, of ITFC’s approved financing consisted of intra-OIC trade support. This amounts to approximately 1 percent of the value of all intra-OIC trade.

### 2.1.2 Islamic Banks Globally

**Islamic banks in many countries have trade finance offerings.** For example, Al Rajhi Bank, the leading Islamic bank in Saudi Arabia and worldwide, offers a number of products and services geared toward both local and international trade, including letters of credit and guarantee, documentary collection, and e-trade information. These offerings variously aim to reduce a trade participant’s exposure to risk of non-payment by its counterparty, to facilitate trade settlement through documentary collection and thereby reduce working capital needs, and to manage the flow of information digitally. Both import and export letters of credit and documentary collections, for example, are available. Moreover, Al Rajhi has an ITF offering through a musharaka letter of credit facility, whereby the customer provides a portion of the funds and the bank supplies the remainder. Al Rajhi also demonstrates the potential for digitalization in trade finance, as it allows letters of credit and guarantee to be issued, modified, and settled through online processes.

**The Al Baraka Banking Group (ABG), a publicly traded Islamic bank based in Bahrain, offers a noteworthy example.** ABG is a banking conglomerate that (1) is present in seventeen countries and throughout the OIC, from Morocco in the west to Indonesia in the east, and thus able to facilitate trade flows and (2) has an explicit corporate commitment to social and sustainable finance, as expressed through the United Nations’ Sustainable Development Goals. ABG highlights the abilities of its subsidiaries in various countries to work with other members of the banking group to facilitate trade finance, in particular those in Turkey, Jordan, Egypt, Algeria, Bahrain, South Africa, and Lebanon, which collectively have hundreds

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19 ITFC: https://www.itfc-idb.org/en/content/trade-finance-glance
of branches able to access potential customers. The conglomerate also has board members and senior management with expertise in trade finance (Al Baraka Banking Group, 2019). ABG has also sponsored business television programs centered on Islamic finance, enhancing awareness of the industry among an influential audience.21

**Leading GCC Islamic banks offer trade finance.** In addition to Al Rajhi and ABG, all the other top 10 Islamic banks in the GCC offer trade finance solutions. The following table shows the top 10 Islamic banks in the GCC, as ranked by total assets in mid-2020, and their trade finance offerings. These banks include four from Saudi Arabia (Al Rajhi Bank, Alinma Bank, Bank Al Jazira, and Bank Al Bilad), two from the UAE (Dubai Islamic Bank and Abu Dhabi Islamic Bank), two from Qatar (Qatar Islamic Bank and Masraf Al Rayan) one from Kuwait (Kuwait Finance House), and one from Bahrain (Al Baraka Banking Group).

### Table 2.1: Trade Finance Offerings of Ten Largest GCC Islamic Banks

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
<th>Country</th>
<th>Letters of Credit</th>
<th>Guarantees (Bank or Shipping)</th>
<th>Documentary/Bills for Collection</th>
<th>Invoice Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Al Rajhi Banking and Investment Corp.</td>
<td>Saudi Arabia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>2</td>
<td>Dubai Islamic Bank</td>
<td>UAE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>Kuwait Finance House</td>
<td>Kuwait</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>4</td>
<td>Qatar Islamic Bank</td>
<td>Qatar</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>5</td>
<td>Alinma Bank</td>
<td>Saudi Arabia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>Abu Dhabi Islamic Bank</td>
<td>UAE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>7</td>
<td>Masraf Al Rayan</td>
<td>Qatar</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>8</td>
<td>Al Baraka Banking Group</td>
<td>Bahrain</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>9</td>
<td>Bank Al Jazira</td>
<td>Saudi Arabia</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>10</td>
<td>Bank Al Bilad</td>
<td>Saudi Arabia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: The Asian Banker

22

**All of the top ten banks offer letters of credit; documentary collection services vary.** Every bank listed offers letters of credit and bank or shipping guarantees, which can be thought of as core trade finance products in widespread use among trade participants that utilize bank-intermediated trade financing. Most also offer documentary collection (D/C) services, which from an exporter’s and importer’s point of view constitute a middle ground between an open account sale and a letter of credit. Although D/C is generally less complicated and cheaper than letters of credit and does not require the bank to set aside capital or fund the trade transaction, it works best between sellers and buyers that already have an established relationship and are located in countries with reliable and efficient legal systems for resolving trade disputes.

**Invoice financing offerings are limited.** Only two of the top ten GCC Islamic banks offering this facility. It is possible that the structured finance aspect of borrowing against receivables makes this financial service too complex for most exporters, or that the volumes of potential invoice financing transactions are too small to induce banks to offer this service. Kuwait Finance House (KFH), the only Islamic bank in the table above to offer all four modes of trade financing listed, including invoice financing, has a presence in Malaysia as well, which will be discussed below. One might infer from the low level of invoice financing that shari’ah
considerations pose a barrier in the GCC. The tawarruq mode of finance – which enables banks to provide cash financing very flexibly – is widely adopted in the GCC (Ahmad, et al.). Rather than providing a factoring product, GCC banks may provide more general tawarruq-based lending that achieves a similar outcome without securing the receivable.

### 2.2. Private Institutions Offering Islamic Trade Finance in Malaysia

**Malaysian banks are also active in providing ITF.** As noted in Chapter 1, the size of the ITF outstanding in Malaysia is approximately US$12.3 billion, while the total trade finance outstanding in Malaysia is estimated at over US$40.2 billion. In addition, the share in Malaysia of total trade finance that is Islamic is about ten percentage points lower than the share in Malaysia of total banking that is Islamic. This disparity represents a market opportunity for banks in Malaysia that offer, or would like to offer, ITF. It also suggests that segments of the business community who have religious objections to conventional trade finance may be underserved and thus less engaged in international trade.

**All top ten Malaysian Islamic banks offer trade finance.** The table below shows the ITF offerings of the top ten IFIs in Malaysia, as ranked by total assets as of mid-2020.

#### Table 2.2 : ITF Offerings of Ten Largest Malaysian IFIs

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
<th>Letters of Credit</th>
<th>Guarantees</th>
<th>Bills for Collection</th>
<th>Invoice Financing</th>
<th>Accepted Bills Financing</th>
<th>Trust Receipts</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Maybank Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>CIMB Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes*</td>
<td>Yes</td>
<td>No</td>
<td>Invoice financing is in the form of conventional financing</td>
</tr>
<tr>
<td>3</td>
<td>Bank Rakyat</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Offers working capital financing</td>
</tr>
<tr>
<td>4</td>
<td>RHB Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Public Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Bank Islam Malaysia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Offers working capital financing, offers export credit refinancing, funded by the EXIM Bank of Malaysia at a special rate</td>
</tr>
<tr>
<td>7</td>
<td>MBSB Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>AmBank Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Offers export credit refinancing</td>
</tr>
<tr>
<td>9</td>
<td>Hong Leong Islamic Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Offers onshore foreign currency financing</td>
</tr>
<tr>
<td>10</td>
<td>Bank Muamalat Malaysia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td></td>
<td>Offers working capital financing</td>
</tr>
</tbody>
</table>

Source: The Asian Banker

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Overall, the data show that Malaysian IFIs offer a greater breadth of ITF solutions than their GCC counterparts. As seen earlier in the analysis of leading GCC Islamic banks, the largest IFIs in Malaysia offer letters of credit and guarantees. All also offer collection and invoice financing services, in contrast to the situation in the GCC, where such forms of trade finance were sometimes (collection) or mostly (invoice financing) not offered. Finally, a majority of the Malaysian IFIs also provide financing against accepted bills and trust receipts (a form of import financing where repayment is due when the imported goods are sold), and several have ventured into working capital financing and export credit financing, areas where GCC Islamic banks appear to be less active. Malaysian IFIs, owned by private shareholders, necessarily focus their ITF activities on “bank-able” clients and transactions in which they can generate sufficient profits.

Malaysian banks have addressed GCC product gaps. Only two of the top ten GCC Islamic banks offer inventory financing, yet all of the top 10 Malaysian IFIs do. Whereas there are no significant product gaps observed between ITF and conventional trade finance in Malaysia, the financing of receivables is a visible gap in the ITF offerings available in the GCC region. While smaller Malaysian IFIs may not have all the products that larger Malaysian IFIs do, a review of the product offerings finds that a full set of ITF products are available in the country.

International banks with an Islamic finance presence in Malaysia play a strategic role in trade finance. For example, HSBC Amanah offers a variety of products for exporters and importers including export financing, bank guarantees, shipping guarantees, documentary collections, and letters of credit, often on the basis of murabaha, wakala, or providing services for a fee, as appropriate. HSBC Amanah also has digital interfaces to enable customers to operationally conduct much of the trade finance process online, including applying for many types of trade finance, providing the required documentation, tracking activity and viewing pending transactions, and obtaining records of completed financings.

Survey responses from two of the international banks provide perspective on offering ITF in Malaysia. The banks report offering a variety of ITF products, such as letters of credit, performance guarantees, and bills for collection. Importantly, the banks agreed that Malaysia has the potential to be a global leader in ITF owing to its leadership in Islamic finance and its high level of trade activity, which provides a natural domestic market. However, they also pointed out that adoption of ITF is lagging despite Malaysia’s embrace of Islamic finance in general, an anecdotal observation that is consistent with the BNM data cited above. The immediate priorities of banks that currently offer ITF in Malaysia appear to be expanding the customer base for ITF, improving usage of technology and online trade platforms, and providing more supply chain finance. In particular, banks expect digitalization of ITF to significantly assist in attracting new customers (as well as serving existing customers better) by enabling new products, permitting better evaluation of funding requests, and facilitating the execution of KYC/compliance requirements, among other specific benefits.

Al Rajhi Bank, which as discussed above is based in Saudi Arabia, conducts ITF operations in Malaysia. Among the relevant services it offers are letters of credit, shipping guarantees, bank guarantees (on a kafalah or cash- or margin-backed wakala basis), and trade commodity financing. Although most of these solutions are marketed toward importers, trade commodity financing is advertised toward a broader audience of both importers and exporters, including those that do not utilize bank-intermediated trade finance but rely on open account financing. Commodity financing offered by Al Rajhi Bank is conducted through a murabaha structure. KFH is another prominent international IFI with a trade finance business in Malaysia. KFH has a

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long operating history, having been founded in 1977 as one of the earliest IFIs and grown by 2019 to the second-largest bank in Kuwait by assets (and largest Islamic bank in Kuwait). KFH opened its Malaysian branch in 2005 as the first foreign Islamic bank to be granted a Malaysian Islamic banking license. Its ITF facilities in Malaysia include letters of credit (under *murabaha* or *wakala* principles), bank and shipping guarantees (under *kafalah* principles), working capital financing (using *murabaha* or *tawarruq* structures), and documentary collection.

### 2.3 Export-Import Banks and ITF

**Export-import banks play an important role in trade finance.** Unlike the banking institutions discussed above, which are private corporations providing a broad range of financial services, export-import banks are expressly geared toward supporting cross-border trade. Export-import banks are government-owned and serve the policy objective to enhance international trade. They do not provide any financial services other than supporting trade, and do not take deposits from individuals or private corporations. They are created by statute or legislation and do not have private shareholders.

**Malaysia’s Export-Import (EXIM) bank provides conventional and ITF.** The EXIM Bank is a government-owned entity founded in 1995 that aims to meet the financial services needs of Malaysian participants in international trade and promote the entry of Malaysian firms into markets abroad. It provides both conventional trade finance products and their Islamic equivalents. Its wide-ranging slate of products and services includes bill collection (both outward and inward); letters of credit (by advising, confirming, transferring, and directly providing them); supplier financing for exporters (available for both financing working capital before goods are produced, as well as for financing exports after shipment has been made); endorsement of transfer documents to facilitate port clearances (for importers); shipping guarantees and bank guarantees (for importers); and trust receipts (a form of short-term financing for importers). The EXIM Bank also offers insurance products designed to promote trade activity, ITF, and overseas investment by Malaysian firms. These are based on *takaful* structures for short-, medium-, and long-term tenors.

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Export-import banks in other OIC member states play similar roles in promoting trade and offering trade finance. Below is a table of the ten largest OIC economies by GDP, the export-import bank in each, and any ITF facilities it offers.

<table>
<thead>
<tr>
<th>No.</th>
<th>Country</th>
<th>Export-Import Bank</th>
<th>Are Shari’ah-Compliant Offerings Featured on Website?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Indonesia</td>
<td>Indonesia Eximbank</td>
<td>Yes (export working capital and export investment financing)</td>
</tr>
<tr>
<td>2</td>
<td>Saudi Arabia</td>
<td>Saudi Export Development Authority</td>
<td>Yes (pre-export financing and buyer financing)</td>
</tr>
<tr>
<td>3</td>
<td>Turkey</td>
<td>Export Credit Bank of Turkey</td>
<td>Yes (participation loans)</td>
</tr>
<tr>
<td>4</td>
<td>Iran</td>
<td>Export Development Bank of Iran</td>
<td>Yes (letters of credit and guarantees)</td>
</tr>
<tr>
<td>5</td>
<td>Nigeria</td>
<td>Nigerian Export-Import Bank</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>United Arab Emirates</td>
<td>Etihad Credit Insurance</td>
<td>Yes. Recent launch of ECI Islamic to include trade credit insurance, letter of credit confirmation insurance, Islamic export finance, foreign investment insurance, and surety bonds.</td>
</tr>
<tr>
<td>7</td>
<td>Malaysia</td>
<td>EXIM Bank of Malaysia</td>
<td>Yes (letters of credit, bills of collection, shipping guarantees, trust receipts, supplier financing, export credit refinancing, Islamic Development Bank co-financing).</td>
</tr>
<tr>
<td>8</td>
<td>Egypt</td>
<td>Afreximbank</td>
<td>Yes (asset-backed lending)</td>
</tr>
<tr>
<td>9</td>
<td>Bangladesh</td>
<td>EXIM Bank of Bangladesh</td>
<td>Yes (issue management, portfolio management, and underwriting services)</td>
</tr>
<tr>
<td>10</td>
<td>Pakistan</td>
<td>EXIM Bank of Pakistan</td>
<td>Set up in 2015 but not yet operational. Received grants from IsDB and ADB to support operations. In 2020, selected a local Islamic bank to develop Shari’ah-compliant trade finance, insurance products, and services (The International News, 2020).</td>
</tr>
</tbody>
</table>

Source: Multiple sources from website

The Malaysian EXIM bank advertises on its website a greater variety of ITF products and services than export-import banks in any of the other large OIC economies. Most of the banks listed have made some form of ITF available, but Malaysia’s EXIM bank is one of only two that offers Islamic letters of credit or guarantees, and the only one offering bills of collection services, for example. Although the export-import banks in this survey may offer ITF products not featured on their websites, Malaysia, although far from the largest OIC economy, appears to have the most sophisticated ITF offering among its peer export-import banks.
2.4 Institutions Promoting Intra-OIC Trade

Several trade promotion institutions focused on intra-OIC trade exist. Although they generally do not offer trade finance facilities directly, they do encourage trade flows, rises in which indirectly support the market for trade finance. As discussed earlier in this chapter, the ITFC runs a trade cooperation and promotion program whose objective is to enhance trade between member countries, a group that currently includes over two dozen OIC members.

Another institution promoting intra-OIC trade is the Islamic Chamber of Commerce, Industry and Agriculture (ICCIA), an affiliate of the OIC. Its members consist of the national chambers of commerce of the 57 OIC member states and it represents the interests of the private sector in OIC nations. The ICCIA’s mission is to enhance collaboration between OIC members in areas such as trade, commerce, financial services, and investment opportunities. It mainly accomplishes its goals through educational and convocational activities, held throughout the OIC or virtually, such as conferences and business forums, workshops and seminars, and training programs. It also provides online reference resources for trade and economic data and other information (e.g., tariff schedules). The ICCIA does not provide trade finance directly.  

A third example of a multilateral institution designed to promote intra-OIC trade and investment is the Islamic Centre for Development of Trade (ICDT), which like the ICCIA is an affiliate of the OIC. Based in Morocco, the ICDT undertakes a variety of activities such as holding trade fairs and exhibitions to enable business leaders from various OIC members and industries to be in contact with one another; consulting with member states in support of their trade promotion and cross-border investment promotion initiatives; collecting and disseminating information about international trade; and conducting studies on trade in different economic sectors and on barriers to trade. Like the ICCIA, the ICDT does not provide trade finance. The ICDT is one of the rare multilateral institutions under the aegis of the OIC that is based in Africa.  

The World Islamic Economic Forum, a global initiative based in Malaysia, resembles the ICDT in that its goals are to promote economic development through increased trade and international business activities. Established in Malaysia in 2005, the Forum is a signature event typically held annually (alternating with non-Malaysian locations) and brings together business leaders, public officials, investors, academics, and other specialists to discuss business and trade opportunities among Muslim countries as well as between Muslim and non-Muslim nations. Brand promotions, investment pitches, and networking are features of the Forum. The organization behind the Forum, the WIEF Foundation, has in recent years launched events to promote startup businesses and entrepreneurs, expanded beyond its prominent Forum event to hold more focused webinars and roundtables, and set up networks and events for businesswomen and young entrepreneurs to share ideas and experiences with others like themselves.

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32 https://wief.org/.
Chapter 2: Islamic Trade Finance: Institutions and Instruments

2.5 ITF Offerings for Trade Finance

Previous sections of this report have touched upon the Islamic finance concepts relevant to trade finance and discussed some of the Islamic finance structures used to create trade finance products and services. In the following table, a comprehensive view is given of the Shari'ah-compliant products and services that have been developed for core trade finance needs.

**Table 2.4 : Islamic Products Developed For Core Trade Finance Needs**

<table>
<thead>
<tr>
<th>Product</th>
<th>Shari’ah Mode(s) Used</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Letter of Credit</td>
<td>Wakala</td>
<td>Issuing institution acts as agent (wakeel) for the applicant. Importer may deposit funds with issuing institution under the wadiah principle. Settlement can be through the wadiah deposit, working capital financing under murabaha, or equity financing through mudaraba or musharaka.</td>
</tr>
<tr>
<td>Guarantees (Performance or Shipping)</td>
<td>Kafalah or Wakala/ Ujrah</td>
<td>Issuing institution acts as guarantor (kafeel) for the applicant. The guarantor can guarantee payment or delivery of goods. Alternatively, issuing institution acts as agent (wakeel) for the applicant in exchange for a fee. The institution’s guarantee can be backed by upfront payment from the applicant.</td>
</tr>
<tr>
<td>Bills for Collection</td>
<td>Wakala</td>
<td>Financial institution acts as agent (wakeel) for payments.</td>
</tr>
<tr>
<td>Trust Receipts</td>
<td>Murabaha; Ijarah</td>
<td>Financial institution acts as owner of imported goods until the importer is able to fund the purchase (such as through an onward sale).</td>
</tr>
<tr>
<td>Supply Chain and Floor Stocking</td>
<td>Murabaha</td>
<td>Financial institution purchases the goods from the supplier and resells them to the client at a markup agreed upon in advance.</td>
</tr>
<tr>
<td>Working Capital Financing</td>
<td>Murabaha; Ijarah; Istisna‘; etc.</td>
<td>Financial institution purchases assets (goods or equipment) and resells or leases them to the client. In the case of Istisna‘, the financial institution finances the manufacturing of products.</td>
</tr>
<tr>
<td>Factoring</td>
<td>Tawarruq (Reverse Murabaha)</td>
<td>Financial institution arranges a commodity transaction by which the client is paid immediately by a third-party and the client later pays the financial institution.</td>
</tr>
</tbody>
</table>

Source: Multiple sources from website

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33 See also Section 1.3
The table below lists different types of ITF facilities in Malaysia based on contract and purpose.

<table>
<thead>
<tr>
<th>ITF Facilities</th>
<th>Islamic Contracts</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Letter of credit-i</td>
<td>Wakala</td>
<td>Method of Trade Settlement</td>
</tr>
<tr>
<td>Letter of credit-i</td>
<td>Murabaha</td>
<td>Method of Trade Settlement and Financing Trade</td>
</tr>
<tr>
<td>Letter of credit-i</td>
<td>Bai’ Istijrar</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Trust Receipt-i</td>
<td>Murabaha</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Working capital-i</td>
<td>Murabaha and Tawarruq</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Accepted Bills-i</td>
<td>Murabaha and Bay’ al-Dayn</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Inward Bills for Collection-i</td>
<td>Wakala and Ujrah</td>
<td>Method of Trade Settlement</td>
</tr>
<tr>
<td>Outward Bills for Collection-i</td>
<td>Wakala and Ujrah</td>
<td>Method of Trade Settlement</td>
</tr>
<tr>
<td>Bills of Exchange Purchased-i</td>
<td>Bay’ al-Dayn</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Export Credit Refinancing-i</td>
<td>Murabaha and Bay’ al-Dayn</td>
<td>Financing Trade</td>
</tr>
<tr>
<td>Bank Guarantee-i</td>
<td>Kafalah</td>
<td>Provide Guarantee Services for Customer</td>
</tr>
<tr>
<td>Shipping Guarantee-i</td>
<td>Kafalah</td>
<td>Provide Guarantee Services for Customer</td>
</tr>
</tbody>
</table>

Source: (Syed Alwi, Shari’ah and Regulatory Issues of Islamic Trade Finance in Malaysia, 2012) and (SAC BNM 194th Meeting 2019)

These ITF products must follow the basic principles of Islamic finance explained in the previous chapter. None should have early settlement fees, compounding late payment charges, extension fees, compounding financing rates, and any other form of hidden fees or charges.\(^{34}\)

### 2.6 Conclusion

ITF is offered by multilateral, private sector, and public sector institutions internationally and in Malaysia. ITFC offers ITF to all OIC member countries. In the GCC and Malaysia, Islamic banks have well-developed ITF offerings. EXIM banks in eight of the ten largest OIC member countries offer some form of ITF. The mandates of institutions from the multilateral, private, and public sectors are generally complementary: multilaterals pursue development projects, private institutions focus on corporate clients with safer credit risk, and public institutions pursue national agendas. Multilateral and public institutions do, however, run the risk of “crowding out” the private sector if they compete for business that otherwise could be serviced by private sector banks.

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The preceding analysis indicates that a wide range of products exist by which IFIs can – and do – provide trade finance solutions. IFIs have developed a broad range of both unfunded products such as letters of credit and guarantees and funded products such as working capital financing. The range of products available in Malaysia appears broader than in the GCC.

The availability of products suggests that shari’ah concerns are not a barrier to offering trade finance. On the contrary, the affinity between trade and Islamic finance may suggest that trade finance is especially aligned with Islamic finance principles. It thus appears that the obstacles to adoption are market-driven in nature.

Product structures appear available for clients who require shari’ah-compliant trade finance. Islamic banks are active in virtually all the major OIC trading nations, and international trade (and with it the need for trade finance) has grown steadily in the OIC for decades. All these facts suggest that the remaining gaps in the ITF market may relate to awareness and demand, rather than lack of supply.

Malaysia appears to have key instruments and institutions in place for ITF. Stakeholders in Malaysia have access to ITF offerings through both domestic Islamic banks and international Islamic banks operating in the country. ITF offerings in Malaysia compare favorably with offerings in the GCC region, where funded products appear less developed. Malaysia further benefits from having an export-import bank that offers ITF. Such institutional support is not always present in other leading OIC-member countries.
CHAPTER 3

Regulatory and Policy Environment
3.1 Overview

An enabling trade finance ecosystem mainly comprises four elements: (i) payment facilitation, (ii) financing solutions, (iii) risk mitigation and (iv) provision of information/documentation flows (Malaket, 2014). Firstly, an effective payment facilitation offers appropriate mechanisms that will allow payments (domestic and cross-border) to be conducted in a secure, timely and cost-effective manner. A wide range of financial products and services are necessary to serve the different needs of the customers (buyers/importers, sellers/exporters, financial institutions, and other parties) at the various stages of the trade value chain. Trade finance instruments also offer risk mitigation for a broad range of risks such as commercial risk/counterparty credit risk\(^{35}\) (including bank risk\(^{36}\)), country risk\(^{37}\) and foreign exchange risk. Lastly, access to timely and accurate information at any point in time of the trade transaction, from the location of a shipment to the status of a payment is critical to ensure the credibility of the trade. Technological developments and innovations have promoted more harmonization, efficiency, transparency, and strengthen security across the processes involved under these four elements (Trade Finance Global, n.d.).\(^{38}\)

A comprehensive trade facilitation and trade promotion strategy needs to integrate the role of trade finance as a key enabler in supporting the growth of trade. International trade is an important contributor to Malaysia’s economic growth and development. Key to Malaysia’s trade policy is its commitment to the rules-based multilateral trading system, regional economic integration through ASEAN, and strengthening of bilateral economic relationships (Maria, 2018). The Government of Malaysia through the HDC has pursued strategies to develop Malaysia as a global hub for the Halal industry which generated almost RM40.2 billion in export value for Malaysia in 2019 (Halal Focus, 2020). At the 2020 World Halal Conference, the Government reaffirmed Malaysia’s willingness to work with other nations especially within ASEAN, on increasing self-sufficiency in halal food (Adila, 2020). This presents significant opportunities to advance the ITF through the various bilateral, multilateral, and regional engagement platforms.

3.2 Malaysian ITF Regulatory and Policy Ecosystem

In Malaysia, trade finance solutions are provided by financial institutions and NBFIs. For international trade, MDBs also play a very important role to fulfil the trade finance gap\(^{39}\) (ICC, 2017). Malaysia’s financial regulators, BNM and SC have the regulatory purview over financial institutions and certain NBFIs which include fintech companies.\(^{40}\)

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35 Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction’s cash flows.
36 This involves mitigating risk arising from exposure to a small financial institution in a high-risk country to a stronger credit-rated financial institution in another jurisdiction.
37 Country risk is the risk that borrowers may be unable or unwilling to fulfil their foreign obligations for country-specific economic or political reasons beyond the usual counterparty-specific factors.
38 See section 4.4 of Chapter 4.
39 Trade finance gap represents the amount of trade financing requests that is rejected by financial institutions. According to the ADB, the current trade finance gap is estimated at US$1.5 trillion globally with 40 percent of the gap originating in Asia and the Pacific (ADB, 2019).
40 Fintech companies are subject to a different regulatory regime. Regulators in Malaysia have taken an activity-based approach that considers the nature of the business conducted. Depending on the nature of these business activities, the fintech companies may or may not fall under the supervision of BNM and/or SC and will be notified of which piece of regulation they must comply with.
3.2.1 Bank Negara Malaysia

Islamic banking institutions and takaful operators are licensed under IFSA and are subject to equivalent micro and macro prudential regulations and supervision as their conventional counterparts. IFSA establishes a comprehensive legal infrastructure to achieve shari’ah compliance through 4 dimensions, namely:

(i) shari’ah governance framework;\(^{41}\)
(ii) shari’ah standards\(^{42}\) for each contract used in Islamic financial transactions
(iii) pre-emptive measures to address issues of concern within IFIs that may affect the interests of depositors and policyholders; and
(iv) the effective and efficient functioning of Islamic financial intermediation (Laldin & Furqani, 2018).

IFSA emphasizes the features of shari’ah contracts in defining “provision of finance” and “financing facility” compared to the conventional definitions prescribed under the Financial Services Act 2013. Under IFSA provision of finance can take various forms of shari’ah-compliant financing such as equity or partnership-based, lease-based, sale-based and others. Financing facility is defined more broadly and may be in the form of any sale or purchase arrangement, joint venture arrangement, deferred payment sale,

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\(^{41}\) Under the two-tier shari’ah governance framework, the SAC of BNM is the apex authority on all shari’ah-related matters while an internal Shari’ah Committee has the decision-making accountability at the IFI-level. A Shari’ah Committee of an IFI is responsible to review and approve any ITF products and services prior to submitting the product application to BNM.

\(^{42}\) BNM has issued 14 shari’ah standards that outline the shari’ah and operational prudential requirements of the respective shari’ah contract. Shari’ah standards on murabaha, tawarruq, wakala and kafalah are most commonly applicable to ITF. Other shari’ah concepts such as ujrah (fee) and bai’ dayn (debt trading) are often used in combination with these standards.
return sharing arrangement or other financing arrangement. This flexibility provides the opportunity for IFIs to structure non-conventional financial products and services that are more attuned to and representative of the unique features of Islamic finance. For example, an IFI is permitted to engage in buying and selling of assets in the provision of ITF.

Relevant prudential guidelines are available and applicable to ITF to ensure proper business conduct and risk management. The following are select pieces of regulation that are key to ITF:

(i) **Specific guidelines were issued to facilitate product structuring. Guidelines on Accepted Bills** provide a uniform set of procedures and conditions governing the creation and trading of shari’ah-compliant accepted bills in Malaysia. The bills were introduced in 1991 to promote domestic and foreign trade through an Islamic financing mechanism. Accepted bills (purchase/sale) is a promised future payment which is a bill of exchange drawn by an IFI/seller and accepted by the buyer/bank to finance purchase/sale of goods and commodities. These bills are structured based on the shari’ah concepts of murabaha and bai’dayn. In 2019, a policy document on Trade Credit Insurance and Trade Credit Takaful was issued to clarify the requirements on the offering of trade credit takaful by a licensed takaful operator as stipulated under IFSA. This was intended to encourage the introduction of trade credit takaful as a risk management tool to reduce risk exposure arising from the offering of ITF.

(ii) **KYC and Anti-Money Laundering, Countering Financing of Terrorism and Targeted Financial Sanctions (AML/CFT and TFS) guidelines are applicable to mitigate trade-based money laundering.** In 2020, the e-KYC policy was issued to facilitate implementation of electronic identification and verification of individuals. The requirements apply to fintech solutions for ITF such as digital on-boarding of customers requiring financing or wanting to make investments in alternative funding mechanisms.

(iii) **IFIs are required to provide adequate capital against their ITF exposures.** The capital treatment of ITF exposures is the same as conventional financial institutions. Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets) specifies the measurement methodologies for calculating risk-weighted assets for credit risk, market risk and operational risk and is aligned to the Basel II capital framework. ITF exposures are largely off-balance sheet and are subject to credit conversion factors (CCF) for the purpose of computing the capital required for credit risk. IFIs utilize shari’ah-compliant hedging instruments and can recognize trade credit takaful as credit risk mitigation (CRM) which can further reduce the capital required to be set aside.

(iv) **ITF exposures in foreign currency are subject to additional foreign exchange rules.** A revised policy on Foreign Exchange Notices was issued in 2020, which outlines the various requirements for obtaining approval from BNM in dealings with financial transactions involving non-residents and foreign currency including those related to settlement of trade in goods and services and export of goods. In March 2021, BNM announced further liberalization of foreign exchange policy to provide greater flexibilities to the export-oriented industries to better support the economic recovery (BNM, 2021b). The move will also provide opportunities to increase trade finance facilitation.

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43 Refer to further discussion in Section 3.5.1.
44 Trade-based money laundering is the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimize their illicit origin (Financial Action Task Force, 2006)
45 For liquidity risk, BNM has issued two policy documents on Liquidity Coverage Ratio and Net Stable Funding Ratio which are applicable to both IFIs and conventional financial institutions. These documents specify the quantitative liquidity requirements related to trade finance.
46 BNM regulation on capital components are in line with Basel III standards. However, BNM has yet to formally announce the timeline to effect the revised requirements on credit risk, market risk and operational risk under Basel III.
47 Refer to further discussion in Section 3.4.1.
3.2.2 Securities Commission

The SC regulates the Islamic capital market and is responsible for issuing licenses to market intermediaries including ECF and P2P. The SC has issued guidelines to facilitate ECF and P2P lending. Under this framework, ECF and P2P provide alternative funding options for businesses that may find difficulties in obtaining finance from financial institutions. From the investor perspective, these alternative avenues allow diversification opportunities beyond traditional asset classes. Currently, two of the 21 registered market operators (RMOs) under SC are offering shari’ah-compliant P2P solutions that facilitate ITF via invoice financing and factoring.

**Box 1:**

Providing Alternative and Innovative Mechanisms for Market-Based Financing

ECF is a mechanism that enables groups of investors to fund start-ups by taking up stakes in the investee companies and selling the shares later. ECF platforms tend to focus on fundraising for fast-growing start-ups and MSMEs. The founders of these businesses usually have ambitions to grow the business to several times the current size and often plan to list the company or sell the business in the future. On the other hand, P2P involves funds being lent at a fixed interest rate over a fixed tenure. P2P also tends to focus more on slowly growing businesses, or businesses with steady cash flow to bridge a short-term financing gap.

Malaysia became the first ASEAN country to regulate the funding avenue. The SC introduced frameworks on ECF and P2P financing in 2015 and 2016 respectively to allow for alternative market-based financing avenues for MSMEs to raise funds. The introduction of P2P and ECF financing has indeed helped to narrow the massive funding gap by providing an alternative source of capital for MSMEs to fund business expansion, finance working capital and meet other financial requirements. There are now 21 licensed financing platform operators in Malaysia (consisting of 10 ECF platforms and 11 P2P platforms). These licensed financing operators include Ethis Ventures Sdn Bhd and Ethis Kapital Sdn Bhd, who were among the first to offer shari’ah-compliant ECF and P2P campaigns respectively. Since its debut, ECF and P2P fundraising activities have grown rapidly, from RM441.56 million in December 2019 to RM629.54 million in December 2020. Total capital raised through ECF in Malaysia grew by a whopping 457 percent to RM127.73 million in 2020 from RM22.92 million in 2019. P2P financing also saw total capital raised increase 20 percent to RM503.31 million in 2020, from RM418.64 million in 2019 alone has benefitted 1,402 issuers which may include MSMEs which are traditionally underserved by the financial system.

Alternative avenues like ECF allows SMEs and start-ups to raise funds by issuing shares to the public. This model is a true musharaka or mudaraba relationship with shared risk and reward. As a leader in Islamic finance, Malaysia must embrace and rapidly adopt ECF and P2P. On this note, the SC encourages existing RMOs to broaden their scope and to consider launching shari’ah-compliant campaigns. Most of these funding activities are currently channeled through conventional offerings, with only a relatively small amount of funds raised through Islamic offerings.

To enhance the value proposition of ECF and P2P financing markets for investors, the SC has also introduced a framework for secondary markets to facilitate a more structured and orderly exit mechanism for investors. This will enable initial investors to exit from deals, which they had earlier invested in and provides an opportunity for new investors to invest in deals that they might have missed earlier.

Post the pandemic, there is a need to focus on segments of the economy where MSMEs play a critical role. Whilst many of them are not eligible for the traditional bank funding, ECF and P2P alternative channels have provided much needed access and avenue to raise financing to boost their contribution to the broader economy.

Source: Securities Commission
3.2.3 Legislation and related legal infrastructure

In general, domestic and cross-border trade transactions are subject to various legislations. The following laws are related to trade and related transactions and impact the operation and promotion of ITF:

(i) Act 235 Customs Act 1967 which governs matters pertaining to customs such as levy and collection of custom duties and export duties.

(ii) Act 204 Bill of Exchange Act 1949 which regulates bill of exchange, cheques and promissory notes.

(iii) Act 136 Contracts Act 1950 which governs all contracts in Malaysia such as bills of exchange, promissory notes, contracts of marine insurance, hire purchase and guarantees.


(v) Act 378 Stamp Act 1949 which governs stamp duties levied on various written documents.

(vi) Act 669 International Islamic Trade Finance Corporation Act 2007 which gives effect to an international agreement for the establishment and operation of the ITFC and enables Malaysia to become its member.

(vii) Act 490 Malaysia External Trade Development Corporation Act 1992 which gives effect to the establishment of Malaysia External Trade Development Corporation (MATRADE).

The Asian International Arbitration Centre (AIAC) formerly known as the Kuala Lumpur Regional Centre for Arbitration, and the International Court of Arbitration of the ICC have signed a Memorandum of Understanding (MoU) in 2017 to cater to the ITF dispute resolution needs of businesses across Asia (AIAC, 2017). The AIAC offers a shari’ah-compliant arbitration mechanism based on its “i-Arbitration Rules” 2018 which provide for, amongst other provisions, the power for the arbitral tribunal to seek reference from the Shari’ah Advisory Council or a Shari’ah Expert (IIC, 2016).

3.2.4 National infrastructure

Malaysia’s National Single Window (NSW) established in 2009 has significantly improved trade facilitation, connecting more than 25,000 users and processed more than 100 million transactions annually (Dagangnet, n.d.). The single window system (SWS) has proven to be successful in streamlining documentation and data processes and can increase trade between countries by 37 percent when both importer and exporter have operational SWS (Martinez-Zarzoso & Chelala, 2020). A fully integrated SWS extends the connections towards broader private sectors stakeholders such as banks, trade finances, cargo insurance companies, freight forwarders, ship agents and carriers (APEC, 2018). Allowing financial service providers to connect to such a system can facilitate a more efficient access to trade finance products and services and address the prevalence of a gap in global trade finance, which continues to be significant.

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48 Act specifies the various functions of MATRADE which among others are to develop, promote, facilitate and assist in the service areas related to trade and to advise the Government on matters affecting or in any way connected with trade.

49 In 2005, the United Nations Economic Commission for Europe (UNECE) in its Recommendation No.33 outlined the single window system (SWS) as “a facility that allows parties involved in trade and transport to lodge standardised information and documents with a single-entry point to fulfil all import, export, and transit-related regulatory requirements. If information is electronic, then individual data elements should only be submitted once”.
3.2.5 Industry association rules

(i) The ICC

The ICC is the leading representative business organization that is involved in rule setting, dispute resolution and policy advocacy governing the conduct of international trade. The ICC rules, although voluntary, have been accepted as global standards. The UCP600 is the most successful privately drafted rules for trade ever developed (IIC, n.d.). The ICC has also developed rules for forfaiting, demand guarantees, supply chain finance and documentary dispute resolution (DOCDEX).

In 2019, the educational arm of the ICC, the ICC Academy launched an e-course entitled “Introduction to Islamic Banking and Finance” which was developed in partnership with the ITFC and the Islamic Research and Training Institute (IRTI). The initiative was a strategic priority of the ITFC and IRTI to promote Islamic finance and to build capacity on trade finance within the private sector (ICC Academy, 2019). Since its introduction more than 150 participants have completed the certification program.

The ICC chapter in Malaysia was established in 2003 and currently has a membership which includes 16 financial institutions comprising of standalone Islamic banks and parent banks of Islamic subsidiaries.

(ii) The FCI

FCI\(^{51}\) is a self-regulatory body for factoring and financing of open account domestic and international trade receivables. FCI members sign an ‘Interfactor agreement’ and commit to be governed by three sets of rules and procedures which define the rights and obligations of the parties to transactions under the two-factor system \(\text{(IIC, 2016)}\):

- (i) General Rules for International Factoring (GRIF) form the legal basis under which nearly all cross-border correspondent factoring business transactions are conducted, and this legal framework has been accepted by every international factoring company around the world.
- (ii) edifactoring.com, like the SWIFT messaging system, provides a sound and secure means by which members can issue factor guarantees, send invoice data, issue dispute notices, and send payment messages.
- (iii) Rules of Arbitration provide a procedure for resolving disputes between FCI members.

According to the FCI, there are inherent similarities between murabaha and traditional international factoring. Consequently, the FCI introduced the Supplemental Agreement for Islamic International Factoring to allow members to conduct factoring transactions in a shari’ah-compliant manner.\(^{52}\) The Supplemental Agreement differs from the GRIF in the following aspects (FCI, 2018):

- (i) As interest is prohibited in Islam, any late payments by the export or import factors will be subject to a ‘late payment amount’ to be agreed on by the parties, not to ‘interest’.
- (ii) As trade of some goods and services are prohibited in Islam, the product or service related to the receivable must be approved by the other party before the first assignment by the export factor.
- (iii) Transactions with prohibition of assignment are not acceptable.

Currently, two Malaysian banking institutions are associate members of the FCI. The Malaysian Factors Association is a member of the FCI and has 20 members, including two banking institutions, which also offer Islamic factoring solutions.

\(^{51}\) FCI was set up in 1968 as a non-profit global association for factoring and receivables finance companies around the world.

\(^{52}\) Produced by a working group comprising members of the FCI’s legal committee, Noor Bank and ITFC.
3.3 Malaysian Government Initiatives to support ITF

The Government has envisioned Malaysia as a leading global hub for the halal industry. The initial strategy was outlined in the Ninth Malaysia (RMK-9), 2006-2010, where Malaysia will be developed as a center for the certification of halal products and the JAKIM certification will be promoted worldwide. The Halal Development Corporation (HDC) was established in 2006 to coordinate the overall development of Malaysia’s Halal ecosystem. In the Halal Industry Master Plan 2030, Islamic finance has been identified as one of the key enablers to support the implementation of the plan through the innovation and promotion of a hybrid Islamic financing structure. In the 2019 Budget, the Government allocated RM1 billion as part of an SME Shari’ah-Compliant Financing Scheme (SSFS) to finance halal exporting companies. Under the scheme, which is made available through IFIs, the Government provides a profit rate subsidy of 2 percent. Over the years, MATRADE has been working closely with several IFIs in making Islamic finance an integral part of the Halal ecosystem, which includes facilitating market expansion and export opportunities. MATRADE has also included the topics on Islamic Banking and Trade Finance as sub-modules in the Exporters Training Program, and had invited AIBIM members to set up information counters during its Export Day and Exporters Training Program to facilitate business inquiries and deals.

In line with the Government of Malaysia’s aspiration, BNM has been playing an active role to support the Islamic finance industry as a key enabler of growth in the Halal market. In 2018, BNM and the Islamic finance industry participated for the first time in the Malaysia International Halal Showcase (MIHAS) which generated 865 business leads (BNM, 2018). Engagements with the industry revealed a low awareness of Islamic business financing facilities among halal-certified companies (BNM, 2019). This information was used to improve subsequent engagement programs where greater focus was given on education, awareness and promotion of Islamic financial solutions. As a result, over RM320 million financing and RM27 million takaful protection coverage requests were obtained during industry-business matching sessions conducted in 2019 (BNM, 2019). In 2020, following engagement with BNM, JAKIM amended its Malaysia Halal Certification Procedure Manual (Domestic) 2020, advocating the use of Islamic financing by halal certificate applicants. Moving forward BNM plans to continue its engagement with key stakeholders and promote tailored education and awareness programs on ITF.

BNM has collaborated with financial industry players to develop innovative trade finance solutions. In 2019, a joint working group with nine banks (including two Islamic banks) developed and tested a solution to digitalize trade finance, initially called Spyder, under the auspices of BNM’s innovation lab (BNM, 2019). Spyder is a DLT-based digital platform which allows banks to securely share invoice information with each other and helps to prevent duplicate invoice financing. This detection ability can facilitate better credit risk management on the part of the financial institutions and give greater confidence in the trade finance ecosystem. Since completion of the testing phase, BNM requested Paynet to develop the digital platform in collaboration with the industry. BNM has also allowed IFIs to pilot new financial solutions that can further expand shari’ah-compliant trade finance facilities such as inventory management (BNM, 2019).

IFIs have been encouraged to engage and leverage on programs offered by MDBs to further expand their capacity building in ITF. In 2018, twenty financial institutions including IFIs participated in a technical workshop organized by BNM and AIBIM on ADB’s Trade Finance Program (TFP) and Supply Chain Finance Program (SCFP). These programs offer guarantee facilities which help manage trade financing risks, for trade with higher-risk emerging markets. The lack of awareness on these programs has led to no take up

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53 The Exporters Training Program is targeted at SMEs to help transition them from domestic selling enterprises to international exporting firms. Specific programs are also run for mid-tier companies and larger entities, focusing on building skill sets to deal with large, regional supply conglomerates worldwide. The focus is to enhance knowledge on market accessibility, global trade requirements, trade practices, branding, import regulations, international product and environmental standards, trade financing, market updates and market requirements (MATRADE, 2021).

54 Payments Network Malaysia Sdn Bhd (PayNet) is the national payments network and shared central infrastructure for Malaysia’s financial markets.
by IFIs in Malaysia even though the TFP and SCFP are also made available in shari’ah-compliant manner. In 2019, in conjunction with INCEIF’s Malaysia Halal Inclusion Roundtable and Masterclass, IsDB organized a technical workshop on the range of ITF and protection offerings by its member institutions namely ITFC, ICIEC and ICD.

### 3.4 Issues and challenges

#### 3.4.1 Regulatory compliance

One of the key determinants of an IFI’s business strategy in the ITF segment is its risk appetite, which may be represented by the level of regulatory capital that it may afford to allocate for its trade finance exposures. Trade finance exposures are generally perceived to be low risk in nature. In 2011, on the basis of the data provided by the ICC, the Basel Committee agreed that short term, self-liquidating letters of credit and guarantees (collateralized by the underlying shipments) would receive a CCF for credit risk of 20 percent and 50 percent respectively, rather than 100 percent under the Basel III’s Standardized Approach. Last year, the ICC released its 2019 Trade Register report reaffirming the low risk nature of trade finance in comparison to other asset classes (ICC, 2019). The report revealed the default rates for LCs were between 0.03-0.08 percent and the corresponding expected losses were between 0.01-0.02 percent of the total LCs issued. In such instance, applying the advanced version of the Internal Ratings Based (IRB) approach for credit risk, instead of the Standardized Approach would result in a comparatively lower capital charge. This may encourage IFIs to increase their ITF exposures. In the World Bank survey of Malaysian IFIs conducted for this report, capital treatment of ITF products was cited as a moderate challenge. The majority of IFIs in Malaysia are on the Standardized Approach but some are considering applying the IRB approach. However, this will require resource investment to improve data collection over some period before such an application can be made.

An IFI’s risk appetite for ITF business, particularly for cross-border transactions, is also impacted by customer type and location as this may pose challenges for KYC and AML/CFT compliance. Information required for compliance purposes, may not be forthcoming especially when transacting with...
MSMEs and when importers or exporters are from countries where data is difficult to obtain or trust. In one survey, 90 percent of respondents said that AML and KYC issues are the leading hindrance to trade finance (CIBAFI, 2018b). However, risk management relating to trade-based financial crime is essential for the safety and soundness of the international banking system, helping to protect the reputation of banks and deterring their use to launder, move or raise illicit proceeds (ICC, 2019). Hence, financial institutions in general will need to adopt more innovative tools to obtain satisfactory information to ensure regulatory compliance. The role of digitalization in this regard is discussed in Chapter 4.

A majority of Malaysian IFIs are a subsidiary of a conventional parent bank and hence do not have their own credit rating which may deter global banks from accepting the ITF instruments issued by the IFIs. This in part is in response to the increased prudential regulations under the Basel III standards, KYC and AML/CFT leading to de-risking by globally active banks and the decline of correspondent banking relationships (CBRs)55 (IFC/ WTO, 2019). This has presented a challenge to the effective participation of local and regional banks in the trade finance market (WEF, 2017). In most instances, IFIs who are subsidiaries of conventional banks would provide supporting documents such as a guarantee from the parent bank to demonstrate their financial strength. Similarly, Malaysian IFIs may also be reluctant to transact with IFIs from other developing countries that may not present a good credit rating.

3.4.2 Lack of ITF standard for cross-border transactions

Differences in shari’ah opinion may limit cross-border transactions between IFIs in different jurisdictions. Initial efforts towards a standardization of ITF were conducted by AAOIFI which published the Shari’ah Standard No. 14 on Documentary Credits in 2003 (last revised in 2015). The standard outlines the requirements for a shari’ah-compliant documentary credit system within the general framework of the ICC rules (Oseni, 2013). However, there are differences in shari’ah opinion on the application of certain shari’ah concepts such as bai’i dayn. The SAC of BNM allows the application of bai’i dayn (debt trading) to structure ITF instruments which is not permissible in most jurisdictions. The non-standardization of shari’ah rulings over bai’i dayn and lack of consensus among different schools of thought regarding the legitimacy of bai’i dayn leads to the use of contracts such as tawarruq that utilize commodity murabaha (Radzali et.al, 2019). Malaysian IFIs rely heavily on debt-based shari’ah contracts and have yet to explore equity-based contracts such as musharaka and mudaraba that are prevalent in the GCC and which can be used to finance export/import operations (CIBAFI, 2018b). Additionally, several shari’ah issues in the Islamic Shipping Guarantee under the kafalah contract such as the status of ujarah (fee), the uncertainty element (gharar), the inexistence of the goods during the execution of contracted liability, and the non-existence of the expiry date of the contract raise shari’ah concerns (ibid).

3.4.3 Lack of awareness of ITF products and services

Lack of familiarity with Islamic finance products and services including ITF is one of the key reasons for the lack of demand. According to BNM, based on a survey conducted in 2018, most exporters surveyed did not have any Islamic finance facilities. Business enterprises, especially SMEs are not aware of the availability of a wide range of ITF instruments. The demand for Islamic finance products, especially ITF, is not met with adequate outreach and awareness programs by IFIs. According to MATRADE, the gap in trade finance could be reduced by encouraging a partnership approach between financial institutions and SMEs. The latter expect more advisory services from financial institutions to support them in business development in their targeted markets through the provision of greater networking opportunities, business contacts and market leads. Such advisory services can help build the SMEs’ business capacity and improve

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55 Through correspondent banking relationships, banks can access financial services in different jurisdictions and provide cross-border payment services to their customers, supporting, inter alia, international trade and financial inclusion.
their access to finance. In addition, there is no incentive or requirement, especially for halal businesses and shari’ah-compliant securities to use ITF for their cross-border transactions. As the halal market grows, the need for ITF products by halal businesses should also increase. However, at present there is a disconnect between halal production and shari’ah-compliant financing to achieve end-to-end halal certification.56

**Lack of ITF expertise among IFIs’ staff also pose challenges on marketing and product development.** In the World Bank survey of Malaysian IFIs conducted for this report, several IFIs cited the difficulty of training, hiring and retaining staff with ITF expertise. This has direct implications on their ability to develop their ITF business segment and innovate better ITF products and services to serve the need of customers requiring more sophisticated instruments. According to the 2016 ADB survey, 37 percent of all banks report that staff knowledge of trade finance was a limitation in their credit expansion (ADB, 2017). Specifically, banks report that they are either not offering the most appropriate type of trade finance instrument or rejecting them due to lack of knowledge about how to process the relevant trade finance instrument such as letters of credit (ADB, 2017).

3.4.4 Lack of perceived competitive advantage over conventional trade finance

Lack of pricing advantage impairs customers’ motivation to apply for and/or switch to ITF. Previously, ITF facilities were able to enjoy some price advantage due to stamp duty remission that was accorded to ITF which has now since been removed (Syed Alwi et al., 2019). In the World Bank survey of Malaysian businesses conducted for this report, respondents noted that pricing of ITF and conventional trade finance products is not materially different. For one respondent with conventional trade finance, they do not see the additional value of obtaining or switching to ITF. Furthermore, unlike pricing for house or vehicle financing, there is limited transparency in the pricing of trade finance loans (BIS, 2014). This limits the ability of financial institutions to market their products and customers to review them based on prices.

Islamic finance contracts may be perceived to be more complex compared to conventional contracts. According to HDC, halal businesses need Islamic financing products that are easily obtained, require simple documentation, have a quick turnaround process, and are price competitive compared to conventional finance.57 This statement is supported by the feedback received from the businesses and IFIs engaged by the World Bank for this report. The IFIs cited that some businesses may find complying with shari’ah requirements to be more complex especially if they are less familiar with Islamic finance contracts. For instance, a customer with a letter of credit (LC) issued under wakala (agency) that requires additional financing has to apply for personal financing using murabaha or tawarruq or execute a sale and buy back of the debt obligation under a bay’ al-inah contract (Syed Alwi, 2012). This increases documentation, transaction costs and processing time. Details explanation on the structure of LC wakala and murabaha is in the Appendix. Therefore, it is imperative to develop standardized and simplified documentation for ITF facilities.

The availability of suitable ITF products and services vary amongst IFIs. The main products offered by most IFIs are Letter of Credit (LC-i), Accepted Bills (AB-i), Bank Guarantee (BG-i), Shipping Guarantee (SG-i), and Bills for Collection. Factoring is only offered by one IFI whilst trade credit takaful is offered by EXIM Bank. No IFIs currently offer SCF despite the availability at their conventional parent bank. Table 3.4 in the Appendix describes the products offered by IFIs.

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56 As stated above, JAKIM has taken an initial step to advocate for an end-to-end halal certification by including the recommendation for utilizing Islamic financial instruments in the Malaysia Halal Certification Procedure Manual (Domestic) 2020.

57 Based on written communication from HDC.
3.5 Broader ecosystem issues

The current regulatory and policy ecosystem provides a strong foundation to facilitate the growth of ITF. However, the following are broader ecosystem issues that warrant attention.

3.5.1 Provision of ancillary shari’ah-compliant risk management instruments

The main risks in international trade that will affect both the sellers and the buyers are

(i) product, production, and transport risks;
(ii) financial risks;
(iii) commercial risks;
(iv) political risks;
(v) adverse business; and
(vi) currency risks. (Trade Finance Global, 2020c).

Thus, trade credit protection, either takaful or insurance, and shari’ah-compliant hedging instruments play a significant role in managing all these risks.

(i) Trade credit takaful

Trade credit protection (insurance and takaful) facilitate businesses wishing to protect their accounts receivables from losses due to credit risks such as protracted default, insolvency, or bankruptcy. The risk of non-payment may occur in cross-border transactions especially when regulations, customs communications, and customer credibility are not entirely understood. Other problems may occur between product shipment and its availability for sale. Trade credit protection helps businesses mitigate country risk and facilitate access to new markets. Account receivables that have credit protection become more secure and financial institutions may also consider such assets as collateral. The role of credit insurance has been confirmed by the EIB, which considers that credit guarantee schemes are significant tools for unlocking lending in Europe because they enhance banks’ risk-taking capacity through risk-sharing (Trade Finance Global, 2020a).

Currently there is very limited trade credit takaful products in the Malaysian market. EXIM Bank offers three types of trade credit takaful:

(i) Export – to protect against the risk of non-payment by overseas buyers;
(ii) Domestic – to protect against the risk of non-payment by domestic buyers; and
(iii) Import – to protect against the risk of default or non-payment by the domestic buyers arising from import trade transactions of strategic goods. CIMB offers online marine cargo takaful for an importer or an exporter to protect against loss or damage during the movement of cargo from one port/country to another.

Takaful operators have yet to offer trade credit takaful products. This may be due to the complexity of the product and the risk appetite of the takaful operators. The SAC of BNM⁵⁸ accords flexibility to take up insurance under the following circumstances:

(i) takaful protection is not offered in particular sectors or classes;
(ii) none of the available takaful operators approve the customer’s application for takaful protection; or
(iii) the cost of insurance coverage is significantly more competitive compared to takaful.

⁵⁸ Ruling of the 181st Meeting of SAC on 27 October 2017 (BNM, 2017).
The lack of trade credit takaful offering presents an untapped opportunity and a necessary gap to be fulfilled to provide adequate support for the growth of ITF.

The table below lists other insurance and takaful products offered by financial institutions and insurance companies in Malaysia to support international trade.

<table>
<thead>
<tr>
<th>No.</th>
<th>Trade Protection Services</th>
<th>No. of Insurance product providers</th>
<th>No. of Takaful product providers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Marine Cargo</td>
<td>11</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>Trade Credit</td>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>Marine Hull</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>Goods in Transit</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>5</td>
<td>Fine Art &amp; Valuable Goods (Specie)</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>Aviation Hull &amp; Liability</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>7</td>
<td>Seller’s interest</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>8</td>
<td>Bill of Lading</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>9</td>
<td>Full Outturn Guarantee</td>
<td>1</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Multiple sources from website

### (ii) Islamic hedging instruments

**Availability of Islamic hedging instruments vary amongst IFIs.** The SAC of BNM and SC have approved the application of a wide range of Islamic hedging instruments (IFSB, 2019) including foreign currency forwards and options, profit rate swap and futures. In Malaysia, there are two wa’ad based products for managing currency risk, namely the Islamic FX Forward and the Islamic FX Option. For the Islamic FX Forward, an IFI provides a wa’ad to provide a designated currency to a customer in return for a fee. For the Islamic FX Option, a customer intending to use this product will obtain a wa’ad from the IFI to either buy or sell one currency for another for a fee. Recently in February 2021, AIBIM successfully led the development of the Malaysian Schedule to the ISDA/IIFM Tahawwut Master Agreement. The Malaysian Schedule provides an option for IFIs to partake in Islamic derivatives and hedging transactions through a framework agreement that is governed by Malaysian laws. This will further strengthen the development of the Islamic derivatives market in Malaysia. Table 3.3 in the Appendix presents the Islamic hedging instruments offered by IFIs in Malaysia.

### 3.5.2 Alternative providers of ITF solutions

NBFIs such as factoring companies and money services businesses contribute significantly to providing trade financing and facilitating trade.

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59 Wa’ad is a unilateral promise which refers to an expression of commitment given by one party to another to perform certain action(s) in the future.

(ii) Islamic Factoring

Factoring is a type of financial transaction whereby a business sells its account receivables or invoices for cash at a discounted price to a third party known as the “Factor.” It involves three parties where the “Factor” purchases the receivables, a “Seller” that sells the receivables, and lastly, the “Debtor” who incurs a financial liability and is required to make payment to the owner of the invoice. The receivables in question are often associated with an invoice for services provided or goods sold that offers the owner of the receivables the legal right to collect money from the debtor. In addition, factoring is often practiced by some firms to obtain cash and manage their cash flows, more so when these firms lack access to bank finance and are cash constrained to meet their current obligations and other cash needs. This is especially important for SMEs because factoring allows businesses to obtain payment sooner and determine the exact period of receiving these payments rather than waiting for 30, 60, or even 90 days. Through factoring, SMEs improve their cash flows and liquidity management. Businesses engaged in factoring are also able to avoid the accumulation of debt and the need for collateral as factoring is not a loan and this is an important consideration for SMEs. Hence, factoring is a necessary tool that enables these firms to cover their short-term cash needs without increasing their debt and using their scarce collateral. The Islamic factoring model uses structures based on commodity murabaha, hawala or Bai Dayn Bil Al Sila (BDBS) (FCI, 2019).

Malaysia’s factoring turnover of US$5.12 billion in 2018 represented 1.4 percent of GDP, which is low compared to the global average of 4.2 percent. Based on the average world penetration, Malaysia’s factoring volume can reach US$14 billion. Thus, the agreement between FCI and the ITFC to create the Islamic Factoring Chapter opens an opportunity for Islamic factoring (FCI, 2019) to grow, especially in Malaysia. The Chapter aims to increase financing opportunities for SMEs via Islamic factoring and support SMEs’ growth in their domestic and international trade under Islamic factoring rules promulgated by FCI. The top 10 Malaysian export countries are among FCI members which can benefit from this FCI-ITFC agreement. Figures 3.7 and 3.8 in the Appendix illustrate the Islamic factoring mechanisms.

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### Box 2:

**Roles of Money Services Businesses (MSBs) in Cross Border Payments**

Malaysia’s MSB industry serves both individuals and SMES for cross-border payments. The current operational requirements for remittance business are as follows:

(i) For a business-to-business (B2B) transaction, the daily outward transaction limit cannot exceed an aggregate amount of RM200,000. For all other transactions the maximum limit is an aggregate amount of RM50,000.

(ii) For outward remittance transactions, the remittance instructions to the correspondent agent should be issued within two business days from the receipt of funds from the customer.

(iii) For inward remittance transactions, the licensee should make the funds immediately available for collection upon receipt of the remittance instructions from the correspondent agent.

eBiz (BizPayments) is a secure global money transfer service offered by Merchantrade to facilitate international commercial payments between businesses such as payments for trade settlements, raw material or component purchases. eBiz is subject to the maximum allowable limit as determined by the regulator or Merchantrade’s internal policy. eBiz will leverage the Merchantrade network with 200 countries.

MoneyMatch, a startup FinTech company, graduated from the BNM sandbox, obtained an MSB license and entered the market with competitive prices. MoneyMatch’s primary focus is to provide cross-border payment services for SMEs to pay to global suppliers but it also offers a competitive service to individual customers.

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61 IFSA provides a definition of “Islamic factoring business” as one of the Islamic intermediation activities. Currently NBFIs engaged in Islamic factoring business are not directly regulated by BNM but are registered with the Ministry of Finance. IFSA empowers the Minister of Finance to designate such institutions as prescribed IFIs to address potential risks in order to preserve financial stability.
3.5.3 Digitalization of ITF and supply chain finance (SCF)

Several IFIs offer online marketplace platforms that embed several benefits for customers. These online marketplaces are integrated solutions that help to increase the efficiency of trade finance processing and can help their customers to reach a wider market for their businesses. For instance, CIMB HalalBizReady offers its customers access to CIMB Trade Club. An exclusive digital e-commerce ecosystem participated in by 14 global banks whose network spans over 50 countries, the platform aims to empower member companies to promote their businesses and expand their markets globally. Table 3.6 in the Appendix describes the various online marketplace platforms provided by Malaysian IFIs.

SCF has recently been defined as a much broader category of trade financing, encompassing all the financing opportunities across a supply chain. Notwithstanding, the product is still very much seen from a narrower perspective, where its key feature is that it is buyer/debtor driven. In such a case, a buyer approaches its financial provider to establish a receivable discounting line for its suppliers to use and discount the invoices they issued to that buyer. This technique is sometimes called reverse factoring or payables finance. This is a very efficient way to underpin the stability of a buyer’s supply chain and market reach vis-a-vis its suppliers, allowing it to benefit from better credit terms and streamlined invoice payment procedures (SCF tends to be made available through online platforms). It is also very beneficial to suppliers, as it allows them to shorten their receivables cycle and, therefore, reinvest their operational cash-flow faster. The advantages also tend to include financing on better terms for both parties, as suppliers do not need to take out financing under their own credit lines and may benefit from their clients’ access to credit at lower rates, and buyers may get credit from their suppliers at a lower cost than that of taking out a loan (Trade Finance Global, 2020a).

According to a survey on trade finance by the ICC (2020), SCF is one of the fastest growing trade finance products and is responsible for most of market growth. Incumbents and disruptors who have succeeded in this market have done so with material technology investment that has allowed the product to work at scale with some of the world’s largest supply chains.

Digital companies, such as TFX and DNex offers digital SCF platform that connect IFIs, buyers, and sellers. Malaysia has seen significant contributions to its GDP from its flourishing digital economy, recording 18.5 percent in 2019 and is expected to grow to 21 percent by 2022. Malaysia is also a nucleus for Islamic digital economic activities comprising of various digital products and services, according to the State of the Global Islamic Economy Report 2019/2020. Other achievements in the digital space for Malaysia include its best practice regulatory regime, new initiatives to accredit halal certifiers worldwide, granting the first Islamic fintech crowdfunding license and launching a new certification scheme for Muslim-friendly hospitality (MDEC, 2020).
TFXi is a fintech company specializing in supply chain financing with the hope of being a trusted digital identity. TFXi provides a technology-driven financing process that links various parties in a transaction – buyer, seller, and financing institutions while ensuring the risk is mitigated along the supply chain. TFXi links partners and creates a vendor management system, connecting buyers, sellers, and financial institutions on an online digital platform. TFXi was created with the aim to bring together the elements of security, flexibility, and simplicity, making it easy to use. At the same time, the risk is mitigated along the supply chain system. TFXi corporate clients are large public and private entities, government linked companies and multi-nationals. TFXi SME clients are those who are generally vendors or suppliers to these corporations, hence they have the tendency to be small, medium and large companies. Financial institutions act as financiers or funders and also collaborate closely with local and foreign financial institutions.

TFXi offers two models to financial institutions

(i) as their fintech enabler
(ii) as Go-To-Market fintech partner.

TFXi’s platform provides expertise in areas where there are gaps in speed, efficiency and security in different aspects, particularly KYC, credit assessment, on-boarding, document management, assignment management, communication, credit insurance and cash management reconciliation. Fintechs like TFXi aim to reduce the administrative costs of trade finance and remove some of these barriers to entry. With the emergence of SCF, trade facilitation has become more complex and requires technology to enable it. TFXi simplifies the complexity and improves the efficiency, providing for a better customer experience.

TFXi platform gets instant data feeds to push beyond the conventional information sources via integrating with third parties such as credit bureaus, buyers and financiers which creates value for its FI partners.

**Tawarruq** Supply Chain Finance is a short-term working capital to finance sellers’ local sales and intangible goods or services. For Trade tawarruq, the finance provider earns profits over *murabaha* financing. *Murabaha* financing occurs when the finance provider purchases the asset or commodity from a third party and resells it to the supplier.

**Source:** Written interview from TFX.

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**Table 3.2 : Digital platform for Islamic SCF offered in Malaysia**

<table>
<thead>
<tr>
<th>Financial Institution</th>
<th>Seller submits the invoices to the financial institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller may sell or trade his receivables to the financial institution in return for advance payment. Financial institution disburses the advance payment directly to the seller.</td>
<td></td>
</tr>
<tr>
<td>Buyer will make payment directly to the financial institution’s bank account on the original maturity date or any other date specified.</td>
<td></td>
</tr>
<tr>
<td>Buyer approves the invoices</td>
<td></td>
</tr>
<tr>
<td>Seller ships the goods at the same time issues their invoice to buyer.</td>
<td></td>
</tr>
<tr>
<td>Buyer makes payment directly to the financial institution</td>
<td></td>
</tr>
</tbody>
</table>

**CapBay**

CapBay is a multi-bank SCF platform established in 2016 and one of the 11 peer-to-peer (P2P) players that obtained approval from the SC to operate. The company employs technology such as optical character recognition and machine learning to provide short-term finance to SMEs cost-effectively. CapBay provides a technology enabled SCF platform that brings suppliers, buyers, and funders together in one place. On CapitalBay’s bank-grade platform, businesses can obtain short-term financing from multiple banks within 24 hours and without collateral (PWC, 2019). CapBay focuses mostly on transactions that are too small for banks. Since starting operations in late-2017, CapitalBay has conducted approximately 1,500 transactions of over RM100 million with zero defaults to date (IMF, 2020). The company has now entered a joint venture with Kenanga to create Malaysia’s first Islamic SCF fintech.
3.5.4 Sustainable development and climate action

The role of trade finance specifically in achieving sustainable development and advancing climate action has received increasing attention especially as the world looks towards economic recovery post Covid-19. Trade finance is seen to be a critical tool that can help support and influence the adoption of sustainable practices by customers and their supply chains (Taafe, 2020 and Fitzgeorge-Parker, 2021). One report estimates that the sustainable supply finance market could reach one-third of the supply finance market, or US$660 billion, representing a US$6 billion opportunity in sustainable trade finance revenue for financial service providers (Norton et.al, 2018).

Various initiatives to embed environmental, social or governance (ESG) risk considerations in trade and trade finance have been initiated especially by developed economies in response to call for sustainable development. In 2014, the Banking Environment Initiative (BEI) developed a financing solution referred to as the BEI’s Sustainable Shipment Letter of Credit (CPSL, 2014). Under the model, banks would offer preferential terms for shipments of sustainable commodities, such as palm oil certified by the Roundtable for Sustainable Palm Oil (RSPO). This can effectively reduce the cost of capital and incentivize sustainable production. The ICC Banking Commission’s Working Group on Sustainable Trade Finance has developed “Customer Due Diligence Guidelines” to promote sustainability in trade finance by identifying high ESG risks associated with commodities or other goods and services produced by a bank customer or within its supply chain, and available mitigants (ICC, 2021). In 2016, the EBRD introduced the Green Trade Facilitation Program (TFP) which allows partner banks to use their existing TFP facilities for the financing of exports, imports and the local distribution of imported green technologies and materials.

In the Asia Pacific region, efforts are underway to further mainstream sustainable trade facilitation measures for SMEs, agriculture, and for women’s engagement (ADB, 2019). Data from the 2019 UN global survey highlighted the lack of trade facilitation programs and measures specifically targeted at SMEs and women and, to a lesser extent, to the food and agricultural sector, all of which are key to the sustainable and inclusive development of economies in the region (ADB, 2019, p.22). In the 2020 ICC Global Survey on Trade Finance, 73 percent of banks in the Asia Pacific region who responded have developed a sustainability strategy applicable to trade finance and supply chain finance (ICC, 2020, p. 64). There is

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62 See also section 4.3 of Chapter 4.
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strong agreement that the environment and climate change should be priorities, with the majority of banks already integrating sustainability risks into credit risk management procedures for clients and conducting sustainability-related due diligence (ICC, 2020, p.13). In the survey of Malaysian banks conducted for the purpose of this report, all respondents acknowledged that a sustainability strategy is in place that applies to ITF and SCF. Respondents identified that sustainability assessments will be integrated into traditional credit risk management processes for clients using ITF within the next 1-2 years. Some respondents also noted requests from their ITF clients for innovative financing mechanisms for implementing more sustainable strategies in their operations.

**Malaysia’s IFIs are well-placed to spearhead the development and offering of sustainable ITF products and services under the Value-based Intermediation (VBI).** The VBI is an initiative introduced by BNM in collaboration with the IFIs and aims to deliver the intended outcomes of shari’ah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, and is consistent with the shareholders’ sustainable returns and long-term interests (BNM, 2017a, p. 6). In 2019, BNM issued the "Value-based Intermediation Financing and Investment Impact Assessment Framework - Guidance Document" (VBIAF) to facilitate the implementation of an impact-based risk management system for assessing the financing and investment activities of IFIs in line with their respective VBI commitments and ESG risk factors (BNM, 2019). Subsequently, in March 2021, the VBI COP published VBIAF Sectoral Guides on Palm Oil, Renewable Energy and Energy Efficiency which serve as an in-depth toolkit to guide ESG risk assessments at a more granular level. (AIBIM, 2021). These initiatives will help to accelerate IFIs’ capacity building and implementation of their sustainability agenda across their business segments including ITF.
CHAPTER 4

Opportunities for Expanding Islamic Trade Finance
4.1 Major users and a potential untapped segment of ITF in Malaysia

The total value of Malaysian Islamic finance assets has increased over the years, as explained in Chapter 1,\(^\text{63}\) reflects an opportunity for ITF to grow. The recent BNM Annual Report 2020 (BNM, 2021c) indicated that the industry continued to post healthy growth, gaining further market share of the overall financial system. Additionally, the Islamic capital market grew by 11 percent, with a total market size of RM2.3 trillion (SC, 2021). In 2020, the market capitalization of listed shari’ah-compliant public listed companies in Bursa Malaysia amounted to approximately RM1.2 trillion, which has increased around 7.5 percent since 2017 as illustrated below in Figure 4.1.

**FIGURE 4.1:** Market Capitalization for Shari’ah Compliance PLCs (RM Billion)

![Market Capitalization Chart](https://www.sc.com.my/api/documentms/download.ashx?id=ccac93f7-c385-418a-811e-47b30843d681)

Source: Securities Commission Malaysia\(^\text{64}\)

The total of Shari’ah-compliant companies is 715, representing 79 percent of the total listed Malaysian securities. The SC’s SAC adopts a two-tier quantitative approach, which applies the business activity benchmarks and the financial ratio benchmarks in determining the shari’ah status of the listed securities. Hence, the securities will be classified as shari’ah-compliant if their business activities and financial ratios are within these benchmarks (SC, 2020).

The top ten Malaysian export products with a total value of approximately RM759.6 billion in 2019, as shown in the **Figure 4.2** are shari’ah-compliant business activities. Several of the exporters\(^\text{65}\) are shari’ah-compliant companies listed on Bursa Malaysia.

**FIGURE 4.2:** Major Exports (RM Billion)


Source: Matrade

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\(^{63}\) See also Table 1.4 of Chapter 1

\(^{64}\) https://www.sc.com.my/api/documentms/download.ashx?id=ccac93f7-c385-418a-811e-47b30843d681

In addition, based on the total revenues of the ten companies listed in the FTSE Bursa Malaysia EMAS Shari'ah Index** whose export products are shari’ah-compliant, are estimated at RM95.9 billion (detailed in Table 4.1). If these companies switch their entire cross-border business transaction to ITF, there is considerable potential for the growth of ITF in Malaysia.

**Table 4.1: Ten Companies listed in the FTSE Bursa Malaysia EMAS Shari’ah Index**

<table>
<thead>
<tr>
<th>Stock Code</th>
<th>Company</th>
<th>Revenue (RM Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4197</td>
<td>Sime Darby Berhad</td>
<td>36,934.00</td>
</tr>
<tr>
<td>2445</td>
<td>Kuala Lumpur Kepong Berhad</td>
<td>15,595.96</td>
</tr>
<tr>
<td>1961</td>
<td>IOI Corporation Berhad</td>
<td>7,802.20</td>
</tr>
<tr>
<td>7113</td>
<td>Top Glove Corporation Bhd.</td>
<td>7,237.43</td>
</tr>
<tr>
<td>3336</td>
<td>IJM Corporation Berhad</td>
<td>6,605.10</td>
</tr>
<tr>
<td>5218</td>
<td>Sapura Energy Berhad</td>
<td>6,449.16</td>
</tr>
<tr>
<td>7084</td>
<td>QL Resources Berhad</td>
<td>4,155.83</td>
</tr>
<tr>
<td>3689</td>
<td>Fraser &amp; Neave Holdings Bhd</td>
<td>3,988.51</td>
</tr>
<tr>
<td>5398</td>
<td>Gamuda Berhad</td>
<td>3,662.96</td>
</tr>
<tr>
<td>4731</td>
<td>Scientex Berhad</td>
<td>3,518.60</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>95,949.75</strong></td>
</tr>
</tbody>
</table>

Source: Based on Annual Report 2020 of these ten companies

The efforts to positioning Malaysia as a global hub for the halal industry offer an opportunity to grow Malaysian ITF. In 2019, the total export of Halal products was approximately RM40.2 billion, with the top destinations comprising China (RM4.7 billion), Singapore (RM4.5 billion), United States (RM2.6 billion), Japan (RM2.4 billion), and Indonesia (RM2.1 billion). (HDC, 2020). Figure 4.3 shows the halal export breakdown by sector. In promoting Islamic finance for the halal industry, JAKIM, in its 2020 Halal certification guidelines, strongly encourages all the certified halal companies to use Islamic finance in all their business transactions.

**Figure 4.3: Halal Exports (RM Billion)**

Source: Halal Development Corporation

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66 The FTSE Bursa Malaysia EMAS Shari’ah Index comprises constituents of the FTSE Bursa Malaysia EMAS index that are Shari’ah-compliant according to the Securities Commission’s SAC screening methodology and FTSE’s screens of free float, liquidity and investability.
Export of agriculture is another sector that can leverage ITF. In 2019, total exports were RM115.5 billion compared to RM114.5 billion in 2018, increasing by 0.9 percent. Total imports were valued at RM93.5 billion compared to 2018 at RM93.3 billion, with an increase of 0.2 percent. This sector’s trade balance rose by 4.1 percent from RM21.1 billion in 2018 to RM22.0 billion in 2019. (DOSM, 2020).

### 4.1.1 Investment Funds Supporting Islamic Finance

In the current global environment of low yields for highly rated debt, syndicated and investment funds dedicated to ITF may represent a significant opportunity. They could both enlarge the slate of investment products offered to holders of large pools of capital who are seeking an adequate return and provide additional funding to support the growth of forms of ITF that require greater cash outlays by financial institutions (such as working capital financing, as opposed to shipping guarantees).

It is noted that rated sukuk remain strongly oversubscribed, suggesting a scarcity of fixed income securities available to Islamic investors. For example, in February 2020 the IsDB, which is rated AAA by S&P, Moody’s, and Fitch, issued its largest sukuk ever, raising US$2 billion at below 2 percent yield from the sale of five-year paper (IsDB, 2020). Later in 2020 both Nigeria and Pakistan issued sovereign sukuk in their local currencies to finance infrastructure projects, and both deals were oversubscribed (Premium Times, 2020; Dawn, 2020). Likewise, in January 2021, the IILM, issued over US$1 billion of short-term sukuk rated A-1 and yielding under 1 percent, in a deal oversubscribed by 1.8 times. The IILM anticipates issuing similar amounts of short-term sukuk throughout 2021 (The Edge, 2021). Farther back, Indonesia’s sovereign sukuk issuances in 2015 and 2016 were 3.4 and 3.1 times oversubscribed respectively (Bloomberg, 2016).

The outlook for sukuk suggests ongoing demand. With global sukuk issuance in 2021 expected to be approximately US$150 billion. This would represent a doubling from the face amount of sukuk issued in 2015, for an annualized growth rate of around 12 percent per year (S&P Global Ratings, 2021).

Providers of ITF, like issuers of sukuk, are readily able to access capital markets. As of 2018, the ITFC had received a credit rating of A1 with a stable outlook from Moody’s, which noted the ITFC’s “prudent treasury investment practices” and “debt service coverage as a share of liquid assets … comparable to other trade finance peers rated by Moody’s.” (ITFC, 2018). Leading Islamic banks are also highly rated, with Al Rajhi Bank rated A- by Fitch, Kuwait Finance House A+ by Fitch, and Maybank A- by S&P and BBB+ by Fitch (Fitch Ratings, n.d.; Fitch Ratings, 2020; Maybank, n.d.).

Considering the issuer-friendly sukuk market, leading IFIs’ strong credit ratings, and the expansion potential for ITF, creating investment products linked to trade finance portfolios could benefit multiple stakeholders. Exporters and importers could have more access to capital, enabling them to expand their trade activities. Investors would have access to yield, which may be especially welcome if interest rates are expected to remain low for an extended period. Financial institutions could achieve greater scale and impact, and deal arrangers could earn fees. These investment products could take the form of syndications, funds, or sukuk.

In the survey of Malaysian IFIs conducted for this report, some banks reported that attracting non-bank capital to create additional ITF was not a priority for them in the foreseeable future. This perspective may reflect the operational and educational challenges discussed earlier that banks face with ITF. Non-bank financial institutions such as asset managers, however, could develop trade finance funds that provide credit to companies engaged in trade and yield to investors. Doing so could add to the scale, dynamism, and visibility of ITF.
4.2 Key factors to get major Malaysian exporters to utilize ITF

Digitalizing ITF products and services with standardization and simplification will help to cater to the issues of complexity in satisfying different shari’ah requirements and ensuring that transactions are processed on time. This is in line with feedback from some of the companies that mentioned that there is no issue, either Islamic or conventional, if they can swiftly fulfil the needs. For example, UAE-based Emirates Islamic bank has launched an online ITF supply chain platform (“El Trade”). It is an innovative electronic solution that allows the bank’s corporate and individual customers to reduce turnaround time and cut costs easily and securely. It provides momentum for ITF activities in the UAE and the region (CIBAFI, 2018b).

Product customization to cater to a different level of needs of clients is crucial. MNCs will mostly use internal resources to finance their international business transactions, mainly when dealing with their regular international clients. Inter-company credit will be used when the buyer directly accords the credit to the seller (buyer’s credit), or inversely by the seller to the buyer (seller’s credit), depending on the ability of one or the other to extend credit and the moment at which the two parties agree that the final payment is due. In supply chain relationships, the ability of firms (i.e. large suppliers) to extend credit to their trading counterparties (buyers) is enhanced by opportunities to discount their receivables, or to mitigate payment risk by purchasing trade credit insurance. Additionally, long-standing relationships between buyers and sellers may lead the two parties to choose to settle transactions on an open account, meaning that the credit for delayed payment is automatically granted by one or the other party (WTO, 2016).

However, business enterprises still need to use financial institutions’ end-to-end services for specific market segments, especially new markets. This is where product customization is essential. In addition, the different needs of SMEs require product innovation such as P2P SCF. One of the challenges to IFIs is to compete with global conventional banks, which have strong capabilities in meeting their clients’ trade finance needs. Partnering with multilateral organizations, trade finance program such as ITFC, Global Trade Finance Program (TFFP-IFC) and Trade Finance Program (TFP-ADB) provide an opportunity to develop the capabilities of local banks.

BNM did a survey in 2018 with exporters on trade finance and found that key factors influencing exporters’ decision to undertake trade finance solutions are pricing, fast approval, ability to improve cash flows, and affordability of repayment. These factors are consistent with HDC’s feedback on halal companies that require financial products that are easy to obtain, less documentation, quick turnaround time, flexible on the collateral requirement, and lower profit rate than other financing options.

4.3 Trade and Recovery from COVID-19

The Covid-19 pandemic caused a decline in global trade, but that decline is expected to be temporary. Concerns remain, however, regarding the pace of the recovery and how equitable the recovery will be for the most vulnerable segments of society. Trade can play an important role in the recovery and trade finance can be especially helpful for businesses that have suffered during the pandemic. Islamic finance instruments can be a part of the solution, especially in accessing MSMEs and segments of the population that have religious concerns regarding conventional finance. Policy makers should thus consider a role for ITF in the framework for Covid-19 recovery.
4.3.1 Impact of Covid-19 on cross-border transactions and implications for growth

Due to Covid-19, the global trade finance market dropped by 14.83 percent in 2020 to US$7.62 trillion. As discussed in Chapter 1, the global trade finance market amounted to US$8.94 trillion in 2019 but is expected to recover and reach US$10.43 trillion by the end of 2026, growing at a rate of 5.37 percent annually from 2020-2026 (QYResearch, 2020).

The sharpest decline, according to UNCTAD data, occurred in the second quarter of 2020 when merchandise and services trade declined by 18 percent and 21 percent, respectively over the prior year (UNCTAD, 2020). As the year progressed, trade volumes grew closer to their previous levels.

It is estimated that the global gross domestic product contracted by 4.3 percent in 2020, creating a meaningful setback to development. An estimated 130 million more people are living in extreme poverty as compared to before the pandemic (UNCTAD, 2020). The economic contraction and rise of extreme poverty have had widespread impact on the pace and priorities of development agendas in many countries.

The pandemic and its associated restrictions on economic activity, on travel and transportation have shaped the dynamics of international supply chains. Four general themes for supply chains, arising from the pandemic have been identified by UNCTAD and are summarized in the table below, and implications for ITF are discussed in Table 4.3 thereafter:

<table>
<thead>
<tr>
<th>Trajectory</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reshoring</td>
<td>Shorter, less fragmented value chains and a greater concentration of value added.</td>
</tr>
<tr>
<td>Diversification</td>
<td>A larger, more diverse set of suppliers participating in the value chain. Participation does, however, require access to digital infrastructure.</td>
</tr>
<tr>
<td>Regionalization</td>
<td>Reductions in the physical length (but not in the fragmentation) of supply chains.</td>
</tr>
<tr>
<td>Replication</td>
<td>A shift from investment in large-scale industrial activity to distributed manufacturing.</td>
</tr>
</tbody>
</table>

Source: UNCTAD (2020)

The pandemic has motivated companies to bring more of their supply chains onshore, as international transportation was impaired, and more emphasis was placed on sourcing locally. At the same time, firms have looked to diversify their supply chains and reduce reliance on a single supplier (or small number of suppliers) that may become distressed during the pandemic or in future crises.

Regionalization has also been an important trend, with companies preferring to have their suppliers close by even if overseas. A more regional supply chain can reduce the risks associated with inter-continental transportation. Importantly, companies seek to maintain a diversified set of suppliers even if they are sourcing more regionally – staying closer to home need not result in a smaller number of suppliers.

Additionally, companies have created more replication and redundancy in their supply chains. This has manifested as decreased reliance on large-scale operators and more comfort with distributed manufacturing and a nimble supply chain.

While the pandemic has clearly reduced trade volumes in the short term, the decrease in activity is not expected to be long-lasting. Changes to the trajectory of supply chains as observed in the trends above, however, are expected to remain in place and affect the nature of trade well into the future.
4.3.2 Role of trade in boosting recovery from the adverse effects of the pandemic

The adverse effects of the pandemic have not been evenly distributed. Although the pandemic has affected all countries, countries with the most vulnerable populations have been most deeply affected. Of the 68.6 million people who are estimated to have fallen into extreme poverty as a result of the pandemic, 45 percent (31.2 million) are in Sub-Saharan Africa, 33 percent (23.3 million) are in South Asia, and 48 percent (33.4 million) are in the least developed countries (across regions). By contrast, only 1.5 percent (1.2 million) of this group is in Europe and Central Asia (UNCTAD, 2020).

The ILO estimated that roughly half of the countries in the world had no social protection responses to the COVID-19 crisis (ILO, 2020). Countries without such social protection were at greater risk of having populations fall into extreme poverty and lose their livelihoods as a result of the pandemic.

MSMEs – which comprise 80 to 90 percent of employment in low-income countries (ILO, 2021) – have been especially vulnerable to the crisis. Confinement measures and travel restrictions have severely impacted tourism, recreation, hospitality, and other sectors in which microenterprises and SMEs are prevalent. Further, many microenterprises operate outside the formal economy and thus may not have access to protection and recovery programs that are available to enterprises in the formal sector (UNCTAD, 2020).

The preceding analysis suggests several levers by which trade (and by extension, trade finance) can help boost the recovery:

i. Trade can support overall economic recovery and GDP growth;

ii. The diversification, regionalization, and replication of supply chains can lead to new trade relationships that foster global and national growth;

iii. Trade involving the least-developed countries (LDCs) – especially those with limited social protection – can be especially supportive of recovery from the pandemic; and

iv. Trade involving SMEs and microenterprises can be especially supportive of the recovery, as these segments have been most vulnerable to the crisis.

4.3.3 Potential of ITF in the context of Covid-19 recovery

Islamic finance instruments have been recognized as relevant to Covid-19 recovery. UNDP has noted that Islamic finance instruments – including both social finance and commercial finance instruments – can be part of the recovery across the short, medium, and longer terms. Zakat has been seen as especially relevant for emergency response, due to its flexibility and its annual disbursement. Asset-based financing and trade finance has been seen as important for the medium term, enabling businesses and economies to rebuild. Sukuk and Awqaf endowments have been recognized as relevant to long-term recovery, providing long-term sources of funding and enhancing social resilience (UNDP, 2020).

Including ITF as part of an overall pandemic response ties directly to the four levers, discussed earlier, by which trade can address the adverse effects of the pandemic. The table below presents the relevance of ITF to each of the four levers:
Table 4.3: Relevance of Islamic Trade Finance in COVID Response

<table>
<thead>
<tr>
<th>Lever</th>
<th>Relevance of Islamic Trade Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supporting overall GDP growth</td>
<td>ITF can enable real economy, asset-linked transactions that boost growth.</td>
</tr>
<tr>
<td>Diversification, regionalization, and replication of supply chains</td>
<td>ITF can enable new trade partnerships. Islamic structuring may be crucial in countries where the population has religious concerns related to conventional finance.</td>
</tr>
<tr>
<td>Trade involving least developed countries</td>
<td>Of the 46 countries classified as LDCs, 17 are OIC member countries. ITF can foster trade relationships with companies in these countries.</td>
</tr>
<tr>
<td>Trade involving SMEs and microenterprises</td>
<td>SMEs and microenterprises may require Islamic structures to access trade finance. In addition to religious considerations, Islamic structures may be more viable due to their asset-orientation.</td>
</tr>
</tbody>
</table>

Source: UNDP (2020)

**ITF, like conventional trade finance, can broadly support economic recovery and GDP growth.** Trade finance may be especially important for businesses that previously did not utilize bank-intermediated trade finance and instead bought or sold through supplier credit. In the crisis, such firms may not have working capital available due to lost sales and ongoing expenses. Further, such companies may be less eligible for general financing from banks due to a weakening of their balance sheets.

**The diversification, regionalization, and replication of supply chains can create opportunities for new trade partnerships.** As companies seek new suppliers closer to home, opportunities for intra-OIC trade can increase. Companies in Brunei, for example, may seek to expand their supplier networks to Malaysia and Indonesia rather than trade partners in other continents. In such instances, it may be likely that the trade partners would seek or prefer ITF. The situation could be similar in the MENA region, West Africa, or South Asia, where there are multiple OIC-member countries in close proximity. The availability of ITF may, in fact, make it easier for companies in this region to source goods and raw materials from their neighbors. While it is noted that rivalries exist between certain OIC countries and some may be reluctant to promote intra-OIC trade and Islamic finance, other OIC countries may welcome the opportunity to deepen mutual trade ties.

**Some LDCs who are OIC members are already significant exporters (for example, Bangladesh) for whom additional trade finance could accelerate the recovery.** Other LDCs who are OIC members have more nascent export industries, and access to trade finance could help fuel their development.

**ITF can also be important in enhancing trade finance for SMEs and microenterprises.** Malaysia’s policies to foster Islamic finance since the 1960s have correlated with levels of financial inclusion that compare favorably with other ASEAN, OIC, and Upper Middle-Income countries (World Bank, 2020). One key beneficiary of this financial inclusion has been the SME and microenterprise sector. The availability of ITF may also encourage smaller enterprises to engage more deeply with the banking sector, which in turn could lead to access to other forms of financing and growth.

**In principle, ITF is asset-based and linked to the value of real assets.** This may make it possible for SMEs and microenterprises that otherwise would not qualify for credit (due to a lack of credit history or limited assets) to access finance. The asset-orientation of Islamic finance may thus make it a means of financial inclusion even for clients who have no religious objections to conventional finance.
4.3.4 Policy and institutional implications

Consideration of the impact of COVID-19 on trade, the role of trade finance in the recovery, and the relevance of ITF, yields the following implications for policy makers and institutions:

i. Include trade finance as part of the policy response.

In addition to policy responses that provide immediate relief and financial support, policy makers can consider trade finance programs. Such programs can accelerate the recovery and help enterprises regain their footing.

ii. Target LDCs and countries with limited social protection –

Policy makers and institutions – especially those with an international development mandate – may wish to target LDCs and countries with limited social protection when crafting their trade finance policies. Such countries have been especially vulnerable during the pandemic and could benefit from the economic activity brought about by trade.

iii. Target SMEs and microenterprises as recipients of trade finance –

SMEs and microenterprises have similarly been vulnerable, even in more developed economies. Trade finance programs that target SMEs (for example, through outreach and awareness building efforts) could have additional impact in accelerating national and global recovery.

Targeting SMEs can be done through both policy initiatives (government allocations, Exim banks, etc.) and institutional measures by financial institutions. Banks and non-bank institutions can take measures to engage with SMEs and microenterprises who are already their customers. Although many of these clients may not be ready for international trade, some may likely be able to better finance their imports or begin exporting their goods. Including such enterprises alongside larger corporate clients can expand the impact of these financial institutions and contribute to a more inclusive recovery. Non-bank interventions such as P2P, crowdfunding, and other technology-enabled platforms can especially accelerate outreach to SMEs and microenterprises.

iv. Include ITF facilities in the response

Including ITF facilities has the important benefit of reducing religious barriers to participation. Such facilities may also hold particular appeal to segments of the population who have been most vulnerable to the effects of the pandemic.

The pandemic has, no doubt, caused significant economic distress across the world. At the same time, key stakeholders in the development community have seen an opportunity to “build back better” (United Nations, 2020). ITF may be able to play a constructive role in such efforts, both within national policy frameworks and as part of the global response.

4.4 Digital ITF and a Global Role for Malaysia

Trade financing’s significance in the overall Islamic financial spectrum has always been a secondary topic of discussion. Trade finance supports around 80 percent of global trade (WEF, 2020), making it an important factor for growth in businesses and economic activity.

In Malaysia, where trade with OIC countries represents a significant amount of cross-border economic activity, Islamic trade financing contributes around 30.3 percent of total trade financing by the banking sector for 2016 and is (BNM, 2016) supported by a robust Islamic banking system.
Trade Finance, the faster need for change

The global supply chain environment has become more complex, underpinned by globalization efforts, geopolitical tension and technological disruptions. Production and supplies are no longer derived from a single source but a network of supply chain integrations. As trade activity among emerging economies becomes more dynamic, many companies have started utilizing certain platforms for online trade finance transactions. These platforms reduce the usage of traditional paper-based ledger systems and replaces them with digital interfaces. The online processes provide transparency, efficiency, reduced transaction cost and time. A transaction, which previously took many days to complete, now can be executed in minutes due to digitalization.

On the financing side, financial institutions continue to re-assess their leverage and risk exposure as part of their capital management exercise. This exercise has resulted in a stringent supply of trade finance funding. According to ADB report, there was a US$1.5 trillion trade finance gap (ADB, 2019). This gap may have arisen from regulatory and compliance requirements that have come into force since the 2008 financial crisis. The mismatch between growing global trade and trade financing availability along with the growing complexity of global production and supply chain networks from emerging economies has amplified demand for a digital financing solution. Despite such pressures, progress towards a full implementation of digital trade finance is still slow.

In Islamic finance digitizing trade finance is relatively new. A survey carried out by the ICC revealed that 59 percent of respondents in the Middle East believe in the potential for digital channels to impact sales volumes. Also, 44 percent of banks in the Middle East region acknowledged that the development and deployment of digital trade and online trade platforms is a strategic priority in the near-term. Over 40 percent of banks in the Middle East are planning to introduce a technology solution for their trade finance offerings (ICC, 2018). ADIB was the first Islamic bank to successfully execute trade finance distribution transactions using blockchain (DLT) technology. The bank started its digitalization by collaborating with Trade Assets, a hyper ledger, fabric-based auction platform. This platform automates trade finance transactions and provides end-to-end shari’ah-compliant trade financing through digital channels (IslamicMarkets, 2020). Following the collaboration, the bank has successfully transacted with banking counterparts in emerging markets.

There are a few challenges which hinder digitalization. Firstly, there is not much volume as most ITF activity was conducted between Muslim-dominated economies or to a certain extent, between OIC members. The OIC total trade in 2016 amounted to around US$3.1 trillion, comprising US$1.41 trillion in exports and US$1.65 trillion in imports. However, intra-OIC trade – amounted to just 19.3 percent of the total OIC trade. On a positive note, intra-OIC export flows have been steadily increasing since 2016, according to OIC Economic Outlook 2020 (SESRIC, 2020). This positive development may provide some incentives for market participants to further enhance their digital undertakings.

Secondly, while public listed companies or large-sized companies tend to have various options to conduct their global trade activities including inter-firm credit, smaller companies like SMEs, whose activities contribute a much larger proportion to the economy, may experience difficulties in getting their global trade financed. This situation creates a supply-demand mismatch. Based on ICC Global Survey (2014), among the main obstacles limiting SMEs’ access to trade finance are increasing compliance/regulatory burdens, and relatively low country and local bank credit ratings (ICC, 2014). Lack of awareness among SMEs about digital finance also contributed to the slow demand and growth in digitization.
Traditionally, trade finance processes involve several different parties such as buyer, seller, financier, export credit agencies, and insurers. It also involves voluminous paperwork and documentation for different types of activities including issuing letters of credit, lending, forfaiting, export credit and financing, and factoring on the back of the growing complexity of global supply chains. Meanwhile, business operators and financial institutions face several costly challenges such as interoperability among parties, increasing number of networks that require connectivity, multiple jurisdictions, growing regulatory requirements, cybersecurity, fraud, and process inefficiencies.

This is where digitalization can add value by improving efficiency and transparency and transforming traditional paper-based processes to a fast and efficient digital experience. For business operators, digitizing international trade finance processes can help to improve cash forecasting, streamline credit collection efforts and improve efficiency in the deployment of working capital. Digital technology such as blockchain provides automation possibilities for documentation processing across the entire supply chain. Reviewing of financial documents in real-time and reduction of correspondent banking transaction fees and requirements can be made possible.

Digitization also helps businesses to have better control of credit facilities, reduce fees and speed up the application process, thus improving transaction volumes without the requirement for additional credit financing. Meanwhile, exporters may be able to offer better pricing as document preparation is made faster and less error prone. Importers may claim goods much earlier after exporters send the original paper documents directly to the issuing bank while providing electronic copies to the domestic bank.

Digitizing trade finance can also provide an opportunity for those who prefer Islamic transactions as such trades can be effectively enabled on a digital platform. Consequently, adopting digitizing processes is a source of competitive advantage as it reduces costs and improves efficiencies.

4.4.1 Blockchain as the next step of revolutionizing ITF

In simple terms, blockchain is a documented series of transactions, or an electronic ledger/register which is distributed among a network of computers. Blockchain transactions record aspects such as time, date, amount, and have a unique digital signature. Blockchain is updated almost instantaneously by each participant on the network to reflect the most recent transaction. As such, it removes the need for multiple copies of the same document and information stored on numerous databases across various entities. For example, in the traditional trade finance system, the importer, exporter, shipper, banks, etc., must individually maintain related documents such as letters of credit, bill of lading, invoices, etc., and each of these documents must be constantly reconciled against each other. When there is an error in
Blockchain provides faster and more transparent cross-border trade and reduces reliance on paper and manual processes.

A single blockchain can embody all the necessary information in one digital document, which is updated almost instantaneously and can be viewed by all members on the network simultaneously. Blockchain’s most potent advantage is the acceleration of settlement times (which currently takes days), increasing transparency between all parties, and unlocking capital that would otherwise be tied up waiting to be transferred between parties in the transaction.

Several institutions have already begun introducing blockchain in trade and receivables finance including SWIFT, Voltron, Marco Polo, We.Trade, Finance Trade Connect, Easy Trade Connect among others. In a related development, a study cited by CNBC found that during the first half of 2016, venture capital firms have invested US$290 million in blockchain technology.

**FIGURE 4.5**: Benefits of Blockchain and Digital Trade Finance

**FIGURE 4.6**: Fintech in Global Trade

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68 [https://www.tradefinanceglobal.com/posts/what-is-tradetech/](https://www.tradefinanceglobal.com/posts/what-is-tradetech/)
CHAPTER 5

Recommendations to Support the Development of Islamic Trade Finance in Malaysia
Deepening the Islamic trade finance markets can bolster Malaysian position as a global leader in Islamic finance. As discussed in the previous chapters, strong support from financial regulators, the readily available ecosystem and talents, a wide range of products and services are among key enablers that can spur the development of Islamic trade finance in Malaysia. Below are key recommendations offered to enhance Malaysian Islamic trade finance.

### 5.1 Robust regulatory and policy support

A more comprehensive strategy across key stakeholders and sectors (beyond just Halal), can realize the full potential of ITF and complement Malaysia’s strategy on global trade and the sustainability agenda. Proactive engagement between BNM, the IFIs and key stakeholders in the ITF ecosystem has helped to identify the issues that are inhibiting the growth of ITF. Currently, there is a limited strategy on ITF within the Halal industry and there is a fragmented approach to addressing the challenges at a national level. A multi-stakeholder approach will not only increase awareness and understanding of the issues but will also facilitate buy-in of the proposed solutions. For example, JAKIM’s recent amendments to its Malaysia Halal Certification Procedure Manual (Domestic) 2020 would have benefitted from a clear, time-bound action plan to achieve full compliance. This requires active engagement with and feedback from the Halal industry certificate holders. The upcoming development of the National Trade Blueprint (2021-2025) should be comprehensive including specifying strategies to address issues and challenges related to trade finance and ITF.

**Nurturing SMEs with ITF.** As in many other developing countries, SMEs also are the backbone of the Malaysian economy, comprising 98.5 percent of all Malaysian businesses. In 2018, SME’s contribution to the GDP and total exports was 38.9 percent (RM552.3 billion) and 17.9 percent (RM176.3 billion), respectively (SME Corp, n.d.). Enabling the continued development of SMEs with ITF to provide greater access to international markets, can increase its utilization. However, the simplification and standardization of documentation is critical along with competitive pricing and processing times. SMECorp and AIBIM can drive this agenda with support from BNM and SC.

**FIGURE 5.1: SMEs by Sector**

Source: SMECorp

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Chapter 5: Recommendations to Support the Development of Islamic Trade Finance in Malaysia

A single window for ITF. CGC, with the support from BNM, has developed “imSME”\textsuperscript{70} as a platform to serve as an online one-stop-center for SME loan/financing by providing an array of financing products and services offered by the participating banks and agencies. Thus, leveraging an existing similar platform for ITF can provide real-time data and reliable information, offer the business enterprises more options with a competitive rate, and push for IFIs to improve their products and services to be in line with the latest market developments.

The Government should leverage its leadership in the Halal sector to develop an ITF framework for the global Halal industry in collaboration with global trade industry associations such as ICC and ITFC. This can facilitate interoperability between different components of the trade ecosystem, standardization of ITF instruments and expedite adoption of innovative products and services across jurisdictions. The standardization of documentation may also provide impetus to digitize ITF processes. The Government should actively engage with its counterparts, especially in the OIC region and countries involved in the Halal industry to explore G2G trade with increased utilization of ITF as one of the primary considerations for Halal certification. The Government could also explore proposals to leverage on the existing ASEAN SWS to advance initiatives promoting the utilization of ITF solutions for trade within the ASEAN region.

Consider the allocation of funds from the Government of Malaysia. According to Syed Alwi et al (2019), some Islamic bankers have recommended that the government should introduce a subsidized program for ITF similar to the Green Technology Financing Scheme (GTFS) and shari’ah-compliant SME Financing Scheme. With this incentive, the government could set targets for IFIs to achieve, especially for banks that provide Islamic and conventional trade finance facilities. Encouraging listed companies to qualify as shari’ah-compliant could also be encouraged.\textsuperscript{71}

5.2 Awareness and promotion

The Government and industry-led initiatives should leverage various international platforms to increase awareness about Malaysia’s ITF ecosystem. This can help clarify the perception of risk that international banks may have in relation to Malaysia’s IFIs and transacting with shari’ah-compliant products. Malaysia’s ITF co-exists with conventional trade finance and thus complies with the same global standards related to financial crimes, tax transparency and prudential regulation.

The Government and industry-led initiatives on trade promotion should have closer engagement with MDBs such as ITFC and ADB to explore and develop trade arrangements in developing markets and to support SMEs. MDBs are very active in expanding international trade, advancing trade policy and determining the agenda of international trade. Since 2008, the ITFC has provided more than US$40.2 billion in shari’ah-compliant financing to its member countries. Malaysian IFIs have the technical capacity to facilitate the development of ITF markets in other jurisdictions. Strategic partnerships with MDBs may accord new opportunities for Malaysian IFIs to expand their international presence and leadership in ITF. Partnering with MDBs will also enable cross border trade risk mitigation to be improved which would allow IFIs to support Malaysian SMEs in expanding their businesses to overseas markets. Through integrated trade schemes, the ITFC provides both SME financing and technical assistance. The Corporation has funded US$13 billion in transactions for OIC SMEs and the private sector, is currently creating a fully integrated “National SME Growth Program” and has suggested the establishment of a dedicated SME Trade Fund to collaborate with MDBs.

\textsuperscript{70} imSME is Malaysia’s first SME financing/loan referral platform, powered by CGC. The platform matches business financing needs of entrepreneurs to suitable financing/loans offered by participating banks. More information on imSME is available at https://imsme.com.my/portal/products/

\textsuperscript{71} See also section 4.1 of Chapter 4
5.3 Strong institutional enablers

Relevant industry associations such as AIBIM and the ICC chapter in Malaysia should take more proactive action to improve dialogue on ITF domestically and globally. The Islamic Chamber of Commerce, Industry and Agriculture can facilitate the discussion related to improving ITF activity among OIC members. There is an urgent need for financing providers to engage in industry dialogue with relevant stakeholders to resolve issues on efficiency and overcoming challenges. There is also a need for a stronger understanding on the importance of streamlining information accessibility on individuals and SMEs to banks and regulators to facilitate KYC/AML processes. This will help banks to effectively evaluate their trade financing risk and lower transaction costs which is much required given the compression in their net interest margins.

Islamic institutions including professionals and academics should continue to work together to mitigate shari’ah challenges and to develop innovative and flexible shari’ah-compliant, equity-based trade finance tools, moving away from dependence on traditional debt-based structures.

Talent development and capacity building in ITF is crucial in ensuring its sustainability. In this regard, experts claim that local IFIs lack specialists with the requisite expertise. Recruitment of talented young resources is imperative. Institutions to support Islamic finance ISRA, INCEIF, IBFIM, and other academic institutions can be leveraged to develop these capabilities.

5.4 Digitization and Islamic FinTech

Digital trade financing platforms and Islamic supply chain finance. Trade finance is becoming more transparent with the growth of fintech and digital Islamic trade platforms. Many trade financing processes have been automated to facilitate the shipment of goods, trade instruments, and exchange documents.

Supply chain finance is another developing area of banks’ trade finance activities, where banks automate document processing across the entire supply chain. In trade financing operations it has many benefits, such as the real-time analysis of financial documents and the elimination of associated banking transaction fees and specifications. Recently, the largest banks in Europe have moved their trade funding to blockchain technology. With Deutsche Bank, HSBC, KBC, UniCredit, etc., IBM was chosen to develop a new blockchain system for cross-border trade finance. Blockchain can also provide a clear regulatory framework for compliance and AML operations.
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Islamic Trade Finance: An Opportunity for Malaysia

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References


Table 3.3: List of Malaysian Islamic banks offering wa’ad based shari’ah-compliant Derivative/Structured Products

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Source: Isma Bacha, (2017) and multiple sources from website
Details explanation on the structure of LC wakala and murabaha

The Figure 3.5 above shows the LC-i wakala structure. The IFI plays the role of the issuing bank in LC wakala because it issues LC-i and acts on behalf of the customer. The flow of LC-i is the same as a conventional LC. It will be forwarded by the issuing bank to the correspondent/agent bank or the advising/negotiating bank in the beneficiary’s jurisdiction. The LC-i will be advised and informed by the advising bank, and it will forward the original copy to the beneficiary. Once the beneficiary is satisfied, he/she will ship the goods and forward all the shipping documents to his/her bank.

There are many advising bank roles such as the financial agents for the beneficiary, confirming the documents, allowing payment to the beneficiary (if authorized) and presenting the documents to the issuing bank. There is a situation where the advising bank becomes the confirming bank when the issuing bank requests it to confirm the LC. When the advising bank negotiates the documents presented by the beneficiary under the LC, it is also known as the negotiating bank.

Upon receipt of the beneficiary documents, the negotiating bank negotiates the documents and forwards them to the issuing bank. The issuing bank will check the documents according to the credit’s terms and conditions once it receives them. If the documents comply with the terms and conditions of the credit, the issuing bank will pay the proceeds to the beneficiary through the negotiating bank using the customer’s deposit or fund and, consequently, release the documents for the customer to collect the goods. The advising/negotiating bank will charge fees or commissions from its customers under the principle of *ujrah* (Sapizi, Zharif, Norelmi, & Asyikin, 2019).

The Figure above explains the flow of LC-i murabaha. The customer of the bank who is an applicant or importer/buyer will also execute the contract of sale of goods with the beneficiary, who is the exporter/seller in the case of LC murabaha. The customer will then approach and inform the Islamic (issuing) bank of his LC requirements when both parties agree to have LC as a settlement method for payment of the trade. Under the contract of murabaha or LC murabaha, the customer will ask the IFI to purchase or import the goods, indicating that he would be willing to purchase the bank’s goods on their arrival.
The IFI will become the owner of the goods in this LC murabaha. The customer is appointed to be an agent for the Islamic bank to purchase the required goods on the bank’s behalf. The bank opens the LC-i and sends it to the advising/negotiating bank to advise the beneficiary of the LC-i. The role of the advising bank in a LC murabaha is identical to its function in a LC wakala.

The beneficiary will forward all the shipping documents to the negotiating bank once the goods are shipped. The documents will be negotiated by the negotiating bank and sent to the issuing bank once it complies with the credit’s terms and conditions. The issuing bank will sell the goods to the customer through the murabaha contract once they receive the documents and have satisfied all the credit terms and conditions. The murabaha contract’s sale price of the goods to the customer includes a principal and a profit margin for settlement by cash or deferred payment. The customer will be offered either MTR-i or AB-i (purchase). Some IFIs will offer another kind of murabaha financing that is murabaha Working Capital Financing-i. The customer’s settlement of payment would normally be on a deferred payment term such as 30 days, 60 days or 90 days or any other period depending on the conditions governing the credit provided by the IFI to the customer.

IFI plays two roles in LC murabaha. The Islamic bank’s first role is as a paying agent using the contract of wakala for issuing LC to the customer. The second role of the IFI is as the owner of the goods required by the customer. The IFI will sell the goods at a profit to the customer under the murabaha contract.

---

**FIGURE 3.7** : Factoring with an Islamic Export Factor

[Diagram of Factoring with an Islamic Export Factor]

Source: FCI

**FIGURE 3.8** : Factoring with an Islamic Import Factor

[Diagram of Factoring with an Islamic Import Factor]

Source: FCI
### Table 3.4: List of Products and Services offered by IFIs for International Trade

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Source: Multiple sources from website
Asian Trade Finance: An Opportunity for Malaysia

### Table 3.5: Banks’ Online Marketplace Platform to support Trade

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<td>Through this platform, the proposition provides financing packages that help businesses become compatible with halal certification requirements, whether by getting their premises, operations, or supply chain to be in line with those requirements. CIMB HalalBizReady comprises three main pillars: SME Transact, SME Financing, and collaborations via industry SME Partners. Other than business financing, CIMB HalalBizReady also gives customers access to a wider global and regional market via the CIMB Trade Club platform[^76] and access to CIMB’s halal-based expertise strategic partnerships, which aim to facilitate businesses to become halal-ready for further growth.</td>
<td>A fully functional ‘best in class’ web-based trade financing service available via Maybank2e.net. It is designed to increase the efficiency of trade finance transactions processing whilst delivering a highly efficient system for reporting and tracing the status of the transactions and its documents. Customer can perform and monitor their trade finance transactions online anytime, anywhere. Maybank Trade Info Centre is an enhanced feature of TradeConnex. It provides information on 186 markets worldwide with complete range of online trade development tools and contents.</td>
<td>Halal360 is designed to help SMEs pursue the halal economy. Financial incentives are granted to halal SME exporters in the form of attractive foreign-exchange (forex) rates on export proceeds, preferential pricing on current and savings accounts, and lower rates on business instalment financing programs. Through this, Malaysian SMEs and large corporations can gain access to the bank’s full suite of shari’ah-compliant trade financing, liquidity management and working capital solutions to meet their local and cross-border requirements.</td>
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<th>4. HSBCnet[^75]</th>
<th>5. Velocity@ocbc[^77]</th>
<th>6. AmAccess Trade</th>
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<td>Global Trade and Receivables Finance solutions delivered through HSBCnet ITS enable customers to initiate and manage trade transactions for their global offices with access to real time trade account information from anywhere, at any time. These solutions increase efficiency, reduce waiting time and allow clients to start their sales, sourcing and manufacturing processes earlier. Features like Instant@device, DocumentExpress, e-PO Trader, e-Receiveables Finance and HSBCnet-SCS have considerably decreased cycle times and improved efficiency.</td>
<td>Velocity@ocbc is a holistic business internet banking platform offering a suite of cash and trade finance solutions, designed exclusively to mitigate risks and enhanced working capital to ultimately drive business expansion. The platform along with a seamless access and overview of trade finance portfolio ensures timely status updates on submitted applications, option to create customized transaction templates for repetitive transactions, online upload of documents and e-retrieval of trade finance advances anytime, anywhere. Features like mobile authorization on the go were introduced to capture part of customers’ ambitions on business regionalization. Shift to open account transactions saw the launch of Invoice Financing and the option to attach and upload documents online, especially catering to the digital needs of SME customers.</td>
<td>AmAccessTrade is a Corporate Internet Banking Solution for Trade Customers. This platform’s main functions are for clients to submit an application for trade services and trade financing online. AmAccess Trade is a web-based application that allows easy access from any time &amp; anywhere. Other features include email alerts, online advice, LC &amp; Payment Copy, and a tracking system.</td>
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<th>7. RHB Trade Solution-i</th>
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<td>Islamic trade financing solution for purchases and sales based on a new product structure combining wakala and istijjar shari’ah concepts. RHB Trade Solution-i offers business customers a simplified banking journey with less documentation upon approval and utilization of the facility. Through this offering, goods in the trade transaction itself are recognized as the underlying asset and this removes the need to undertake commodity trading to complete the transaction as required by other Islamic finance instruments based on more common shari’ah concepts. The RHB Trade Solution-i supports trading of goods in ringgit as well as in any global currency. The RHB Trade Solution-i offers customers, including SMEs, the advantages of lower cost and improved time efficiency in facilitating their B2B trade transactions both locally and globally.</td>
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[^72]: https://www.theedgemarkets.com/article/cimb-islamic-offers-m100m-financing-smes-become-halalready
[^76]: https://www.maybank2e.net
[^77]: https://www.theedgemarkets.com/article/cimb-islamic-offers-m100m-financing-smes-become-halalready
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