

OPINION PAPER: OIL PALM AND ISLAMIC FINANCE AS THE TWO INTERCONNECTED INDUSTRIES

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ABSTRACT

This paper investigates the evolving dynamics of the oil palm industry and its intricate implications for Islamic finance, particularly in the context of Malaysia where both sectors hold significant economic importance. Given the pivotal role of oil palm as a key commodity in Islamic financial instruments, notably in tawarruq (commodity trading), understanding the interplay between these two industries is crucial for charting a strategic path forward for both. Building upon prior research that has explored the oil palm-Islamic finance nexus, this study delves deeper into the specific Malaysian context, where oil palm reigns as the most frequently utilised commodity by Islamic financial institutions. By analysing the latest developments, we aim to uncover not only the inherent risks but also the untapped potential that oil palm presents for the Islamic finance sector. Effectively managing the risks associated with oil palm production and trade, while simultaneously harnessing its potential benefits, can significantly enhance the growth trajectory of both the oil palm industry and the Islamic finance sector in Malaysia. This, in turn, could have far-reaching implications for the overall economic development of the country. The insights gleaned from this research will be invaluable for policymakers, financial institutions, and industry stakeholders alike, enabling them to make informed decisions that foster sustainable growth and resilience in these interconnected sectors.

Keywords: commodity, interconnected, Islamic finance, oil palm, *tawarruq*.

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INTRODUCTION

Malaysia implements a dual-financial system, wherein both Islamic and conventional forms of financing are utilised simultaneously to accomplish the country's economic objectives. Malaysia's competitive advantage lies in its ability to establish itself as the leading global hub for Islamic finance.

Thus far, the government's endeavour has shown positive results, positioning Malaysia as a reference in this specialised industry, while facing fierce competition from other countries such as Bahrain, the United Arab Emirates, Saudi Arabia and Indonesia as depicted in the recent global report, the Islamic Financial Services Board (IFSB) Stability Report 2023.

However, Malaysia is fortunate to possess an abundance of natural resources, some of which are particularly advantageous for the Islamic finance industry. These resources include commodities like oil palm, rubber, tin mines, iron ore, and several others. This study seeks to examine the progression of the oil palm sector and its effects on Islamic finance within the context of commodities trading.

Commodity trading in Islamic finance strictly follows the rules of Islamic law, often known as Shariah. Shariah-compliant commodities trading adheres to precise criteria and limits to guarantee that transactions align with Islamic principles.

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This specialised financial industry advocates for ethical and socially conscious trade. Investments and trading operations that include the exploitation, unjust treatment, or harm to society are unequivocally forbidden.

The commodity trade in Islamic finance must guarantee that the transaction takes into account these essential elements:

Prohibition of Interest, Extreme Uncertainty, and Gambling

Riba or usury is categorically forbidden in Islamic finance. Hence, any commodity trading transaction that incorporates interest is deemed non-compliant. Islamic finance is built on the premise that the industry prioritises the profit-and-loss sharing agreements over other forms of transactions, although in reality the predominant modes of Islamic finance transactions are debt trading, leasing and asset-backed trading, just to name a few.

The tension between theory and practice underscores the ongoing evolution of Islamic finance as it seeks to balance its core principles with the practicalities of the modern financial landscape and often, asset-backed trading that utilises commodity such as oil palm in the form of *tawarruq* (commodity trading) contract becomes the preferred model. *Gharar* is the term used to describe an excessive level of uncertainty, ambiguity, or conjecture in a contract. Islamic commodities trading opposes agreements that have ambiguous terms or high unpredictability (Ali Azizan *et al.*, 2022; Muhamat *et al.*, 2023). Contracts must possess clarity, transparency, and be devoid of any ambiguity. Transactions characterised by considerable uncertainty and resembling gambling or are strictly forbidden in Islamic finance. Any speculative deals and significant uncertainty are prohibited.

Physical Assets Support

Shariah-compliant commodities trading frequently includes tangible assets (Muneem *et al.*, 2024, Muneeza *et al.*, 2020). Transactions ought to be associated with tangible assets, such as physical commodities, as opposed to speculative financial instruments.

Spot Transactions

Islamic finance prioritises spot transactions, which include the instantaneous exchange of goods at the prevailing market price (Rahman and Rahman 2023). Nevertheless, Shariah-compliant financial practices permit the use of deferred payment methods, such as *murabahah* (cost plus mark-up) and *salam* (sale with advance payment).

Acceptable Goods

The goods being exchanged must adhere to Islamic standards. Trading in alcohol, pork, and other forbidden commodities is strictly banned. Nevertheless, commodities such as food, metals, and agricultural items are often deemed acceptable.

UTILISATION OF COMMODITIES IN ISLAMIC FINANCE

It is crucial to acknowledge that there might be divergent interpretations of Islamic financial principles, and experts may hold differing perspectives on specific activities (Rahman and Rahman, 2023). Hence, people and institutions engaged in commodities trading in the realm of Islamic finance frequently consult Shariah scholars for assistance to guarantee adherence to Islamic standards. Islamic finance allows for the utilisation of many commodities in transactions and investment frameworks that adhere to Shariah rules. Here are some prevalent examples of commodities commonly utilised in Islamic finance:

Valuable Metallic Elements

Gold (*dhahab*) and silver (*fiddah*) are frequently utilised in Islamic finance due to their inherent worth and longstanding recognition as a means of trade. Gold is extensively employed in numerous Islamic financial products, including gold-based savings accounts and Islamic gold bonds.

Commodities of the Farming Industry

Agricultural commodities, such as palm oil, wheat, barley, and rice, have a substantial impact on Islamic financing. Agricultural items are frequently traded via contracts like *salam* (sale with advance payment) and *istisna* (manufacturing contract), which entail selling in advance and delivering at a later date. These goods are vital for ensuring food security and facilitating commerce.

Domesticated Animals Such as Cattle and Sheep

The inclusion of livestock in Islamic contracts, such as *murabahah* and *qard hassan*, is possible. They also hold significance in Islamic agricultural and farming initiatives.

Energy and Natural Resources

Oil and gas. Although fossil fuels are often sold in traditional markets, Shariah-compliant frameworks can be employed in the Islamic

financial industry. Energy resources can be subject to contracts such as *murabahah* and *ijarah*. Allocating funds towards renewable energy sources, such as solar and wind projects, adheres to the concepts of sustainability and environmental responsibility in Islamic banking.

Metals and minerals. Copper, iron, and other industrial metals are utilised in many industrial applications and infrastructural projects. Transactions involving these metals can adhere to Islamic financial rules, such as *tawarruq* (commodity trading), *murabahah* (cost plus mark-up sale), and *mudarabah* (partnership contract).

Agricultural commodities. Cotton, coffee, and other soft commodities refer to agricultural items that are cultivated rather than extracted from mines. These terms are frequently employed in Islamic finance agreements, particularly in relation to commodities trade and supply chain financing, such as *salam* and *istisna*.

COMPATIBILITY OF OIL PALM AS COMMODITY FOR ISLAMIC FINANCE

Oil palm is extensively utilised across several sectors and is regarded as a commodity. Within the context of Islamic finance, oil palm can be employed in transactions and investments, but it is imperative that such utilisation adhere strictly to Shariah law. Islamic financial institutions may impose specific requirements on oil palm farmers and merchants to ensure compliance with ethical and sustainable business practices, as per Shariah guidelines (Nordin *et al.*, 2017).

The acceptability of oil palm in Islamic financing is contingent upon examination by Shariah experts and adherence to Islamic norms, similar to any other product. The acceptability of oil palm-related transactions in Islamic finance by Shariah scholars and local regulatory agencies may be influenced by local legislation and guidelines. Islamic financial firms commonly consult Shariah boards to guarantee adherence to Islamic rules when handling different sorts of commodities.

Characteristics of palm oil that render the product appealing for Islamic finance:

Halal Nature

Palm oil is halal under Islamic dietary regulations due to its plant-based origin. This renders it widely permissible within the context of Islamic financing.

Trading of Commodities

Palm oil is often exchanged as a commodity in global marketplaces. Palm oil transactions can be conducted using Shariah-compliant commodity trading mechanisms, such as *murabahah* (cost-plus mark-up) or *salam* (sale with advance payment) (Uluyol, 2024).

Supply Chain Finance

It refers to the financial activities and strategies involved in managing the flow of funds within a supply chain. The application of Islamic finance can facilitate supply chain financing for the palm oil sector. For example, *murabahah* contracts may be employed to fund the acquisition and trade of palm oil along the whole supply chain.

Principles of Sustainability

Shariah principles promote the adoption of ethical and sustainable business operations. Islamic financial institutions may prioritise palm oil production methods that comply with environmental and social responsibility criteria (Sufian, 2018). The ideals of Islamic financing are in harmony with the sustainable and ethical sourcing of palm oil.

Typically, Islamic financing contracts commonly involve the use of palm oil as a commodity in their transactions. However, among these contracts, *tawarruq* stands out as the primary contract that extensively utilises commodities, including palm oil. This is because *tawarruq* is specifically designed to employ commodities as its asset-backed financial transaction.

PALM OIL DEMAND

The demand for palm oil is influenced by several factors, necessitating consideration of both global and regional dynamics. By 2024, it is projected that there would be a little increase in the demand for palm oil compared to 2023 (The Star, 2024). However, the supply is predicted to remain stable owing to adverse weather conditions caused by the *El Nino* phenomena. According to Alam *et al.* (2024), *El Nino* poses a significant threat to palm oil production and meteorological conditions.

As reported by Standard and Poor's, the projected value of crude palm oil futures is RM4000/t, which is an increase from RM3798/t in 2023 (Kondalamahanty *et al.*, 2023).

Indexmundi (2024) sources provide information on the primary nations which are the major producers of palm oil in 2023.

Indonesia, Malaysia, and Thailand, among other Southeast Asian nations, constantly play a significant role in the global production of palm oil. Similarly, this is a key factor that makes palm oil the favoured commodity for Islamic financial transactions in the country, as compared to other commodities.

TABLE 1. MAJOR PALM OIL PRODUCERS IN 2023

Rank country	Production (1000 t)
1 - Indonesia	47 000
2 - Malaysia	19 000
3 - Thailand	3 450
4 - Colombia	1 800
5 - Nigeria	1 400

Source: Indexmundi (2024).

Several crucial elements that exerted effect on such demand are:

Food Sector

Palm oil is extensively utilised in the food sector as a cooking oil, margarine, and in the production of other processed goods. The escalating worldwide population and surging per capita income in developing nations contribute to the burgeoning demand for edible oils, particularly palm oil (World Bank, 2024).

Developing Economies

Palm oil is often in high demand due to the growth of emerging markets in Asia, Africa, and Latin America (Furumo and Aide, 2017). These areas undergo population expansion and urbanisation, resulting in a rise in the consumption of processed and convenient goods that use palm oil as an ingredient.

Renewable Fuels Derived from Biological Sources

Palm oil is utilised in the manufacturing of biofuels, specifically biodiesel. The implementation of government policies that encourage the use of biofuels as a sustainable energy alternative can have an effect on the market demand for palm oil (Kaniapan *et al.*, 2021).

Industries That Do Not Include the Production or Distribution of Food

Palm oil is utilised in the manufacturing of several non-edible commodities, such as soaps, cosmetics, and detergents (Sulaiman *et al.*, 2022). Factors such as economic development

and changes in personal hygiene exert a significant influence on the demand for these items.

Public Policies Implemented by the Government and International Trade Dynamics

Palm oil demand may be influenced by government policy, both domestically and globally (Salleh *et al.*, 2021). The palm oil sector may be affected by policies concerning biodiesel requirements, trade laws, and environmental sustainability.

The worldwide movement of palm oil can be influenced by international trade agreements and geopolitical concerns. Trade policy and agreement modifications can impact the movement of palm oil between nations that produce it and those that consume it.

The palm oil business has been subject to scrutiny due to environmental and social issues, prompting initiatives to advocate for sustainable methods. Consequently, several firms and consumers are actively pursuing and advocating for the use of sustainably and ethically derived palm oil.

Current Atmospheric Conditions

Palm oil output can be influenced by weather circumstances, such as the presence of *El Niño* or *La Niña* phenomena. Unfavourable weather conditions, such as droughts or heavy rainfall, can affect crop production and have an impact on pricing (Abubakar *et al.*, 2022).

INTERTWINING OF ISLAMIC FINANCE AND PALM OIL

Three primary challenges provide a vulnerability to the palm oil sector. Firstly, let's discuss the meteorological phenomenon known as *El Nino* and *La Nina*, which were previously discussed. Following that is the volatility of pricing, and finally, trade conflicts, namely with the European Union (EU).

Although weather is sometimes attributed to divine intervention as it is beyond human control, individuals may nevertheless minimise its effects via effective preparation. During the *El Nino* era, it is feasible to utilise treated wastewater for agricultural purposes and employ cloud seeding or rain-inducing techniques in the affected regions.

The volatility of palm oil prices is crucial in the context of Islamic finance as it can impact the borrowing costs. This is because a significant portion of Islamic financial transactions rely on commodity trade, with physical assets playing a role

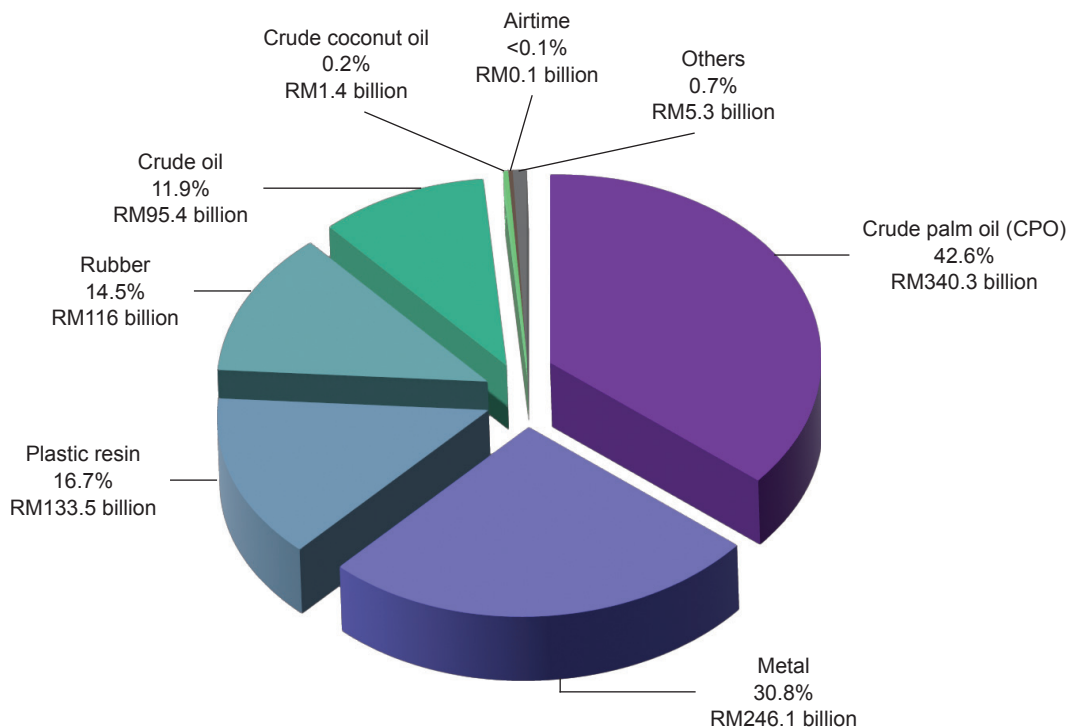
in many processes such as investment, borrowing, and settlement. While other commodities may be utilised, palm oil stands out as a primary commodity.

Figure 1 depicts the utilisation of commodities in Islamic financial transactions. It reveals that palm oil holds the largest share, accounting for 42.6% or RM340.3 billion in 2022. The numbers indicate the strong dependence of Islamic finance on the commodity. They also demonstrate that Islamic financial institutions are actively involved in trading the commodity, both as sellers and purchasers. This direct involvement has a significant impact on the demand for the commodity and, consequently, its price. Furthermore, Malaysia is leading the global Islamic finance industry. This implies that the involvement of Islamic financial institutions in international trade will also support the worldwide demand for palm oil. However, it is crucial for us to comprehend the inherent risks that arise from this circumstance.

A number of Islamic finance experts raised this concern about 15 years ago at a period of rapid development in the field of Islamic finance (Liau 2008). Kuen (2022) expresses a similar viewpoint while evaluating the agency’s performance in the Islamic capital market platform for commodities trading in 2022, referred to as Bursa Suq Al-Sila. During that year, the average daily volume amounted to RM41.92 billion, in contrast to RM37.28 billion recorded in the initial three months of 2021.

Here, it is noteworthy to emphasise the interdependence between the Islamic stock market price and the movement of crude palm oil (CPO) price. Razak and Masih (2017) highlighted the strong correlation between the movement of the CPO and the Islamic stock market, which is particularly relevant for long-term projections. However, a discrepancy is observed when it comes to short-term forecasts. A study conducted in 2021 observed similar results in Indonesia about the correlation between the stock market movement and the CPO price. Therefore, it is imperative to maintain the price movement of palm oil to ensure the spread is not too big.

A significant factor exacerbating the situation is the escalating trade tensions between the Southern Hemisphere nations, primarily palm oil producers, and their Northern Hemisphere counterparts, who are both consumers and competitors (through canola and sunflower oil production). These tensions have been fuelled by accusations against palm oil producers regarding human rights abuses and environmental degradation. The palm oil stakeholders are currently working to counteract the sentiments and actions taken by the EU (Saratian and Arief, 2018; Neo, 2023). A prohibition on palm oil in Islamic finance transactions in Europe, due to human rights and environmental concerns, could significantly impede the growth trajectory of the Islamic finance industry, particularly impacting Islamic financial institutions operating in Europe and their involvement in international transactions.



Source: Bank Negara Malaysia (2022).

Figure 1. Composition of commodities used in Islamic finance in 2022.

This possibility of disruption stems from the fact that oil palm is a key commodity in many sectors, and its exclusion from Islamic finance could severely limit the scope of permissible investments and financial activities. This limitation could create substantial challenges for European Islamic financial institutions, potentially hindering their ability to expand their operations and engage in cross-border transactions.

Moreover, the exclusion of palm oil could also have ripple effects on other sectors and industries connected to Islamic finance, further exacerbating the disruption. The resulting uncertainty and complexity could deter investors and clients, ultimately undermining the industry’s overall growth potential in the region.

In addition, it is a widespread practice for well-known and established firms, particularly Islamic financial institutions, to associate themselves with the United Nations’ Sustainable Development Goals (SDGs). The Malaysian Islamic Financial Market Report 2023 emphasises the ongoing trend among Islamic financial institutions to align with the central bank’s agenda on value-based intermediaries (VBI). These institutions are introducing environmentally conscious and socially responsible products, implementing policies that support environmental protection, and engaging in corporate social responsibility activities and campaigns for flora and fauna (Bank Negara Malaysia, 2023).

Figure 2 illustrates the procedural steps involved in *tawarruq* as practiced by Islamic financial institution in Malaysia. *Tawarruq* is one of the popular modes of financing that is used by the Islamic financial institutions.

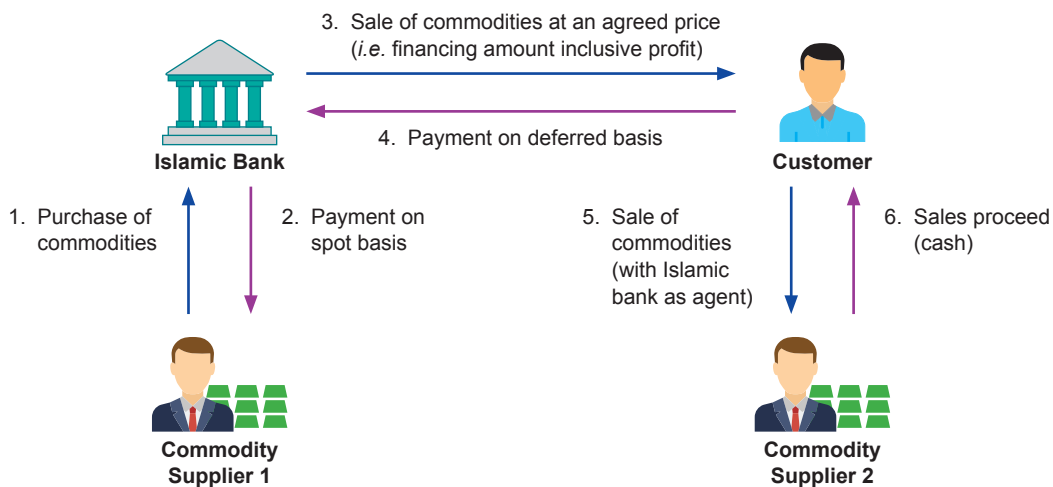
The procedural steps of *tawarruq* in Islamic financial transactions will include two commodity providers, with the Islamic financial institution acting as the overseeing agent. The Islamic financial institution will get the commodity, such as palm oil, from supplier 1 at the current market price and thereafter sell it to the customer at a later date, at a price greater than the initial transaction with supplier 1. The client has the option to either utilise it for their own business or transfer it to another provider (supplier 2).

CONCLUSION

This paper has outlined the impact of palm oil towards Islamic finance which can be described as critical interdependency due to the closely interconnected of the Islamic financial institutions over the palm oil as their asset-backed commodity in their financial transactions.

For a country like Malaysia, which excels in both the Islamic finance industry and palm oil production, the expansion of either sector will positively impact the other. Put simply, Malaysia, as a nation, will reap advantages from this circumstance. However, as previously mentioned, the oil palm industry bears a greater burden due to its nature – Agriculture. The success of palm oil manufacturers in managing the risks associated with agricultural production specifically the oil palm plantations, while capitalising on available opportunities, greatly impacts both industries.

Hence, the Islamic financial institution must possess an understanding of the ramifications resulting from the variability in both the demand



Source: Bank Negara Malaysia (2022).

Figure 2. Tawarruq mechanism.

and price of the product. This can be achieved by the use of Shariah-compliant hedging instruments and the deployment of risk management strategies, such as procuring the palm oil supply in advance.

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