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Three New Licences for Islamic Fund Management Companies

The SC approved applications of three leading financial institutions to establish Islamic fund management companies (IFMCs) in Malaysia. The three are Kuwait Finance House (Malaysia) Bhd, DBS Asset Management Ltd and CIMB-Principal Islamic Asset Management Sdn Bhd.

The establishment of the three new IFMCs follows on from the measures announced in Budget 2008 to strengthen Malaysia's position as an international Islamic financial centre.

The approval of these companies will play a catalytic role in the internationalisation of the Malaysian ICM. It also reflects the global recognition of Malaysia's position as a centre of Islamic finance and enhances Malaysia's opportunity to be a leading Islamic fund and wealth management hub.

Part I: Islamic Alternative To Stock Borrowing and Lending

The Malaysian securities market introduced the framework of stock borrowing and lending (SBL) at end-1995, followed by the guidelines on regulated short selling (RSS) in September 1996. However, both were suspended at end-1997, following the economic crisis. In January 2007, both RSS and SBL were reintroduced into the Malaysian capital market, marking another implementation of the recommendations under the Securities Commission's Capital Market Masterplan.

In the Malaysian stock market, besides allowing the borrowing of eligible securities,[1] for the purposes of settling a failed transaction or to cover regulated short sell, the SBL framework also allows the facilitation of borrowing for the needs of exchange-traded funds (ETFs).[2]

The current SBL framework, however, involves conventional or interest-based lending and borrowing securities. Thus, the framework is non-permissible from the Shariah perspective. As the international growth and development of ICM is very rapid, the need to have an alternative to the conventional SBL could not be overlooked. Hence, the situation requires looking at what Shariah principles can be used in introducing Shariah-compliant SBL.

"...Under this arrangement the lender will earn a fee (or a return on the reinvestment of cash collateral) as consideration for the loan of the securities."

"RSS means that at the time of execution of the sale of an approved class of securities, the seller does not have an unconditional right to vest the securities in the purchaser but has executed an agreement to borrow them from other parties, before the time of the sale."

Before further elaborating the Islamic alternative to this conventional SBL, it is important to first understand the concept of short selling and RSS.

Short selling and RSS

Stock lending involves the transfer from a securities lender to a borrower of collateralised loan of securities for a limited time period. Under this arrangement the lender will earn a fee (or a return on the reinvestment of cash collateral) as consideration for the loan of the securities. At the end of the borrowing period, the borrower returns to the lender similar securities as borrowed, but equivalent only to the number borrowed and not the value as at time of borrowing.

Generally, short selling refers to the practice of selling a security that the seller does not own at the point of transaction. The seller bets on the likelihood that he will be able to buy the shares at a lower price than the

1 Mean securities that are prescribed by the Clearing House (Bursa Malaysia Securities Clearing) in the SBL circular from time to time as being eligible for lending or borrowing through the Clearing House.
2 The short selling in ETF is done via a permitted short selling framework (PSS).

price at which he sold short. This is normally termed as naked short selling. Many jurisdictions disallow this naked or uncovered short selling in their stock markets because it involves many unique risks and pitfalls. Similarly in Malaysia, naked short selling is disallowed under section 98 of the Capital Markets and Services Act 2007 unless it is conducted in the form of RSS or covered short selling as prescribed through the Rules of Bursa Malaysia Securities.

RSS means that at the time of execution of the sale of an approved class of securities, the seller does not have an unconditional right to vest the securities in the purchaser but has executed an agreement to borrow them from other parties, before the time of the sale.

From the Shariah perspective, the short-selling activity is not allowed as it involves the selling of shares not owned by the seller. As a result, such transactions fall under the category of bai` ma`dum. Islam prohibits bai` ma`dum since the delivery of the subject matter cannot be affected and this brings about the prohibited element of gharar (uncertainty).

Since RSS can only be conducted with SBL arrangements in place, there is thus the certainty that the stocks will be delivered to the buyer, and the element of gharar will no longer be significant. Consequently, when obstacles that hinder the recognition of a certain activity as Shariah compliant is overcome, then that activity can be classified as Shariah compliant. The fiqh ruling will thus be fulfilled:

إذا زال المانع عاد الممنوع

> Meaning: When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible.

The Shariah Advisory Council of the Securities Commission has resolved that RSS on eligible securities[3] will be permissible provided the SBL is Shariah compliant. The next issue of the Malaysian ICM bulletin will discuss the Islamic alternative to replicate SBL.

"The Shariah Advisory Council (SAC) of the Securities Commission (SC) has resolved that RSS on approved securities will be permissible if the SBL framework complies with the Shariah principles."

[3] Eligible securities are Shariah-compliant securities

Guidelines and Best Practices on Islamic Venture Capital Industry

The *Guidelines and Best Practices on Islamic Venture Capital* (guidelines) issued by the SC on 7 May 2008 aim to promote the adoption of appropriate standards for the development of the Islamic venture capital industry.

The guidelines stipulate the minimal requirements for the establishment of an Islamic venture capital corporation (VCC) and Islamic venture capital management corporation (VCMC). It also includes a set of best practices to promote appropriate Islamic standards in the industry.

Consistent with previous guidelines on ICM products and services, the appointment of a Shariah adviser is one of the core requirements imposed. A Shariah adviser must be appointed to provide expertise and guidance on conformance to Shariah principles in all matters of the Islamic VCC or Islamic VCMC.

The set of best practices cover the responsibilities of the Shariah adviser, appointment and roles of a compliance officer, other administrative matters relating to portfolio management and maintenance of accounts.

The best practices for the Islamic VCC or Islamic VCMC, however, are voluntary in nature but the adoption of these best practices will raise the standards of the Islamic VCC or Islamic VCMC, and enhance professionalism in the industry.

Measures to Further Promote Sukuk and Bond

Malaysia has established a broad and diversified bond market which provides long-term funding and strengthens the country's financial resilience. In 2007, the value of fund-raising proposals approved for debt securities doubled to RM159 billion. At the same time, the gross issuance of corporate bonds and *sukuk* increased by 78% from last year, reaching RM69 billion. Measured as a ratio of GDP, the Malaysian bond market is now the third largest in Asia and is characterised by a diversified issuer and investor base.

The growth is partly due to our effort in creating a facilitative framework for the issuance of bonds and *sukuk* in Malaysia. The great diversity of issuer base and the withholding tax exemption for foreign investors have substantially raised the profile of the domestic bond market in the international arena.

To increase the efficiency of the issuance framework that is consistent with international standards and best practices, and to complement the broader developmental agenda of transforming Malaysia into an international Islamic financial centre, the following additional measures were announced on 25 March 2008:

- The extension of existing deemed approval process to ringgit bond issues rated AAA, based on domestic currency rating or a minimum BBB rating based on foreign currency rating;

- The extension of existing deemed approval process to foreign currency bond issues rated a minimum BBB rating, based on foreign currency rating;

- The extension of existing exemptions from Division 4 of Part VI of the *Capital Markets and Services Act 2007* (CMSA) to bond issues rated AAA, based on domestic currency rating, or a minimum BBB rating, based on foreign currency rating; and

- Allowing the use of international documentations for ringgit bond issues rated AAA, based on domestic currency rating, or a minimum BBB rating, based on foreign currency rating.

SUKUK

Sukuk musyarakah for tolled highway business

In June 2008, PLUS Expressways Bhd (PEB) issued a *sukuk* programme of up to RM4 billion in nominal value based on the principle of *musyarakah*, via an independent special purpose vehicle PLUS SPV Bhd (Issuer). Proceeds from the issuance of Islamic medium-term notes were utilised to refinance PEB's existing borrowings, general business and working capital requirements, which are Shariah compliant.

Under the *sukuk* structure, another special purpose company, that is, SPV 1 was also set up to facilitate the transaction. The investors will form a partnership among themselves to invest in the trust assets and the issuer will act as the manager of the trust assets. Should the periodic payments fall short of the expected return under the *sukuk*, PEB will top up and make good the difference which will be set-off against PEB's obligation under the purchase undertaking. The *sukuk musyarakah* have maturities ranging from one to 18 years and were assigned AA1 rating by Rating Agency Malaysia Bhd.

Toyota Group's inaugural foray into the ICM

The SC has approved a RM1 billion Islamic funding programme issued by UMW Toyota Capital Sdn Bhd (UMWTC), a subsidiary of Toyota Financial Services Corporation (the finance and insurance umbrella of Toyota Motor Corporation). The issuance comprised Islamic commercial papers (ICPs) and medium-term notes (IMTNs) with maturities of up to seven years.

Structured based on the principle of *musyarakah*, the *sukuk* holders will from time to time form a partnership among themselves to invest in the identified assets via subscription of the *sukuk* issued by UMWTC. The proceeds from the issuance of the *sukuk musyarakah* will be utilised mainly for Shariah-compliant working capital relating to UMWTC's Islamic financing products.

Under a purchase undertaking granted by UMWTC (Obligor) to the trustee (acting on behalf of the *sukuk* holders), the trustee may require UMWTC to purchase the *sukuk* holders' interest in the *musyarakah* venture at the exercise price upon the maturity date of the *sukuk musyarakah* or the declaration of a dissolution event. The ICPs and IMTNs were accorded P1 and AAA ratings respectively by Rating Agency Malaysia Bhd.

Sukuk ijarah issuance for aircraft industry

Air Asia Bhd opted to raise up to RM500 million from the issuance of *sukuk ijarah* under a medium-term notes programme. The bank-guaranteed *sukuk* have maturities of up to five years and will be issued by Air Asia's wholly-owned subsidiary, Aras Sejagat Sdn Bhd.

Based on the structure, Air Asia will enter into either a sale and leaseback, or lease and leaseback transaction from time to time with the issuer. Under each lease agreement, the first lease rental would comprise the nominal value of the *sukuk* issued which relates to that lease agreement (fixed amount) and the corresponding profit element. However, so long as a default does not occur, the fixed amount will be automatically deferred.

The unlisted *sukuk* has been given the rating of AA+ID(bg) by Malaysian Rating Corporation Bhd. The proceeds from the issuance will be utilised by Air Asia for capital expenditure and debt refinancing purposes which are Shariah-compliant financing products.

Collective Investment Schemes

Islamic commodities structured fund

Two Islamic commodities structured funds, managed by CIMB-Principal Asset Management Bhd were launched in April 2008. The funds known as CIMB Islamic Commodities Structured Fund 1 and 2 will potentially provide annual returns of 10% to 15% each by investing in commodities, such as energy, agriculture products, and metals.

Both are close-ended funds which will invest in structured products and principally protected when held to maturity. They are ideal for investors seeking refuge from market volatility. The funds are suitable for retail investors to have exposure in commodities via structured products, which were previously an asset class and investment tool for institutional investors. The minimum subscription is only RM10,000.

CIMB Islamic Commodities Structured Fund 1 will invest at least 95% of its net asset value (NAV) in a three-year Islamic Dynamic Best of Commodity Structured Product to be issued by CIMB Investment Bank, and up to 5% of its NAV in liquid assets. The CIMB Islamic Commodities Structured Fund 2 will invest in a five-year Islamic Dynamic Best of Commodity Structured Product. The total approved fund size is 600 million units for each fund.

Islamic global emerging market equity fund

Backed by the record that emerging markets had outperformed global equities for the past five years due to strong earnings growth, CIMB-Principal Asset Management Bhd and Principal Global Investors (PGI) launched global Islamic fund for retailers known as CIMB Islamic Global Emerging Market Equity Fund. The fund is targeted to provide respectable annual returns from investments in regions, such as Eastern Europe, Africa, the Far East, and Latin America.

The fund invests in companies from regions that have businesses in sectors, such as infrastructure, commodities, and technology. It provides investors an enhanced global diversification across the multiple emerging markets. The emerging markets cater to a wide range of currencies which may serve as a hedge against the current concern of investors – domestic inflation. The fund has a total approved size of 300 million units of 50 sen each and the minimum investment required for any investor is RM1,000.

Domestic optimal growth fund

A new Islamic equity fund that invests in domestic Shariah-compliant stocks was launched by Public Mutual Bhd in April 2008. The fund, Public Islamic Optimal Growth Fund, is designed for investors who wish to achieve an optimal combination of capital appreciation and income growth over the long term. Its objective is to provide income and capital growth by investing in Shariah-compliant stocks which offer attractive dividend yields and growth stocks.

The equity exposure of the new fund ranges from 75% to 95% of its NAV. The fund's initial offer price is RM0.25 per unit and the minimum initial investment is RM1,000. The total approved fund size is 1.5 billion units.

Islamic cash management fund

Islamic cash management fund for corporate and institutions investors to diversify their investment portfolio was recently introduced by RHB Investment Management Sdn Bhd. This new Islamic money market product known as RHB Islamic Cash Management Fund (RHBICMF) is the Shariah-based adaptation of the RHB Cash Management Fund that was launched in August 2007.

The RHBICMF is suitable for corporate and institutional investors who are looking for liquidity and a regular stream of income in Shariah-compliant money market instruments in the short term. It plans to invest in a diversified portfolio of short-term Islamic debentures, money market instruments and deposits with financial institutions. Strategically, it allocates at least 90% of its investments in Islamic money market instruments and deposits with financial institutions that are less than one year in maturity with the balance 10% being invested in financial institutions whose products are between one and two years in maturity.

The fund, is managed by RHB Investment, has approved fund size of 500 million units and its initial offer price is at RM1 each.

Updated List of Shariah-compliant Securities by the SAC

The SC released an updated list of Shariah-compliant securities approved by its SAC. The updated list of Shariah-compliant securities listed on Bursa Malaysia took effect from 30 May 2008. The full list is posted on www.sc.com.my.

Twenty-three newly classified Shariah-compliant securities have been added to the list, which currently totals 843 securities. Twelve securities from November 2007 list, have been excluded. Based on the current list, 85% of the listed securities on Bursa Malaysia are classified as Shariah compliant.

In classifying the listed securities, the SAC received input and support from the SC and has applied a standard criteria in focusing on the activities of the companies listed on Bursa Malaysia. The approach and criteria in classifying the securities as well as the SAC's advice and guidance on disposal of Shariah non-compliant securities are stated in the list.

The next updated list will be available in November 2008.

Sustainability of Islamic Finance[1]

Despite the global credit crunch, the momentum of Islamic finance continues to progress. The industry is expanding and attracting new players. As a result, the range of Shariah-compliant products offered to Islamic customers has proliferated. At the same time, the industry is becoming much more competitive: customers no longer have to pay high premiums for Islamic products.

The *sukuk* market, in particular, remains robust, with global issuance expected to remain healthy. While some issuances were apparently delayed on concerns over pricing and overall risk aversion to credit markets, the market on the whole is expected to expand rapidly. It attracts a greater number and range of issuers' calls for a vibrant and liquid international secondary market in *sukuk*, where investors are assured of trading large orders readily at efficient prices.

Athough much attention has been focused on the phenomenal growth of Islamic finance, it is crucial that the aspect of sustainability is addressed to ensure the future potential of Islamic finance is fully optimised.

The four Cs of sustainable Islamic finance

1. Compatibility

The industry continues to push the frontiers of innovation in structuring products and offering services that are Shariah compliant. Those seeking funds are also looking for more flexible forms of financing which can cater to their specific business requirements. Investors are looking for more innovative ways of capturing and maintaining returns. These developments, while extremely positive for Islamic finance, have also given rise to some skepticism. Questions have been raised on whether mirroring existing products and returns through financial engineering is a sound basis on which the industry should develop.

It is important that the approaches are compatible with each other and with the real needs of the market. It is only natural that models of Shariah compliance tend to start as being more domestic-centric, consistent with national legal and tax frameworks. But as the global industry grows, all interested parties need to work together to foster a greater convergence in their approaches. Shariah scholars from different jurisdictions have been interacting more closely with each other and deepening their understanding of respective *fatwa* pronouncements. International Islamic institutions such as the IFSB and AAOIFI and locally, the Shariah advisory councils of the SC and of Bank Negara Malaysia (BNM), have provided the critical intellectual leadership.

In Malaysia, there has been an increase in dialogue among international Shariah scholars to learn from one another. The SC has also allowed foreign Shariah scholars to participate in the local market. Clearly, global clarity is needed on what is mutually acceptable rather than to focus on differences in views.

Users of financial products and services, whether conventional or Islamic, also want to be assured that globally accepted standards and best practices in regulation and supervision apply to them. In Malaysia, the SC emphasises a common regulatory approach for both Islamic and conventional products, based on the International Organization of Securities Commissions (IOSCO)'s objectives and principles of regulation. It is essential that the Islamic capital market is subjected to the same regulatory framework as the conventional market and satisfy the same requirements for disclosure, transparency, and governance.

2. Capacity

Given the rapid growth of the industry, there is a shortage of human resource with the right qualifications. The problem with finding the right people is that it requires Islamic finance managers with cutting-edge knowledge of mainstream markets (to be competitive) and of Shariah principles.

For now, the typical business model splits the work

[1] This article is based on the keynote address of Dato' Zarinah Anwar, delivered at the Malaysia Islamic Capital Market Conference 2008, Kuala Lumpur on 18 June 2008.

between trained finance professionals who run the business and make the institutional decisions on investments and other financial matters, and the Shariah scholars who vet those decisions. However, many of these scholars include those trained in traditional Islamic schools where the emphasis on finance may be limited; as a result, they may not have a complete grasp of financial markets. On the other hand, financial practitioners, even those who claim to be knowledgeable about Shariah standards, do not have the authority to rule on religious edicts.

In Malaysia, these issues are tackled through training programmes whose objective is to widen the pool of Shariah expertise and deepen skill sets. These programmes have three levels:

- Entry level: Fresh Shariah graduates through training and attachment with the industry;
- Intermediate level: Shariah scholars through skills training; and
- Advance level: Increase skills and number of Shariah scholars able to participate in the international arena.

3. Capital markets

Islamic finance has increasingly moved into the realm of capital markets. While the most visible sign has been the growth of *sukuk* instruments, innovation is fast taking place in other areas, in particular, structured products. This is not surprising because the structuring of risks and financing requirements is intrinsic to Islamic finance.

However, key to the sustainability of Islamic finance is that innovation must be from within, and not just mimicking the conventional industry. It needs to actively pursue strategic differentiation. The strategy for Islamic finance must be to identify an integrated set of actions designed to produce or deliver products and services that customers perceive as being different in ways that are important to them.

In Islamic finance, it is important to emphasise the link between financial assets and real assets – especially given the problems concerning the apparent disconnect resulting from complex and highly leveraged financial engineering in the conventional market. In this regard, venture capital may be a promising growth area, because the financing techniques required are similar to the stated principles of Islamic finance. Moreover, by providing funds to entrepreneurs with good ideas, Islamic finance can help to promote innovation, invention, job creation, and the development of high-growth industries.

In addition, the development of a global Islamic capital market also requires the emergence of many more centres and players. There is also room for major Islamic centres to emerge within regions and across regions.

4. Connectivity

Bilateral or multilateral linkages between economies and markets make cross-border product issuance and distribution easier. They allow freer movement of intermediaries and other professionals, formalise links between exchanges and market participants, and reduce friction that would otherwise raise the cost of cross-border transactions and market access.

In Malaysia, strong measures were taken to promote these linkages. The first global Malaysian sovereign *sukuk,* for example, was listed simultaneously in Labuan, Bahrain, and Luxembourg. Khazanah's Islamic exchangeable trust certificates were listed on the Dubai International Financial Exchange, Labuan, and Hong Kong. At the same time, *sukuk* issued by the Gulf Co-operation Council (GCC) states were listed on Labuan. In 2007, the SC and Dubai Financial Services Authority signed a mutual recognition agreement for product distribution and marketing.

The importance of such linkages should not be underestimated. There are excess savings among members of the Organisation of Islamic Countries (OIC) needing to be invested in Islamic capital market (ICM) products and services. A more connected or "integrated" market bridging the resources of the Middle East, Asia, and Africa, coupled with innovation in providing for Islamic products, would meet these demands far more readily than a set of fragmented markets. Some have pointed out that this would go some way towards achieving the Shariah principle of ensuring an equitable allocation of capital to achieve the objectives of the *Ummah*.

Regional Integration of Islamic Capital Markets – Key Issues[2]

Taking the global Islamic financial markets to greater heights

Islamic finance has emerged as one of the fastest-growing and resilient components of the global financial system. It has moved past the pioneering stage and provides conclusive evidence that Shariah-compliant financing instruments are a commercially viable and effective tool for mobilising investment assets to finance productive economic activities.

The Asian and Middle Eastern economies have huge surpluses while at the same time require substantial investments to propel their economic growth. Clearly, there are opportunities for Islamic finance to strengthen its role in intermediating surplus savings into economic development. However, the pools of Islamic liquidity are currently fragmented and this hampers the ability to tap these opportunities. Markets and innovation cannot thrive in isolation. It is, therefore, critical to build greater connectivity between both economies and markets to promote the growth of Islamic financial markets around the world.

Integration of Islamic capital markets: Strategic consideration

In terms of economic integration, the most comprehensive model is the European Union where integration involves freedom of movement for goods, services, labour, and capital, as well as political union through establishing a European Parliament and monetary union through a common currency.

Both the ASEAN and the GCC have adopted less extensive models for economic integration. ASEAN plans to create an ASEAN Economic Community by 2015 transforming the region with free movement of goods, services, investment, skilled labour, and a freer flow of capital. The GCC have implemented a customs union with capital and investment flows facilitated through relaxed regulation.

In market integration, greater cross-border investments generally facilitate pooling of liquidity and risks and improve the efficiency of capital allocation. Capital market integration will also enhance the ability of the region to compete for capital and order flows while aligned national regulatory approaches will reduce the costs of operating in the regional market.

Integration of financial markets can occur through a broad range of channels to facilitate investors in one jurisdiction to transact or finance economic expansion in another. Strategic alliances among exchanges represent one such approach. For example, European bourses initially amalgamated into Euronext and OMX but these were subsequently taken over by the US exchanges. The European experience demonstrates that integration of exchanges is largely driven by market forces and is determined mainly by commercial considerations.

But exchange alliances are just one means of enabling market integration. There are other approaches and these include the harmonisation of standards, mutual recognition regimes, cross-border issuances, depository receipts and the expansion of intermediaries through branch offices and alliances. In fact, cross-border investing can also occur through the introduction of regional exchange-traded funds.

The integration of markets need not necessarily be bound by geography but rather by identity. The OIC member countries could collectively form a substantial base that can be considered to logically offer a distinct Islamic "brand value" for both market-based intermediation and financing activities. To elaborate, the 57 OIC member

[2] This article is extracted from the speech delivered by the SC Chairman, Dato' Zarinah Anwar at the 5th Islamic Financial Services Board Summit, Amman, Jordan on 13 May 2008.

countries have a population of about 1.5 billion with a combined GDP of US$7.7 trillion (based on purchasing power parity) accounting for 12.8% of total world GDP. In contrast, there are 23 exchanges covering 29 countries in the OIC with a combined market capitalisation of US$2 trillion accounting for only 3.3% of global market capitalisation. The contrast between economic and market development with only half of OIC member countries having exchange operators suggest the Islamic community have insufficient access to market mechanisms to fund domestic growth.

This also suggests that substantial economic efficiency gains can be derived through pursuing a shared identity for Islamic markets through integration. One key aspect of the integration strategy must be to promote the recycling of surplus savings in some Islamic nations to finance economic development in other Islamic countries. Hence, collaboration through market integration can expand intermediation activities in a positive and mutually reinforcing process that will grow both economies and markets in OIC and, in turn, strengthen the brand value of Islamic capital markets.

Catalytic role of governments and regulators

Efforts to promote the various forms of market integration require the strong and active support and involvement of governments and regulators. There is, therefore, a major role for OIC governments and regulators to play in terms of creating an enabling environment to facilitate a sequenced and orderly integration of Islamic capital markets.

In Malaysia, various initiatives have been introduced to facilitate cross border transactions and linkages. The first global Malaysian sovereign *sukuk* was listed in Labuan and Bahrain as well as in Luxembourg. The Khazanah Shariah-compliant exchangeable trust certificates issued in July 2007 was listed on the DIFX as well as in Labuan and Hong Kong. Under the Malaysia International Islamic Financial Centre (MIFC), new banking licences have been granted to Middle Eastern banks, new capital market licences are being offered to increase intermediation flows with the Middle East and a fully liberalised environment with attractive incentives has been established for Islamic fund management.

Similarly, GCC members have also listed *sukuk* in Labuan which opened up other opportunities in strengthening the co-operation in other segments such as for Islamic funds where the SC has inked its first mutual recognition agreement (MoU) with the Dubai Financial Services Authority (DFSA). The MoU allows cross-border distribution and marketing of Islamic unit trust products.

In this regard, the ASEAN Capital Market Forum (ACMF) – which comprises the heads of securities regulators – plays an active role in leading initiatives to promote integration of the regional capital market, in line with the ASEAN roadmap for regional financial integration. The ACMF has established various working groups to formulate a set of common standards for cross border offerings, for disclosure requirements, for distribution rules on IPOs, offering rules for debt securities, promote convergence with International Accounting Standards and mutual recognition regimes for market professionals and capital market products.

The integration of Islamic capital markets can be accelerated through greater collaboration to promote the growth of markets throughout the OIC. The Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB) have released their 10-year Framework and Strategies, designed for the development of a dynamic, comprehensive, and innovative Islamic financial services industry that is well integrated within the international financial system.

Specific areas and initiatives for collaboration between OIC members

The Islamic capital market has considerable potential to recycle excess savings from surplus OIC countries and to intermediate these surpluses to promote economic development in deficit member countries. This is consistent with the Shariah principle to ensure equitable allocation of capital to achieve the objectives of the Ummah.

In ASEAN, the ASEAN Finance Ministers have established a task force headed by Malaysia to create an ASEAN Infrastructure Financing Mechanism to proactively address various inefficiencies and impediments that hamper the availability of financing for infrastructure development.

Another potential benefit is the possibility of using the mechanism to fast-track corporate sector development through creating listed vehicles which could undertake or own infrastructure projects. This, in turn, could provide a deal pipeline for equities and debt instruments which could stimulate the development of the capital market. Similarly, there may also be opportunities to pursue collaboration among Islamic countries to finance infrastructure development in lower-income countries with a view to promoting the growth and integration of capital markets within the OIC.

As outlined in the 10-year Framework and Strategies for the development of Islamic financial services industry Islamic countries should also endeavour to integrate their Shariah-compliant financial systems within the international financial system. Where Islamic capital markets are concerned therefore, rules should, as much as possible, be harmonised, in line with globally accepted standards, and best practices. This can range from benchmarking with the IOSCO principles of securities regulation, adopting international accounting standards and promoting best practices for corporate governance. These efforts will increase the attractiveness of our Islamic capital markets to international investors as well as facilitate integration of markets on the basis of a common reference standard. The point needs to be made that the Islamic capital market is subject to the same regulatory framework as the conventional market and needs to satisfy the same requirements for disclosure, transparency, and governance. Naturally, Islamic capital market products must also comply with Shariah requirements.

At the same time, there is also a need to intensify international collaboration on Shariah standards. In the developmental stages, Shariah standards were formulated based on the domestic perspective to be consistent with the national legal and tax frameworks. As the global ICM develops, we need to foster greater convergence in these standards. Towards this end, Shariah scholars from different jurisdictions have proactively increased their interaction and deepened their understanding of respective *fatwa* pronouncements.

International Islamic institutions such as the IFSB and AAOIFI, have provided intellectual leadership and Malaysia has sought to contribute to the cause through publishing and disseminating our Shariah resolutions. But certainly more work is needed, particularly on the follow-through, on providing greater clarity and achieving greater consistency on the interpretation of the Shariah principles and their application to Islamic products.

In tandem with this, there is also a need to increase international collaboration on the development of Islamic products. The development of global products, such as the *sukuk* has been a catalyst in promoting greater financial integration among Islamic capital markets. Malaysia recently launched a Shariah-compliant ETF with the aspiration that such products can be used to provide convenient access for international Islamic investors seeking to invest in Malaysia and to provide index-based products which can be used by Islamic fund managers deploying sophisticated investing strategies.

Islamic finance practitioners should also collaborate to promote greater awareness of the virtues of Islamic financial products. In this regard, communication approaches should focus on the positive values of Islamic finance, such as the concern on the welfare of humanity and the concepts of partnership and participation. It may also be timely to launch Islamic products that are branded as ethical, socially-responsible, and environmentally-friendly.

Conclusion

Regional market integration is not a new concept to the Islamic world. In fact, during the Islamic Golden Age and Muslim Agricultural Revolution, there existed a market economy and early forms of merchant capitalism between the 8th to 12th centuries. The Islamic society flourished based on a dynamic economy through the amalgamation of many regions supported by the expanding circulation of a high-value currency (the dinar). Innovative business techniques and new forms of business organisation were pioneered by merchants and traders.

In the new millennium, there is an opportunity to create a new "Islamic Golden Age" through adopting the same dynamic spirit to bridge Islamic markets spanning the various continents. The future ahead for ICM practitioners is certainly exciting.

Taking the Lead in Developing a Robust Islamic Venture Capital and Private Equity Industry[3]

Venture capital can profoundly impact the economy. It bridges the financing gap where direct bank lending or financing through the debt or equity market is difficult to obtain. The unique nature of the venture capital model, which is based on active management leads to improved corporate governance and an overall alignment of stakeholder interests with that of the management. This then creates significant value above and beyond the use of financial engineering. New companies and industries spawned by venture capitalists, for example, Apple Computer Inc., Federal Express, Google, and IBM have irreversibly changed the way we live and work today.

The initial years

The first venture capital company in Malaysia was established in 1984, when the Singapore-based South East Asian Venture Investment (SEAVI) set up Malaysian Ventures with a fund size of approximately RM13.8 million. The second venture capital fund (Southern Bank Venture Capital Corporation) was only set up in 1989. After the slow initial years, we are now seeing a reasonably healthy growth in the industry. As at end 2007, there were 98 venture capital companies and venture capital management companies registered with the SC with total committed funds under management of RM3.3 billion.

Government's commitment to the industry

The government's commitment to the venture capital industry can be seen on various fronts and at different stages. In addition to grants available under various Ministries, the government has also allocated RM1.6 billion for venture capital under the Ninth Malaysia Plan, a hefty two-fold increase from the previous plan.

"The Government has allocated RM1.6 billion for venture capital under the Ninth Malaysia Plan, a hefty two-fold increase from the previous plan."

The Malaysian Venture Capital Development Council (MVCDC) was established in January 2005 chaired by the Chairman of the SC. The MVCDC is tasked to facilitate the development of the venture capital industry by co-ordinating government initiatives and incentives toward charting the industry's strategic direction. It also acts as a platform for policy makers and industry players to discuss matters relating to the development of the industry and to channel views and strategies to the government.

In its ongoing efforts to create a conducive and attractive environment for the venture capital industry to flourish, the government has also introduced various tax incentives in addition to liberalising equity ownership for venture capital corporations and venture capital management corporations. The government has also established its own venture capital companies, such as Malaysia Venture Capital Management (MAVCAP), Malaysian Technology Development Corporation (MTDC), and Kumpulan Modal Perdana (KMP) to further develop certain strategic sectors of the economy.

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[3] This article is based on the keynote address of Dato Dr Nik Ramlah Nik Mahmood, the SC's Managing Director, delivered at Islamic Venture Capital and Private Equity Conference 2008, Kuala Lumpur on 7 May 2008.

Leveraging our strengths in ICM

It has been widely acknowledged that Malaysia has made significant strides in the area of ICM and today it has a full complement of products, infrastructure, intermediaries, and investors which have contributed to the development and deepening of the entire capital market. With the rapid expansion and innovation of ICM products, such as *sukuk*, Islamic unit trust funds, Islamic real estate investment funds (REITs), Islamic ETF and Shariah-compliant listed securities, it is now time for Malaysia to encourage and facilitate the growth of Islamic venture capital as another available asset class in its broad range of Islamic products. The development of Islamic venture capital will offer the opportunity for Muslim investors to diversify their portfolios. Also, the fact that venture capital does not have perfect correlation with other asset classes, such as listed securities, allows more opportunities for investors to enhance their portfolio returns.

What is an Islamic venture capital? An Islamic venture capital is similar to a traditional venture capital except that it is structured and managed in accordance with Shariah principles. Venture capital exemplifies the Islamic finance model because at the core of it, investments are made in businesses that offer Shariah-compliant products and services and because the investment model is based on long-term active partnerships and risk sharing consistent with the Shariah principles of *mudharabah*, *musyarakah*, and *wakalah*.

Both Islamic finance and venture capital are areas high on the agenda of the Malaysian government. Islamic venture capital is an area where Malaysia can easily distinguish itself from other venture capital markets in the emerging economies. Internationalisation of the venture capital industry can be undertaken by leveraging on Malaysia's strengths in Islamic finance and capital market.

Guidelines and Best Practices on Islamic Venture Capital

It has been widely acknowledged that issuance of Shariah-specific rules and guidelines are a significant enabler for the growth of ICM in Malaysia as it leads to compliance with Shariah principles. The guidelines also provide market participants with clarity and certainty as to what is acceptable and what is not. With standardisation, the cost of structuring products and services become more competitive.

The SC has issued the *Guidelines and Best Practices on Islamic Venture Capital* to assist venture capital corporations and venture capital management corporations in carrying out Islamic venture capital businesses or activities.

The guidelines and best practices on Islamic venture capital will set a benchmark for the industry in better understanding Islamic venture capital business and also set an example for Islamic venture capital in other jurisdictions to follow.

Attracting global funds

The petro-dollar driven liquidity and the relatively under developed capital market in GCC countries has resulted in a search for investments regionally and overseas. A report by the Gulf Venture Capital Association (GVCA) indicated that US$7.1 billion had been raised in private equity funds in 2006, up from US$4.3 billion in 2005. Total private equity fund sizes have reached US$14 billion, which is a significant increase over the US$78 milion in 2001. Early indications show that this growth rate is continuing with funds over US$9 billion being raised in the first half of 2007.

There are emerging numbers of Islamic VC/PE funds in the Middle East today looking for Shariah-compliant investments. There is a need for an efficient intermediation of new found wealth and affluence which will offer tremendous opportunities for markets offering Shariah-compliant investments. To attract these funds, we need a conducive environment which has Shariah compliance processes and procedures, and offers attractive deal flows.

Conducive environment and attractive deal flows

Malaysia already has a reputation as a favorite destination for foreign investments given our pull factors, such as strong economic growth and international trade, IT savvy workforce that is fluent in English, good laws, comparatively low cost of living, infrastructure and banking facilities. The Middle Eastern investors are reported to be making significant investments in companies ranging from construction to airlines to telecommunication and also in the Iskandar Development Region. This proves that good deals and a conducive business environment will never fail to attract foreign investments.

Ensuring Shariah compliance

Another important requirement in attracting global funds including GCC funds is by adhering to norms and rules of the global markets. In structuring a transaction for a conventional venture capital, various financial instruments are used which include, different classes of preferred stock, debt, warrants or hybrid instruments. These instruments allow venture capitalists to allocate risk, establish ownership rights, control management and provide them with incentives. Interpretive issues may arise in relation to the features of some of these instruments. Appointing a Shariah adviser from the point of establishment would be extremely helpful in addressing these matters. The Shariah adviser reinforces Shariah compliance throughout the whole process or value chain – from deal structuring, investing right up to exit. This enhances confidence and attracts greater potential Islamic investors. The existence of a single SAC for the ICM at the SC goes a long way in ensuring robust Shariah governance frameworks.

Creating talent for the industry – product knowledge and management skills

A key critical success to accelerate the growth in Islamic venture capital industry would be human capital. A primary challenge for Malaysia is building a new generation of venture capitalist with the right combination of talent and qualifications and a good understanding of Shariah principles. Talent is needed to take Islamic venture capital to the next level. The Shariah advisers should work closely with financial experts to create indigenous Shariah products, and try to innovate rather than imitate.

Developing talent and skill for the ICM is an initiative being actively pursued under the MIFC where Malaysia aims to be a centre for Islamic finance education, training, consultancy and research. In this regard, International Centre for Education in Islamic Finance (INCEIF), was established in 2006 to develop Islamic finance professionals and experts to fulfil the human capital needs of a rapidly expanding industry.

Complementing this, the SC has also embarked on an ICM Development Plan with initiatives targeted towards further promoting and developing the ICM. Recently, the SC organised the inaugural international ICM Forum themed "Product Innovation – Islamic ETF and Commodity *Murabahah*". Other initiatives under the ICM Development Plan include collaborative efforts with World Fatwa Management Research Institute of Universiti Sains Islam Malaysia to issue world-first compilation on ICM and partnership with Universiti Malaya for a Visiting Scholar Programme. The SC has also established an International Advisory Committee (IAC) comprising prominent Shariah scholars and practitioners to provide strategic guidance and international perspectives for ICM development projects.

Conclusion

Malaysia's comprehensive regulatory framework and excellent track record for product innovations are its strengths in ICM. Given these competitive edge, Malaysia can play a significant role in developing the Islamic venture capital industry which is a vital element in the value chain of corporate finance that will serve to increase the breadth and variety of Malaysia's capital market offering. Leveraging on the achievements and strides of Malaysia's ICM, Islamic venture capital is set to grow further.

News Round-up

Islamic Markets Programme 2008

The annual Islamic Markets Programme (IMP) 2008 was held from 6 to 11 July at the SC. Themed "Product Innovation: Integrating Shariah and Market Needs", the programme was led by course director Wan Abdul Rahim Kamil.

This year's IMP concentrates on the need for integration while innovating. Given the strong growth in demand for Islamic financial instruments and a shortage of satisfactory ICM products, the role of innovation in meeting client needs still remains absolutely critical. However, the rapid innovation required must be based on a profound understanding of the fundamentals and mechanics of the Islamic capital market and its instruments. Therefore, the IMP covers the principles of Islamic finance on which further successful innovation and product development must be based.

The IMP is designed to cater to a wide audience of both experienced practitioners and new entrants into the world of Islamic finance. It is an interactive programme designed to facilitate the exchange of views through presentations, case studies and panel discussions. The content of the programme was holistic, ranging from key principles of Islamic finance to product development and innovation in *sukuk*, stocks, funds, real estate investment trust and structured products. The content also included sessions on corporate governance, marketing and trading, risk management, and the CEOs forum emphasised the bottom lines and business implications of the Islamic products.

The programme attracted 64 local and foreign participants from Bangladesh, Cambodia, Comoros, Croatia, Djibouti, Jordan, Iran, Kazakhstan, Kosovo, Maldives, Nigeria, Sri Lanka, and Uzbekistan. Reputable speakers from various financial institutions and SC senior representatives shared their knowledge and experience.

Malaysia International Halal Showcase 2008 (MIHAS 2008)

The SC participated in the 5th MIHAS 2008 which was held from 7–11 May 2008. MIHAS 2008 was hosted by the Ministry of International Trade and Industry (MITI) and jointly organised by the Malaysia External Trade Development Corporation (MATRADE) and the Islamic Dakwah Foundation Malaysia (YADIM). The trade fair congregated the largest annual gathering of halal industry players and embraced the *halal* concept in all market segments, including Islamic investment, banking and *takaful*.

The SC booth was set up to showcase ICM development and its milestones in Malaysia. Promotional materials on Malaysian ICM covering market infrastructures, products and services were distributed to create greater awareness on the development and regulation of ICM.

Malaysia's Islamic Capital Market Conference 2008

The inaugural Malaysia Islamic Capital Market Conference 2008, hosted by Bursa Malaysia was held from 18–19 June in Kuala Lumpur. Endorsed by the MIFC, the conference provided a platform for all to gain an insight into the outlook of Malaysia and global economies as they embrace Shariah-compliant products and services. Key discussion topics included Islamic equities, Islamic REITs, *sukuk*, ETF, commodity house and Islamic hedge funds.

The Second Finance Minister of Malaysia, Tan Sri Nor Mohamed Yakcop, and the SC's Chairman, Dato' Zarinah Anwar, were honoured to deliver the keynote addresses. Notable presenters and panelists local and abroad discussed their experiences, challenges, successes, views and strategies towards the further development of ICM globally. The SC was represented by Dato Nik Ramlah Mahmood, Managing Director, as a panellist in one of the sessions entitled 'Global Islamic Capital Market – Islamic Equities, the Next Leap Forward'.

IFSB Summit in Amman, Jordan

The 5th Islamic Financial Services Board (IFSB) Summit was held on 13 and 14 May in Amman and hosted by the Central Bank of Jordan. The one-and-a-half day summit entitled "Financial Globalisation and Islamic Financial Services" discussed some of the major opportunities and challenges which financial globalisation poses on the Islamic financial services industry.

The SC's Chairman delivered a presentation in a session entitled "Regional Integration of Islamic Capital Markets – Key Issues". The summit was attended by more than 200 delegates comprising mainly senior officials from international institutions, regulatory and supervisory agencies, and market players with vested interest in the Islamic financial services industry.

Islamic Venture Capital and Private Equity Conference 2008

Malaysian Venture Capital and Private Equity Association (MVCA) together with Islamic Banking and Finance Institute Malaysia (IBFIM), jointly organised the inaugural Islamic Venture Capital and Private Equity Conference held from 7–8 May 2008 at Shangri-La Hotel, Kuala Lumpur.

Dato Dr Nik Ramlah, the SC's Managing Director, delivered a keynote address in the conference and announced the issuance of *Guidelines and Best Practices on Islamic Venture Capital*. The two-day conference attracted foreign and local participants to discuss issues, exchange ideas, experience and promote a better understanding of Islamic venture capital and private equity in this region and the Middle East.

Malaysian ICM – Facts And Figures

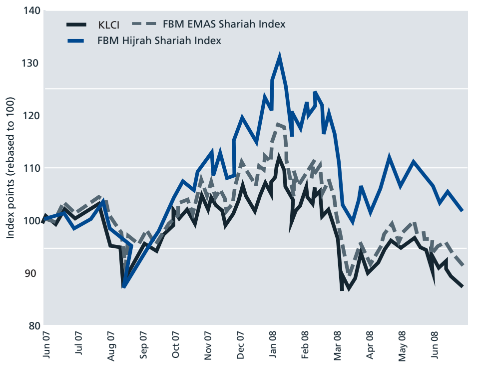
Shariah-compliant securities on Bursa Malaysia

Number of Shariah-compliant securities – May 2008+	843 securities
% to total listed securities	85 %
Latest Market capitalisation – Jun 2008	(RM billion)
Shariah-compliant	590.74
Total market	901.24
% of Shariah-compliant securities to total market	65.5%

Equity market indices	31 May 08	30 Jun 08	% change
KL Composite Index (KLCI)	1,276.10	1,186.57	-7.0%
FBM EMAS Shariah	9,067.73	8,587.00	-5.3%
FBM Hijrah Shariah	10,329.14	9,723.32	-5.9%

+ *The SAC of SC releases the updated Shariah-compliant securities list twice a year in May and November.*

Chart 1
Performance of KLCI vs Shariah Indices

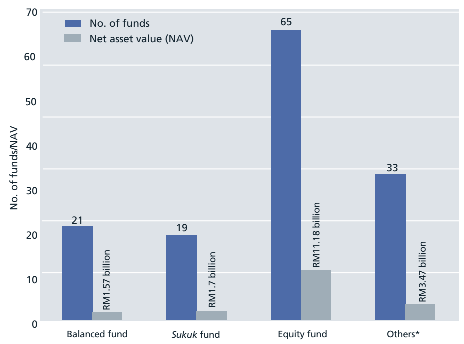


Shariah-based unit trust funds

Number of approved funds	2007	2008*
Shariah-based	134	136
Total industry	521	530
Net asset value (NAV) of approved funds		
Shariah-based (RM billion)	16.90	17.98
Total industry (RM billion)	169.40	159.85
% of Shariah-based to total industry	10.0%	11.2%

* *As at June 2008.*

Chart 2
Shariah-based unit trust funds by category



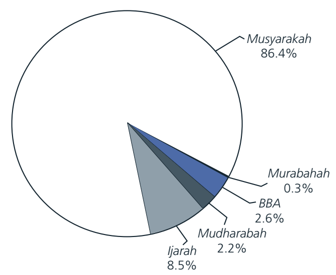
* *Including feeder funds, fixed income funds, money market funds and structured products*

Sukuk

Sukuk approved	2007+	Q2-2008++
Number of *sukuk*	59	7
Size of *sukuk*	RM121.30 bln	RM5.87 bln
Size of total bonds approved	RM158.80 bln	RM36.26 bln
% of size of *sukuk* to total bond approved	76.4%	16.2%
Sukuk issued*	2007	Apr-2008
Size of *sukuk* issued	123.11	31.23
% of *sukuk* issued to total bonds issued	37.6%	23.1%
Sukuk outstanding*	2007	Apr-2008
Size of outstanding *sukuk*	RM199.10 bln	RM197.73 bln
% of outstanding *sukuk* to total outstanding bonds	35.3%	32.8%

+ *The sukuk figure includes the approval of seven combination issuances (conventional bonds and sukuk).*
++ *Sukuk approved from April–June 2008 (Q2-2008).*
* *Sukuk issued and outstanding include all l/t and s/t papers from public and private sectors.*

Chart 3
Sukuk approved based on various Shariah principles



RM-denominated Sukuk approved by the SC in Q2-2008

	Issuer	Shariah principle	Size of issues (RM million)	Date of approval	Initial rating
1	UMW Toyota Capital Sdn Bhd	*Musyarakah*	1,000	15 Apr 08	AAA P1
2	Matang Highway Sdn Bhd	*Musyarakah* & *Mudharabah*	70	21 Apr 08	AA-
3	Aras Sejagat Sdn Bhd	*Ijarah*	500	25 Apr 08	AA+
4	Talam Corporation Berhad	BBA	150	29 Apr 08	BBB-
5	Plus SPV Berhad	*Musyarakah*	4,000	26 May 08	AA1
6	Muhibbah Engineering Berhad	*Mudharabah*	130	23 May 08	A1
7	Serrisa Sinar Berhad	*Murabahah*	20	19 Jun 08	A+

Book Series on the Islamic Capital Market

The SC is embarking on an initiative to publish a six-part book series on the Islamic capital market. It will cover key subjects like *sukuk*, equities (2 Parts), structured products, risk management and derivatives products, and regulatory framework. The book series, which is to be launched in 2009, is designed to serve as comprehensive and practical sources of reference to the industry players, legal and accounting practitioners, regulators and academicians involved in or studying the ICM.

The book series are meant to provide a clear guidance on the fiqh understanding of the ICM; the practical workings of the ICM – both the instruments and the players; and the opportunities available in the Islamic capital market.

The first title in the series i.e. Islamic Capital Market Part 1: Sukuk will be based on the following outline:

- How Islamic instruments differ from conventional bonds and loans?
- Shariah ground rules
- Legal challenges in the Islamic capital market
- *Murabahah sukuk*
- *Ijarah sukuk*
- *Salam sukuk*
- *Istisna` sukuk*
- *Musharakah sukuk*
- *Mudharabah sukuk*
- *Wakalah sukuk*
- New sukuk variants and innovation
- Exotic *sukuk* features
- Key regulatory issues for *sukuk* and the need for regulatory innovation
- *Sukuk* vs syndication
- Derivatives and Islamic capital market
- *Sukuk* and capital adequacy
- *Sukuk*, securitisation and treasury management
- How expansive are the frontiers?
- Performance measurements for Islamic instruments
- Shariah oversight

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