



# malaysian ICM



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by the Securities Commission Malaysia

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## MEGA SUKUK DEFAULTS – ACID TEST FOR ISLAMIC FINANCE?

Islamic finance is also affected by financial crises because it is interconnected with the global financial market and exposed to similar systemic and specific risks, as highlighted in an article entitled, "The Resilience of Islamic Finance" in the November 2008 issue of the *Malaysian ICM* quarterly bulletin. Therefore, sukuk and a host of other Islamic finance products are not isolated from risks, whether defaults or capital losses.

This article revisits the topic at a time when the sukuk market seems to have taken a beating. Starting with the alarm bells over a bankruptcy filing of East Cameron Partners, concern over sukuk risks heightened with the Investment Dar washout and the latest being the financial fallout of Dubai, which was hit with an estimated US\$80 billion–US\$90 billion total debt at stake.<sup>1</sup> The big ticket exposures were Nakheel and Dubai World and as they struggled to meet obligations, shockwaves were transmitted throughout the global financial market. Ironically, the multi-national banks which were unscathed during the 2008 credit crisis were not spared this time. Another large sukuk default to the tune of US\$95 million in Pakistan was also reported.<sup>2</sup>

<sup>1</sup> *IFIS Newsletter*, Nakheel Sukuk: Did the Islamic Structure Protect Investors?

<sup>2</sup> Dawn.Com online dated 10 Dec 2009

## IJARAH MAWSUFDAH FI ZIMMAH (FORWARD LEASE)

*Ijarah mawsufah fi zimma* is one of the Shariah principles that can be applied in Islamic financial products. The Shariah Advisory Council (SAC) of the SC has approved the application of *ijarah mawsufah fi zimma*, which is based on the primary contract of *ijarah*, in a sukuk structure. Its introduction has led to further innovation in the structure of sukuk.

*Ijarah mawsufah fi zimma* is a lease of an asset that is not yet available or owned by the lessor, at the time of agreement. The agreement, however, is based on the undertaking by the lessor to deliver the asset based on agreed detailed specifications, value and time of availability. The rental payment under this *ijarah* represents the right of the lessee to use the property in the future whenever the property is ready to use. Scholars from different schools of thought have also accepted this *ijarah*.

There are also other terms used by the scholars that also refer to *ijarah mawsufah fi zimma*, such as *ijarah al-zimma* or *ijarah waridah `ala al-zimma* or *`aqd `ala manfaah fi al-zimma fi syai' mawsuf madbut bi sifat*.

As an *ijarah* contract on an asset that will exist in future but with its detail specifications clearly stated in the contract, *ijarah mawsufah fi zimma* resembles *bai' salam* from the following angles:

### (1) Subject matter and method of payment

While the subject matter does not exist when the *ijarah mawsufah fi zimma* contract is concluded, the lessee would have determined its specifications during the contract, which mirrors *bai' salam*. At the time of the contract, the lessee determines detailed specifications of the leased asset, including the rate of the lease rental, nature of the leased asset, lease period and method of payment with detailed work specifications.

AAOIFI<sup>1</sup> has given similar views, as follows:

(a) An *ijarah* contract may be executed for

an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications, even if the asset so described is not owned by the lessor. In this case, an agreement is reached to make the described asset available during the duration of the contract, giving the lessor the opportunity to deliver the asset as specified;

- (b) To take into account the ability of the lessor to acquire the specified asset or produce it;
- (c) It is not a requirement that the rental should be paid in advance as long as the lease is not executed according to *bai' salam* or *salaf*; and
- (d) Should the lessee receive an asset that does not conform to the specification, then he is entitled to reject it and demand for replacement of asset that conforms to the specification.

### (2) Failure of the lessor to conform to the specification as determined by the lessee

Should the lessor fail to make available the asset as specified, despite several attempts to make delivery, the lessee is entitled to cancel the contract. This condition is consistent with AAOIFI's stipulation that the lessee is entitled to reject the asset delivered by the lessor if the asset fails to meet the specifications.

In conclusion, the development of Islamic capital market in Malaysia over the past few years has spurred growing interest among market players to innovate more products that comply with Shariah principles. By introducing Shariah principle of *ijarah mawsufah fi zimma*, it is hope that it will open more room for innovation on a comprehensive range of Shariah-compliant investments that meet the needs of modern society.

<sup>1</sup> AAOIFI Shariah Standards 2010, Shariah Standard No. 9, paragraph 3/5, pg. 113.

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In Dubai's case, it is perplexing that a problem of this magnitude could have been solely caused by sukuk, when the Emirates' sukuk issuance is barely 10% of total debt. Neither is it demonstrably linked to Islamic finance and the structures of Islamic securities. Regardless, fingers were pointed at the exposures to Islamic finance i.e. sukuk for the failings.

Although the Malaysian sukuk market is not free from defaults, there were only seven sukuk defaults totalling RM741 million, accounting for only less than half a per cent of the country's total sukuk market, between January and November 2009. The factors which contributed to the defaults were

no different from those of conventional bonds i.e. mainly the result of credit issues brought about by the deterioration in the issuer's business or external events.

In response to the adverse attention given to sukuk presently, this article attempts to isolate the crux of the crisis and examine if factors contributing to the defaults were only unique to Islamic finance. Due to its legal structure, accounting treatment and differing *fiqh muamalat* interpretations, sukuk remains misunderstood even among financial practitioners, lawyers and Shariah experts. As such, a thorough description of sukuk is needed.

### Three fundamental contracts for constructing sukuk

- *Uqud muawadah* (contract of exchange), comprising of contracts, such as *ijarah*, *salam*, *istisna`* and *murabahah*. The majority of jurisdictions only use *ijarah* as contracts of exchange for sukuk because *salam*, *istisna`* and *murabahah* contracts cannot be traded as underlying assets. Notwithstanding, some Shariah scholars have permitted the partial composition of *dayn* (debt) as the underlying assets, as in the case of asset-backed securitisation.<sup>3</sup>

The most common form of *ijarah sukuk* involves the sale of the underlying assets by the originator to a special purpose vehicle (SPV) which in turn issues sukuk to investors. The SPV leases back the assets to the originator, thus providing the SPV with periodic lease rental payments. Depending on the legal framework, if an issuer defaults, there could be a possibility that its legal standing would be equivalent to an unsecured creditor.

- *`Aqd wakalah* or contract of agency. *Wakalah* has been widely used for fund management. Many takaful companies are now taking up the *wakalah* model over *mudharabah*. Of late, there has been a shift to *wakalah* for sukuk in the GCC countries. Its popularity is due to the ease of Shariah application where the fee has been made clear up-front.
- *Uqud isytirak* or contract of participation in the form of *mudharabah* and *musharakah* as the platform. *Uqud isytirak* has been the preferred structure, even during the time of Prophet Muhammad (PBUH) as a means to fund business or venture that involves risk sharing. *Mudharabah* and *musharakah* are premised on profit sharing and equity sharing, respectively. Risks are shared among the originator and the investors, with the likelihood of fluctuations in dividend/profit payment and capital redemption. The whole presentation of the structure is one where investors are meant to receive a share of the profits and not interest on debts – two different obligations.

<sup>3</sup> Malaysia and Iran accept the practice of debt trading.

## Sukuk and its structures

Sukuk is a certificate which shows ownership of an underlying asset issued following contracts of exchange, contracts of participation or contracts of agency. Sukuk is intended to be the Islamic alternative to bonds i.e. an instrument that meets the capital requirements of the issuer and is an important liquidity tool for Islamic financial institutions. Bonds are not acceptable under the tenets of Shariah, principally because of its interest payments which are tantamount to usury or *riba*. Sukuk seeks to comply with prohibitions on interest and is meant to give investors a share of a tangible cash-generating asset. Ideally, sukuk would be secured instruments with the risk of non-payment linked more to the asset performance. Sukuk instead provides returns in the form of lease rentals (for *ijarah* structure), profits or agency fees (for *wakalah* structure) – analogous to coupon payments.

However, if financial instruments were purely structured on this (*uqud isytirak*) basis, they would not be largely subscribed by banks' treasuries since banks' portfolios require that their assets be largely made up of capital protected instruments<sup>4</sup>. Thus, sukuk practitioners have developed innovative ways to achieve this, such as the incorporation of *tanazzul* or waiver upfront, if actual profits exceeded expected profit. Where there is a shortfall from the expected profit, the originator provides for funds to be drawn from a reserve account or liquidity facility. And thirdly, the purchase undertaking price has been pre-determined as equivalent to the par value. The purpose of these three applications<sup>5</sup> is to ensure investors of a fixed profit payment and redemption at par value.

## The crux

If we examine the defaults of sukuk and bonds, they are by no means unique to the past financial crisis. Similar traits were present in the following cases:

- Property bubble – the ample liquidity driven by petro-dollars receipts had channelled funds to finance infrastructure and properties – a preferred Shariah choice for investments. This scenario of property bubble was no different from the mortgage crisis in the US.
- Large single exposure to a single group – if financing was grouped, it ultimately led to a single entity. The banks relied on implied government support. Still the banks were overzealous, considering the magnitude of the financing.
- Reliance on foreign liquidity – enormous liquidity was being channelled into the GCC market. It was thought that petro-dollars would sustain any negative economic elements. It was unfortunate that the steep decline in petrol prices played a role in some of the banks' failings.

Nonetheless, an inherent problem for sukuk that has never been severely tested before, until recently, is the legal framework or the lack of it. In some jurisdictions, there is a misconception that sukuk investors have proprietary rights. Most sukuk have purchase undertakings with rights reverted back to the obligor on maturity or default, to enable creation of "amount owing" to investors. Thus, in reality, sukuk do not have proprietary rights but

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<sup>4</sup> Like bonds, treasuries and other money market instruments.

<sup>5</sup> Non-permissible by AAOIFI resolution.

<sup>6</sup> Where the laws prohibit the transfer of assets to non-residents.

instead, beneficial ownership. The legal standing of investors is, therefore, akin to that of creditors.

Where the legal framework is unclear, complexity arises, such as when a *mudharabah* or *musharakah* issuer is not generating profit. If Shariah principles are to be adhered to, then the originator or obligor should not have to pay investors because there are no profits to be distributed. For *ijarah* structures, when the issuer is unable to pay lease-rentals, investors may have a problem of disposing the assets if the beneficial interest cannot be enforced.<sup>6</sup> Issuers could take the initiative to explore all options, for example, the lack of standardisation means that default interest may

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not be contractually payable or it could lead to non-payment of such “challengeable” profit-payments. In most cases, however, the obligation is clear and unambiguous – the obligations are subjected to civil code jurisdictions where the Shariah may be incorporated as a source of law, but is not the governing law applicable to commercial transactions – and ultimately, enforcement under local law is required.

### Islamic finance take-off

When modern Islamic finance took off fifty years ago, it was found mainly in jurisdictions which possessed a rudimentary banking framework. This was despite the Ottoman Empire having a fairly developed civil code. Being detached from an established banking system could have provided the impetus to mould Islamic finance into its ideal form and substance, rather than replicating the conventional model. This explains that the earlier Islamic assets were in the form of debt i.e. *murabahah* and *ijarah* while the liabilities – deposits and *takaful* policies were *mudharabah*-based. *Dayn* was not traded and therefore, not an issue as Islamic liquidity market was non-existent. Liquidity needs were satisfied by bilateral arrangements and later by the central banks.

### Milestones in developing Malaysia’s Islamic finance

- *Islamic Banking Act*, 1983 leading to the first Islamic bank in Malaysia;
- *Takaful Act*, 1984 leading to the first *Takaful* company in Malaysia;
- *Islamic Interbank Money Market in 1993*. Then, the creation of Islamic banking windows that required banks to maintain separate books for Islamic assets;
- First sukuk issuance in 1990;
- First Shariah-compliant stock list in 1997 spurring the development of Islamic funds;
- Establishment of the SC’s Shariah Advisory Council (SAC) in 1996 as the central approval authority for Islamic capital products; and
- Islamic guidelines and provision specific to ICM products.

However, developing Islamic finance from scratch is a long journey, having to endure trials and tribulation. And when errors do occur it may be detrimental to the financial system. Islamic finance cannot afford to create an Islamic financial system on a trial-and-error basis. Thus, Malaysia took the path of building its Islamic finance framework based on the strong conventional banking framework which was already in existence while ensuring that the operations would be Shariah compliant.

## Standards

Let us now look at how the established legal system, accounting standards, tax framework, banking framework, and uniform Shariah practice helped shape Islamic finance in Malaysia.

### *Legal standards*

The legal system in Malaysia is based on a set of written and unwritten laws. Among the written laws are the Federal Constitution and legislations enacted by Parliament and State Assemblies. The unwritten laws comprise the principles of English common law adapted to local circumstances, case law and local customary law. Muslim law is also an important source of law applicable only to the Muslim population on matters relating to family, inheritance etc. and administered by a separate system of courts. The legal documentation of Islamic finance transaction is premised on the principles of Law of Contracts and other principles of English common law. Accordingly, disputes in Islamic finance transactions are dealt with in the civil courts.

In Malaysia, although the regulatory treatment between conventional debt securities and Islamic securities are similar, the current regulatory framework clearly distinguishes Islamic securities from conventional debt securities, as Islamic securities are not debt securities per se. Accordingly, sukuk investors have contractual rights and rank as creditors rather than equity holders.

Effectively, the interests of sukuk investors are protected and enforceable. Malaysia also has a trust law which facilitates the safe custody of assets in

a trustee from the originator – allowing for securitisation of true sale to investors. The financial recourse to the issuer is thus transparent. Sukuk is subjected to the *Guidelines on the Offering of Islamic Securities* issued by the SC, requiring among others, for the issuer to disclose the utilisation of the proceeds, rating and approval by the Shariah adviser etc.

### *Accounting standards*

All Islamic finance transactions are accounted for in accordance with the Malaysian Accounting Standards Board's (MASB) approved standards, namely the Financial Reporting Standards (FRS). The FRS adopts the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Islamic financial transactions are accounted for in accordance with MASB approved standards, namely the FRS. The MASB has given careful consideration to Shariah principles underlying the transactions, and their implications for financial reporting in formulating its pronouncements on accounting for Islamic financial transactions.

In the process of developing Islamic accounting pronouncements, the MASB has solicited the views of practitioners, accountants, auditors, regulators, and users of financial statements of Islamic financial institutions. The FRS is legally binding, enforceable and should not hinder the healthy development of Islamic financial practices. Issuance of Islamic accounting pronouncements will guide Islamic banking operations, promote disclosure-based principles, enhance transparency, and help nurture the development of the Islamic capital market. MASB has adopted a principle of accounting for Shariah-compliant transactions and events, in accordance with MASB approved accounting standards, in the absence of any Shariah prohibition to do so.

Malaysia is the first jurisdiction to grant tax exemptions for transactions required to facilitate Islamic finance transactions by applying tax neutrality between Islamic and conventional products.

### *Shariah standards*

The SAC issues resolutions on ICM and they are the standards adopted for ICM practices in Malaysia. The

SAC continues to review new structures and decree whether these would be Shariah compliant. One of the SAC members also sits on the Shariah board of AAOIFI.

In the recent amendment to the *Capital Markets & Services Act 2007* and the *Central Banking Act 1958*, the Parliament granted approval for the SAC of the SC and BNM, respectively, to respond effectively to disputes in Islamic finance. The provisions of these Acts state that the courts have to refer any issue involving Shariah to the SAC. When a matter is referred to the SAC, the judge is obliged to follow its opinions.

## Conclusion

The mega sukuk defaults in GCC have put a damper on new sukuk issuance. Restructuring and new issues may end up in the conventional market unless regions keen on issuing sukuk domestically address prevailing legal concerns. Until then, a lack of confidence may cause investors to consider other jurisdictions with more robust frameworks. Nevertheless, despite the gloom overhanging sukuk defaults, CIMB Islamic Bank has forecasted that the global sales of sukuk, led by Southeast Asia, will increase by 24% in 2010 to reach US\$25 billion.

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## BURSA SUQ AL-SILA' AWARDED MOST OUTSTANDING ISLAMIC FINANCE PRODUCT

Bursa Suq Al-Sila', Bursa Malaysia's world's first Shariah-compliant commodity trading platform, was awarded the 'Most Outstanding Islamic Finance Product' by KLIFF Islamic Finance Awards 2009. The Minister in the Prime Minister's Department, Tan Sri Nor Mohamed Yakcop presented the award at the KLIFF Dinner and Award Presentation Ceremony held on 3 November 2009 in Kuala Lumpur.

Launched in August 2009, the platform received international recognition with cross-border trades being performed by Islamic financial institutions across several markets, including the UK and the Gulf Cooperation Council (GCC) countries.

Bursa Suq Al-Sila' is designed to facilitate commodity-based Islamic financing and investment transactions under the Shariah principles of *murabahah*, *tawarruq* and *musawwamah*. The platform is the first initiative of its kind in the world encompassing a hybrid market providing participants a choice between participating in the exchange through the traditional voice broking system or the faster automated electronic exchange system which is web-based. In the preliminary stage, crude palm oil is used as the launch commodity. In the near future, it will be expanded to other Shariah-approved commodities, such as tin, coal and aluminum.

## MALAYSIA – WORLD'S TOP SUKUK LISTING DESTINATION IN 2009

Bursa Malaysia topped the world's exchanges in the value of sukuk listing, recording a total of US\$17.6 billion as at end of 2009. From August to end of the year, the bourse listed 12 sukuk. Petroliam Nasional Bhd (Petronas) Al-Ijarah sukuk led the inaugural US dollar listing of US\$1.5 billion and Cagamas MBS Bhd (Cagamas MBS) became the first to list Islamic papers in Malaysian ringgit totalling approximately

RM4 billion. In November, the bourse witnessed the inaugural foreign listing of US\$500 million sukuk issued by GE Capital on Bursa Malaysia. This five-year sukuk is structured based on *ijarah*. In December, CIMB Islamic Bank listed its RM2 billion subordinated sukuk programme while Khazanah Malaysia listed its outstanding sukuk programme amounting to US\$14 billion.

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## MALAYSIA AND HONG KONG IN LANDMARK PACT TO DEVELOP ISLAMIC CAPITAL MARKET

On 9 November 2009, the SC and the Securities and Futures Commission of Hong Kong (SFC) achieved a major milestone in their regulatory co-operation by signing a mutual recognition agreement (MRA) to further develop the ICM, in particular, Islamic collective investment schemes (CIS).

The SC Chairman, Tan Sri Zarinah Anwar and SFC Chairman Dr Eddy Fong signed the MRA in Kuala Lumpur, witnessed by the Minister of Finance II, Dato' Seri Ahmad Husni Hanadzlah and Ms Au King Chi, Permanent Secretary for Financial Services and the Treasury, the government of the Hong Kong Special Administrative Region.

The MRA will help pave the way for deeper and broader Islamic investment markets in both jurisdictions and foster closer regulatory co-operation. Under the agreement, Malaysian capital market intermediaries will be allowed to distribute their Islamic products in Hong Kong's financial hub with minimal regulatory intervention. Similarly, Islamic funds that are authorised and primarily regulated by the SFC and managed by SFC-licensed managers can now be marketed in Malaysia.

The SC Chairman said the MRA marked a new chapter in the mutual co-operation between SC and SFC and cleared the way for the development of a common platform for cross-border offerings of Islamic CIS.

Besides facilitating the cross-border offerings of Islamic funds, the SC and SFC will also collaborate in capacity building and information sharing in the development of legal and regulatory framework for Islamic CIS and mutual exchange of regulatory experience relating to Shariah principles.

This initiative is another step towards establishing Malaysia as a centre for Islamic product intermediation and enhancing the attractiveness of both Malaysia and Hong Kong as a market place for global Islamic CIS products – enabling both jurisdictions to tap the potentially lucrative investments from the Middle East and Asia where there is a large Muslim population.

The cross-border offerings of Islamic CIS will be supported by co-operation in supervision and enforcement. Both regulators will work closely to assist enforcement of their respective laws and regulations and ensure adequate protection for investors. Capital market intermediaries intending to offer their Islamic funds beyond their respective home jurisdiction are also expected to comply with relevant guidelines on disclosure in the offering document, advertising and marketing to ensure adherence to certain minimum standards.

The MRA with the SFC is the second MRA signed by the SC with a foreign regulator. The first MRA, signed between the SC and Dubai Financial Services Authority in March 2007, allows the offering of Islamic funds constituted and domiciled in Dubai International Financial Centre to Malaysian investors and vice-versa.

The SC's *Guidelines for the Offering, Marketing and Distribution of Foreign Funds*, first issued in March 2008 has been amended to reflect the requirements that must be complied with by SFC-licensed managers intending to offer their funds in Malaysia. The revised guidelines are available on [www.sc.com.my](http://www.sc.com.my).

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## EXPANSION OF ICM TAX INCENTIVES IN BUDGET 2010

With more than 20 years of experience developing its ICM, Malaysia has garnered a strong influence in this area. The country is the world's largest sukuk origination centre driven largely by an investor-friendly

regime, as well as a robust regulatory and Shariah framework. To ensure the rapid development of ICM, the government in its Budget 2010 proposed several tax incentives to be extended until 2015.

### **Budget 2010 tax incentives:**

- Stamp duty exemption of 20% on Islamic financing instruments;
- Double deduction on expenditure incurred in promoting Malaysia as the international Islamic financial centre;
- Deduction on expenditure incurred on the establishment of Islamic stockbroking companies; and
- Deduction on expenditure incurred on issuance of Islamic securities approved by the SC.

### **Updated List of Shariah-compliant Securities**

The SC released an updated list of Shariah-compliant securities approved by its SAC. The updated list, which took effect on 30 November 2009, features a total of 846 Shariah-compliant securities. These counters constitute 88% of the total 959 listed securities on Bursa Malaysia.

The list includes 13 newly classified Shariah-compliant securities and excludes four from the previous list issued in May 2009. It also indicates that Shariah-compliant securities are well represented in all sectors of industry.

The full list, which is updated twice a year, is now available at [www.sc.com.my](http://www.sc.com.my). It is also published in a booklet which can be obtained from the SC. The next updated list will be available in May 2010.

## THE ERA FOR TAJDID (RENEWAL)<sup>1</sup>

### Introduction

In the aftermath of the global financial crisis, there is clearly an increasing interest in Islamic finance not merely to complement the conventional system but also to help address gaps and weaknesses in the system. Given that Islamic finance is currently merely a sliver of the global financial system, this is indeed both a tremendous challenge and an opportunity for developing and promoting Islamic finance.

There is no doubt that Islamic finance has grown tremendously since it first emerged in the 1970s. It is estimated that the current global Islamic financial assets have reached a size of US\$750 billion and is expected to expand to US\$1.6 trillion by 2012. This compares to US\$178 trillion of financial assets worldwide, making Islamic financial assets less than 0.5% of the global total.<sup>2</sup> But as the Islamic financial industry builds its growth momentum, the global financial landscape is facing a crisis of proportions – world financial assets fell by US\$16 trillion in 2008, the largest setback on record and a significant break in the three-decade-long expansion of global capital markets. Mature financial markets are expected to grow more slowly, thus presenting opportunities for other sectors, like Islamic finance, to play a bigger role in driving global asset growth.

### Crisis provides opportunity for change

We have learnt from history that major financial crises bring about fundamental changes in the international economic system. The Great Depression, for example, marked the departure from the gold standard and the emergence of the US dollar as the world's reserve currency. The disequilibria generated by US deficit spending on the Vietnam War ended the era of fixed exchange rates in the early 1970s.<sup>3</sup>

Similarly, from a regulatory perspective, bouts of market turmoil are almost invariably followed by a slew of regulatory reforms that attempt to address weaknesses in the regulatory system perceived to have contributed to the crisis. The *Glass-Steagall Act*, which attempted to separate investment banking activities from commercial banking activities, and the creation of the US SEC were responses to the crash of 1929. The *Sarbanes-Oxley Act* was put in place to ensure higher levels of corporate accountability after the Enron debacle. We have completed yet another bull-bear market cycle and it can only be expected that the current global financial crisis will bring about changes of similar proportions.

Where does Islamic finance stand even as our conventional counterparts revisit their regulatory

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<sup>1</sup> This article is extracted from the keynote address given by the SC Managing Director, Dato Dr Nik Ramlah Mahmood, at the 6th Kuala Lumpur Islamic Finance Forum on 4 November 2009.

<sup>2</sup> Global total as of 2008. Source: McKinsey Global Institute.

<sup>3</sup> *New Era after the Crisis?* By Jorg Zeuner. [www.investmag.net/articles](http://www.investmag.net/articles).

paradigms and approaches? Professor Mervyn Lewis, a visiting scholar under the SC-UM Visiting Scholar Programme, in his analysis of the crisis, said that from the standpoint of Islamic finance, the causes of the failure of the financial systems are fundamental i.e. that it depends on *riba* as the underlying structure, greed, uncertainty in dealings or *gharar*, over speculation, lack of governance, and financialisation (i.e. where the value of financial asset greatly exceeds that of tangible asset).<sup>4</sup> The notion that free markets are rational and efficient has been challenged – the belief that each participant in the economy will act as a rational *homo economicus* in investment transactions and decisions has been proven to be erratic and unreliable in the light of recent events.

So, Islamic finance practitioners ponder over what Islamic principles in trade and finance has to offer in terms of wisdom. Many of these virtuous principles go back in history and will need translation to modern day commerce and finance but the usefulness of principles is that they have a validity that transcends time. A Jewish Orientalist, S.D. Goitien<sup>5</sup> who researched on the Geniza: *The Unfolding Truth* of the synagogue of Old Cairo, wrote on commerce and finance that thrived between 900 AD–1500 AD in the Mediterranean Region. Trade, commerce and banking were not just well developed and disciplined, but interest (*riba*) was shunned and in fact of little significance, and that Islamic finance was vibrant. There were sophisticated contracts for trades; business procedures and practices, documentation and banking practices derived based on economic models. Amazingly, this was the structure of commerce and finance that thrived not just within the Mediterranean but also across Europe. Muslim practices of venture capital under the structures of *qirad* or *mudharabah* was the only norm of contract that was used in investments. In medieval Italy, the *Qirad* and *Mudarabah* concepts were adapted in the 10th century as the *commenda*<sup>6</sup>, a business arrangement which was generally used for financing maritime trade.

These *commenda* not only facilitated international trade transactions, it was also a financial instrument that was widely accepted for secondary transactions.

In order to ensure fair practices, quality standards, transaction procedures, arbitration processes and markets were regulated by the governmental institution of *hisbah*. The institution of *hisbah* has been generally understood as one seeking to ensure correct economic and commercial practices among the Muslim *ummah*<sup>7</sup>. Such was the contribution of Islamic finance in the early days.

### The virtues of Islamic finance

Today, Islamic finance is being studied with greater seriousness not only in Muslim countries but also in financial centres across the globe. The Islamic economic perspective offers new growth opportunities and is also intellectually appealing in that many of the Islamic principles embedded in finance provide the potentially preventative medicine to future crises. Observations have been made that if greed can be tampered internally through self restraint; if individuals taking mortgages had been fully informed about the essence of their financial contracts;

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<sup>4</sup> Islamic Perspective of the Economic Financial Crisis, Public lecture by Visiting Professor Mervyn K Lewis at the SC, 22 April, 2009.

<sup>5</sup> *Geniza: The Unfolding Truth*, Mohamed Imad Ali. An Analysis of Chapter 3, Volume 1 "The World of Commerce and Finance" of "A Mediterranean Society, The Jewish communities of the Arab World" as portrayed in the documents of the Cairo Geniza, written by S.D. Goitein.

<sup>6</sup> Jairus Banaji (2007), "Islam, the Mediterranean and the rise of capitalism", *Historical Materialism* 15 (1): 47-74, Brill Publishers.

<sup>7</sup> Ibn Taymiyya. *Public Duties in Islam: The Institution of the Hisba*, trans. Muhtar Holland, publ. Islamic Foundation (UK), 1982, (paperback) (orig. title: al-Hisba fi al-Islam).

*Islamic finance therefore, has been offered a unique opportunity for renewal and universal acceptance because many in the world are disenchanted by the current conventional financial system and are looking for credible alternatives. Indeed, Islamic finance is shaping as a potential candidate to provide a system architecture that can constrain the excesses inherent in the current global financial model.*

if speculation and risky trading had been forbidden or restrained; if religious principles have been written into bank and corporate governance; if usury had been banned and instead financing was based on real assets; and if the financial sector grew in harmony and did not outstrip real activity in the economy, then maybe the global financial crisis might not have happened<sup>8</sup>. The Vatican, in particular, noted this and issued a statement that called upon banks to study the values of Islamic finance as an avenue to restoring confidence among their clients at a time of global crisis. "The ethical principle of which Islamic finance is based may bring bankers close to their clients in the true spirit which should mark every financial service.. [the] Free market model has grown too much and badly in the past two decades<sup>9</sup>."

Islamic finance therefore, has been offered a unique opportunity for renewal and universal acceptance because many in the world are disenchanted by the current conventional financial system and are looking for credible alternatives. Indeed, Islamic finance is shaping as a potential candidate to provide a system architecture that can constrain the excesses inherent in the current global financial model. Universally, an ethical and healthy relationship between man and the society can be premised on the key principles of transparency, ethical conduct and participatory arrangements. From a religious viewpoint, the most important is that the *homo economicus* is commanded to act as a *khalifah* or vicegerent<sup>10</sup>, subject to the dictates of the *Quran* and *Sunnah*.

### **Islamic finance in Malaysia**

Malaysia provides an interesting model to promote the co-existence of an ethical and societal-based finance that facilitates Islamic finance to appeal to non-Muslims and to operate on a universal basis. We have taken vital steps to develop a facilitative regulatory framework, create a large pool of players, introduce a comprehensive range of innovative and competitive Islamic financial product and services, and ensure sufficient depth to facilitate liquidity management.

Today, Malaysia has a highly diversified Islamic finance landscape. As at September 2009, Islamic banking assets constitute close to 19% of total banking assets at RM213.8 billion (US\$62.9 billion). Takaful assets constitute 7.5% of total insurance assets at RM10.57 billion (US\$3.11 billion).

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<sup>8</sup> Mervyn Lewis, op cit.

<sup>9</sup> Osservatore Romano, Vatican Official Newspaper, March 4, 2009. Quoted from Bloomberg.

<sup>10</sup> Surah Baqarah: 30 "Behold, thy Lord said to the angels: "I will create a vicegerent on earth."

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In the equity market, as at September 2009, 88% of all securities listed on Bursa Malaysia are classified as Shariah compliant, representing about RM574 billion or 63% of the total market capitalisation of Bursa Malaysia. From two Islamic unit trust funds in 1993, we have 144 Islamic unit trust funds with a total NAV amounting to RM21.2 billion, representing 11.3% of the total NAV of the unit trust industry. This represents 27% of NAV of the global Islamic unit trust industry.

There has also been unprecedented growth in the sukuk market. As at September 2009, over 39% of all bonds approved by the SC were sukuk – with a total value of RM14 billion.

### **Addressing gaps to continuously strengthen the system**

Islamic finance's rapid growth signifies that it has moved past the pioneering stage and established Shariah-compliant financing instruments as a commercially viable and effective tool for mobilising investment assets to finance productive economic activities. In the light of these successes and rapid growth, it is natural that gaps would appear and this needs to be continuously addressed.

Indeed, we must have the humility to also learn lessons from the global financial crisis as no system is completely insulated from asset price bubbles and contagion. In retrospect, the nature of the contracts and other Shariah-compliance requirements did provide Islamic finance some degree of insulation. Nonetheless, the economic slowdown and fall in property values did create conditions that tested for instance, the structures of some sukuk.

From a regulatory perspective, we must ensure that there is a reliable and speedy dispute resolution process. While the application of the Shariah alone is sufficient for ensuring that the form of transactions

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are compliant, issues could arise if the contracts under which they are structured do not address clearly the rights and obligations of parties, such as the rights of sukuk holders in the event of an issuer's insolvency.

Also Shariah opinions differ between jurisdictions as to what constitutes a true sale. Furthermore, what constitutes a true sale from a Shariah perspective may not necessarily be so according to the law of the land. Though standards issued by the Islamic Financial Services Board (IFSB), stipulate that sukuk holders should have a claim on the assets held in the investment vehicle, the issue of how the underlying asset have been transacted needs to be addressed.

We have placed considerable emphasis on transplanting substantive norms from classical Shariah practices. It is also now evident that similar emphasis needs to be placed on ensuring sufficient interface with the process of developing new legal contracts to minimise the risks of unresolved legal issues. Conceptual clarity without legal certainty is clearly insufficient.

### **Implementing *tajdid***

We recognise how the Islamic financial system of the past had for several centuries operated in an efficient, organised and ethical culture surrounding market

and transactions. However, the implicit institutional arrangements that had developed and allowed the system to flourish were not formalised: conventions and practices were not codified; roles and accountabilities not explicitly defined; and contracts were enforced purely through self and collective discipline. Borders expanded and practices became more uniform but the system never produced institutions and other organisations that provided the kind of stewardship needed to sustain these arrangements for the longer term. Hence, the relative decline of Shariah-based finance over the past several hundred years amid the rise of the fractional banking system. In order for Islamic finance to respond to current global needs, we need to constitute renewal (*tajdid*) in our practices.

History does not often present people with the same opportunity twice; however, we are fortunate and should not miss this opportunity to establish a strong regulatory and institutional foundation for modern Islamic finance. We must learn from the past and continue to improve ourselves and our capabilities.

This renewal not only calls for *ijtihad*s in the ruling on contemporary market practices, such as in the area of hedging or other risk management needs; the industry must also be prepared in totality to meet global needs in terms of documentations and dispute resolution. The legal and regulatory framework particularly needs to be revisited in order to address cross-border issues and various systemic risks.

In embarking on these reforms and renewals, we must take decisive and concerted steps to address a number of critical areas concerning contemporary institutional arrangements. First, the need to keep enhancing the level of clarity in Shariah opinions. The current governance framework is not yet sufficiently comprehensive and this needs to be addressed. A number of statements, resolutions and judgments have been issued that have triggered not merely debates but also doubts over the very nature of the Shariah governance process within the global Islamic finance industry. In this regard, the existing governance standards address the structures and set up of the Shariah committees or internal decision-making processes of the institutions, but does not address the general industry needs on how resolutions are or should be achieved.

According to the eminent Dr Mohammad *Elgari* on this: "Shariah scholars should follow scientific methods to reach their conclusions. We have seen many mistakes where declarations have been issued. Only the correct resolutions will prevail. Shariah is not a group of infallible people. It is a science. It requires methodology, and resolutions require peer review and market consultation."

Second, we must ensure investor protection principles are properly embedded within product structures. Opacity in the market and products were anathema to Islam and create latent risks to investors. In addition,

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there is a need to deal with conflict of interests issues in product structures.

Third, we need to promote greater harmonisation not only for Shariah standards but also in key areas of disclosure and transparency, and market practices that could lead to abuses or regulatory arbitrage. It is critical that we safeguard confidence in the Islamic financial system through promoting greater standardisation in documentation, providing greater legal and regulatory certainty and high levels of transparency.

Fourth, we must increase the level of co-ordination and collaboration among jurisdictions. It might be a tall order for the moment to talk of a single Islamic market, but we are in a position to make a start through converging standards within and across jurisdictions so that eventually we can create the necessary regulatory and supervisory structures to facilitate cross-border flows through mutual recognition and co-ordination; not just between the different jurisdictions and Islamic financial institutions but also between the Islamic institutions and conventional financial institutions.

Lastly, we must promote the development of common *hisbah* standards for commercial and financial practices.

## Conclusion

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. While in essence Islamic finance is global in character, in reality there are mismatches or gaps.

Markets and innovation cannot thrive in isolation. As in the past, it is only through building greater connectivity between our economies and markets that we can promote the relevance and growth of Islamic finance around the world.

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## NEWS ROUND-UP

### Second Visiting Scholar Programme – Closed-Door Dialogue



*Dr Abbas Mirakhor, former executive director of the International Monetary Fund*

The SC hosted a closed-door dialogue on 14 October 2009 on "Further Progress in Islamic Finance". The dialogue explored the application of participatory securities issued by the public sector and the use of index-based equity derivatives by the private sector. Dr Abbas Mirakhor, former executive director of the International Monetary Fund, who was engaged as the visiting scholar under the SC-University of Malaya visiting scholar Programme, presented his views on the subject and led the dialogue session.

### MIFC road shows to Qatar and Bahrain

From 10 to 16 October 2009, the MIFC organised a road show to Qatar and Bahrain. The objective was to strengthen bilateral relationship between Malaysia and both Qatar and Bahrain. It was also to provide a platform for potential business collaboration and investment opportunities between the financial industry and market players of the two countries.

The road show was led by Raja Dr Nazrin Shah, Financial Ambassador to the MIFC and was supported by a delegation of more than 60 organisations, comprising regulators and intermediaries from the financial industry, totalling about 80 participants.

### MIFC road show to Korea

As an effort to deepen collaboration between Malaysia and South Korea, the MIFC secretariat organised a road show in Seoul from 19 to 20 November 2009. The MIFC delegation was represented by regulatory bodies and industry players from various financial sectors. The SC Managing Director, Dato Dr Nik Ramlah Mahmood delivered a keynote address at MIFC-KRX Islamic Capital Market Conference.

### 6th Kuala Lumpur International Islamic Finance Forum 2009

The 6th Kuala Lumpur Islamic Finance Forum (KLIFF 2009), organised by CERT Events Sdn Bhd, was held from 2 to 6 November 2009. The forum was officiated by the Prime Minister of Malaysia, Dato' Sri Mohd Najib Tun Abdul Razak. Dato Dr Nik Ramlah Mahmood delivered a special keynote presentation entitled "The Era of *Tajdid* (Renewal)". During the event, the MIFC's booth comprising the SC, Bank Negara Malaysia and Bursa Malaysia was set up to showcase recent developments and achievements of Islamic finance in Malaysia.

## MALAYSIA ICM – FACTS AND FIGURES

### Shariah-compliant securities on Bursa Malaysia

|  |                  |                     |                 |
|--|------------------|---------------------|-----------------|
| Number of Shariah-compliant securities – Nov 2009* |                  | 846                 |                 |
| % to total listed securities                       |                  | 88%                 |                 |
| <b>Latest market capitalisation – 31 Dec 2009</b>  |                  | <b>(RM billion)</b> |                 |
| Shariah-compliant                                  |                  | 637.90              |                 |
| Total market                                       |                  | 999.45              |                 |
| % of Shariah-compliant securities to total market  |                  | 63.8%               |                 |
| <b>Equity market indices</b>                       | <b>30 Nov 09</b> | <b>31 Dec 09</b>    | <b>% change</b> |
| KL Composite Index (KLCI)                          | 1,259.11         | 1,272.78            | 1.09%           |
| FBM EMAS Shariah                                   | 8,423.08         | 8,509.52            | 1.03%           |
| FBM Hijrah Shariah                                 | 9,259.90         | 9,312.02            | 0.56%           |
| DJIM Malaysia Titans 25                            | 746.91           | 750.94              | 0.54%           |

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

### Shariah-compliant funds\*

|  |                 |                 |
|--|-----------------|-----------------|
| <b>Number of approved funds</b>                | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Shariah-compliant                              | 149             | 150             |
| Total industry                                 | 579             | 565             |
| <b>Net asset value (NAV) of approved funds</b> | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Shariah-compliant (RM billion)                 | 17.19           | 22.08           |
| Total industry (RM billion)                    | 134.40          | 191.71          |
| % to total industry                            | 12.8%           | 11.52%          |

\* Including feeder funds, fixed income funds, money market funds and structured products  
Note: Effective January 2009, wholesale funds was excluded from the above statistics

### Islamic exchange-traded funds (ETF)

|  |                 |                 |
|--|-----------------|-----------------|
| <b>Number of approved ETF</b>                  | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Shariah-compliant                              | 1               | 1               |
| Total industry*                                | 3               | 3               |
| <b>Net asset value (NAV) of approved funds</b> | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Shariah-compliant (RM million)                 | 482.73          | 656.6           |
| Total industry* (RM million)                   | 1,022.91        | 1,177.9         |
| % to total industry                            | 47.2%           | 56%             |

Note: Islamic ETF- DJIM MyETF-DJIM25 was launched on 22 January 2008.

\* Including bond ETF - ABF Malaysia Bond Index Fund.

### Islamic real estate investment trusts (REITs)

|                              |                 |                 |
|------------------------------|-----------------|-----------------|
| <b>Number of REITs</b>       | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Islamic REIT                 | 2               | 3               |
| Total REITs                  | 13              | 12              |
| <b>Market capitalisation</b> | <b>Dec 2008</b> | <b>Dec 2009</b> |
| Islamic REIT (RM million)    | 1,241.04        | 1,827           |
| Total REITs (RM million)     | 4,070.02        | 5,268           |
| % total industry             | 30.5%           | 34.7%           |

Chart 1  
Performance of KLCI vs Shariah indices

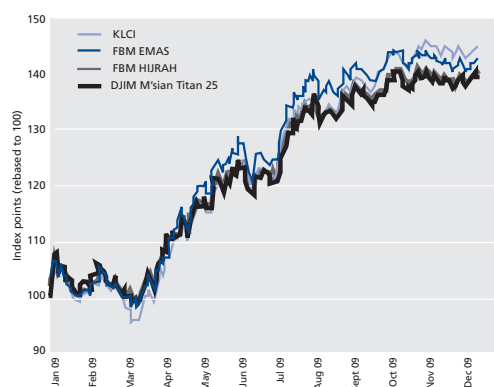
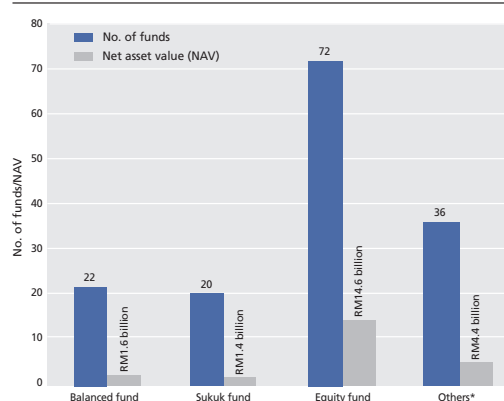


Chart 2  
Shariah-compliant funds by category



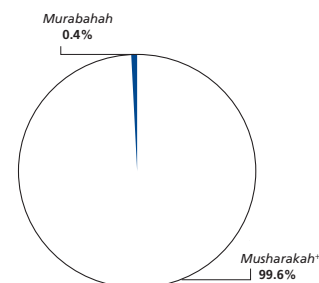
\*Including feeder funds, fixed income funds, money market funds, structured products and mixed asset funds

### Corporate sukuk

| Sukuk approved                                    | 2008   | 2009               |
|---|--------|--------------------|
| Number of sukuk                                   | 47     | 11                 |
| Size of sukuk (RM billion)                        | 43.23  | 33.96 <sup>+</sup> |
| Size of total bonds approved (RM billion)         | 139.99 | 57.5               |
| % of size of sukuk to total bonds approved        | 30.9%  | 59.1%              |
| Sukuk issued <sup>+</sup>                         | 2008   | 2009               |
| Size of sukuk issued (RM billion)                 | 20.8   | 32.3               |
| % of sukuk issued to total bonds issued           | 43.7%  | 52%                |
| Sukuk outstanding                                 | 2008   | 2009               |
| Size of outstanding sukuk (RM billion)            | 152.8  | 172                |
| % of outstanding sukuk to total outstanding bonds | 57%    | 57%                |

<sup>+</sup> Includes an approval of sukuk by Pengurusan Air SPV Bhd valued at RM20 billion which was based on a combination of Shariah principles, musharakah and ijarah.

Chart 3  
Sukuk approved based on various Shariah-principle size (RM million)



### RM-denominated sukuk approved by the SC in 2009

| Issuer                           | Shariah Principle         | Size of Issues (RM million) | Date of approval | Rating               |
|----------------------------------|---------------------------|-----------------------------|------------------|----------------------|
| Unique Wealth Management Sdn Bhd | <i>Musharakah</i>         | 1,000.00                    | 30 Jan           | AA-                  |
| Pinnacle Tower Sdn Bhd           | <i>Musharakah</i>         | 450.00                      | 3 Feb            | AAA<br>MARC-1        |
| Telepal SPV Sdn Bhd              | <i>Murabahah</i>          | 150.00                      | 2 Mar            | AA                   |
| ABS Passage Bhd                  | <i>Musharakah</i>         | 2,000.00                    | 16 Mar           | AAA<br>AA2<br>B3     |
| CIMB Islamic Bank Bhd            | <i>Musharakah</i>         | 2,000.00                    | 22 May           | AA                   |
| CIMB Bank Bhd                    | <i>Musharakah</i>         | 5,000.00*                   | 28 May           | AA                   |
| Jati Cakerawala Sdn Bhd          | <i>Musharakah</i>         | 855.00                      | 12 Jun           | AA3                  |
| UMW Holdings Bhd                 | <i>Musharakah</i>         | 800.00                      | 22 Jun           | MARC-1<br>AAA<br>AAA |
| United Growth Bhd                | <i>Musharakah</i>         | 2,200.00                    | 24 Jun           | AA2                  |
| Sime Darby Bhd                   | <i>Musharakah</i>         | 4,500.00                    | 24 Sep           | AAA                  |
| Pengurusan Air SPV Bhd           | <i>Ijarah, Musharakah</i> | 20,000.00                   | 16 Oct           | AAA, P1              |

\* Combined issue size limit of RM5.0 billion (or its equivalent in foreign currency) with Multi-Currency Subordinated Debts Programme approved in March 2009.

We appreciate your feedback and comments. If you would like to know more about the Malaysian Islamic capital market or require further information from the Securities Commission Malaysia, please contact the following persons at the Islamic Capital Market Department:

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