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Conference on Islamic Banking & Investment "Regulatory Framework & the Role of the SC in Developing the Islamic Capital Market."

Introduction

Malaysia's phenomenal success in developing a working Islamic banking system that co-exists in parallel with the conventional system has been acknowledged by industry participants world-wide. In fact, along with the accolades that were first received more than a decade ago with the enactment of the Islamic Banking Act 1983 and the establishment of Bank Islam Malaysia Bhd, many Islamic countries have chosen to model their Islamic banking system after us.

The banking sector, however, is only one component of the financial system; the capital market is the other. The strong winds of disintermediation that is blowing across financial markets globally will soon spread to Islamic finance. Hence the Islamic banking sector must necessarily be complemented with, and augmented by, an Islamic capital market. Both need to co-exist symbiotically in order to offer issuers with efficient and acceptable modes of raising capital and investors with the choice of instruments acceptable to Islam. A successful and mature Islamic banking system which is supported by an equally successful and vibrant Islamic capital market will provide Malaysia with a niche that will greatly contribute towards the attainment of our objective of making Kuala Lumpur a regional financial centre.

The success of Islamic banking in Malaysia is a reflection of the large amount of funds available in the hands of investors who are looking for instruments and modes of investment that are acceptable to, and in compliance with, the syari'ah. To ensure its continued success, the fast growing pool of domestic capital within the Islamic banking system cannot be allowed to be just stuck within the system, without being efficiently and productively mobilised. The provision of retail Islamic banking services must be accompanied with the provision Islamic investment banking services. This will also open up opportunities for capital market intermediaries like the stockbrokers and fund managers to expand the scope of their businesses beyond the conventional dealing and portfolio and asset management activities.

The Development of an Islamic Capital Market in Malaysia

As is the case everywhere, the capital market in Malaysia has had a far more recent history than the banking sector. As such, it is therefore not surprising that the state of Malaysia's Islamic capital market is not as advanced as the corresponding banking sector. Currently the types of Islamic securities available range from unit trusts, government and corporate bonds as well as mortgage debt securities to stocks which have been designated as "permissible", i.e. shares of companies whose main business activities do not involve interest-based financial services, gambling, alcoholic beverages other or non-halal activities or products. As at August of this year, eight Islamic unit trust funds have been approved and launched with net asset value of RM1.2 billion. In

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view of the growing acceptance of Islamic funds as a savings and investment vehicle, the Minister of Finance in the 1997 Budget Speech had announced the introduction of an Islamic share index for both the Main Board and Second Board to be developed by the Kuala Lumpur Stock Exchange (KLSE). These indices will function as a benchmark for investors to evaluate the performance of these Islamic funds.

In terms of financial intermediaries, there is only one full-fledged Islamic stockbroking company on the KLSE whose operations have been customised to comply with syari'ah principles. In addition, there are four other stockbroking companies that provide Islamic stockbroking activities by having an Islamic window alongside its conventional operations.

The development of Malaysia's Islamic capital market like the development of the capital market generally must, necessarily, take a multi-pronged approach. Efforts to introduce a variety of Islamic instruments for the capital market to meet the needs of issuers who seek the lowest cost of financing, and investors who want the highest return for a level of risk which they are comfortable with, must be intensified. At the same time, market intermediaries will be encouraged to offer a wide array of Islamic capital market services to provide depth and breadth in the system. Educational programmes will be conducted to expose both Muslim and non-Muslim investors to the workings of a capital market in accordance with the syari'ah, and to ensure the existence of a sufficient pool of intermediaries who are well versed with the various aspects of an Islamic capital market. Dialogues and discussions between syari'ah scholars and industry and market practitioners must be encouraged and intensified. At the end of the day, it is hoped that this developmental agenda will see the formation of a truly Islamic capital market, one where capital is allocated and risks are managed according to the principles of Islam.

The Securities Commission (SC) and its developmental role

The SC, unlike most other capital market regulators, has both a regulatory as well as a developmental role. Indeed, the statutory functions of the SC under Section 15(1) of the Securities Commission Act 1993 include, inter alia,

- to advise the Minister on all matters relating to securities and futures industries,
- to take all reasonable measures to maintain the confidence of investors in the securities and futures market by ensuring adequate protection for such investors, and
- to encourage and promote the development of the securities and futures markets in Malaysia including research and training thereto.

Playing the role of both facilitator of capital market development and watchdog of capital market activities involves maintaining a delicate balance. And, it is in maintaining this delicate balance that the SC has to weigh the market's need for more innovative

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investment products along with concerns regarding market integrity, systemic stability and investor protection.

The development of an Islamic capital market is very much part and parcel of the overall agenda in the development of the Malaysian capital market. It is not an isolated, one-off stand-alone programme that is divorced or distinguishable from the main agenda. The SC's agenda for the Islamic capital market, as in the SC's agenda for the capital market as a whole, is based on a holistic and comprehensive strategy. As mentioned above, this holistic approach involves the development and strengthening of market institutions, the enhancement of skills and professionalism amongst market intermediaries, the introduction of a sufficient variety of instruments to cater to the different needs of issuers and varying risk appetite of investors, and above all, the assurance of adequate investor protection. The successful development of an Islamic capital market, therefore, demands that all these areas be addressed.

Key Success Elements

A well-functioning capital market brings together investors and issuers; with a variety of financial arrangements and instruments that will facilitate the allocation and transfer of funds for productive uses at least cost. Issuers who need capital to carry out their business activities and wish to do so in accordance with Islamic principles, in the absence of an Islamic capital market, would be reluctant to resort to the conventional market to raise capital and as a result may be hard-pressed to use existing financing modes that are acceptable to Islam but may incur higher cost. Those who cannot wait for such financial instruments to be developed over time at home will seek avenues in other markets. Trends in the globalisation of financial markets supported by advances in information and communication technology have eased the way for issuers and investors to seek capital market instruments beyond their national borders; whether it be Bahrain, London or New York.

An Islamic capital market requires the existence of a market where investors looking for investment in accordance with the Syari'ah should feel comfortable that the market offers them a sufficient array of instruments, and caters to their investment needs in a fairly comprehensive way. Apart from the choice of financial instruments, market intermediaries should be sufficiently skilled and well versed regarding the products on offer. Only then will the market be able to attract the interest and participation of issuers and investors, which in turn will promote the growth of ancillary financial services and motivate market intermediaries to be more innovative and competitive.

In short, an Islamic capital market cannot come into existence by way of an edict - it can only be established and grow when there are sufficient players in the market, i.e. issuers, investors, intermediaries and Islamic scholars who are confident in, and willing to use, the instruments and services offered to them as well as those who are committed to further developing the instruments and services. It is for this reason that

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the development of an Islamic capital market must be seen as a continuous developmental agenda - always evolving. In a sense, Malaysia is fortunate to have in place, three very important elements that support the establishment of an Islamic capital market :

- full commitment of the government,
- interest and commitment of investors and issuers because of the success of the Islamic banking sector, and
- an available pool of experts - industry participants and Islamic scholars who are willing to discuss and debate issues in a manner that would benefit the market.

We will have to build on these strengths.

Initiatives for the development of the Islamic capital market.

Let me now elaborate on the efforts and initiatives that have, hitherto be taken by the SC since its birth on March 1, 1993, to develop the Islamic capital market in Malaysia. These initiatives can be divided into 2 categories, viz. setting-up the necessary infrastructure for research, discussion and dialogue and specific efforts to broaden and deepen the market.

- Setting-up the necessary infrastructure

1. Islamic Capital Market Unit

In carrying out its statutory obligation of developing the capital market, the SC has included the development of an Islamic capital market as a major programme area in its 3-year Business Plan (1995-97). The SC's commitment and conviction to developing the Islamic capital market in Malaysia is reflected in the setting up of a dedicated Islamic Capital Market Unit within its Research and Development Division. This Unit is staffed by researchers who are well versed in conventional capital market practices as well as others who are trained in fiqh muamalat. The mandate of this unit is to carry out research activities in areas which are related to Islamic financial products and Islamic jurisprudence.

2. The Islamic Instruments Study Group

The SC is fully cognisant of the fact that the development of the Islamic capital market, as is the development of any other aspect of the capital market, cannot be carried out by the Islamic capital market Unit, however qualified the staff may be, within the confines of the Commission. Recognising that the development of this aspect of the capital market in particular, requires input from and constant

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dialogue and discussion with, not merely industry participants but also Islamic scholars, the SC in 1994, established an informal group called the Islamic Instruments Study Group (IISG). This was done with the objective of facilitating a process whereby through discussion and debate, Islamic scholars and industry participants can assay existing capital market instruments and guide market participants on matters pertaining to Islamic capital market issues. The IISG comprised reknown Malaysian fiqh scholars, corporate figures who are active in the area of Islamic banking and Islamic securities and academicians.

3. The Syari'ah Advisory Council (SAC)

The Islamic Capital Market Unit provides extensive research and secretarial support to the IISG. The success of the IISG and its ability to fill a much felt lacuna in the area of Islamic capital market expertise prompted the SC to propose the establishment of a more formal body with the responsibility of not only evaluating specific capital market instruments but also ensuring that the operation of the Islamic capital market fulfils all syari'ah principles. With the blessings of the Minister of Finance, the SC's Syari'ah Advisory Council (SAC) was established in May of this year. The terms of reference of the SAC is to advise the SC on all matters pertaining to the systematic development of a comprehensive Islamic capital market and to serve as the focal point of reference on all issues relating to the Islamic capital market and syari'ah.

While the Securities Commission Act 1993 does not specifically provide for the establishment of the SAC, section 16 of the Act provides that the Commission shall have all such powers as may be necessary for or in connection therewith, or reasonably incidental for, the performance of its functions under the securities laws.

Furthermore section 18 of the Securities Commission Act specifically allows the Commission to establish such committee as it considers necessary or expedient to assist it in the performance of its functions under the Act. The Act further allows the Commission to appoint any person to be a member of such committee.

- Specific efforts to broaden and deepen the market

Through the Islamic Capital Unit and the IISG and of late the SAC, the SC has, since its inception, undertaken the following developmental activities:-

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1. **Increase the universe of Islamic financial instruments**

This is done in two ways. The first, is by identifying existing conventional capital market instruments that are acceptable to Islam. This approach is premised on the basis that there is no need for the reinvention of the wheel. Irrespective of their origin, financial instruments that are by their very nature consistent with the teachings of Islam, or where elements that are unIslamic can be removed without affecting the utility of the instruments or impose undue cost burden, can be used.

In looking at existing conventional instruments and verifying whether they are acceptable to Islam, the approach taken by the SC is to dissect the instrument and analyse each component to see if they contain elements that are not acceptable in Islam. Apart from ordinary stocks in companies that do not partake in non-halal activities, the SAC in using this approach has endorsed call warrants as acceptable provided the mother shares themselves are halal. This is based on the Islamic concept of haq tamalluk, which is a right that can be sold and transferred. Similarly transferable subscription rights (TSRs), which do not fundamentally differ from call warrants, are acceptable provided they involve the right for subscription to stocks of companies carrying out permissible activities. Asset securitisation which reflects very closely the concept of bai' al-dayn in Islam has also been pronounced as acceptable.

The other approach that is used to increase the universe of Islamic financial instruments is a more proactive approach. While the acceptance of conventional instruments can be handy, we will not do justice to the richness of Islamic fiqh if we do not use it to originate and innovate new instruments which are acceptable to Islam. Hence, the first approach of identifying and isolating conventional instruments that are acceptable to Islam must be supported by efforts to originate and innovate Islamic financial instruments based on the various Islamic concepts such as:

1)	Al-Ujr	-	payment for services rendered
2)	Bai' Al-Dayn	-	the sale of debt - where the debt must arise out of a contract of exchange or 'uqud al-Mu'awadat al-Maliyah such as asset sale (based on Bai' Bithaman Ajil) or trade financing (based on Murabahah)
3)	Ijarah	-	lease of operating assets
4)	Istisna'	-	a contract of acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of job completion
5)	Mudharabah	-	trust financing, i.e. a contract whereby one party provides 100% of the capital and another party

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		manages the project using his entrepreneurial skills. Profits are shared based on agreed ratio and the losses are borne by the provider of the funds
6)	Murabahah	- sale of goods on a cost-plus basis as agreed to by both parties
7)	Qardhul-Hasan	- interest-free loan given mainly for welfare purposes
8)	Musyarakah	- partnership or joint venture where both profits and losses are determined on the basis of equity participation

Developing and originating new muamalat instruments is, however, a longer and more demanding process. It requires a detailed understanding of the various types of Islamic financial contracts and a thorough appreciation of the contemporary needs of the issuers, investors and intermediaries in the market. It also requires the ability to structure products which not only satisfy the syari'ah but are also consistent with the commercial legal system of the country. The ability of fiqh scholars and industry experts to work together to structure such products is clearly manifested by the use of various muamalat concepts such as bai' al-dayn, istisna', murabahah, bai' bithaman ajil and ijarah in structuring Islamic debt papers. The concept of a benevolent loan or qardhul-hasan has also been used in structuring government investment certificates.

2. **Review of 'permissible counters' on the KLSE**

The Minister of Finance in his 1997 Budget Speech has announced the establishment of an Islamic Index by the KLSE. The creation of such an index necessitates the identification of permissible counters from amongst the companies listed on the KLSE, followed by continuous monitoring of business activities of these companies. Prior to the establishment of the SC, Bank Islam Malaysia Berhad, in responding to the need to identify such counters, has reviewed the activities of companies listed on the KLSE and has identified a list of companies deemed to be "permissible counters for investment". BIMB should indeed be applauded for the pioneering work in this respect. Given the complexities of company activities and company structures, any thorough analysis of the activities of these companies as well as those of their subsidiary and associate companies is no mean task. However given the exponential growth in the number of companies listed on the KLSE, and the number of investors looking for 'permissible counters'; and given the establishment of the SC as an institution responsible for regulating and developing the capital market, efforts are underway for the SC to strengthen, update and further develop the

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invaluable work pioneered by BIMB. In doing so, however, the SC will continue to tap on the expertise and experience of BIMB as well as others within the industry.

3. **Issue Islamic benchmark paper to lead the development of the Ringgit bond market**

Despite significant developments in the Malaysians capital market over the past decade, the Ringgit bond market still lags behind the equity market. While growth in the primary issue of corporate bonds has been encouraging, the secondary market remains relatively inactive and lackadaisical. One reason is that the supply-demand imbalance of Malaysian Government Securities has prevented a liquid default-risk free benchmark yield curve from developing. Without such a benchmark, the pricing of bonds in both the primary and secondary market will be difficult and complicated. This situation is not conducive to the growth of the bond market.

In response, the SC has, upon the request of the Ministry of Finance, conducted a study to develop a framework to issue benchmark bonds based primarily on the experiences of the Hong Kong Monetary Authority in the development of its domestic bond market. The Minister of Finance in the 1997 Budget Speech has announced the implementation of a programme of issuing sovereign-rated default-free paper aimed at providing a benchmark yield curve in the corporate bond market. The benchmark bond will be based on the Islamic principles of murabahah and bai' al-dayn, as was proposed by the SC.

This is another first for Malaysia's capital market - an Islamic product that will be watched and followed by the conventional market. The benchmark paper, structured using the Islamic principles of murabahah and bai' al-dayn will be similar to a zero-coupon or discounted bond. An Islamic benchmark bond in this form will be the first of its kind because almost all Treasury yield curves around the world are based on coupon-paying paper. Studies have shown that a zero-coupon yield curve will eliminate the problem of non-uniqueness in the yield-to-maturity relationship. Furthermore, for the development of a bond futures market, zero-coupon paper which is homogeneous will be easily deliverable into the futures contract, thus killing two birds with one stone.

4. **Islamic Accounting Standards**

An Islamic Financial Accounting Working Committee has recently been formed under the initiative of the Malaysian Association of Certified Public Accountants, to provide technical support and advice in respect of Islamic reporting and

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accounting standard. The Working Committee consist of representatives from financial institutions, certified public accountants and academicians as well as representatives from Bank Negara Malaysia and the SC. The functions of the Working Committee that have been identified include:

- developing an accounting framework in the field of Islamic finance
- identifying accounting issues in relation to Islamic products and processes
- resolving issues concerning accounting and reporting practices of Syari'ah-based transactions
- advise and submit recommendations to the SAC on accounting and reporting matters pertaining to instruments and activities within the Islamic capital market.

Conclusion

The target of Malaysia's Islamic capital market development efforts is the creation of a dual system - one Islamic and the other conventional - which is equally innovative, competitive and modern. This mandates rigorous and continuous efforts at broadening and deepening the market. The challenges ahead would be to develop local expertise in all areas of Islamic finance, to broaden the consensus between syari'ah scholars and industry experts as well as to educate investors and issuers of the choices available to them within a dualistic system.

At the end of the day, the success of a financial market, be it Islamic or otherwise, will depend on the following elements:

- confidence in the system and process
- a variety of quality products
- a reason for investors and issuers to use these products

A regulatory framework can be designed and put in place to influence the above factors; developmental efforts can and will be intensified to achieve the same. Ultimately however, it is the investors issuers and intermediaries who would determine the success of efforts to develop the Islamic capital market.

Thank you.