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Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

Suruhanjaya Sekuriti
Securities Commission
Malaysia

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ICM Development Initiatives

Significant strides have been made and considerable recognition gained over the past few years in Islamic finance, yet it remains a mere sliver of the world's financial system. The talent pool for Islamic finance remains very shallow world-wide and there are hardly any reference material or published articles available. There needs to be more applied research, more co-ordinated and concerted efforts among regulators, industry, and academia in promoting and developing Malaysia as an Islamic financial centre.

It is for these reasons that the SC has embarked on an Islamic Capital Market Development Plan with several targeted initiatives which are consistent with and intended to complement the Malaysia International Islamic Financial Centre (MIFC) agenda.

The initiatives include:

- Strengthening partnerships through collaborative efforts;
- Establishing an International Advisory Committee; and
- Convening of the semi-annual International Islamic Capital Market Forum.

The Capital Market Development Fund has endorsed and will financially support the rolling out of these initiatives which will positively impact the overall Malaysian capital market.

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The Muwa`adah[1] Principle for the Buying and Selling Contract

In the previous issue, we discussed the principle of *muwa`adah* for the currency exchange contract. It was concluded that *muwa`adah* without any condition is more acceptable because there is no clear evidence from the Quran and Sunnah which prevents *muwa`adah*. Furthermore, *muwa`adah* is not a contract but a promise to execute a contract at a future date.

Following on, this article discusses the principle of *muwa`adah* for the buying and selling in the future. In this instance, Shariah scholars have expressed three different views, namely:

- Permissibility of *muwa`adah* if it is not binding on the parties involved;
- Permissibility of *muwa`adah* even though it is binding on the parties involved; and
- Permissibility of *muwa`adah* for import and export.

Permissibility of muwa`adah if it is not binding on the parties involved

According to Majma` al-Fiqh al-Islami, *muwa`adah* for *bai` murabahah* is allowed. However, *khiyar* (option) must be offered to one or both parties involved whether to conclude the contract or otherwise in the future. If *khiyar* does not exist, then *muwa`adah* is not allowed as it resembles the contract of buying and selling itself (*bai` murabahah*).

The following are some arguments of contemporary jurists who disallow *muwa`adah* if it binds on the parties involved:

- *Muwa`adah* that binds the parties is already considered a contract although the word "promise" is used instead of "sell and buy";
- *Muwa`adah* that binds the parties involved in selling something which is yet to be possessed and this is prohibited. According to the Hadith, a person is prohibited from selling something that he does not possess as it would trigger Shariah issues, such as *gharar*; and
- One of the conditions for a contract to be legally concluded is the existence of a mutual agreement between the two parties in the contract. If *muwa`adah* binds the parties in the contract, then the condition cannot be fulfilled as the parties are considered as being forced to conclude the contract in the future.

Permissibility of muwa`adah even though it is binding on the parties involved

Some contemporary jurists view that *muwa`adah* is permissible to execute a promise even though it is binding. According to this view, *muwa`adah* binds both parties involved, based on the following arguments:

- Rasulullah s.a.w said:

  لا ضرر ولا ضرار

  Meaning: There should be neither harm nor malice

[1] Muwa`adah is defined as a mutual promise between two parties with the intention to conclude a contract in the future.

From the above Hadith, it can be understood that if *muwa`adah* is not binding, it can be harmful to the parties involved. Therefore, a *muwa`adah* that binds is necessary.

- *Muwa`adah* that binds both parties allows a contract to be concluded between them in the future. Hence, it avoids a serious conflict and/or dispute between them when the contract is concluded.

- The permissibility of a unilateral (*wa`d*) and *muwa`adah* is based on the same evidence as both of them are related to a promise. This view is supported by Rafic Yunus al-Misri, the author of an article entitled "The Binding Unilateral Promise (*wa`d*) in Islamic Banking Operations", who views that *wa`d* and *muwa`adah* are the same because a person cannot make a promise without involving a counter party, especially in the buy and sell transaction.

Permissibility of muwa`adah for import and export

According to Majma` al-Fiqh al-Islami, *muwa`adah* for import and export activities is permissible where there is a general need (*hajat `ammah*) to bind the parties involved in accordance to the relevant rules or norms in international trade (*al-a`raf al-tijariyyah al-duwaliyyah*), such as the requirement in the letter of credits (*al-i`timad al-mustanadi*).

In this case, *muwa`adah* is yet to be considered as a contract. Therefore, there is no transfer of ownership right between buyer and seller. The contract is concluded when there is an offer and acceptance (*ijab* and *qabul*) at an agreed time in the future. Furthermore, *Majma` al-Fiqh al-Islami* also explains that if one party breaches the *muwa`adah*, he must bear the loss for the amount owed to the other party.

Dr Sami Hammud, the author of *Tatwir al-A`mal al-Masrafiyyah Bima Yattafiq Ma`a as-Syari`ah al-Islamiyyah*, also share the similar view that allows *muwa`adah* for import and export activities.

Conclusion

After reviewing the above, the view that *muwa`adah* is permissible even though it is binding i.e the second view, appears to be more acceptable.

The reason is that *muwa`adah* is not a contract but a mere promise. The contract will only happen when both parties conclude the contract with *ijab* and *qabul* at the future agreed time. Furthermore, contemporary and classical jurists are of the view that *ijab* and *qabul* in the contract of buying and selling use the word "sell and buy" such as "I sell and I buy" (بعت/اشتريت). However, in *muwa`adah*, only the word "promise" is used.

"…the view that muwa`adah is permissible even though it is binding, appears to be more acceptable…"

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Strengthening partnerships through collaborative efforts

Two Memoranda of Understandings (MOUs) have been signed under this initiative. The MOU with Universiti Sains Islam Malaysia (USIM) will facilitate the compilation and publication of global Shariah rulings, and the MOU with Universiti Malaya (UM) will establish a Visiting Scholar Programme.

These were signed at the opening of the inaugural International Islamic Capital Market Forum in Kuala Lumpur which was officiated by the Deputy Finance Minister 1, Datuk Ahmad Husni Hanadzlah.

(a) Compilation of Shariah Rulings

The SC is collaborating with the World Fatwa Management Research Institute of USIM to issue the world-first compilation of *fatwas* (Shariah rulings) which will be produced in several volumes over three years. A consolidated source of Shariah rulings will extend the possibilities in concept and application of the Shariah and will facilitate the development of standard guidelines and cohesive rules to expedite the process of product innovation.

The compilation marks a milestone development in the ICM industry as it will provide academics and practitioners a single source of reference of all rulings culled from major jurisdictions around the world. The proposed compilation will be the first of its kind in the modern world as the last such compilation, called the *Mejelle*, was undertaken more than a century ago by the Turks during the Ottoman period. Furthermore, the SC's publication of its own Shariah Advisory Council rulings has been well received internationally and is being used as a reference material around the world. The second edition has been translated and published into Persian, Thai, and Arabic.

The first volume of the compilation is expected to be published in early 2009.

(b) ICM Visiting Scholar Programme

To promote scholarships and encourage research in Islamic capital market, the SC and the University Malaya have agreed to collaborate on a Visiting Scholar Programme. The programme will allow both academia and industry to tap on each other's knowledge and experiences.

Under this programme, internationally renowned scholars will be attached with Universiti Malaya for a period of up to three months. It is hoped that a Visiting Scholar will be brought in by end of the year.

International Advisory Committee

The SC has established an International Advisory Committee (IAC) to provide strategic guidance and international perspectives for projects that are relevant and appropriate, not merely for Malaysia, but also for the global Islamic capital market. The six-member IAC, chaired by SC Chairman, Dato' Zarinah Anwar, comprises:

- Dr Mohamed Ali Elgari, Shariah Scholar, Saudi Arabia;
- Sheikh Nizam Yaqubi, Shariah Scholar, Bahrain;
- Abdulkader Thomas, President and CEO, SHAPE Financial Corporation, USA and Kuwait;
- Dato' Salman Younis, Managing Director, Kuwait Finance House, Malaysia; and
- Iqbal Khan, Founding Board Member and CEO, Fajr Capital, UK.

Convening of the Semi-annual International Islamic Capital Market Forum

In view of burgeoning worldwide interest in Islamic finance, the SC has developed the semi-annual international Islamic capital market forum to serve as a platform for scholarly exchange of ideas and views to bring about a greater awareness and understanding of particular aspects of Islamic finance among international scholars, industry practitioners, regulators, intermediaries, and investors.

The inaugural forum, themed "Product Innovation – Islamic ETF and Commodity Murabahah" featured renowned speakers from Malaysia, the Middle East, and the US, held on 27 March 2008. It was attended by over 300 local and international participants. Two of the IAC members, Dr Mohamed Ali Elgari and Abdulkader Thomas, spoke on product innovation in Islamic ETF and commodity *murabahah*.

New Guidelines Strengthen Shariah-based Unit Trust Funds

In March 2008, the SC issued the revised *Guidelines on Unit Trust Funds* (UTF Guidelines). It sets out requirements to be complied with by any person intending to establish a unit trust fund in Malaysia and issue, offer or invite any person to subscribe or purchase units of the unit trust fund. For Shariah-based unit trust funds, there were additional requirements:

1. Appointment of Shariah Adviser

The requirement for the appointment of a Shariah adviser is the main distinctive criterion for a management company to establish any Shariah-based unit trust fund. The Shariah adviser should–

(a) be independent of the management company;

(b) be registered with the SC;

(c) (where individuals are appointed) comprise at least three individuals; and/or

(d) (where a corporation is appointed) engage at least one Shariah expert who meets the fit and proper criteria as mentioned in the guidelines.

Individuals appointed should not hold office as a member of the investment committee of funds managed and administered by the same management company.

2. Roles of the Shariah Adviser

(a) To advise on all aspects of unit trust and fund management business in accordance with Shariah principles;

(b) To provide Shariah expertise and guidance in all matters, particularly on the fund's deed and prospectus, fund structure, investments and other operational matters;

(c) To ensure that the fund is managed and operated in accordance with Shariah principles, relevant SC regulations and/or standards, including resolutions issued by the SC's Shariah Advisory Council;

(d) To review the fund's compliance report and investment transaction report to ensure that the fund's investments are in line with Shariah principles; and

(e) To prepare a report to be included in the fund's annual and interim reports stating its opinion whether the fund has been operated and managed in accordance with the Shariah principles for the financial period concerned.

Where there is ambiguity or uncertainty as to an investment, instrument, system, procedure and/or process, the Shariah adviser should consult the SC.

3. Compliance Officer

The compliance officer of Shariah-based unit trust funds must have basic knowledge of Shariah laws/principles. He is also required to report to the Shariah adviser on whether dealings in the fund's property are appropriate to the fund in accordance with Shariah principles.

Details of the above guidelines are available at www.sc.com.my

Khazanah's Third Exchangeable Sukuk

On 5 March 2008, Khazanah Nasional Berhad (Khazanah) raised US$647 million through a combined sale of exchangeable trust certificates (*sukuk*) and stock placement. The stocks were essentially shares of Parkson Retail Group Limited (Parkson), the largest department store operator in China.

The *sukuk* made up about 85% of the combined sale, or US$550 million, and was exchangeable for Parkson's ordinary shares. Issued via independent Labuan incorporated special purpose company, Paka Capital Ltd, the *sukuk* marked the third exchangeable sukuk issued by Khazanah since 2006, and was widely accepted by international investors.

Concurrent with the *sukuk* issuance, Pangkor Investment (Cayman Islands) Limited, i.e. Khazanah's wholly-owned subsidiary, sold US$97 million worth of shares at HK$71 per share. The said placement of 10.6 million Parkson shares formed approximately 1.9% of Parkson's issued and paid up share capital. Parkson is listed on the Stock Exchange of Hong Kong.

Due in 2013, the *sukuk* comes with a put option on year three and no periodic payments. The papers were oversubscribed by more than 10 times, proving the overwhelming response for such papers, with 50% of the *sukuk* allocated to Middle Eastern and Islamic investors.

According to Khazanah, the RM647 million deal "effectively monetises more than 900% Khazanah's original investment" in Parkson which was made in 2005. Not only was Khazanah able to progressively divest its holdings, this deal also enhanced Malaysia's position as a global Islamic finance centre and linked the Middle East to investments in China.

Redeemable Sukuk With Warrants

In March 2008, WCT Engineering Bhd (WCTE) issued a RM300 million Islamic redeemable *sukuk* with up to 145,902,376 detachable warrants. The issue comprised a serial *sukuk* with tenures of three, four, and five years respectively from the date of issuance.

Structured on the principle of *musyarakah*, WCTE and the *sukuk* holder(s) as *musyarakah* partners, agreed to participate directly in the Shariah-compliant general business of WCTE. Under the transaction, the primary subscriber contributed a capital up to RM300 million on a staggered basis. The *sukuk* comes with a sweetener, warrants which will be detached and sold by the primary subscriber to eligible existing shareholders. The proceeds will then form the balance of the primary subscriber's capital contribution into the venture.

The unlisted *sukuk* has been accorded a long-term rating of AA-IS by Malaysian Rating Corporation Bhd (MARC).

Asset-backed Sukuk Ijarah

The SC approved the issuance of RM1.1 billion asset-backed *sukuk ijarah* by Menara ABS Berhad (Menara ABS), an independent special purpose vehicle. The *sukuk*, issued in January 2008, involved an Islamic sale and lease-back transaction of properties between Telekom Malaysia Bhd (TM) and Menara ABS.

The completed transaction involved the true sale of Menara TM, Menara Celcom, Cyberjaya Complex, and Wisma TM Taman Desa to Menara ABS. Subsequently, the properties were leased back to TM for 15 years under a master *ijarah* agreement. To date, this is the largest property securitisation deal in Malaysia which enabled TM to monetise its non-core assets. Accordingly, this Islamic structure is globally acceptable as it involves the lease of assets via an operating lease whereby the assets are removed from the balance sheet of the original owner.

The issuance comprised three classes of *sukuk* and the proceeds were used to pay for the purchase consideration due to TM.

Public Mutual's Domestic Islamic Fund

The Domestic Islamic Fund, Public Islamic Select Treasures Fund (PISTF) was launched by Public Mutual on 26 February 2008. PISTF is an Islamic equity fund that seeks to achieve capital growth through investment in companies with market capitalisation of up to RM6 billion and which comply with Shariah requirements in the domestic market. The fund invests in Shariah-compliant securities which have promising growth prospects in the medium to long-term.

The equity exposure of PISTF ranges from 75% to 95% of its net asset value (NAV). The issue price/NAV of PISTF was at RM0.25 per unit during the 21-day initial offer period of 26 February 2008 to 17 March 2008. The minimum initial investment was RM1,000.

CMS Absolute Return Shariah Fund

CMS Trusts Management Bhd is managing the CMS Absolute Return Syariah Fund for accredited investors. The fund has a targeted annual return of at least 8% every year for three years and a minimum potential annual distribution of 4%.

Absolute return funds are an emerging trend in the unit trust industry. This investing approach involves a fixed or targeted return instead of being benchmarked against stock market indices. Most absolute return funds typically include a performance fee levied only when the fund performs better than targeted. In foreign countries, absolute return funds are commonly associated with hedge funds which use both "long" and "short" strategies.

Lipper Fund Market Insight Report, reported that for 2007, the aggregate performance of Islamic unit trust funds was better by 22.84%, outperforming the broad market's return of 21.33%.

Developing A Robust Islamic Funds Market in Asia[1]

Perspective on the Asian fund management industry

Asia has a varied investment management landscape. The industry is well established in Japan, Hong Kong, and Singapore, managing not only domestic savings but also functioning as Asian outposts for the global fund management industry. However, in many emerging markets in the rest of Asia, the fund management industry is relatively new. But, "emerging Asia" is accumulating wealth at a rapid pace – powered by a combination of oil revenues, trade surpluses, high savings, and youthful demographics. These strong fundamentals operate in an environment of economic reforms and market liberalisation and will feed into strong Asian demand for investment products and fund management services in the coming decade.

The rapid pace of economic growth and accumulation of wealth in the Gulf States, the giant economies of China and India, and the economies of the Far East are prompting investment institutions in the US and Europe to increase their portfolio exposure to Asian assets. These global institutions are also positioning themselves across Asia, to be nearer to the markets they invest and to take advantage of asset-gathering opportunities.

Similarly, Asian firms are being unfettered from the boundaries of their domestic markets through increasing capital account liberalisation to venture into other markets. Typically, they prefer the new Asian pastures which offer more untapped opportunities rather than the more mature and highly saturated markets in the US and Europe.

With the fund management industry in Asia set to undergo a sustained period of rapid growth, the Asian markets are themselves competing to attract more international fund management companies to their shores while providing incentives for home-grown fund managers to grow and to expand regionally. As part of this process, many Asian countries are implementing extensive policy reforms on their tax and regulatory frameworks to strengthen their competitive positioning as a wealth management centre.

Challenges to building an Asian Islamic fund management industry

The Islamic fund management industry has gained increased prominence especially since the rise in oil prices. McKinsey estimates that the revenue of Gulf states from oil and gas will be between US$2 trillion to US$3 trillion this decade. Already, as at 2006, the GDP per capita of the Gulf states is estimated at close to US$20,000.

Despite the high levels of affluence, the Asian Islamic fund management industry is still relatively small – with the exception of some prominent Sovereign Wealth Funds and private equity investors. There is, therefore, an anomaly that needs to be addressed; that is the gap between the large surpluses and the nascent state of the Islamic fund management industry. Quite clearly, there are missing gaps hindering the development of the industry which should rightfully occupy centre-stage in the Asian landscape and be the mechanism ensuring that Islamic savings are efficiently intermediated.

One major constraint is the relatively scarce global supply of Shariah-compliant assets. The latent demand for Shariah-compliant assets is quite evident given the high over-subscription rates for most Shariah issues – whether they are equities or *sukuk*. There is, a need for Islamic countries to collaborate to press ahead with the task of building Islamic capital markets at a much

[1] This article is based on the SC Chairman's keynote address delivered at Islamic Funds Asia 2008 Conference, Kuala Lumpur on 10 March 2008.

faster pace. The rising need for efficient intermediation of Islamic affluence will offer tremendous opportunities for markets offering Shariah-compliant products and services.

However, the Islamic intermediation value chain in many markets has yet to be fully developed and the numbers of specialised Islamic intermediaries – whether full-fledged or operating as a window of a conventional operation – is still insignificant. This then impedes the origination, distribution, and trading of Islamic assets on a global basis.

In this regard, it is important that the Islamic fund management industry is not perceived as a "deposit-taking" institution that acts as a passive guardian of Islamic savings. It must generate value-add for their clients through pursuing innovative strategies in managing assets. At the moment, most of the innovation for Islamic fund management is taking place at traditional financial centres where advanced portfolio strategies, such as absolute return and hedge funds are being replicated and extended to the Islamic arena. The Asian Islamic fund management must seek to expand the frontiers of possibilities in terms of active asset management strategies that are compliant with Shariah-requirements. This would certainly include building the expertise to invest in a broader range of asset classes particularly those with high alpha portfolios and to enhance the ability to deploy risk management strategies to insulate capital.

Most critically, it is important that Islamic fund managers also consider adopting activist strategies in engaging with companies to improve the value of their investments. The tangible benefits of good governance and activist fund managers that adopt an "owner operator" mindset have become increasingly evident and will contribute to the ability to generate superior rates of return. Co-operation among Islamic countries is also required to build capacity and to rapidly expand the number of Islamic finance professionals. There is a substantial shortage of professionals who are well-versed both with Shariah and finance. If the talent pool is not quickly expanded, these shortages will constrain

"It is important that the Islamic fund management industry generate value-add for their clients through pursuing innovative strategies in managing assets"

the development of the Islamic fund management industry and the Islamic capital market.

To develop a comprehensive and integrated regulatory and Shariah-compliant framework to provide investor protection, Malaysia has adopted a regulatory approach to ensure that all participants in our capital market are provided the same degree of clarity, certainty, and protection. In addition, the SC has recently established a specialised unit to strengthen our supervision of the fund management industry. The SC has moved towards a principles-based approach to regulation where the focus is very much on outcomes – are customers being treated fairly; are conflicts of interest being managed appropriately; are financial instruments being valued fairly and in accordance with firm policies; and are the business risks being appropriately and vigilantly managed?

The Shariah Advisory Council of the SC has also issued the *Guidelines on Islamic Fund Management* in 2007 to promote greater clarity and consistency in Shariah-compliance for Islamic fund management business as carried out through standalone operations or under Islamic windows. Overall, the SC's objective was to assure investors in Malaysia's Islamic Capital Market that we have an investor protection regime that is among the best internationally.

The Malaysian Islamic investment management industry

In Malaysia, the most prominent component of the investment management industry is the unit trust industry. In 1993, there were only two Islamic unit trust funds; as at March 2008, there were 136 with a net asset value of RM16.6 billion.

Apart from the unit trust industry, intensifying research and development work has resulted in tremendous growth in the body of knowledge and financial sophistication. This has created a facilitative environment for the introduction of other Shariah-based collective investment schemes in Malaysia.

Malaysia also became the first market to release the *Guidelines for Islamic Real Estate Trusts* (REITs) in 2005 and this was followed by the launch of two Islamic REITs – with hospitals and plantations as their main assets. In January 2008, Asia's first Islamic ETF was launched. The MyETF Exchange Traded Fund is designed to track the Dow Jones Islamic Market Malaysia Titan 25. Within the wealth management industry, various structured investment product based on Shariah principles targeted at institutions and high networth individuals have also been launched.

It is a priority for Malaysia to create an attractive and fully liberalised environment for the Islamic investment management industry. Therefore, under the Malaysia International Islamic Financial Centre or MIFC initiative, international participation in the Islamic fund management industry has been fully liberalised with the removal of restrictions on ownership and investment abroad. In addition, income tax exemption on fees received for Islamic fund management activities was provided. In tandem with this, the SC will act as a one-stop centre to expedite the approval process for the establishment of Islamic fund management businesses in Malaysia.

In addition, Malaysia also recognises the need to promote increased cross-border investments across Islamic markets. The SC signed a mutual recognition agreement with the Dubai Financial Services Authority (DFSA) for the cross-border marketing and distribution of Islamic funds between the two countries.

The SC also seeks to attract Islamic fund managers to locate in Malaysia and to encourage Malaysian fund managers to expand their operations to other markets. At the same time, we continue to explore opportunities for further mutual recognition arrangements to promote cross-border distribution of Islamic products and origination and intermediation activities.

Conclusion

In order to take the Islamic fund management industry to new heights, greater efforts must be channelled into developing collaboration among countries to establish a thriving and vibrant global network of Islamic capital markets. This will create opportunities to stimulate cross-border investment flows that so often act as a catalyst for development.

Malaysia is committed to working closely with other centres to create an Islamic capital market network that can provide the linkages necessary for the optimisation of opportunities to unlock Islamic savings in Asia through effective intermediation processes.

"The SC will act as a one-stop centre to expedite the approval process for the establishment of Islamic fund management business in Malaysia"

Risk and Rating Perspective for the Islamic Financial Services Industry[2]

Given the current turmoil affecting the financial services industry in the US and Europe, the Islamic financial services industry has largely been protected from the global credit crunch and the U.S. sub-prime crisis.

This, however, is no excuse for complacency. The collapse of the U.S. sub-prime market, and its far-reaching consequences across the global financial market, have raised important implications and concerns among regulators. For regulators in markets with a sizeable Islamic financial services industry, a key priority is to ensure that the industry continue to remain strong and inspire the confidence of the ever-increasing number of investors, issuers, and intermediaries that participate in the industry world-wide.

We must, therefore, continue to ensure that current risk standards are adequate and proper, given the fact that most of the conventional banks affected by the sub-prime crisis are no small players, but instead, are of international standing, have high ratings, practise good governance and possess high caliber management capabilities.

It is, therefore, crucial that the industry, supervisory institutions and regulators all play their part in bringing about comprehensive and effective initiatives which will further improve market transparency and risk management practices. As such, it is pertinent for all parties to come together and formulate the necessary methodologies and measures to ensure that the rating of Islamic financial service providers is comprehensive and reflective of the strength and capabilities of the rated institutions.

Over the last decade, the Islamic financial services industry has achieved remarkable growth. New products, new markets, and new linkages are highlighted in the news almost on a daily basis. Markets are linked as never before. Despite these frenetic developments, it is encouraging to note that risk management practices among the Islamic financial services providers have continued to grow in importance. There is also considerable progress in the efforts of intermediaries at enhancing their risk management capabilities, particularly in traditional areas such as market, credit, and liquidity risks.

There are however limitations. The common assumption is that financial risks are predictable and assessable through the use of historical data. While history is indeed a useful starting point for recognising and assessing risk, risk trends do not necessarily follow historical patterns. Most instances of sudden deterioration in the credit standing of a corporate borrower for example, are not predictable. This reflects fundamental weaknesses in economic or financial structures which are not captured by available data. The current sub-prime crisis is a good example. In the Islamic financial services sector, there is added reality that available history is too short to provide a good assessment of risk trends.

However, the fact that Islamic financial services and products have inherent strengths, in that the transparency requirements differ greatly from conventional finance, provides some comfort to Islamic market players. Ensuring Shariah compliance necessarily demands a more robust disclosure regime which

[2] This article is extracted from the SC Chairman's welcome address delivered at IFSB Seminar on Rating of Institutions Offering Islamic Financial Services and Islamic Financial Instruments, Kuala Lumpur on 20 February 2008.

"Ensuring Shariah compliance necessarily demands a more robust disclosure regime which requires a thorough evaluation and analysis of products and processes"

requires a thorough evaluation and analysis of products and processes, prior to any approval. As a result, every stage of a transaction is comprehensively assessed to ensure compliance with Shariah requirements. In theory therefore, Shariah-compliant products or operations pose lower probabilities of submerged weaknesses. The challenge, therefore, is how to further strengthen the operational aspect of ensuring Shariah compliance.

In today's business environment, the ability to process information on risks and returns on investment opportunities, will determine the strength, soundness and efficiency of capital mobilisation and allocation capabilities. In short, the market needs to be guided by standards that measure such qualities of the institutions. Thus, as the Islamic financial services providers compete with and complement each other in financial intermediation, their ability to manage capital efficiently will determine their competitive edge.

The Islamic financial services industry must not only deal with risks unique to the industry, but also with risks arising from new products and structures. These include risks associated with risk sharing arising from the nature of the underlying contracts and possible variations in Shariah application with respect to these contracts. Therefore, these institutions are not only expected to be well equipped with the skills, but also well informed on all aspects of Shariah application and its implications.

In the past, we have only seen the use of less risky contracts, such as *murabahah* and *ijarah* as the primary contracts for capital raising or mobilisation. Today, participatory contracts such as *musharakah* or *mudharabah*, with profit-and-loss sharing or profit sharing structures, are becoming widespread. Furthermore, these contracts now appear not only in their traditional structures, but also in composite forms such as structured products.

Aside from addressing the adequacy of capital, quality of assets, capability of the board of directors and management, the quality of earnings and adequacy of liquidity, this evaluation must also be able to determine the safety and integrity of the institutions. This goes beyond just taking into account the managerial, operational, financial, and performance factors, but also the capability and integrity of the Shariah management team. In other words Shariah safety and integrity can be taken as a separate component.

As Islamic financial services industry advances to become an integral component of the international financial system, continuous efforts are needed to further develop measures and methodologies on rating that are appropriate to meet the changing requirements of a highly dynamic and rapidly evolving environment. In the quest to build a viable and sustainable Islamic financial system, the aim is to contribute to the channelling of capital flows to productive investments, create wealth and promote economic activities that conform to the principles and values of Shariah. With this, the Islamic financial system will ultimately bring benefit not just among Muslims but with the rest of humanity.

Islamic Venture Capital: An Emerging Industry

The venture capital (VC) industry is a critical funding source which promotes business creation and entrepreneurship and helps in the overall development of the capital market. The growth of the venture capital industry in this region and across the globe has progressed. The number of committed funds has risen to US$10 billion in the first half of 2007 from US$7 billion over the same period in 2006. In Malaysia, while total committed funds under management as at 31 December 2007 was relatively unchanged at RM3.3 billion, the total investments in 2007 was 54% higher compared to 2006.

It has become apparent that most Asian countries, following their Western counterparts, have strong acceptance of venture capital as an alternative vehicle into the mainstream capital market products of debt, equities and derivatives instruments. Not only does underlying economic growth continue to accelerate, businesses and management teams across the region are starting to recognise the benefits of seeking capital from private equity investors who can add value both to their growth strategies and to their positioning in the capital markets.

In spite of the phenomenal growth in the capital markets, Islamic venture capital remained the least developed section as compared to mainstream Shariah-compliant investments. It is, therefore, important to identify key ingredients that will spur the interest of all stakeholders to further boost Islamic venture capital not only in this region but also in the Middle East.

In 2007, the SC continued to be actively involved in promoting the growth of this industry either directly, or through the Malaysian Venture Capital Development Council (MVCDC), a one-stop agency, comprising leading policy-makers and VC practitioners responsible for the development of the Malaysian venture capital industry. One of the strategies being considered by MVCDC in internationalising the VC industry is by leveraging on Malaysia's strength in Islamic finance and capital market. The availability of an established Islamic finance regulatory framework capable of accommodating a variety of Islamic structures certainly allows Malaysia to position and profile itself as an international Islamic financial centre.

Why is the focus placed on Islamic VC? According to most scholars, Islamic finance should emphasise partnership and risk-sharing while shunning the use of interest-bearing instruments such as loans. Venture capital offers Islamic investors the opportunity to increase returns, while diversifying their portfolios. Furthermore, venture capital is fundamentally consistent with core Islamic economic principles of active partnerships and risk taking. Key features such as the relationship between general partners, distribution of profits and dealing with defaulting limited partners are all areas that can be structured in accordance with Shariah principles in order to appeal to both Islamic and conventional investors.

It has also been highlighted that increasingly large amounts of VC funds are moving towards Asia. According to *The Economist*, over the next five years private equity and VC funds plan to increase their commitments to emerging markets. Asia (excluding Japan, Australia and New Zealand) is expected to be the prime beneficiary since it attracts 70% of private

"Venture capital offers Islamic investors the opportunity to increase returns, while diversifying their portfolios"

equity and VC investments in emerging markets. We believe that Islamic VC is the distinguishing factor that differentiates Malaysia from other emerging markets. Ultimately, the development of Islamic venture capital will serve as a valuable asset class for the Islamic finance industry. Currently, most Islamic funds are tied to short-term instruments, such as *murabahah* transactions, or are invested in the public markets and real estate. The introduction of long-term investments, like Islamic bonds and venture capital, will provide greater opportunities for portfolio diversification and matching of investors' needs.

Islamic Venture Capital and Private Equity Conference 2008

Malaysian Venture Capital & Private Equity Association (MVCA), in a joint collaboration with Islamic Banking and Finance Institute Malaysia (IBFIM) will be organising the first Islamic Venture Capital and Private Equity Conference

On : 7–8 May 2008 (Wednesday and Thursday)
At : 9.00 am
At : Shangri-La Hotel, Kuala Lumpur

The two-day conference aims to attract foreign and local participants to discuss issues, exchange ideas, experience and promote a better understanding of Islamic Venture Capital (VC) and Private Equity (PE) to boost Islamic VC and PE industry, not only in this region, but also in the Middle East. Among the key information that will be discussed at the conference are:

- Discovering the potential of Islamic VC/PE in developing vibrant and high growth companies;
- Understanding and appreciating various technical and operational mechanisms of Islamic VC/PE (entry and exit strategies);
- Developing new skills for competitive analysis necessary for the Islamic financial institutions worldwide; and
- Enhancing co-operation and co-ordination in various activities among Islamic finance-related industries and government agencies.

The speakers include international and local venture capital and private equity professionals and renowned Islamic scholars. Please refer to the brochure for further details. If you require further information or any clarification, please do not hesitate to call our secretariat office at +603-2096 2094 or e-mail admin@mvca.org.my.

News Round-up

International Islamic Capital Market Forum

On 27 March 2008, the SC successfully organised the inaugural International Islamic Capital Market Forum. The forum was part of the key programmes under the Islamic Capital Market Development initiatives. It aimed to highlight to the industry, new products innovation; specifically, the concept of the product, and the application of Shariah principles underlining the structures.

The forum, themed 'Product Innovation – Islamic ETF and Commodity Murabahah', was officiated by Deputy Finance Minister Datuk Ahmad Husni Hanadzlah and was attended by more than 300 industry players, academicians, and Shariah scholars.

Islamic Funds Asia Conference

The Islamic Funds Asia Conference, organised by Terrapin, was held from 10 to 13 March 2008 at the Westin Hotel, Kuala Lumpur. Dato' Zarinah Anwar, the SC Chairman, delivered a keynote address entitled "Developing a Robust Islamic Funds Market in Asia."

The two-day conference aimed to–

- explore successful fund management strategies from established Islamic asset management;
- navigate through the complexities of the legal and tax issues surrounding Islamic funds;
- assess the increasing demand for Shariah-compliant funds across Asia; and
- understand the risk and rewards for the institutional investors seeking the most ideal option in Asia.

Islamic Finance *news* Road Show

Islamic Finance *news*, the Islamic finance news provider, hosted Islamic Finance news Forum Road Show in Singapore on 2 April 2008. The one-day forum's main objective was to explore Islamic finance market development in the featured country and to tap into the valuable potential which has yet to emerge. The forum attracted about 250 delegates who shared their views and insights.

Dato' Dr Nik Ramlah, SC Managing Director, gave a presentation entitled "Overview of the Malaysian ICM".

Seminar on Rating of Institutions Offering Islamic Financial Services and Islamic Financial Instruments

Hosted by the SC, the Seminar on Rating of Institutions Offering Islamic Financial Services and Islamic Financial Instruments was held on 20 February 2008. Organised by the Islamic Financial Services Board (IFSB), it discussed the approaches of external credit assessment institutions in assessing Shariah-compliant financial assets in line with the principles presented in the Guidance Note.[3]

The SC Chairman, Dato' Zarinah Anwar delivered the welcome address while Dato' Kris Azman Abdullah (SC Executive Director) and Wan Abdul Rahim Kamil (SC ICM Consultant) spoke at the seminar.

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[3] The IFSB issued an exposure draft on *Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAI) on Shariah Compliant Financial Institutions* in September 2007, which aimed to complement the existing IFSB Capital Adequacy Standard (IFSB-1) issued in December 2005.

Malaysian ICM – Facts And Figures

Shariah-compliant securities on Bursa Malaysia

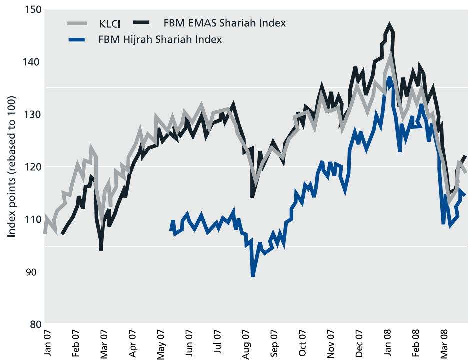
Number of Shariah-compliant securities – Nov 2007+	853 securities
% to total listed securities	86%
Market capitalisation as at Mar 2008	
Shariah-compliant	RM604.01 bln
Total market	RM952.32 bln
% of Shariah-compliant securities to total market	63.4%

Equity market indices	29 Feb 2008	31 Mar 2008	% change
KL Composite Index (KLCI)	1,357.4	1,247.52	-8.1%
FBM EMAS Shariah	9,937.3	8,848.45	-10.9%
FBM Hijrah Shariah@	11,299.5	10,053.91	-11.0%

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

@ *Launched on 21 May 2007*

Performance of KLCI vs Shariah Indices



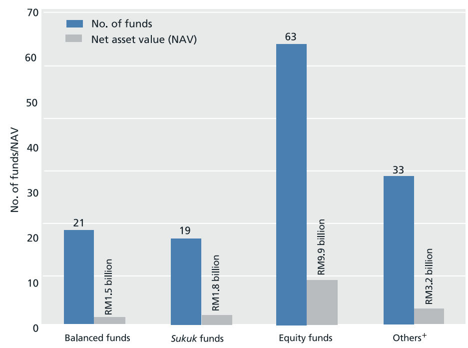
Shariah-based unit trust funds

Number of approved funds	2007	2008^
Shariah-based	134	136
Total industry	521	539
Net asset value (NAV) of approved funds	2007 (RM billion)	2008^ (RM billion)
Shariah-based	16.90	16.41
Total industry	169.40	158.16
% of Shariah-based to total industry	10.0%	10.4%

^ *As at 31 March 2008*

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

Shariah-based unit trust funds by category



Sukuk

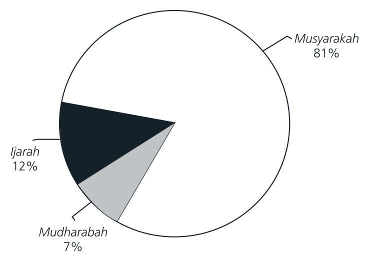
	2007	2008^
Size of outstanding *sukuk* (exclusive of Government *sukuk*)	RM135.8 bln	RM149.0 bln
% of outstanding *sukuk* to total outstanding bonds	56.0%	56.1%
Sukuk approved by the SC	2007+	Q1 2008++
Number of *sukuk*	59	29
Size of *sukuk*	RM121.30 bln	RM11.85 bln
Size of total bonds approved	RM158.80 bln	RM38.32 bln
% of size of *sukuk* to total bonds approved	76.4%	30.9%

^ *As at 31 March 2008*

+ *The sukuk figure includes the approval of seven combination issuances (conventional bonds and sukuk).*

++ *The sukuk figure includes the approval of two combination issuances.*

Sukuk approved (value) based on various Shariah principles as at Q1 2008



RM-denominated sukuk approved by the SC in Q1 2008

Issuer		Shariah principle	Size of issues (RM million)	Date of approval	Initial rating
1	Westports Malaysia Sdn Bhd	*Musyarakah*	800	25 Jan 08	AA+
2	WCT Engineering Berhad	*Musyarakah*	300	25 Jan 08	MARC-1 AA-
3	WCT Engineering Berhad	*Musyarakah*	300	30 Jan 08	AA-
4	Hong Leong Industries Berhad	*Musyarakah*	500	30 Jan 08	P1, A1
5	Stratavest Sdn Bhd	*Ijarah*	120	4 Feb 08	AA-
6	New Pantai Expressway Sdn Bhd	*Musyarakah*	900	6 Feb 08	AA3
7	The Export-Import Bank of Korea (PN2A)	NA	3,000*	20 Feb 08	NA
8	Cosmo-Jupiter Berhad	*Ijarah*	600	29 Feb 08	AA2
9	Lingkaran Trans Kota Sdn Bhd	*Musyarakah*	1,145	12 Mar 08	AA2
10	Lingkaran Trans Kota Sdn Bhd	*Musyarakah*	300	12 Mar 08	AA2
11	Lingkaran Trans Kota Sdn Bhd	*Musyarakah*	100	12 Mar 08	P1
12	Industrial Bank Of Korea (PN2A)	*Ijarah, Musyarakah, Mudharabah & Istisna'*	3,000*	12 Mar 08	AAA
13	Tanjung Langsat Port Sdn Bhd	*Musyarakah*	250	17 Mar 08	AA-
14	Tanjung Langsat Port Sdn Bhd	*Musyarakah*	135	17 Mar 08	MARC-1 AA-
15	Muhibbah Engineering Berhad	*Mudharabah*	400	28 Mar 08	A1 P1

**Combination issues (conventional and sukuk)*

NA – not available

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, please contact:

Mr Nik Ruslin Nik Jaafar
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8589
E-mail: ruslin@seccom.com.my

Dr Md Nurdin Ngadimon
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8105
E-mail: nurdin@seccom.com.my

Mr Syed Azhan Syed Mohd Bakhor
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8376
E-mail: azhan@seccom.com.my

Securities Commission
3 Persiaran Bukit Kiara Bukit Kiara
50490 Kuala Lumpur Malaysia
Tel: 03–6204 8000 Fax: 603–6201 5082
Website: www.sc.com.my

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