SEPTEMBER 2009 VOL 4 NO 3

Suruhanjaya Sekuriti
Securities Commission
Malaysia

malaysian ICM

Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission Malaysia

Contents

The Role of Islamic Finance in Shaping the Future Global Financial and Capital Market Landscape[1]

Markets and innovations in finance have funded production and trade that has underpinned the growth of the modern economy and society. Yet, every now and then, and more so today, we are reminded that the financial system is not infallible. We have to reflect and deal with its consequences and this symposium should provide much thought leadership on the challenge.

We cannot deny the benefits of financial innovation. At the same time, how do we explain to ordinary people who have lost their savings and their homes or are having difficulty finding a secure job to earn a livelihood that this is but a side effect of financial innovation? They view the financial services sector as having created this crisis and being responsible for their predicament. Who can contradict them?

Society has come to view markets and market intermediaries as institutions that we should trust and trust is the cornerstone of modern finance. Individuals

---

[1] This article is based on the keynote address delivered by the Crown Prince of Perak, His Royal Highness, Raja Nazrin Shah at the World Capital Markets Symposium, in Kuala Lumpur, on 11 August 2009.

▶▶ page 4

Bursa Suq al-Sila' – Shariah-based Commodity Trading Platform

Bursa Malaysia through its wholly-owned subsidiary, Bursa Malaysia Islamic Services Sdn Bhd has officially launched Bursa Suq Al-Sila' or commodities market in Arabic on 17 August 2009. It was previously known as Commodity Murabahah House. Bursa Suq Al-Sila' is another effort to promote Malaysia as an international Islamic financial centre. It will serve the growing demand for Shariah-compliant financing needs and close the gap currently faced by international Islamic financial players.

This world's first Shariah-based international commodity platform is fully electronic and facilitates commodity-based Islamic financing and investment transactions under the Shariah principles of *murabahah*, *tawarruq* and *musawwamah*. Bursa Suq Al-Sila' enables lenders to create financing transactions which involve specific assets, fulfilling the Shariah requirement that all deals must involve real economic activity. When an Islamic bank uses commodity *murabahah* to give out financing, it will first buy an asset and then sell it to the borrower. The borrower then sells the commodity to a third party using the bank as its agent, and receives payment which secures the financing it had sought. All transactions done via Bursa Suq Al-Sila' will involve a true sale with a real transfer of ownership and goods which can be delivered.

To begin, crude palm oil will be used as the launch commodity. It will then be expanded to other Shariah-approved commodities covering both soft and hard commodities. As an international commodity trading platform, Bursa Suq Al-Sila' is multi-currency, allowing more choices, access and flexibility for international financial institutions to participate in this market.

Bursa Suq Al-Sila' has now gained a footing in the Gulf Co-operation Council (GCC) markets as more cross-border Islamic finance transactions were witnessed. This platform received recognition in the GCC with recent trades being undertaken by CIMB Islamic and several GCC institutions. Through these trades, Bursa Malaysia hopes to meet the increasing demand for Shariah-based commodity-financing and liquidity management in the GCC countries and globally. It will also serve the needs of global Islamic financial institutions seeking multi-currency platforms to aid their financing needs.

> *"Bursa Suq Al-Sila' enables lenders to create financing transactions which involve specific assets, fulfilling the Shariah requirement that all deals must involve real economic activity."*

First Listing of Sukuk on Bursa Malaysia Under 'Exempt Regime'

Sukuk development in Malaysia takes another step forward when Petroliam Nasional Bhd (Petronas) and Cagamas MBS Bhd (Cagamas MBS) listed both their sukuk and conventional bonds on Bursa Malaysia on 14 August 2009. A framework for the listing of such instruments under an 'exempt regime' was introduced by Bursa Malaysia in December 2008. This framework applies to sukuk or debt securities that are issued, offered or subscribed in accordance with section 229(1) and section 230(1) of the *Capital Markets and Services Act 2007* (CMSA).

Petronas, via its special purpose vehicles, listed its maiden global EMAS sukuk (*ijarah*) of US$1.5 billion and US$3 billion conventional bonds on Bursa Malaysia, Labuan International Financial Exchange (LFX) and Luxembourg Stock Exchange. Both securities were issued in US dollars and for a period of five and ten years respectively.

Meanwhile, Cagamas MBS listed all the outstanding sukuk and bonds issued under its five residential mortgage-backed securitisation transactions (RMBS), totaling approximately RM4 billion of sukuk and RM6 billion of bonds on Bursa Malaysia. Both sukuk and bonds were issued in ringgit with tenures between 3–20 years. The sukuk is structured based on *musharakah* principle.

Listing under `exempt regime' means the sukuk or debt securities listed on the exchange will not be quoted or traded on the exchange. This regime specially caters for issuers who intend to list its sukuk or debt securities on Bursa Malaysia for the listing status and profiling purpose. The targeted group of investors for these instruments will be sophisticated and not retail investors. Hence, the listing of these instruments will offer institutions or high networth investors an alternative investment product with enhanced transparency.

"Listing under `exempt regime' means the sukuk or debt securities listed on the exchange will not be quoted or traded on the exchange. This regime specially caters for issuers who intend to list its sukuk or debt securities on Bursa Malaysia for the listing status and profiling purpose."

Streamlining Registration of Shariah Advisers

The Securities Commission Malaysia (SC) issued the *Registration of Shariah Advisers Guidelines* which will make it easier for individuals and corporations providing advice on Islamic capital market products and services. The guidelines took effect on 10 August 2009.

Under the guidelines, Shariah advisers can now, through a single registration, provide advice on all Shariah-based products and services regulated by the SC. Prior to this, Shariah advisers had to register separately for each product and services based on the respective guidelines.

The guidelines supersedes the various provisions on the eligibility and registration criteria outlined in other SC's guidelines covering various Islamic products and services. They include the *Guidelines of Unit Trust Funds* and *Guidelines on the Offering of Islamic Securities.*

The guidelines, among others, stipulate the criteria and procedures for registration and renewal, matters pertaining to registration and deregistration and continual professional development. The guidelines is available at www.sc.com.my.

---

from cover page ►►

pass their savings to their financial intermediaries to invest in markets with the faith that the intermediaries will be responsible stewards of their wealth.

All of us would like to believe in the system of finance, but it seems to have let us down. It has tried to place mathematics at the centre of a financial system to manage risks and provide reassurances – and that is all well. Yet, no matter how sophisticated the calculations are, they can never be a substitute for trust. Formulas cannot replace the human conscience, and markets will not flourish if people no longer believe in the products being sold or in how markets work. There is a century old maritime brokers' motto "My word is my bond", and a century later, this should still ring true.

The five pillars of Islam

Trust can be an elusive concept, and simply changing rules or systems will not be sufficient to either rebuild trust or restore confidence in finance. In my view, rebuilding confidence in the financial system is about creating belief without reservation. The challenge ahead is therefore to put faith back into finance. Perhaps, it is timely for finance to learn from the lessons of life. To learn what shapes beliefs and to learn what the obligations are to maintain one's faith.

My topic today is on "the role of Islamic finance in shaping the future global financial and capital market landscape". I am reminded of what Einstein wrote about science and religion in a 1930 New York Times article, and since it is the science of finance that I have been talking about, and religion as it relates to finance that I am going to talk about, allow me to share this with you and I quote:

> "*Even though the realms of religion and science in themselves are clearly marked off from each other there are strong reciprocal relationships and dependencies ... science without religion is lame, religion without science is blind ... a legitimate conflict between science and religion cannot exist*".

It is often that in our endeavours our minds run fast and that our hearts and souls follow; it is in the name of innovation at first but that can quickly lead to greed as well. The equilibrium created by balancing these two important facets of our being, our hearts and our minds, is truly a virtue. The best possible scenario is when the morals and the mechanics of our actions are balanced.

"In financial markets, rules and systems, whether they are laws or guidelines help to govern the markets. They can only be effective if everyone believes in the rules and follows them. It is incumbent on market players to understand and follow the rules and systems to ensure integrity and responsibility in market activities."

Today I would like to add for our deliberations the lessons I believe drive Islamic finance.

I would like to draw on the five pillars of Islam, which are the basic tenets of the religion, to draw some parallels. These five pillars form the fundamentals of the religion and provide a structure to our faith. They are *shahada*, the profession of faith; *salat*, or daily prayer; *zakat*, which is the giving of alms; *sawm*, or fasting; and *hajj*, the pilgrimage.

Shahada (Profession of faith)

The first of the five pillars is the profession of faith or *shahada*. The act of professing faith by stating your intention is the initiation of faith. The professor states in one statement that he or she believes in and has trust in the faith and that profession of belief and trust fulfils the obligation of the first pillar of Islam. Similarly, the act that signals to markets that the trust of the economy is in them is when investors are willing to invest: it is through this act, the act of investment, that investors profess their faith in the markets.

The availability of information builds confidence in the market. Without information there can be no knowledge, and without knowledge there can be no basis for trust and confidence. For the economies to profess faith in their markets there needs to be transparency and disclosure. Of late, there has been a great erosion in that trust and this is why the industry's greatest priority should be to rebuild trust and to restore confidence.

This industry is based on reciprocity of trust where the markets depend on investors and investors depend on markets. Unfortunately, markets have recently let the investors down and need to work hard to regain their trust. The first move must come from the market but to re-establish this relationship, investors must also start placing responsibility on and trust in the markets. Trust begets trust.

Salat (Prayer)

Prayer, or *salat*, is the second pillar of Islam. There are five daily prayers for the Muslim and it is the duty of the Muslim to perform these prayers. Importantly, prayer starts with a declaration of intention, or *niyya*. This declaration of intention is supposed to help one remain focused and direct to the objectives at hand. This type of explicit disclosure and statement of objectives is fundamental to any serious act, personally and for businesses. Financial management and fiduciary responsibility are a combination of serious acts and responsibilities.

There are clear guidelines on prayer in Islam and this helps everyone to pray together in the same way. Prayer helps instil discipline, and helps establish orderliness, regulating people and the way they do things; down to how they divide their days. One is required to pray at specific times of the day, towards a specific direction, and in a specific manner. Prayer is a very communal concept in that it suggests that one should try to pray as part of a group whenever possible. It is about following rules.

In financial markets, rules and systems, whether they are laws or guidelines help to govern the markets. They can only be effective if everyone believes in the rules and follows them. It is incumbent on market players to understand and follow the rules and systems to ensure integrity and responsibility in market activities. We hear of rogue traders, fraudulent practices, and the selling of dubious products to innocent people. It is clear that there must be extensive discipline in the market to ensure that all participants are aware of these rules and that they follow these rules. If enough market participants follow these rules, it becomes harder for the others to go astray.

This is not just about rigidly following the rules, but like in *salat* or prayer, it is as much about understanding the principles and spirit behind those rules.

Zakat (Alms)

Contribution to community and society by way of giving *zakat*, or alms, is the third of the five pillars of Islam. *Zakat*, from Arabic, is translated to alms giving in English, or tithe. This is not to be confused with charity, or *sadaqa*, which is not an obligation in Islam. *zakat*, however, is obligatory. The giving of alms, from your own wealth, to benefit the growth of the community is analogous to a gardener pruning his plants to make them grow more healthily.

The concept of *zakat* is to ensure societal and individual virtues and it translates quite well into the modern-day business philosophy. No financial or commercial enterprise operates in isolation from its community. Hence, many firms now adopt stakeholder approaches and place emphasis on meeting their corporate social responsibilities. Incorporating the responsibility to the community is healthy in that it dilutes the preoccupation with excessive profits and lessens the motive of greed.

A firm that contributes to its community and that is aware of and concerned with its stakeholders will generate goodwill and inspire trust among its investors, employees, customers, and other stakeholders. This will build more confidence in the firm.

Sawm (Fasting)

Fasting is the fourth pillar of Islam. During the holy month of Ramadan, Muslims are supposed to abstain from the comforts of life from dawn until dusk. The idea is that both manners and moderation are founded in the mind with the Muslim developing a heightened conscience through the exercise of fasting. The awareness of what is needed as opposed to what is desired and what constitutes excess is borne of this fourth pillar of Islam.

In the recent financial crisis, I feel the fault lies not so much with innovation, but with the loss of the industry's moral compass. Investors who lost their life-savings are now distrustful of the financial services sector and they have every reason to be. Finance has come to be known for excesses and for inequities; this is surely not how this endeavour should be seen.

It is true that the concepts of financial engineering provide us with tools but it is ultimately human behavior, whether as individuals or collectively, that determines the outcome. Financial innovation must be guided by a strong code of ethics to be able to avoid the traps of excess, greed, and ego.

Hajj (Pilgrimage)

The final pillar of Islam is pilgrimage, or *hajj*. For Muslims, the *hajj* is a call for global brotherhood and unity. Once a year, Muslims from all over the world gather in Mecca to perform the *hajj*. Though the *hajj* is a prescribed duty, if the Muslim cannot afford to perform it, it is forgiven. Nonetheless, Muslims strive to make the pilgrimage at least once in their lifetime.

Several generations ago, the greatest challenge in performing the *hajj* was the journey itself. From Malaysia, the journey would take weeks by boat and not all pilgrims were sure about their safe return home. But the journey is only the first step. Once there, pilgrims from all over the world and from different backgrounds have a chance to meet as equals, learn from each other, join in the greater network of Muslims around the world, and in doing so fulfill their obligation.

The lessons of *hajj* show us that a greater awareness of our global brotherhood would make us feel more responsible to and for each other. This lesson is especially pertinent for today's financiers. The development of the awareness of global interdependence and the knowledge that they are responsible to prevent excesses that could tip the balance and damage the global financial world is now more important than ever before.

Islamic finance today

Today, finance is not delineated by the boundaries of a city or even a country. It is global and interconnected; each interwoven strand is dependent on the next. The fabric of global finance today is a tightly woven one and if even one of components is weak, the integrity of the system could be at risk.

The Islamic finance industry grew substantially and spread from the banking sector into the capital markets with the first offering of sukuk in 1990. It is now a truly global market, participating across borders with a vast range of investment alternatives including sukuk, mutual funds, commodity funds, ETFs, REITS, *takaful*, Shariah-compliant derivatives, and hedge funds. Market participants in the Islamic finance industry now include banks that have Islamic windows, Shariah compliant financial institutions, brokerages, fund managers, and *takaful* operators, and more established financial centers are vying to be global hubs for Islamic finance.

Recent developments have included the possibility of an Islamic bank in France, the publishing of a book on Islamic finance in Italian, Shariah-compliant real estate funds in Australia, and there is news of expected sukuk issuances from the UK, Australia, and Korea. Islamic finance is no longer limited to the Islamic world. The world is interested and I believe Islamic finance to be up to the challenge.

As the industry grows, it is more apparent that there is more demand by non-Muslim investors and issuers to play a role in the industry. Here in Malaysia, for instance, there is just as strong a demand for Shariah-compliant products among non-Muslims as there is among Muslims. Around the globe, there have been a diverse range of issuers of Shariah-compliant products, including the World Bank, the IFC, the German state of Anhalt-Saxony, Aston-Martin, and Shell, which pioneered the sukuk; and the list continues to grow.

While we have seen rapid growth in the industry so far, for it to continue to flourish, I foresee that industry participants will have to be unambiguous in defining their corporate strategies. They must share their risk management best practices and document plans and processes so that they may be used for studies evaluating the industry; such self-critical evaluation can only help.

This type of disclosure, transparency, and self critical evaluation will help establish accountability and help the Islamic finance industry and Islamic financial institutions stand apart from those of their conventional peers that have recently engaged in the type of business that led to the crisis.

One of the most important goals of the Islamic finance industry should be to integrate into the global financial system and one of the important goals of global finance should be to open doors to Islamic finance.

The values circle

We all must work together to rebuild the trust in finance. Finance requires trust; and we have established that. Trust is comprised of a set of universal elements like honesty, fairness, justice, and clarity, which can be found in all religions. By virtue of the Islamic finance industry being based on the principles of religion,

"...we must ensure that the investments we make and allow are sustainable, that they fuel real economic activity, and that the commitment of capital is met with an intention of creating real value in the economy and benefit for society."

these universal values are an integral component of its makeup. The guidance provided by these values is supposed to help in ensuring that responsibility is exercised when making decisions to do with the deployment of capital.

Going forward, we must ensure that the investments we make and allow are sustainable, that they fuel real economic activity, and that the commitment of capital is met with an intention of creating real value in the economy and benefit for society. These are intentions inherent in Islamic finance as it sticks to the prescription of a high moral standard and I believe, in this sense, Islamic finance plays a great role in today's financial landscape.

To date, Islamic finance has borrowed from conventional finance in terms of the products it offers, but I think the time has arrived where the flow of information and knowledge can and should flow the other way as well. As conventional finance has taught Islamic finance how to balance portfolios and manage funds, I believe Islamic finance can now return the favour by lending conventional finance its set of principles for good governance and responsibility.

Islamic finance can help the global finance industry to be more aware, to help it follow the rules, to help it curtail excesses, and to create the infrastructure of honesty, fairness, and integrity. But I believe Islamic finance can offer much more than this. At its heart, Islamic finance is an aspiration towards good finance; and as we have seen, good finance is about trust, and trust is a cornerstone of stability. Therefore, I believe that Islamic finance can help break the vicious cycle of boom and bust that has come to characterise global finance.

Concluding remarks

To conclude, I would like to leave you with some thoughts on Islamic economic ideas of societal justice, the distribution of resources, and individual responsibility.

Like their Western counterparts, Islamic thinkers have also made a distinction between needs and wants. Needs concern necessities. Wants, on the other hand, have to do with conveniences, refinements and luxuries. In Islamic thought, the distribution of resources is to provide justice in society. The necessities of life should be met first; next should come conveniences; then refinements. And only when there is an equitable distribution of resources in this way, can resources be spent on luxuries. And at all times, excesses should be avoided.

So, in Islamic economics, the distribution of resources has a very clear purpose, that is societal justice. By extension this applies to Islamic finance as well. The idea is that resources are ultimately not ours. They belong to God and are His blessings. Our responsibility for these resources, therefore, is paramount and we are fully accountable for how we use them.

This concept of stewardship does not exclude a person from rights of ownership. It is to promote the idea that future generations of our race depend on these same resources and that we should be responsible with them.

Justice, self-discipline, integrity, good morals and responsibility are core attributes of the Islamic faith and of all other faiths. And I believe they have good application in the markets and finance as well. While finance has faced turbulence recently, this period provides us with an opportunity to get together and plan for the future. Let us begin with the basics. Let us challenge ourselves to break the vicious cycle of mistrust and greed and give the world an alternative that they can put their trust in. Let us put faith back in finance.

Innovating for the Future: Challenges for Islamic Capital Markets[1]

Two decades ago, the Shell Group in Malaysia was looking for a more creative way to meet its funding needs for a large project, and approached the country's only Islamic financial institution then to explore possibilities. Islamic financing, based on the concept of participation and deferred payment sales, and predicated on profits rather than interest, was new to Shell then and indeed to the world. Little did they realise that what they were doing was breaking new ground in an instrument that would grow to become a significant global asset class over the next 20 years.

Since those pioneering days, Islamic finance is now viewed as part of the mainstream of global finance. This "mainstreaming" owes much, to the global development of the sukuk market. Malaysia's own experience serves to illustrate this well. The Shell sukuk described above was a milestone in many respects: it was the first sukuk to be issued in ringgit; it was the first ringgit sukuk to be issued by a multinational company; and importantly, it jump-started the Malaysian Islamic capital market.

Previously, Islamic finance in Malaysia had been synonymous with banking; the advent of sukuk brought Islamic finance firmly into the realm of capital markets, enabling users to more effectively manage balance-sheet risks, diversify investments, lower the cost of funding and maintain capital adequacy through financial practices that comply with Shariah. As a result, what Malaysia has today is truly Islamic finance, in the broadest sense of the word.

There is now a broader geographical spread of issuers, ranging from corporates to multilateral agencies to governments. A similar pattern has emerged among investors where, encouragingly, non-Muslim investors have typically taken up a large proportion of issues. Servicing these users are an increasing number of providers operating out of various global centres of expertise, including London, Kuala Lumpur and Dubai, and potentially Tokyo, Hong Kong, Paris and Singapore. And their activities are now being guided by a number of global regulatory frameworks driven by international bodies like the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

Importantly, these developments have come with a raft of innovation that has opened up possibilities, allowing a wide range of financial needs to be met in compliance with Shariah. Taking Malaysia as an example, sukuk has been instrumental in financing, among other things, major national infrastructure and utilities, including the North-South Expressway, which links all major cities on the west coast of Peninsular Malaysia, and virtually the whole of the country's mobile telecommunications network. Sukuk has also facilitated balance sheet management of companies and banks through the securitisation of properties and mortgages.

If innovation is generally thought as the successful introduction of something new and useful, then perhaps the most recent important innovation in Islamic finance is sukuk itself. Sukuk provides the flexibility of cash-flow financing structures with participation offered through equity; strengthens the link between investments and real assets; and addresses the ethical considerations underscored by Shariah.

But what has become apparent is that financial innovation, including that which relates to Shariah-based financiers, is now facing a series of challenges arising largely from the credit crunch and financial climate. Risk aversion, although down from levels experienced at the height of the crisis, remains significantly higher than in the past. Unsurprisingly, this has reduced the appetite for more innovative forms of finance. On the supply side, product development has taken a back seat while banks and other financial institutions continue to focus on asset quality. In the end, products themselves are undergoing much

[1] This article is based on the special keynote address delivered by the SC Chairman, Tan Sri Zarinah Anwar, at the 2009 London Sukuk Summit, in London, on 3 July 2009.

heavier scrutiny. In the Islamic finance industry, it is not just the more exotic varieties of instruments that are being reassessed; scholars have been casting a fresh eye on more common structures for compliance with Shariah principles. Regulatory changes over conventional instruments could also impact on Islamic markets.

Restoring faith in finance

Given these challenges, then, how much scope is there for future innovation in Islamic finance? While Shariah principles have been with us for nearly 1500 years, modern Shariah-based finance has been in existence for only four decades. It is still a young discipline and the demand from financial institutions, insurance companies and pension funds across the Muslim and non-Muslim world will continue to grow.

But recent financial crisis has clearly shown that in innovating for the future, Shariah-based finance needs to pay particular attention to the following three areas.

The first area concerns consumer interest. Users of financial products and services, whether conventional or Islamic, must be assured that the same regulatory principles apply to them. Malaysia emphasises a common regulatory approach for both Islamic and conventional products, based on the International Organization of Securities Commissions' (IOSCO) objectives and principles of regulation. An IOSCO task force chaired by the SC in 2004 took the view that Islamic capital market activities were consistent with the objectives and principles of IOSCO. A 2008 working group conducted a deeper study and reaffirmed this, albeit recognising the need for specific provisions in some areas to ensure conformity with Shariah principles.

The second area is acceptability. There must be a greater effort made to achieve clarity and consistency in pronouncing what is and what is not Shariah compliant. Otherwise, it may breed skepticism about Islamic finance and ultimately jeopardise the ability of Shariah-based financing to meet the real needs of the market. There is also a need to work more closely to foster greater harmonisation in our approaches. Therefore, it is a good sign that Shariah scholars from different jurisdictions have been interacting more closely with each other to deepen their understanding of respective pronouncements. Malaysia and other Muslim countries and international Islamic institutions, such as the IFSB and AAOIFI, have, and will continue to provide much needed platforms for regular high level intellectual discourse.

While there is an effort towards harmonisation in areas of mutual acceptance, there is also a need for an effective way of managing differences. A progressive and promising way forward is one that recognises these differences provided the supporting explanations and reasoning are made transparent. This will allow the richness of the Shariah to be fully explored for the benefit of the *ummah*. Arguably this is consistent with the disclosure-based approach to regulation which is premised on the important principle that issuers provide proper disclosure so that consumers are fully informed about the structures and the Shariah principles being adopted. Of course, there are undeniably issues concerning reporting and accounting, as well as disclosure and transparency that are still to be resolved.

In the case of financial reporting and accounting, although there is a call for a set of Islamic accounting standards to address unique aspects of Islamic finance, the view of Malaysia's national Shariah advisers is that generally-accepted accounting principles are not in conflict with Shariah. As for disclosure and transparency, this still differs significantly across jurisdictions and types of products. For instance, while Malaysia requires full disclosure over the use of proceeds from sukuk issuance, this is not a common practice. As Islamic finance becomes more global, more frequent and intensive dialogues and engagements would go a long way in meeting the needs of Islamic investors.

The third area relates to cost-competitiveness and efficiency. As key players in Islamic finance, quality, cost-competitiveness and efficiency are important aspects to be observed, to support the demand from consumers. The long-term growth of Islamic finance therefore depends on how to address the needs of business (and business-minded) people, on top of being a platform for meeting compliance with Shariah. In this regard, the two important factors that promote cost-competitiveness and efficiency are infrastructure and capacity.

Infrastructure

Innovation needs the support and involvement of governments and regulators in creating an enabling environment. Malaysia's growth has been driven by the government's strong commitment since the 1980s to building and sustaining a fully-fledged system of Islamic finance. This was then taken to the next level more recently through the establishment of the Malaysia International Islamic Financial Centre (MIFC). Through the provision of a facilitative legal, accounting and tax framework, Malaysia has tried to achieve a level playing field between conventional and Shariah-based finance, and give appropriate incentives to encourage the further development of the Islamic sector. The government has also actively revised and adapted policies and regulations to meet changes in the domestic and international environment. For instance, the breakthrough in Malaysia's sukuk market occurred when sukuk was decoupled from the conventional legal concept of debentures. This allowed the market to adopt a wider range of structures involving the element of equity participation.

Capacity

Innovation also requires more capacity. Given the kind of growth in the industry, there is clearly a shortage of people with the right mix and level of skills. The industry requires financiers with cutting-edge knowledge of both mainstream markets and Shariah principles. The prevailing business model typically splits this work between trained finance professionals, who run the business and make the institutional decisions related to investments and other financial matters; and Shariah scholars, who supervise to ensure Shariah compliance. The majority of scholars are, however, trained in Shariah where the emphasis on finance may have been limited, while the financial practitioners, even those who are knowledgeable about Shariah principles, do not have the authority to rule on religious edicts.

Therefore, ideally capacity-building programmes should target all groups involved in the value chain of Islamic finance. To enlarge the talent pool, fresh graduates, including Shariah graduates must be enticed into the market; existing Shariah scholars must be provided with greater exposure through training and attachment with industry; as well as participation and debate at international forums.

The regulators must understand Islamic products and structures even if the approach to regulation is one that is based solely on disclosure. The SC together with our training arm, the SIDC, have introduced a comprehensive range of bespoke programmes to address the training needs of the different groups namely the Islamic Capital Market Graduate Training Scheme for fresh graduates, regular product workshops for registered Shariah advisers and the annual Islamic Capital Markets Program for regulators and industry leaders. Additionally, the International Islamic Capital Market Forum provides Shariah scholars and market participants with an opportunity to learn about the latest products and structures in Islamic finance.

Innovating for the future

The above three areas; consumer interest, acceptability, and cost-competitiveness and efficiency are not mutually exclusive. Harmonisation of views, or at least clarity over the underlying justification of Shariah opinions, would promote the interest of consumers. At the same time, efforts at developing an enabling environment through the removal of legal uncertainty and other barriers would also contribute to wider acceptability of Shariah-based financial innovations. The requirement for higher standards of consumer protection would in turn demand a higher degree of professionalism and competency from industry players.

Ultimately, all this must feed into the innovative process and succeed in introducing something new and useful for the market. But where is innovation most lacking and needed? There are three focus areas that can be considered, which are:

First, risk management

Writing nearly 15 years before the recent credit crisis, John Kenneth Galbraith stated that

> *"All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy*

> *by real assets ... All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment."*[2]

In the case of Islamic financial innovation, however, there is no doubt that strict rules on transparency, leverage and risk-taking contributed to the relative stability of Islamic financial markets and institutions during the recent global credit turmoil. It is true that the sukuk market has seen some consolidation of late: after growing by around 48% a year in recent years, sukuk issuance fell by more than half in 2008. But difficulty in raising money was inevitable as the extensive nature of the financial crisis led investors to shun all forms of capital-raising.

What is more of a concern, however, is a lack of tools for hedging for Islamic financial institutions and consumers of Shariah-based finance which would run a disadvantage to conventional financing in being less able to mitigate natural risks inherent in financial transactions. Hedging tools have their merits, but like many other things, they can also be abused. Shariah-based hedging instruments can be acceptable so long as they are properly regulated, for instance, by having proper trading, clearing and settlement systems, so that transactions are done in a fair, orderly and transparent manner. Malaysia already has some Shariah-compliant hedging tools that work on the basis of real transactions or structured on real underlying assets. However, the country is continuing to develop a wider range of tools to meet market demand, including Shariah-compliant regulated short-selling. These may not be very sophisticated compared to some of the more complex derivatives available, but they certainly have the capability to hedge a number of Shariah-based transactions.

The second focus for future innovation needs to be on fund-raising. At present, Malaysia and the United Arab Emirates are said to account for three-quarters of global sukuk issuance, while in 2007, Saudi Arabia reportedly issued a fifth of the global sukuk. Large markets with predominantly Muslim populations remain largely untapped, especially in Asia. But, Shariah-based investors are not confined only to Muslims. So, the sukuk market remains a strong growth prospect.

However, while sukuk brought Islamic finance into the realm of capital markets, Islamic capital markets are not confined only to sukuk. Indeed, the equity market is an area where there are strong opportunities, enabling issuers to expand their potential funding pool through the Islamic equity market. In May 2009, Xingquan, a China-based company seeking to list on the Malaysian stock exchange, also applied for and received pre-IPO Shariah-compliant status for its shares. This will thus make the company eligible for inclusion in the investment portfolio of individual and institutional investors seeking Shariah-compliant investments.

Equities offer a wide scope for innovation. Instruments such as Shariah-compliant exchange-traded funds, real-estate investment trusts and structured products are attracting a strong interest. For instance, in Malaysia, there are good prospects for Shariah-compliant REITs, whereby recently a conventional REIT has converted from a conventional structure to be Shariah based.

A third area of innovation is investment. Shariah-compliant financing instruments have proven themselves to be commercially viable and effective in mobilising investment assets to finance productive economic activities. Asian and Middle Eastern economies have large surpluses; at the same time they require substantial investments to drive their growth. Clearly, there are opportunities for Islamic finance to strengthen its role in intermediating surplus savings into economic development.

Investment management products are therefore, a strong growth prospect. Despite Malaysia being home to more than 140 Islamic funds of great diversity, there is still much potential for developing Shariah-based investment management. In attempting to tap into this potential, Malaysia has completely liberalised the Islamic fund management industry.

con't page 14 ▶▶

[2] *A Short History of Financial Euphoria*. By J.K. Galbraith. Penguin (Non-Classics). 1994

Islamic Structured Products and Current Issues in Islamic Finance[1]

The plunge in financial markets and the disintegration of the finance industry in the US has caused considerable hardship to and undermined the confidence of investors. In many parts of the world, buyers of Lehman Brothers' structured products, for example, have had their investments destroyed, with victims claiming that they had not been made sufficiently aware of the underlying risks attached to such complex instruments.

While the packaging of basic instruments into structured products with specific investment goals and risk profiles has opened up to the general investing public, investment opportunities traditionally available to institutions and high networth individuals, these products also raise important investor protection concerns. As can be seen with the Lehman case, retail investors can be (and have been) subjected to significant losses as a result of being ill-informed about the often complicated payoff structures of such products. Poor sales practices resulting in the lack of transparency in the description of the risks and returns of such products is a significant source of investor protection concerns.

In general, what one could say about the global financial crisis is that 'exuberance had paved the way'. Aggressive financial innovation facilitated by excess liquidity had led to a crisis that has resulted in severe challenges to the financial system. But in the search for solutions, amidst the severe aversion to risk, it is still necessary to acknowledge that market participants must retain an enthusiastic approach towards new businesses. Enthusiasm, accompanied by responsibility and the ability to accept and usher in what is new and useful, can effect positive change.

There is therefore a need to look for, identify and take advantage of opportunities where they lie. In this regard, it is incumbent on the market players to recognise that there are investors who continue to explore opportunities during this trough, to continue to innovate and create new products and to position themselves appropriately for when market conditions improve and investor sentiments recover.

Islamic Finance

The lessons from the crisis though have served to emphasise the need to address the ethical considerations of finance as underscored by the Shariah with its strict rules on certainty, transparency, leverage and risk taking. For instance, the requirement on the part of someone selling something to help the buyer understand the product before purchasing is a critical principle especially when viewed in the context of the distribution of the Lehman structured products. The fact that there is emphasis on contracts and documenting of transactions is equally important. The prohibition on ambiguity in Shariah helps ensure the ability for specific performance of a contract.

Today, more than ever, the values underlying Islamic finance have great significance as a moral compass, and

> *"...In an effort to broaden and deepen the Islamic capital markets in Malaysia, a diverse range of Shariah-compliant securities, such as sukuk, Shariah-compliant funds, warrants, crude palm oil futures contracts, REITs and ETFs have been made available for investors."*

[1] This article is extracted from the opening address delivered by the SC Chairman, Tan Sri Zarinah Anwar, at the 3rd International Islamic Capital Market Forum, in Kuala Lumpur, on 30 July 2009.

as a new and legitimate way of approaching business. As we begin to realise the range of opportunities that can be harvested from the current crisis, it is apparent that the future for innovation in Islamic finance is promising. But as the crisis has shown, there is need for markets to be founded on sound business principles, and that the requirement for disclosure, transparency and governance is paramount. Users of financial products, whether conventional or Islamic, must be assured that sufficient safeguards exist to adequately care for consumer interest and investor protection.

In an effort to broaden and deepen the Islamic capital markets in Malaysia, a diverse range of Shariah-compliant securities, such as sukuk, Shariah-compliant funds, warrants, crude palm oil futures contracts, REITs and ETFs have been made available for investors. The list of these securities continues to grow. As structured products can comprise a range of these securities, it is expected that the growth of Islamic structured products to continue and the debate on surrounding issues to become more robust.

While structured investments have grown exponentially worldwide, both in size as well as in complexity, in Malaysia the market is still small. Since April 2006 until July 2009, the SC approved 42 structured products programmes, of which nine were Islamic programmes worth RM22.8 billion. But with the growth in the market and the increasing complexity of the nature of these products, risk management is particularly challenging, especially for the complex structured investments transactions, including concerns on general market stability risks due to concentration, as happened during this current crisis.

Using such innovative finance for credit transfers and enhanced risk management therefore requires all parties involved to observe the appropriate standards of conduct. Financial institutions need to invest in resources to develop and maintain robust internal control frameworks and risk management infrastructure that will enable to identify, assess and address the risks associated with these products.

At the regulator's level, this entails a dynamic and continuous process of assessing risks to ensure that controls at the firm level are commensurate with the level of risk being undertaken. It is important that regulators and industry continue to be vigilant to identify new risks and to ensure that appropriate risk management measures are in place. The principles underpinning Islamic finance can help bring focus and more clearly define roles, responsibilities, and motives.

from page 12 ▶▶

But markets and innovation cannot thrive in isolation. Right now, pools of Islamic liquidity remain fragmented and this makes it difficult to tap opportunities. What is needed is to build more links between Malaysian economies and markets to promote the growth of Islamic financial markets worldwide; connectivity is key. The mutual recognition agreement between the SC and the Dubai Financial Services Authority is one example of this. The sector needs more partnerships of this nature.

Conclusion

Innovation has been a hallmark of the development and growth of Shariah-based finance for at least over the last 20 years. But in the past 18 months, the global financial sector has had to face some of its biggest challenges in a very long time. There are some concerns that the impact of a shift away from financial innovation as a result of the crisis will do irreparable damage to the prospects for Shariah-based finance. However, this view is not necessarily true. Financial innovation will return, albeit in a slightly modified way and most likely for the better.

With more attention given to consumer interest, acceptability, and cost-competitiveness, the Islamic capital markets will be in a strong position to benefit from the global recovery and meet the demands for risk management, investment and fund-raising.

News Round-up

Inaugural Islamic Capital Market Graduate Training Scheme

The SC and the SIDC have jointly developed and introduced the Islamic Capital Market Graduate Training Scheme (ICMGTS). The inaugural ICMGTS commenced on 1 July 2009, and the first batch consisted of 37 graduates. This seven-week programme applies a variety of teaching methodologies comprising lectures, illustrative examples, case studies, simulation and interaction to help equip the graduates with the necessary technical knowledge and skills to enter the industry. After graduation, the students will be placed in the industry for 11 months.

The ICMGTS is designed to create a pool of human capital to facilitate the development of ICM in Malaysia. It is intended to provide an avenue for graduates to acquire the right skill set and a basic knowledge of ICM by providing a comprehensive overview of ICM. To ensure the success of this key objective, emphasis is placed on producing forward thinking professionals with sound technical knowledge and good communication skills.

Islamic Capital Market Book Series

The SC has published a series of books on Islamic capital market that will form the basic module for the ICMGTS. The series was launched by the Chairman in conjunction with the 3rd International Islamic Capital Market Forum on 30 July 2009.

Written by industry experts and scholars, the series comprising six books, is aimed at providing an understanding of the basic concepts, features and philosophy of Islamic finance. It also explores the regulatory issues, legal and accounting frameworks of Islamic finance, as well as the fundamentals and governing principles of Islamic commercial law. In addition, it discusses the distinctive features and structures of Islamic equities and sukuk. The books are available at SIDC bookstore and major bookstores. Order can also be placed through LexisNexis at 03-7882 3500.

Malaysia-UK Islamic Finance Forum

On 8 July 2009, the Malaysia-UK Islamic Finance Forum was held in Kuala Lumpur. The half-day forum was organised by Commonwealth Business Council in partnership with the Malaysia International Islamic Financial Centre, UK Trade and Investment, The City of London and International Financial Services London.

During the event, the SC Managing Director, Dato Dr Nik Ramlah Mahmood moderated a session on Education, Training and Qualifications. Meanwhile, the SC Executive Director, Goh Ching Yin, represented SC as a panelist in a session entitled, "Opportunities in Islamic Finance in Malaysia and the UK".

3rd International Islamic Capital Market Forum

The SC hosted the 3rd International Islamic Capital Market Forum (IICMF) on 30 July 2009 themed, "Islamic Structured Products and Current Issues in Islamic Finance". The forum addressed the landscape and current views on Shariah-compliant structured products and hedging tools, an examination of the building blocks in constructing these products, the approach and philosophies in regulating the Islamic capital market in Malaysia and case studies.

More than 250 participants comprising industry players, Shariah advisers, regulators and academicians attended the forum. Renowned speakers consisting of practitioners and Shariah scholars from both local and international markets shared their thoughts and experiences in this forum.

Visiting Scholar Programme

The second Visiting Scholar Programme, a collaboration between the SC and Universiti Malaya (UM), commenced on 24 September with Dr Abbas Mirakhor, the former Executive Director of International Monetary Fund (IMF), invited as the visiting scholar. He delivered a public lecture on 29 September at the SC, entitled "Strengthening the Islamic financial system: lessons from the crisis", and participated in other events during his three week stint in Malaysia. He was also attached to the UM, where he delivered talks, assisted in academic research and provided consultation on dissertations and thesis by postgraduate students.

IFN 2009 Issuers and Investors Asia Forum

The IFN 2009 Issuers and Investors Asia Forum (formerly known as the MIF Forum) was held from 3–5 August 2009 in Kuala Lumpur. Similar to the last three forums, the industry's elite was invited to provide insightful, explorative and thoughtful discussion on the topical areas in Islamic finance. Dato Dr Nik Ramlah Mahmood moderated one of the sessions at the forum.

World Capital Markets Symposium

The SC hosted the inaugural World Capital Markets Symposium from 10–11 August 2009 in Kuala Lumpur. The Prime Minister of Malaysia, Dato' Sri Mohd Najib Tun Abdul Razak delivered a keynote address on the first day of the Symposium. The Crown Prince of Perak, His Royal Highness Raja Dr Nazrin Shah, who is also the Financial Ambassador to the MIFC, delivered the second keynote address on the final day.

The symposium brought together influential opinion leaders, policy makers and market players to discuss contemporary challenges and trends in the capital market. At the symposium, renowned international Islamic capital market practitioners and Shariah scholars were also invited to provide insightful discussion on several contemporary issues in an interactive session entitled "Islamic finance in the changing global landscape".

4th IFSB Seminar

The Islamic Financial Services Board (IFSB) organised its 4th IFSB Seminar on Legal Issues in the Islamic Financial Services Industry from 28–29 September in Kuala Lumpur. The seminar brought together expert contributions from regulators, legal practitioners and consultants on pertinent issues and challenges faced in enhancing the legal framework of the evolving Islamic financial services industry. Dato Dr Nik Ramlah Mahmood represented the SC as a panelist in a session entitled, "Shariah and legal issues in Islamic structured products".

Malaysia ICM – Facts and Figures

Shariah-compliant securities on Bursa Malaysia

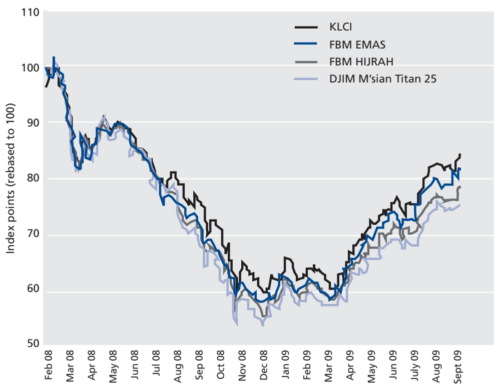
Number of Shariah-compliant securities – May 2009+	848
% to total listed securities	88%
Latest market capitalisation – September 2009	**(RM billion)**
Shariah-compliant	573.92
Total market	910.52
% of Shariah-compliant securities to total market	63%

Equity market indices	28 Aug 09	30 Sep 09	% change
KL Composite Index (KLCI)	1,174.27	1,202.08	2.37%
FBM EMAS Shariah	8,198.55	8,271.22	0.89%
FBM Hijrah Shariah	8,868.79	8,989.70	1.37%
DJIM Malaysia Titans 25	716.96	723.56	0.92%

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

Chart 1

Performance of KLCI vs Shariah Indices



Shariah-based unit trust funds

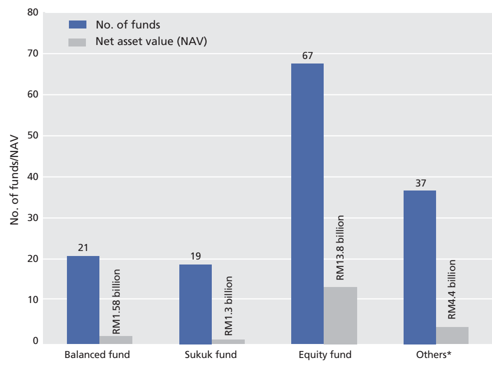
Number of approved funds	Dec 2008	Sep 2009
Shariah-based	149	144
Total industry	579	559
Net asset value (NAV) of approved funds	**Dec 2008**	**Sep 2009**
Shariah-based (RM billion)	17.19	21.18
Total industry (RM billion)	134.40	187.39
% to total industry	12.8%	11.3%

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

Note: Effective January 2009, wholesale funds was excluded from the above statistics

Chart 2

Shariah-based unit trust funds by category



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

Islamic exchange-traded funds (ETF)

Number of approved ETF	Dec 2008	Sep 2009
Shariah-based	1	1
Total industry+	3	3
Net asset value (NAV) of approved funds	**Dec 2008**	**Sep 2009**
Shariah-based (RM million)	482.73	638
Total industry+ (RM million)	1,022.91	1,156
% to total industry	47.2%	55%

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)

Number of REITs	Dec 2008	Sep 2009
Islamic REIT	2	3
Total REITs	13	13
Market capitalisation	**Dec 2008**	**Sep 2009**
Islamic REIT (RM million)	1,241.04	1,748.65
Total REITs (RM million)	4,070.02	5,199.96
% total industry	30.5%	33.6%

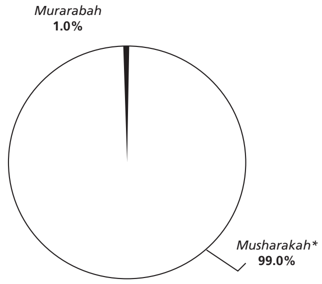
Corporate sukuk

Sukuk approved	**2008**	**Q1 2009**	**Q2 2009**	**Q3 2009**
Number of sukuk	47	4	5	1
Size of sukuk (RM billion)	43.23	3.6	10.9	4.5
Size of total bonds approved (RM billion)	139.99	10.6	22.9	7.03
% of size of sukuk to total bonds approved	30.9%	34.0%	47.4%	64%
Sukuk issued+	**2008**	**Q1 2009**	**Q2 2009**	**Q3 2009**
Size of sukuk issued (RM billion)	20.8	6.6	10.3	9.2
% of sukuk issued to total bonds issued	43.7%	62.6%	52.0%	63.9
Sukuk Outstanding	**2008**	**Mar 2009**	**Jun 2009**	**Sep 2009**
Size of outstanding sukuk (RM billion)	152.8	161.29	167.8	168
% of outstanding sukuk to total outstanding bonds	57%	57.5%	58.2%	57.7%

+ Includes the approval combination issuances (conventional bonds and sukuk).

Chart 3

Sukuk approved based on various Shariah-principle asset funds



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

RM-denominated Sukuk approved by the SC in Q1 – Q3 2009

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

* 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:

Mohd Radzuan A Tajuddin (Head of Department)
Tel: 03–6204 8000 ext 8718
E-mail: Radzuan@seccom.com.my

Badlishah Bashah
Tel: 03–6204 8000 ext 8373
E-mail: badlisha@seccom.com.my

Zainol Ali
Tel: 03–6204 8000 ext 8666
E-mail: zainol@seccom.com.my

Azmaniza Bidin
Tel: 03–6204 8000 ext 8280
E-mail: azmaniza@seccom.com.my

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