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Contents

Epistemology in Islamic Finance

The rapid expansion of Islamic finance in recent years has resulted in all sides of the industry being increasingly exposed and dissected by the media, journals and an array of publications. We also witnessed how the pronouncements made by Shariah bodies attracted media attention and received wide coverage. In addition, various issues and challenges facing Islamic finance have invited incessant debates and deliberations among regulators, practitioners (in both conventional and Islamic finance), Shariah scholars, academicians, economists, lawyers, accountants and rating agencies. All these have created confusion in the Islamic finance industry.

Islam is universal and compartmentalising Muslims as conservative, liberal, extremist is indeed doing injustice to Islam. Instead, in trying to understand various viewpoints on Islamic finance, this article first delves into the proponents of Islamic finance, namely the idealists, reformists and realists, with the intention of giving readers an understanding of the diverse thinking which exist in Islamic finance. It then moves into the birth of the first modern Islamic bank and thereafter, the approaches available in implementing an Islamic financial system.

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Leverage Through Debt from a Shariah Perspective

Leverage has a vast definition and application across a different spectrum of groups and subjects. In the context of corporate finance, leverage refers to the use of debt as a supplement to an owner's own capital, when making investments. The principal objective of leverage is to receive a higher return in investment through reducing the capital outlay. This is done through–

- secured/unsecured loan;
- margin account; and
- leverage as a collateral.

Leverage enables an investor with minimal capital to be exposed to a larger investment.

Traditionally, leverage is prevalent when taking loans for capital expenditure, leasing etc. More sophisticated leverage comes in the form of derivatives.

As a simple illustration, we assume that ABC Company plans to purchase a RM1 million factory. The company is only required to pay RM100,000 or 10% from the value of the factory and the balance of RM900,000 or 90% will be financed by the bank. From this example, the leverage ratio used by ABC Company is 10:1 which means that for every RM10 investment, the capital required is RM1 and another RM9 is loan. In other words, through leverage strategy, the company is able to procure the factory worth RM1 million with a smaller outlay of RM100,000.

This article does not discuss the application of leverage in detail. It focuses on the permissibility of a loan or a debt in leverage from an Islamic perspective because leverage usually involves a loan or debt.

Issue 1: Loan

Leverage through conventional loans has the element of interest (*riba*) that is prohibited by Shariah. From the Islamic perspective, an interest-based loan is classified as *riba al-qurud* and is explicitly against Shariah. This is based on a maxim which states:

كل قرض جر نفعا فهو ربا

Meaning: Each loan that bears benefits to the loan provider, is *riba*.

This is strengthened by the opinion of Ibn Qudamah which states that:

كل قرض شرط فيه أن يزيده فهو حرام بغير خلاف

Meaning: Each loan that requires an additional payment is prohibited without any *khilaf*.[1]

However, if the leverage does not involve the element of *riba* but based on Islamic financing, then it is permitted by Shariah.

Issue 2: The extent of permissibility of debt in Islam

A question may arise: if someone takes a loan and uses that loan as a collateral for taking another loan, to what extent can he, as a debtor, pay the debt? For example, a fund manager buys a number of shares of a company through loans. Later on, these shares are used as collaterals for other loans to buy more shares of other companies. The situation continues when the manager makes another loan to fund more investments. This means that there are elements of excessive loans or debt, resulting in a large exposure of debt.

In the above situation, the risk of excessive use of leverage may cause the fund manager to be exposed

[1] *Khilaf* is differences of opinion among scholars.

to liquidity risk as he may face the inability to repay the short-term loans when they fall due while on the other hand the investment is not in-the-money yet. Thus, from a Shariah perspective, to mitigate liquidity risks from excessive leveraging, it is necessary to measure the extent of permissibility of debt in Islam.

In Islam, payment of debt is something deemed material and the obligation is carried to his grave. In one of the *hadith*, the Prophet Muhammad SAW stated that "all sins of *shahid* (martyr) are forgiven except debt." This clearly shows that the settlement of debt is a heavy responsibility placed on every Muslim even if he dies a *shahid* (martyr).

However, Islam does not forbid debt outright. Instead, it is permissible if the need for it arises. In order to ensure the debt is properly managed, the debt needs to be recorded accordingly. This is supported by the following Quranic verse:

يأيها الذين ءامنوا إذا تداينتم بدين إلى أجل
مسمى فاكتبوه وليكتب بينكم كاتب بالعدل...

> Meaning: O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you…[2]

Furthermore, the debt is allowed as long as it does not burden the debtor or creditor. This is consistent with a maxim which states that:

لا ضرر ولا ضرار

> Meaning: No harm and should not cause harm to others (in Islam)

Based on this maxim, as long as the debtor can pay the debt and does not cause harm to himself or the creditor, then the debtor may proceed with the transaction, but it must be free from any element that contradicts with the Shariah, such as interest, etc. Therefore, the use of excessive leverage is not recommended. This is because it can result in the increasing amount of debt and expose the debtor to the risk of not being able to repay the debt. This situation can lead to a situation in which the parties may be declared bankrupt.

It was a consensus among the scholars that restrictions (الحجر) should be imposed on the bankrupt, barring him from being involved in any financial transactions on his property, so that the creditor's right and property is protected. This shows that the application of leverage by the fund manager needs to be scrutinised to ensure that excessive exposure to the debt can be minimised. This is to prevent bankruptcy from a failure to pay the debt in the event of a severe market decline.

Although debt is a necessity for some individuals and institutions, increasing debt without reasonable cause is not to be encouraged. Thus, there should be a limit in debt even if it is allowed by Islam.

Leverages involving loans or debts are also allowed as long as they not contradict with Shariah. The extent or degree of leverage is constantly and continuously being debated by contemporary scholars. It must be managed in a prudent manner so that the use of excessive leverage can be minimised. This is to prevent investors from being exposed to the risk of loss and the inability to settle the loans or debts during market turmoil.

2 Surah *al-Baqarah*: Verse 282.

Inaugural SC-OCIS Roundtable and Forum

The SC and the Oxford Centre for Islamic Studies (OCIS) joined hands in creating an international platform for debate, dialogue and study on contemporary issues and challenges faced in bringing Islamic finance into the mainstream. The inaugural collaboration between the SC and OCIS – well-known for its research and academic excellence – helped further facilitate intellectual discourse among Islamic finance experts, Shariah advisers and scholars from around the world.

Towards this end, both sides jointly hosted a high-level roundtable and a public forum on 15 and 16 March respectively to discuss the way forward for Islamic finance following the global financial crisis. The topic of the roundtable was "Developing a Scientific Methodology on Shariah Governance for Positioning Islamic Finance Globally". The participants comprised renowned Shariah scholars, practitioners and academicians. During the roundtable, two research papers were deliberated namely, "Governance Standards and Protocols on Shariah Decision Making Process" and "Facilitating Origination instead of Adaptation: Shariah-based vis-à-vis Shariah-compliant" by Dr Mohamed Ali El Gari, Professor of Islamic Economics, King Abdul Aziz University, Jeddah and Dr Abbas Mirakhor, First Holder, INCEIF Chair of Islamic Finance respectively.

Meanwhile, the public forum carried the theme, "Contribution of Islamic Finance Post Global Financial Crisis". Prominent Islamic finance experts from both local and abroad were invited to speak at the forum and it attracted some 300 industry practitioners, regulators and scholars. His Royal Highness Raja Dr Nazrin Shah, the Financial Ambassador to the Malaysia International Islamic Financial Centre (MIFC), delivered his keynote address at both events.

SC-OCIS Roundtable


SC-OCIS Forum

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Idealists

In the context of Islamic finance, the idealists strictly follow the primary sources of Shariah (Quran and *sunnah*), as well as secondary sources (*ijma'* and *qiyas*). They believe that any application or interpretation should be strictly based on the aims and objectives that are set by Allah and laid out in Shariah. These aims relate to both the worldly life and the hereafter – to live and interact only for worldly benefits is prohibited and condemned. Idealists propagate the idea of an attainable model for society, where the embodiment of *akhlak* (morality) makes all the difference in the world. Their stand is that improper means do not justify a noble end, there being, the application of *maslahah* (public interest), *istihsan* (preference) and *'urf* (customs) is treated with caution, not wanting to fall into *hilah* (diversion). A case of this would be certain Islamic finance structures which they deem as being *riba'*. Although many idealists like Shariah scholars do keep matters (pertaining to the industry) in check by giving their Shariah perspectives, those (idealists) who do not have a strong grasp of economics or finance are unfortunately unable to guide or suggest viable alternatives that meet the needs of society since society itself seeks different objectives. Notwithstanding, proclamations by idealists do have a bearing on the industry and could cause the players to cease from using certain Islamic platforms or structures. Idealists propagate a closed Islamic finance architecture that is bound by stringent *ahkam* (rules).

The success of the bank which mobilised the savings of small investors was notable. Concurrently, problems of rural debt were reduced, with borrowers no longer having to depend on cut-throat money-lenders.

Realists

Realists are those who propagate an open architecture, reflecting their acceptance of conventional structures. Given that Islamic finance is still at a nascent stage, realists view that it has to operate in a system that is akin to the conventional financial system to render its benefits to society. Realists view that each new undertaking brings it closer to understanding what is best for Islamic finance. For this reason, realists tolerate credit, debt and leverage,[1] which are the basis of the present day banking system.

Reformists

Reformists believe that gradual changes in Islamic finance can ultimately change society's fundamental economic relations. They offer a new paradigm to what is the normal practice in looking for new economic alternatives within the boundaries of Shariah. Reformists propagate a new finance architecture that is based on equity whereas debt is mostly confined to the likes of trade. Many of the prime movers in Islamic finance are reformists.

Modern Islamic finance

Now let us go back to the birth of the modern Islamic bank to understand the evolution of Islamic finance – the establishment of the Mit Ghamr Local

[1] It would be impossible for an Islamic bank operating on 100% equity capital to compete on cost structure and capital when conventional banks are able to leverage on taking deposits and benefitting from deposit-taking insurance scheme.

Saving Banks in 1963. Mit Ghamr closely resembled the ideals of Islam as it neither replicated many of the conventional banking offerings nor did it operate along the then rudimentary conventional banking framework. The bank's founder, the late Dr Ahmad El Naggar reformed interest-based banking by offering deposit accounts, loan accounts, equity participation, direct investment, and social services, which were based on Shariah.

The success of the bank which mobilised the savings of small investors was notable. Concurrently, problems of rural debt were reduced, with borrowers no longer having to depend on cut-throat money-lenders. Consequently, the bank helped to improve the standard of living of many in its areas of operation, by attracting the support of a large number of farmers and villagers who regarded the bank as their own.

Unfortunately, secular political groups that viewed Islam movements with suspicion placed Mit Ghamr under the direct control of the state administration, causing the bank to change its operations on interest basis. Even though Mit Ghamr ceased to be an Islamic institution, the bank's success was a watermark for the development of modern Islamic finance. This implies that Shariah (*fiqh muamalat*) is relevant to present day economic issues.

The first initiative (under the second approach) in the development of the Islamic finance industry was by introducing products that met the needs of society and at the same time comply with Shariah.

The Mit Ghamr was a pioneering example for the formation of the Islamic Development Bank, and further stimulated the establishment of Islamic banks in several other countries including Dubai, Kuwait, Iran, Sudan and Pakistan. Malaysia opted to run an Islamic banking system parallel to its existing conventional system, based on an open architecture. Products developed were modelled after conventional products and incorporated Shariah principles. This approach propelled Malaysia into a developed Islamic financial centre with a wide array of product offerings.

Implementing an Islamic financial system

From the perspective of economics and finance, society has been accustomed to conventional banking practices, which has been in existence for over 700 years. Given that this practice has been part of our lives, it becomes a challenge to introduce any new alternatives.

There are two ways to implement Islamic finance. The first approach is to impose strict codes of conduct regardless of the circumstances and create the building blocks for an Islamic financial system as a prerequisite for the development of "true" Islamic financial products. Clearly, such a system would take a very long time to materialise. Also one standard cannot fit all when some jurisdictions may be far behind in its financial infrastructure. In the mean time, it would appear that Islamic financial institutions should not engage in the likes of *tawarruq* and are left with no choice but to use *qardh hassan*[2] (benevolent loan). Certainly, no banks driven by commercial goals would want to take that path.

[2] Majma Fiqh proclaimed the non-permissibility of organised and reversed tawarruq, whether done explicitly or implicitly or based on common practice. Instead *Majma Fiqh* espoused Islamic banks to use qardh hassan (benevolent loan) to loan to those desirous of cash.

The second approach is to implement Islamic finance progressively. As an analogy, we shall look at the prohibition of *al khamr* (liquor) onto the subjects of Allah swt, which took place in stages rather than instantaneously.

Initially, *al khamr* was declared to have more bad than good.[3] When Sayyidina Ali became the imam for prayers albeit in a drunken state[4] and recited Surah *al-Kafirun* incorrectly (having the opposite meanings), Allah SWT merely warned His subjects against consuming liquor before performing *solat*. Only when there was anarchy in Medina resulting from the consumption of *al khamr* did Allah totally prohibit it[5] alongside gambling.

Why did it take three verses before decreeing *al khamr* as haram? *Wallahu a'lam*. We can deduce that it would have been hard for the subjects of Allah to instantaneously abstain from consuming *al khamr*. *Al khamr* had been customary for Arabs, thus its prohibition had been done in progression to enable His subjects to learn, observe and realise its evils.

The first initiative (under the second approach) in the development of the Islamic finance industry was by introducing products that met the needs of society and at the same time comply with Shariah. The means to achieve the objective is by replicating existing conventional products. The replication of products is necessary, otherwise creating products that are devoid of meeting any legal or tax requirements could open them to legal disputes, risk, tax and accounting issues. In this respect, Islamic finance products can exist within the realms of a conventional financial system, and with further improved structures over time.

Expanding this further, "true" *musharakah* and *mudharabah* financial instruments would never survive in the conventional financial system as no banks would subscribe to a non-capital protected structure as part of its liquid portfolio, not to mention the higher capital charge required under Basel standards. Realising this, Islamic finance practitioners have crafted sukuk with debt-like features to enable it to meet the regulatory requirements. Until such time when an ideal Islamic financial system exists, we will have to live in this state of evolution.

In an ideal state where Islamic finance has been provided with the right kind of attention, it is so efficient and has a great chance of surviving even if it exists in a conventional environment. This is like uprooting a plant from its original environment and transplanting it into an inhospitable environment. There is a high chance for the plant to survive if it is given all the attention it deserves. If the rules that exist within the Islamic financial system do not exist in the new (conventional) system, what needs to be done is to ensure that the latter will not contaminate the Islamic financial system. Continuous attention in terms of regulation and supervision must be given for the Islamic financial system to sustain within the conventional environment.[6]

What has worked so far is the open financial architecture promoted by the realists and reformists but even some of these are not free from controversies. The idealists will certainly continue to have a bigger role to play in putting new Islamic products and structures into check as more sophisticated conventional financial institutions taking up Islamic finance will further hasten development of new Islamic finance products.

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[3] Surah *al-Baqarah*: 219.

[4] Surah *al-Nisa*: 43.

[5] Surah *al-Maidah*: 91–92.

[6] Extracted from the closed-door lecture by Dr Abbas Mirakhor during his engagement and the SC-University of Malaya Visiting Scholar Programme in September 2009.

Year in Review: 2009[1]

Malaysia continues to strengthen its position as the largest and most comprehensive Islamic capital market through continuous innovation to enhance its value proposition.

Launch of Bursa Suq Al-Sila'

Malaysia's position as a centre of innovation was reinforced with the launch of the world's first Shariah-based commodity trading platform, Bursa Suq Al-Sila' on 17 August. This was a collaborative effort of the SC, BNM and Bursa Malaysia; supported by Malaysian Palm Oil Board, Malaysian Palm Oil Association and Malaysian Palm Oil Council. The electronic multi-currency trading platform enables Shariah-based financing and liquidity management based on the principles of *murabahah*, *tawarruq* and *musawwamah*. The trading platform is operated by Bursa Malaysia Islamic Services Sdn Bhd. The initial underlying commodity is crude palm oil and it is intended that the range of commodities will be subsequently expanded in the future.

Achieving new heights in the sukuk market

The fall-out from the global financial crisis dampened domestic sukuk issuance activities with sukuk proposals approved by the SC declining to RM34 billion in 2009 from RM43 billion in the previous year. Nonetheless, Malaysia continued to make significant strides in promoting its sukuk market. Within a year of introducing its facilitative listing framework for sukuk, Bursa Malaysia overtook other international stock exchanges to emerge as the exchange with the highest value of sukuk listings. As at the end of 2009, Bursa Malaysia had 12 sukuk listings with a value of RM60.1 billion (US$17.6 billion).

Petroliam Nasional Bhd (Petronas) and Cagamas MBS Bhd (Cagamas MBS) were the first to list their sukuk in August. Petronas, via its special purpose vehicle (SPV), listed its maiden US$1.5 billion foreign currency global EMAS Sukuk based on *ijarah* and conventional bonds amounting to US$3 billion on Bursa Malaysia, Labuan International Financial Exchange (LFX) and Luxembourg Stock Exchange with maturity periods of five and ten years respectively.

Cagamas MBS listed its RM4 billion sukuk based on *musharakah* and RM6 billion bonds issued under its five residential mortgage-backed securitisation transactions (RMBS) with tenures of between three and 20 years.

In 2009, we also witnessed the inaugural foreign listing of US$500 million sukuk issued by GE Capital based on *ijarah*. In the domestic sukuk market, notable exercises included the approval of up to RM20 billion issuance, comprising an Islamic medium-term notes programme and Islamic commercial papers programme by Pengurusan Air SPV Bhd. The company is a wholly-owned subsidiary of Pengurusan Aset Air Bhd to finance the acquisition of water assets in Peninsular Malaysia and Labuan.

To sustain the tax competitiveness of Malaysia's ICM, the government extended the tax deductions on sukuk issuance expenses. In addition, the government established a financial guarantee institution to provide credit enhancements for sukuk[2] which would increase the creditworthiness of Malaysian sukuk and reduce the time required to place new issues. In tandem with this, the SC introduced several measures to further reduce time to market and

Selected sukuk approval in 2009

Issuer	Shariah principle	Amount (billion)
Pengurusan Air SPV Bhd	*Ijarah, Musharakah*	RM20.0
Petronas	*Ijarah*	US$1.5
Sime Darby	*Musharakah*	RM4.5
Cagamas MBS	*Musharakah*	RM4.0
CIMB Islamic Bank Berhad	*Musharakah*	RM2.0

[1] This article is extracted from the *Securities Commission Malaysia Annual Report 2009*.
[2] Also applicable to conventional bonds.

transaction costs, such as facilitating revisions to approved terms of sukuk.[3]

Islamic fund management hub

The attractiveness of Malaysia as a hub for Islamic fund management was reaffirmed with the granting of seven new licences for Islamic fund management companies.

Malaysia also inked another mutual recognition agreement (MRA) for cross-border distribution of Islamic fund products. The SC and the Securities and Futures Commission of Hong Kong (SFC) signed an MRA to facilitate capital market intermediaries to distribute their Islamic fund products in both countries with minimal regulatory intervention. Both regulators also agreed to collaborate in capacity-building and information-sharing for the development of Islamic collective investment scheme regulatory frameworks.

Shariah Advisory Council

The Shariah Advisory Council (SAC) continues to enhance its reputation as a scholarly reference centre for Shariah ICM-related issues. Throughout 2009, 15 meetings were held to deliberate various issues with several key resolutions as presented in the table below.

Expansion of the regulatory and tax framework

The SC further strengthened the Shariah regulatory and governance framework to provide more clarity on Shariah compliance and to offer greater flexibilities as follows:

- *Registration of Shariah Advisers Guidelines* – The registration process was streamlined so that Shariah advisers can provide advice on a broad range of Shariah-based products and services regulated by the SC.

- *Guidelines on Wholesale Funds* – The guidelines gave effect to the requirement for fund managers managing wholesale Islamic funds to comply with the *Guidelines on Islamic Fund Management* and the resolutions of the SAC.

The government, in Budget 2010, outlined several measures to ensure the rapid development of ICM by extending the following incentives to 2015:

- Stamp duty exemption of 20% on Islamic financing instruments;

- Double deduction on expenditure incurred in promoting Malaysia as international Islamic financial centre;

Key resolutions by the SAC in 2009

Naming of sukuk involving the application of multiple Shariah principles	The SAC agreed that the sukuk should be named according to issuer's name or as sukuk *istithmar*, where appropriate, in cases where multiple Shariah principles are involved/applied in a sukuk structure. This is to avoid confusion and potential elements of misleading information to investors.
Using *wakalah* principle in structuring sukuk	The SAC resolved that the Shariah principle of *wakalah* can be used in structuring sukuk in Malaysia and agreed to the issuance of sukuk *wakalah bi al-istithmar*.
Structuring sukuk *murabahah* based on combination of fixed and floating rate	The SAC agreed to the structure of sukuk *murabahah* based on combinations of fixed and floating rates subject to conditions.
Islamic structured warrant	The SAC resolved that only collateralised structured warrant is permissible. In cases where the reference underlying assets comprise Shariah compliant index/indices, the underlying components of the index/indices must have features of deliverability prior to any cash settlement.

[3] The SC would previously evaluate the rationale for amendments/revisions, the impact on credit rating and the basis of other disclosures.

- Deduction on expenditure incurred on the establishment of Islamic stockbroking companies; and

- Deduction on expenditure incurred on issuance of Islamic securities approved by the SC.

Strengthen international collaboration and building capacity

The SC intensified its efforts to strengthen international discussion and collaboration among Shariah scholars to promote the growth of the global ICM. Several high profile conferences and various capacity-building programmes were undertaken to deepen knowledge and develop the talent pool for the ICM.

- The Visiting Scholar Programme under the auspices of the SC and University of Malaya (UM) brought in eminent international scholars to be attached with the UM. In 2009, Professor Mervyn Lewis from University of South Australia and Dr Abbas Mirakhor, the former Executive Director of the International Monetary Fund (IMF), participated in the SC programmes and lectures, assisted in academic research, and provided consultation on dissertations and theses of postgraduate students.

- The 4th Islamic Markets Programme (IMP) is an SC flagship training programme and was themed "Seizing Opportunities While Strengthening Resilience". The programme enhanced Malaysia's reputation as an Islamic financial centre of educational excellence imparting knowledge in key areas, such as corporate governance, securitisation, risk management and transaction processes to promote sustainable growth for ICM.

- The 3rd International Islamic Capital Market Forum on "Islamic Structured Products and Current Issues in Islamic Finance" addressed current views on the landscape, regulatory approaches and philosophies and reviewed case studies.

- The inaugural seven-week Islamic Capital Market Graduate Training Scheme (ICMGTS) was jointly developed by the SC and the SIDC to provide an avenue for graduates to acquire the necessary skills and knowledge of ICM to enter the industry. Participants were placed with the industry for 11 months to gain practical experience.

- Three series of Expert Talks were held to educate the industry on various specialised topics, namely, Islamic venture capital, the Bursa commodity house and the role of trustees in sukuk structuring.

- A Shariah Advisers Workshop on "Islamic Alternative Strategy Funds" was organised to enhance Shariah advisers' knowledge on Shariah issues in alternative investment strategies.

Efforts were also channelled towards providing authoritative sources of information and references on Islamic market practices, conventions and processes. These publications, produced for the benefit of a broad range of stakeholders, included:

- *Malaysian ICM* quarterly bulletin – 14 issues have been published by the SC since its first publication in 2006.

- *Islamic capital market* book series – the book series form the basic modules for the ICMGTS and aims at providing an understanding of basic concepts and the philosophy of Islamic finance. It explores regulatory issues, legal and accounting frameworks and the governing principles of Islamic commercial law.

- *Sukuk* is the first volume of another *Islamic Capital Market Series* by the SC. The book is a contribution of articles written by professionals in the Islamic finance industry as well as Shariah scholars and legal practitioners, both internationally and locally. The book attempts to give readers a clear understanding and guidance on *fiqh*, its practical workings from both the perspective of instruments and players including the various structures and features, insights of legal and ratings experts and the outlook for sukuk in the global context.

- *Malaysian Debt Securities and Sukuk Market – A Guide for Issuers and Investors.* The SC worked together with BNM to jointly publish a comprehensive guidebook on the Malaysian debt securities and sukuk market. A soft copy is available on the SC website.

Progress of Islamic Finance and the Way Forward[1]

Knowledge of economics and finance has strong roots in academic research. Theorists have been particularly important in laying the foundations for the behaviour of financial markets, while mathematicians, also known as 'quants', have been responsible for the growth of the modern financial industry. Well-known examples are the Nobel Laureates Fischer Black and Myron Scholes, whose options pricing model in the early 1970s spawned an entire financial derivatives industry.

Both these gentlemen were also directors of Long-Term Capital Management, one of the early hedge funds that had to be bailed out almost exactly a decade before the spectacular failure of Lehman Brothers in 2008. A less famous name is that of China-born David Li, whose mathematical work in 2000 led to the rapid growth of collateralised debt obligations or CDOs. Rightly or wrongly, Mr Li has been said to be partly responsible for the recent global financial meltdown.

Modern finance therefore heavily relies on scholarly research, research that can be said to be conducted in a largely value-free environment and then subsequently commercialised by investment banks. The primary driving force behind the derivative desks of these banks is profit. Larger questions of social good are either left to the workings of the market or else left unanswered. Even the moderating hand of government is by and large absent. Indeed, bankers stoutly defend their right to originate and distribute financial products without regulation, arguing that such regulation inhibits innovation and therefore the making of profits.

Islamic finance also intensively engages the services of scholars but takes a rather different tack. Rather than treat societal welfare as an after-thought, it is inbuilt into the instruments right from the start. The requirement for funds to be invested only in worthy businesses, to be based on risk-sharing and on real assets, and the prohibitions against interest and speculation, ensures that no financial product that can cause harm leaves the office. There is already a great deal of consumer protection in place even before regulatory overview takes place.

This dissimilarity is the reason that Islamic finance can take its place as an alternative to conventional finance. I do not think that Islamic finance can substitute conventional forms of finance just yet but what it can do is inform, influence and, ultimately, improve, the world of global finance.

If one thing is clear, markets alone will not produce the kind of results we all desire. The testimony of former Chairman of the US Federal Reserve, Alan Greenspan, to Congress in March 2009 is highly instructive. He basically admitted that his long-standing belief in the efficient markets hypothesis and his decades-long rejection of government regulation was misplaced. As the world grapples with the effects of the recession and plots the path of recovery, I would argue that the principles of Islamic finance are integral to the reform of regulation. The cases, lessons and views found in this great body of knowledge can be applied and could contribute greatly to what is to become the renewed and stronger fabric of the financial markets.

"Islamic finance also intensively engages the services of scholars but takes a rather different tack. Rather than treat societal welfare as an after-thought, it is inbuilt into the instruments right from the start."

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[1] Keynote Address by His Royal Highness Raja Dr Nazrin Shah, the Financial Ambassador to the Malaysia International Islamic Financial Centre (MIFC), at the Inaugural Securities Commission Malaysia – Oxford Centre for Islamic Studies Forum held on 16 March 2010, at the Securities Commission Malaysia, Kuala Lumpur.

Are these qualities recognised and respected? Is Islamic finance making any headway? I think the answer is clear from the following facts. Last month, the UK House of Commons approved legislation that provides a level playing field for corporate sukuk as an alternative investment bond. In introducing it, the Secretary to the Treasury said that the government's purpose behind the amendment was to maintain the UK's position as a centre for international Islamic finance and to ensure that everyone, irrespective of belief, has access to competitively priced products.

The UK has now five fully Shariah-compliant banks and 17 others with Islamic finance windows for a total of 22. There are 20 sukuks listed on the London Stock Exchange and the first private sukuk issue in the UK, by a private healthcare organisation, is in the offing. There have also been movements, albeit delayed, towards a sovereign sterling sukuk issue.

And it does not just stop in London. Luxembourg was even earlier in recognising the demand for Islamic financial services and now offers favourable tax treatment to a whole range of Islamic finance products. There are 15 sukuk issues listed on its stock exchange and almost 40 Shariah-compliant investment funds and sub-funds. There have also been similar developments in Hong Kong, Tokyo and Singapore. Even South Korea will shortly approve laws aimed at establishing tax neutrality for sukuk, thus allowing them to be utilised by foreign and domestic issuers.

These facts indicate that Islamic finance is now growing in momentum. In my view, we are now at the third, and perhaps most critical, stage of development. The first stage was to establish Islamic finance as a viable business. This is no longer an issue. Islamic finance is neither a fledgling nor a fringe activity. It is growing by leaps and bounds in all the major financial centres of the world.

The second stage was to ensure that it was stable and therefore trustworthy. The global financial crisis has tested financial institutions to an inordinate degree. It is clear that by avoiding much of the excesses of conventional finance, Islamic financial institutions have an innate ability to remain stable.

The third stage, as I see it, is to broaden its acceptability and grow the market. For all its successes, Islamic finance still accounts for less than one percent of global financial instruments. Muslims make up over 20 per cent of the world's population. Even in Muslim-majority countries, the assets of conventional banks far outstrip those of Islamic ones.

While there is no doubt that Islamic finance has a great deal to offer, whether it will do so is another matter. It will take careful and astute initiatives before Islamic finance can begin to actually make such a contribution. We will have to adopt strategic approaches in widening its acceptability.

First, we must define what needs to be done. Merely lecturing the world on the merits of Islamic finance is not sufficient. We should seek to develop strategic and complementary approaches to making them competitive and attractive.

Second, we should be as transparent as possible. Transparency ensures predictability and confidence in processes. While there may inevitably be some element of complexity when devising risk management products, it is important that there are clear and direct relationships between products and their underlying assets.

Third, we must ensure that we are inclusive. Engagement of stakeholders, especially consumers and financial institutions, is the key to unlocking the potential within Islamic finance. The western world badly needs to roll back the era of financial capitalism where financial transactions trump those of the real economy. We ought to be restoring balance and actively debating how to create more value for all stakeholders.

Fourth, there must be a high level of innovation. True innovation, as opposed to imitation, also requires the involvement of all stakeholders and not just jurists and regulators. Islamic finance scholars have a great deal to contribute in this respect. Their work should not be confined only to Islamic finance but encompass that of the wider world of global finance.

I want to close by deliberating a little on the fifth element, that of the role institutions. Islamic finance has come a long way from where it was even a decade ago. This has been accompanied, indeed facilitated, by the institutionalization of Islamic finance. Institutionalisation introduces sustainability through the formalisation of practices and processes. A sustainable model for the industry requires a widely shared objective and well-established practices.

These include not only the financial institutions that originate and distribute the Islamic financial products but also a wide array of supporting infrastructure. There are indeed a host of entities that are working toward achieving the common objective of making Islamic finance more robust.

Each is an integral and indispensable component of the Islamic finance value chain. What is especially critical is that this value chain functions seamlessly and effectively across borders so that investors are left in no doubt about the purity and trustworthiness of Islamic finance products. For this to happen, there must be greater consultation among the institutions concerned so that depositors and investors do not end up perplexed.

Conclusion

Harmonisation and convergence will take its own course, and diligence, patience and determination are what are required of us. We must at all times not lose sight of our common vision; that of making the global Islamic industry a robust one, one that can withstand the test of crises and time.

"With good leadership and smart governance, we will have laid the foundation for a truly conducive Islamic finance ecosystem. Strong leadership has brought us this far and it comes in many forms – as scholars, practitioners and regulators."

With good leadership and smart governance, we will have laid the foundation for a truly conducive Islamic finance ecosystem. Strong leadership has brought us this far and it comes in many forms – as scholars, practitioners and regulators. More and more, however, I am seeing that our leadership is being transferred to institutions. This is part of the evolution of the industry. We need to work together to ensure that everything is in place for the industry to continue to expand its reach and influence in the coming years.

Islamic Capital Market Graduate Training Scheme

The second Islamic Capital Market Graduate Training Scheme (ICMGTS) commenced from 11 January to 8 March 2010. For this intake, 46 graduates, representing an increase of 25% from the first intake, from both Shariah and non-Shariah background enrolled in the course. Throughout the programme, students were exposed to a combination of structured and experiential learning comprising lectures, illustrative examples, case studies, simulation and interaction to help equip them with the necessary technical knowledge and skills to enter the industry.

Malaysia ICM – Facts and Figures

Shariah-compliant securities on Bursa Malaysia

Number of Shariah-compliant securities – November 2009+			846
% to total listed securities			88%
Latest market capitalisation – March 2010			**(RM billion)**
Shariah-compliant			670.35
Total market			1,061.06
% of Shariah-compliant securities to total market			63.18%
Equity market indices	**25 February 2010**	**31 March 2010**	**% change**
Kuala Lumpur Composite Index (KLCI)	1,270.78	1,320.57	3.92%
FBM EMAS Shariah	8,560.2	8,925.85	4.27%
FBM Hijrah Shariah	9,211.92	9,458.09	2.67%
DJIM Malaysia Titans 25	752.30	769.66	2.31%

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

Shariah-compliant funds+

Number of approved funds	March 2009	March 2010
Shariah-compliant	141	155
Total industry	552	574
Net asset value (NAV) of approved funds	**March 2009**	**March 2010**
Shariah-compliant (RM billion)	16.99	22.69
Total industry (RM billion)	134.75	204.40
% to total industry	12.61%	11.10%

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

Islamic exchange-traded funds (ETF)

Number of approved ETF	March 2009	March 2010
Islamic ETF	1	1
Total industry+	3	3
Net asset value (NAV) of approved funds	**March 2009**	**March 2010**
Islamic ETF (RM million)	491.28	669.29
Total industry+ (RM million)	1,013.78	1,189.01
% to total industry	48%	56%

+ including bond ETF – ABF Malaysia Bond Index Fund
Note: Islamic ETF– DJIM MyETF-DJIM25 was launched on 22 January 2008.

Chart 1
Performance of KLCI vs Shariah indices

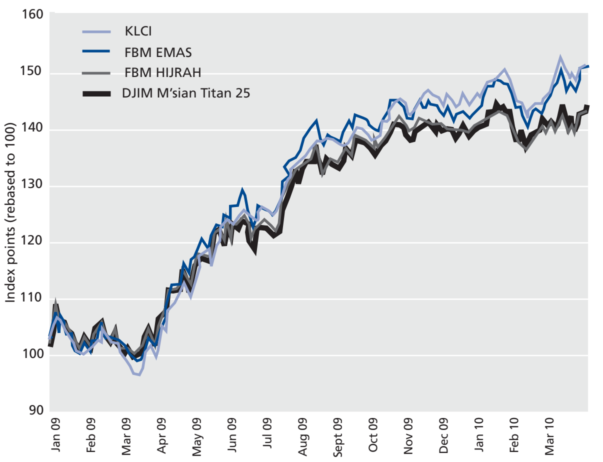
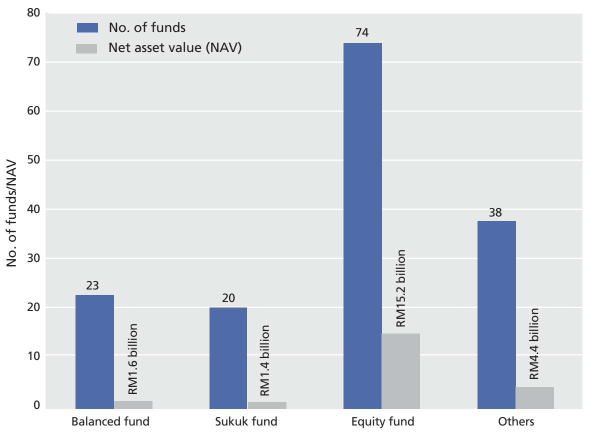


Chart 2
Shariah-compliant funds by category



Islamic real estate investment trusts (REITs)

Number of REITs	**March 2009**	**Mar 2010**
Islamic REIT	3	3
Total REITs	13	12
Market capitalisation	**March 2009**	**March 2010**
Islamic REIT (RM million)	1,281.07	1,894.08
Total REITs (RM million)	4,132.95	5,423.12
% to total REITs	31%	35%

Corporate sukuk

Sukuk approved	**March 2009**	**March 2010**
Number of sukuk	4	2
Size of sukuk (RM billion)	3.6	0.59
Size of total bonds approved (RM billion)	10.6	9.18
% of size of sukuk to total bonds approved	34%	6%
Sukuk issued	**March 2009**	**March 2010**
Size of sukuk issued (RM billion)	6.6	2.66
% of sukuk issued to total bonds issued	63%	42%
Sukuk outstanding	**March 2009**	**March 2010**
Size of outstanding sukuk (RM billion)	161	168
% of outstanding sukuk to total outstanding bonds	58%	57%

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

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