

Islamic Finance: Malaysia's Journey

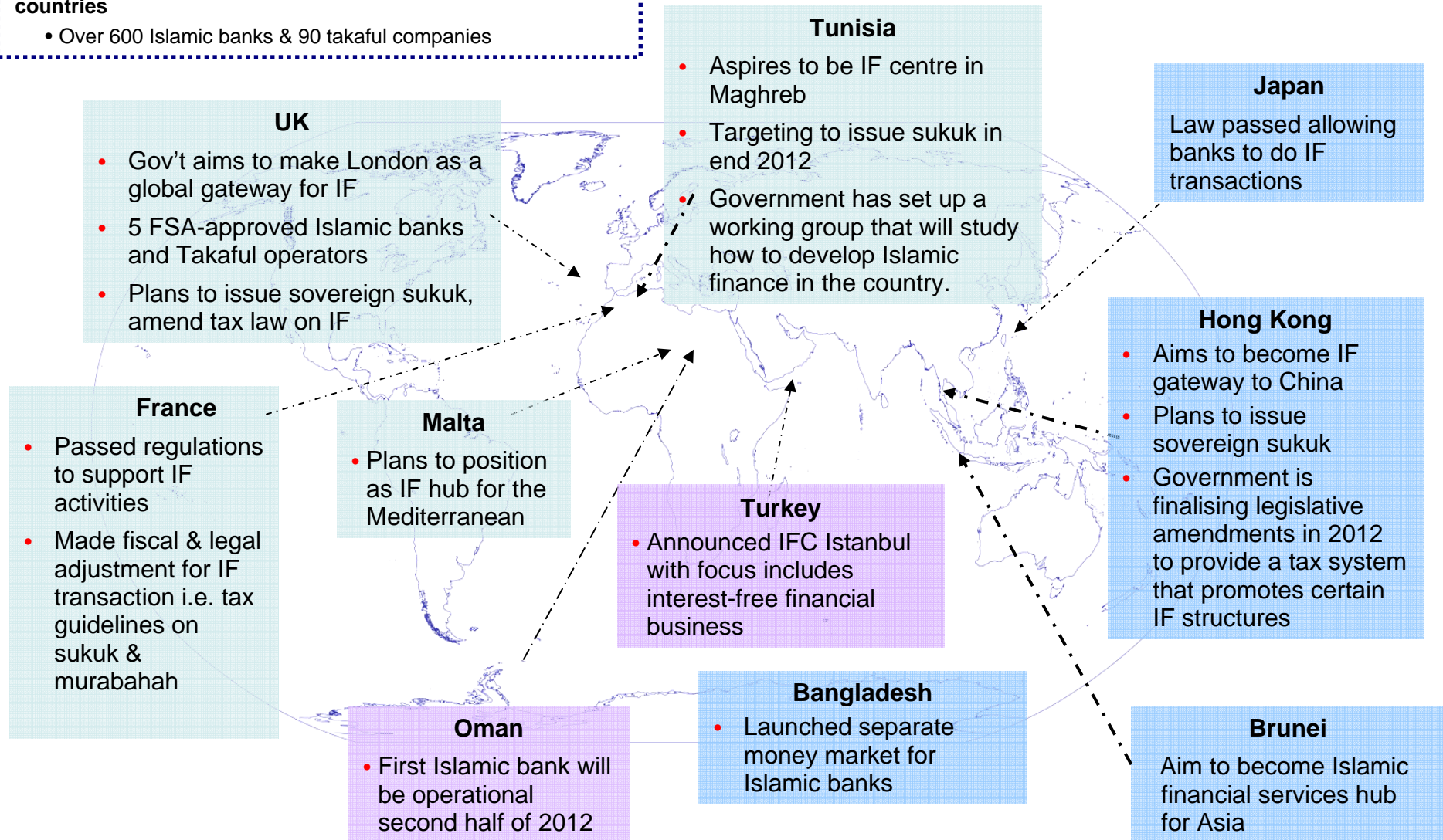


Malaysia International Islamic Financial
Centre (MIFC) Promotions Unit

Islamic finance..gaining traction in traditional & emerging economies

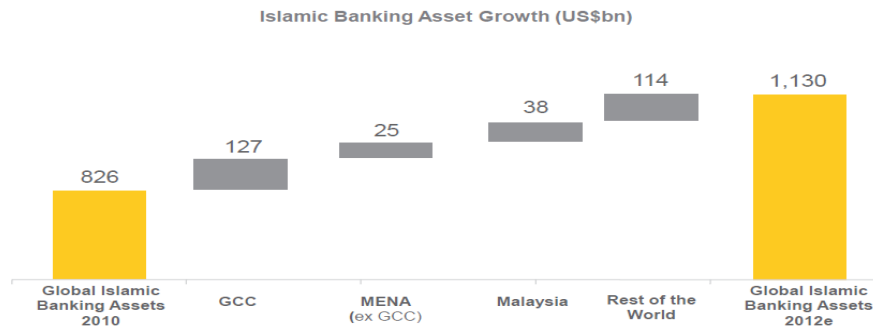
Increasing number of Islamic financial institutions in over 75 countries

- Over 600 Islamic banks & 90 takaful companies



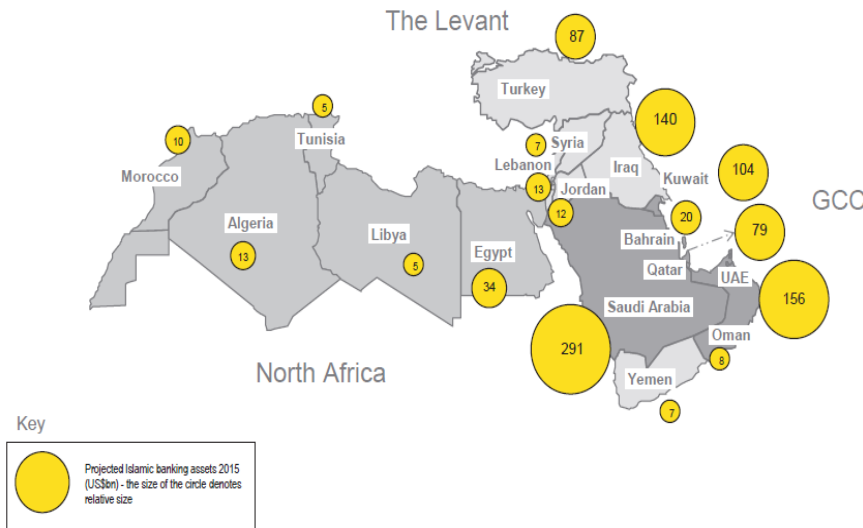
China has also made progress in Islamic finance...

Immense potential and opportunities in Islamic finance



By 2015, the MENA Islamic banking industry is projected to be worth \$990bn... a significant growth story (2010: \$416bn assets)

MENA Islamic Banking Assets - 2015 Forecast (US\$bn)



Source: 2010 Company Reports, Global Insight, EY perspective

Asia

- **Asia and Saudi** set to dominate the sukuk market in with high quality quasi-sovereign issuers taking the lead, especially to fund infrastructure and projects in the oil, gas, petrochemicals and transport sectors
- India to tap GCC fund via Islamic finance

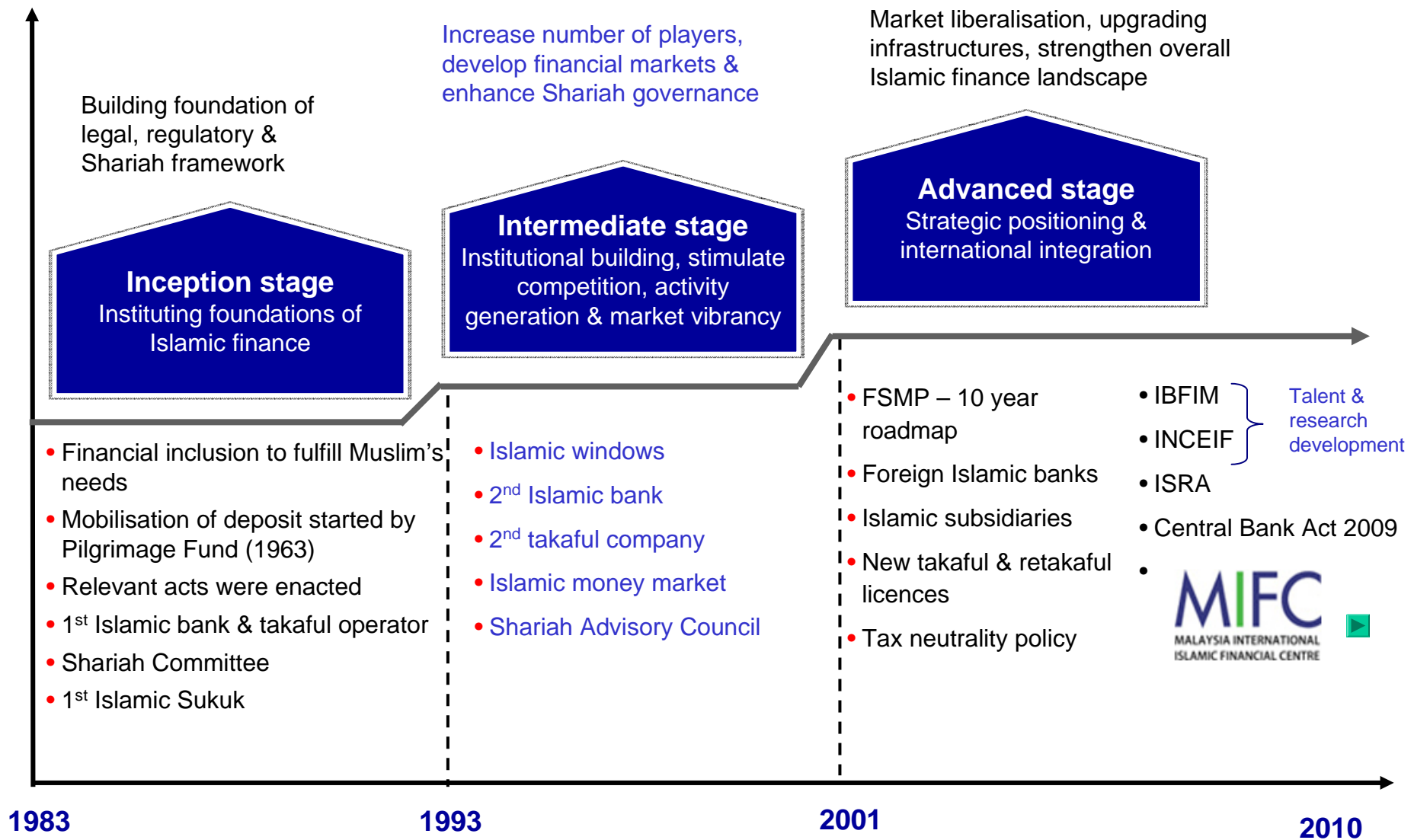
MENA:

- Islamic banking set to grow by an **additional \$575 billion** by 2015
- **Potential demand for an estimated 100 new Islamic financial institutions across MENA by 2020**
- Higher possibility of issuing a **sovereign sukuk**

Sub-Saharan Africa:

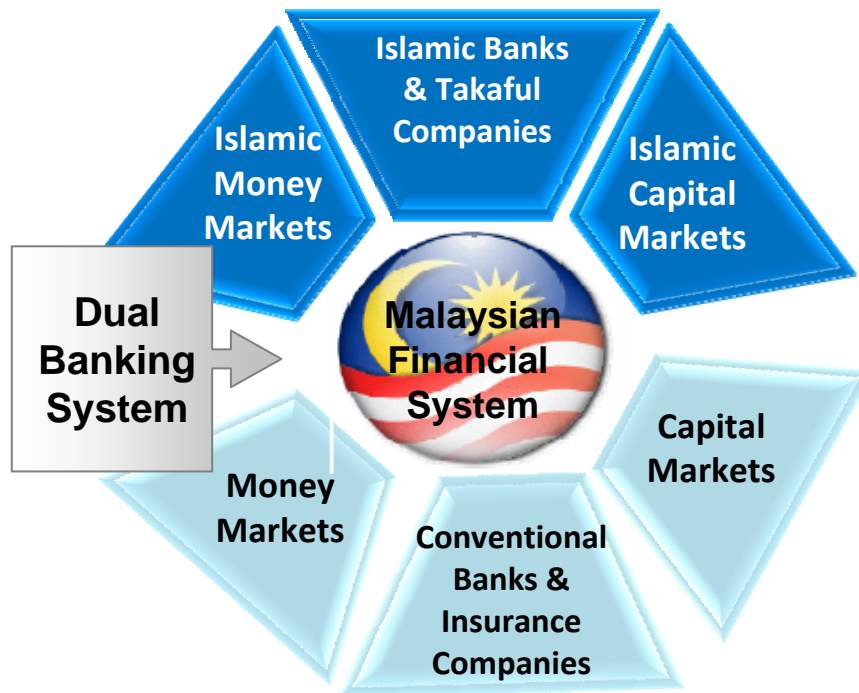
- Large 'room to grow' in IF due to the under-development of its banking industry

Malaysia's gradual & holistic approach to Islamic finance...



FSMP – Financial Sector Masterplan, IBFIM - Islamic Banking and Finance Institute of Malaysia, INCEIF - International Centre for Education in Islamic Finance, ISRA – International Shariah Research Academy for Islamic Finance

Islamic finance - integral component of the Malaysian financial system



Supported by:

Diversified players with wide-ranging products

Professional services with familiarity on IF

Integrated human capital infrastructure

Islamic Banking

Strongly positioned within overall financial system

- Total asset: RM459.2b (USD150.5b) (23.1% market share)
- Total financing: RM274.8b (USD90.1b) (24.5% market share)
- Total deposits: RM312.1b (USD102.3b) (23.2% market share)
- RWCR: 14.95% (Banking sector: 14.7%)
- Net NPF: 1.4% (Banking sector: 1.7%)

Takaful

Consistently register double digit growth

- Contribution: RM4.9b (13.6% market share)
- Asset: RM17.7b (8.7% market share)

Islamic Capital Market

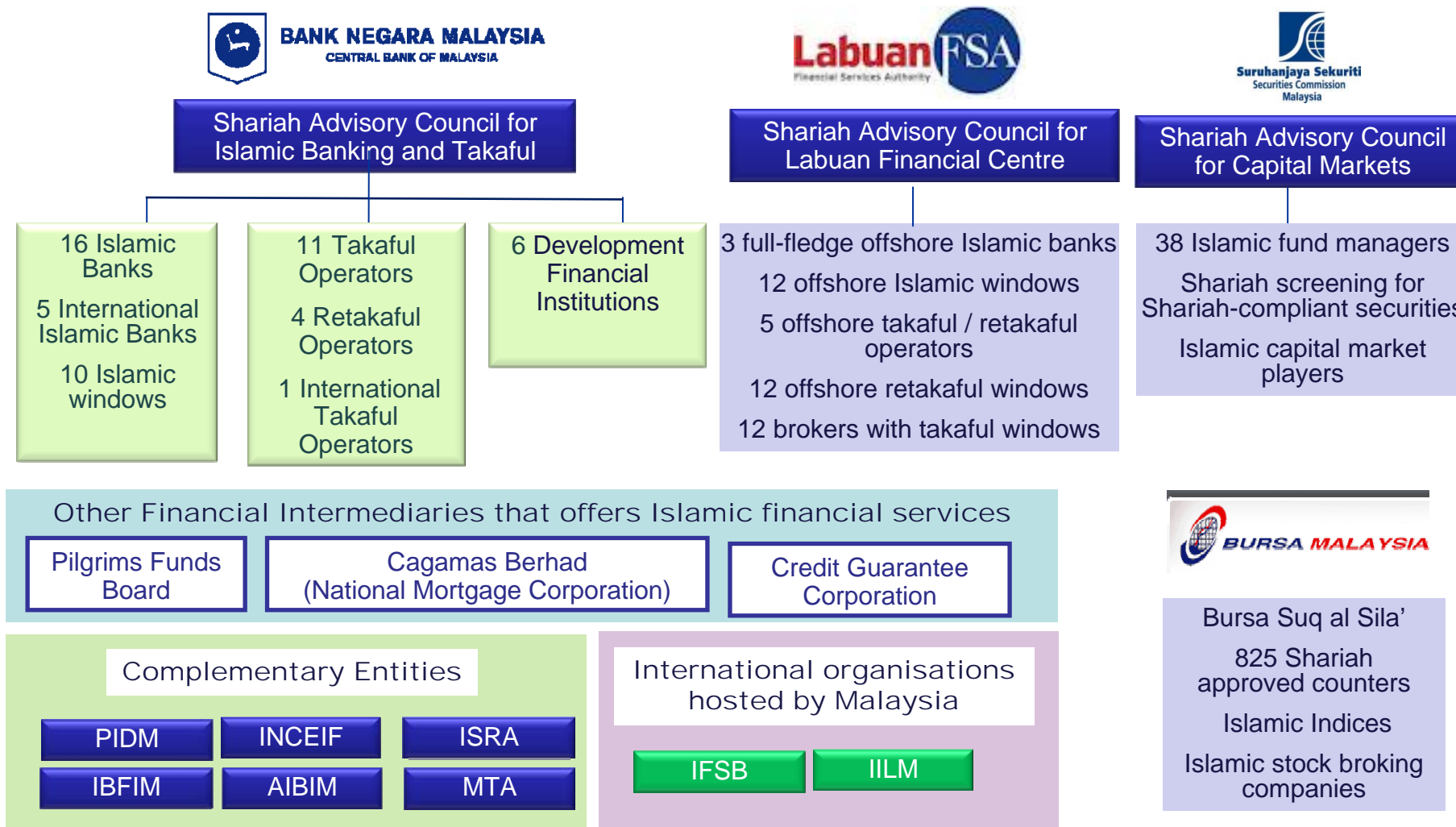
- Almost 50% of total outstanding debt securities
- 14% from the total industry assets under management (AUM) - inclusive of collective investment schemes and private mandates
- 89% of listed securities are Shariah compliant

Islamic money market

- Annual trading volume of exceeds RM1 trillion

Note: Data as at Q1 2012 ,Asset, Financing & deposit figures include DFIs

Today's landscape of Islamic financial system



INCEIF – International Centre for Education in Islamic Finance
 ISRA – International Shariah Research Academy for Islamic Finance
 IBFIM – Islamic Banking and Finance Institute of Malaysia
 IFSB – Islamic Financial Services Board

IILM – International Islamic Liquidity Management Corporation
 PIDM – Perbadanan Deposit Insurans Malaysia
 [MDIC – Malaysian Deposit Insurance Corporation]
 AIBIM – Association of Islamic Banking Institution Malaysia
 MTA – Malaysian Takaful Association

Comprehensive & coordinated efforts in human capital development is essential to caters for the need of IF industry

Different training platforms for financial services professionals at different stages of career development

Entry level

Leadership



IoHL

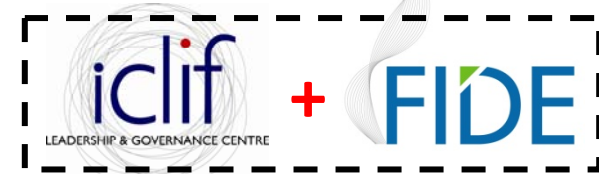
Institutions of Higher Learning offers both undergraduates & post graduates programmes on Islamic finance

INCEIF

International Centre for Education in Islamic Finance to provide professional & academic qualifications in Islamic finance

ibfim

Islamic Banking and finance Institute Malaysia (IBFIM)
focuses on Islamic banking, takaful & Islamic capital market program



International Centre for Leadership in Finance for training in management, leadership & governance through the Financial Institutions Directors' Education programme, including in the area of Islamic finance

Reinforced by continuous effort to promote Shariah research and intellectual discourses

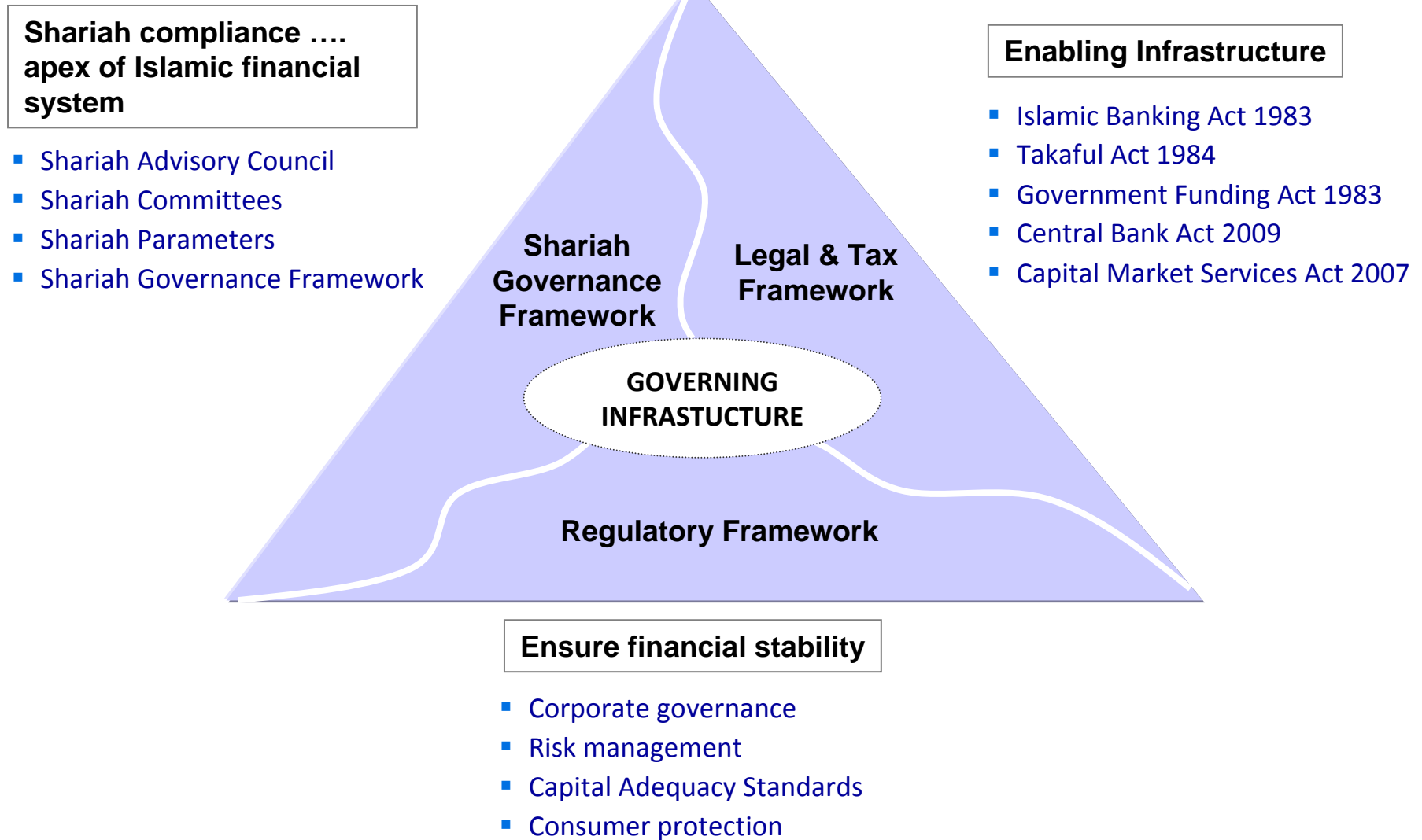
ISRA

International Shariah Research Academy

- Centre for applied research in Shariah & Islamic finance and to become reference point for Shariah interpretations
- Platform for discourse among scholars, academicians, regulators & practitioners

Well-developed Governing Infrastructure

...Preserving sound Islamic financial system...



Comprehensive legal framework to govern specificities of Islamic finance

Specific legislation

- Islamic Banking Act 1983
- Takaful Act 1984
- Labuan Islamic Financial Services and Securities Act 2010
- Government Funding Act 1983

Supportive Legislations

- Banking and Financial Institutions Act 1989
- Development Financial Institutions Act 2002
- Malaysia Deposit Insurance Corp. Act 2005

Dispute Resolution Mechanism

- Dedicated High Court judge to adjudicate Islamic finance cases
- KL Regional Centre for Arbitration
- Financial Mediation Bureau as alternative dispute resolution mechanism

Ongoing effort

- Tax neutrality principles
- Law Review Committee
- Law Harmonisation Committee

Central Banking of Malaysia Act 2009

1

Recognition of dual financial system

- The financial system shall consist of conventional & Islamic financial system
- *Section 27*

2

Shariah Advisory Council as highest authority

- The court or arbitrator shall take into consideration rulings of BNM's Shariah Advisory Council (SAC) & to refer any Shariah questions to the SAC for its ruling
- *Section 56 (1)*
- Rulings of SAC shall be binding on Islamic financial institutions, courts or arbitrators
- *Section 57*

3

Malaysia International Islamic Financial Centre

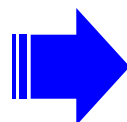
- BNM has the role to develop Malaysia as an international Islamic financial centre
- *Section 68(1)*

Regulatory framework for Islamic finance...a combined approach

Adapt existing sound practices and formulate specific policies to address Islamic finance characteristics...

Capitalize on strength of conventional regulatory system

- Conventional regulatory infrastructure already in place & proven effective
- Leverage on existing framework to address similar risks in Islamic finance
- Islamic finance are governed by similar regulatory framework as in conventional banking
 - Corporate governance
 - Capital adequacy
 - Liquidity management
 - Financial transparency & market discipline
 - Risk management and auditing



Gradual establishment of Islamic finance regulatory framework

- Modify existing framework to address salient characteristics of Islamic finance
- Establish Shariah compliance & governance mechanism
- Adoption of international Islamic prudential standards issued by Islamic Financial Services Board - to addresses unique characteristics of Islamic financial transactions

... to minimise regulatory arbitrage



Convergence towards international best practices...

DOMESTIC REGULATION

Separate guidelines on areas specific to IF

Governance

- Shariah Governance Framework
- Corporate Governance Guidelines

Risk management

- Framework of Rate of Return
- Guidelines on Profit Equalisation Reserve
- Guidelines on Property Development & Investment Activities
- Takaful Operational Framework

Capital adequacy

- Capital Adequacy Framework for Ibs
- Guidelines on Recognition and Measurement of PSIA Risk Absorbent
- Risk Based Capital Framework for Takaful Operators

Consumer Protection & Fair Dealing

- Guidelines on Late Payment Charges
- Guidelines on Rebate (Ibra') for Sale-based Financing

Other prudential regulations

- Firewalls for Islamic window operation
- Guidelines on Musharakah & Mudharabah
- Guidelines on Financial Reporting

INTERNATIONAL BEST PRACTICES

Prudential standards issued by IFSB

Guiding Principles of Risk Management

Capital Adequacy Standards

Guiding Principles on Corporate Governance

Supervisory Review Process

Transparency & Market Discipline

Governance for Islamic Collective Investment Scheme

Capital Adequacy Requirements for Sukuk, Securitization & Real Estate Investment

Guiding Principles on Shariah Governance Systems

Conduct of Business for IIFS

Governance for Takaful Undertakings

Solvency Requirements for Takaful Undertakings

Guiding Principles on Liquidity Risk Management

Guiding Principles on Stress Testing

Shariah Governance in Malaysia



Guided by two important legislation & guidelines

Central Bank of Malaysia Act 2009

Shariah Governance Framework for IFIs

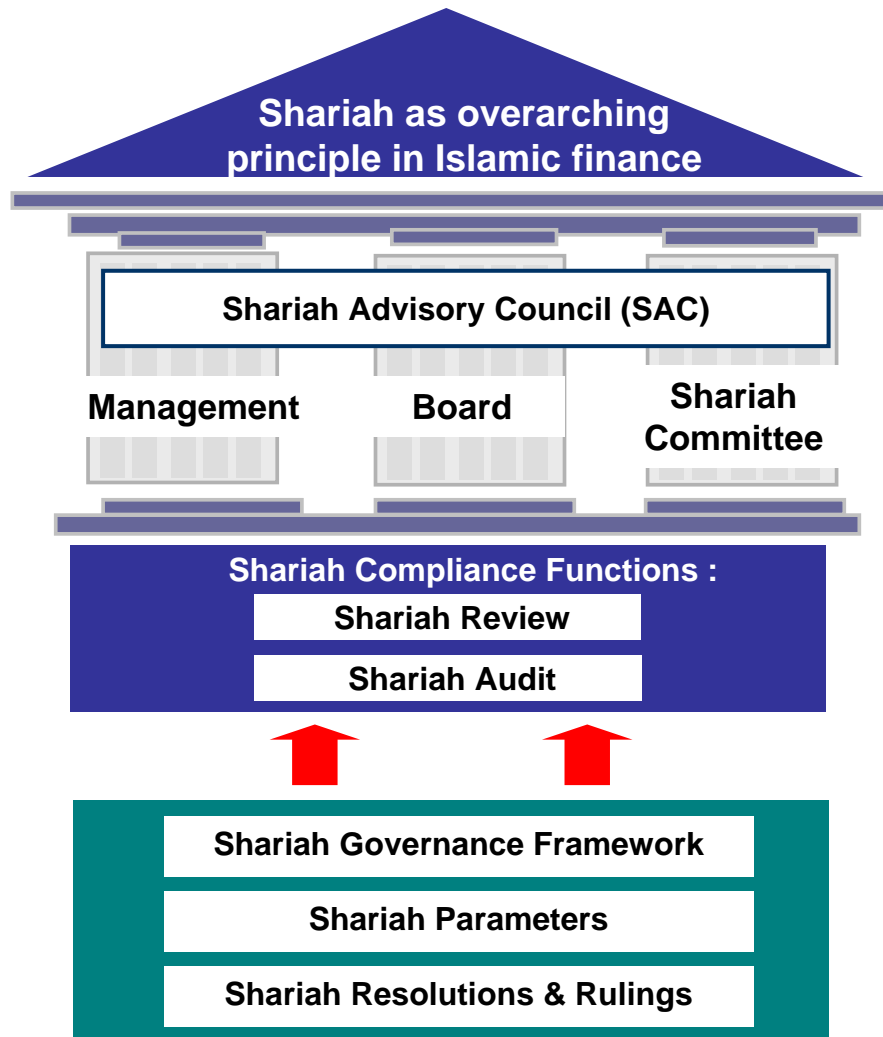
Key Features:

- An apex authoritative body for the ascertainment of Islamic law for the purposes of Islamic financial business
- Advise the Bank (and also IFIs) on any Shariah issue relating to Islamic financial business
- Appointed by the King, on the advice of the Minister of Finance after consultation with the Central Bank
- The court & arbitrator shall take into consideration any published rulings of the SAC, prior to any proceedings on Shariah matters
- Rulings made by the SAC shall be binding on IFIs, court or arbitrator

Objectives:

- Set out the expectations of the Bank on an IFI's Shariah governance structures, processes & arrangements to ensure that all its operations & business activities are in accordance with Shariah
- Provide comprehensive guidance to the board, Shariah Committee and management of the IFI in discharging its duties in matters relating to Shariah
- Outline the functions relating to Shariah review, Shariah audit, Shariah risk management and Shariah research

Two-tier Shariah assurance supported by a **credible Shariah governance structure**



Proper governance provides assurance on Shariah compliance & enhance public confidence on Islamic finance operation:

1. **SAC's legislative stature as highest authority** for Shariah matters in Islamic finance is accorded under the Central Banking Act.
2. Shariah committee of IFIs are fully **accountable on decision, views & opinions** related to shariah matters
3. Board & senior management with **sufficient expertise & capability** in dealing with issues specific to Islamic financial transactions
4. Emphasise the function of Shariah review & Shariah audit to **provide check & balance**
5. Shariah Committee member of another institutions within the same industry shall not be appointed – **avoid conflict of interest & maintain info confidentiality**
6. **Institutionalise mutual respect** by recognising differences of Shariah interpretations in various jurisdiction
7. Shariah parameters provide **guidance on main features, principles & rulings** of Shariah contracts

Global Islamic finance initiatives towards ensuring financial stability & sustainability

1

Islamic Financial Services Board



- Malaysia, the host country of the IFSB, plays leading role in establishment of IFSB in 2002
- International standard-setting organisation issuing global prudential standards & guiding principles
- IFSB has issued 13 IFSB standards & 5 Guidance notes

2

International Islamic Liquidity Management Corporation

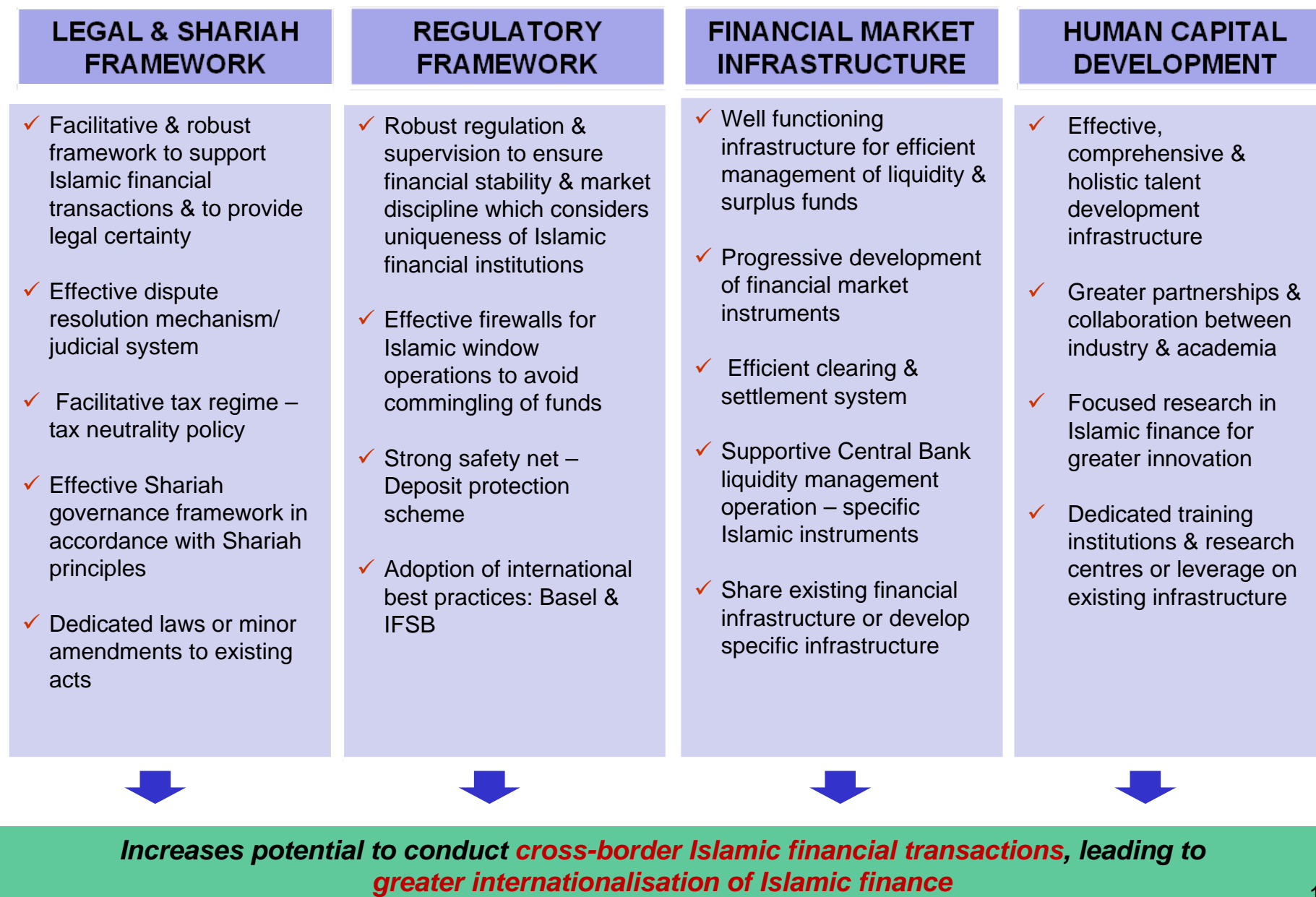
- IILM commenced operation on 1 January 2011
- Supranational to facilitate cross-border short-term liquidity management
- Diversify availability and range of high-quality liquid and tradable products
- Enhance international linkages of Islamic financial markets
- Founding shareholders: 12 CBs of Indonesia, Iran, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, S. Arabia, Sudan, Turkey, UAE & 2 MDBs i.e. IDB & ICB

3

Islamic Finance Stability Forum

- IFSF is based at IFSB and established in April 2010
- Strategic platform for IFSB members to build cross-border dialogue to promote financial stability within the Islamic finance system
- Collaboration in areas of surveillance, crisis prevention, implementation of international standards, capacity building and development of emergency infrastructure

Building blocks for an effective Islamic finance ecosystem



The Next Roadmap: Internationalisation of IF

Roadmap



Financial Sector
Masterplan
2001-2010

Vision

Developing an Islamic banking & takaful industry that is in parallel with conventional banking & insurance

Focus Areas

- Institutional capacity enhancement
- Financial infrastructure development
- Regulatory framework development



Financial Sector
Blueprint
2011-2020

Continue to expand IF in Malaysia, reinforced by the global expansion where creation, preservation & distribution of wealth are effectively undertaken by market participants in a manner that promotes the universal values of Shariah

- Increased diversity in terms of players as well as financial products & services
- Greater range of offerings in terms of Islamic fund & wealth management activities
- Enhanced liquidity, market efficiency as well as depth and vibrancy of Islamic financial markets, supported by robust platforms
- Strengthened business framework & enhanced financial linkages between different jurisdictions
- Optimise synergy with other Islamic financial centres to further stimulate Islamic financial transactions & IF education & training

Development & regulatory challenges

- **Regulatory framework**

Regulation in line with international best practices

- Adoption of prudential standards set by Islamic Financial Services Board
- Avoid potential of regulatory arbitrage in dual financial system
- Takes into account distinctive features of Islamic finance

- **Talent supply**

Increase pool of talent

- Ensure sufficient pool of talent - Shariah & finance conversant (both within industry and regulatory authorities)

- **Shariah harmonisation**

Greater consistency in Shariah pronouncement

- Regional and international Shariah dialogues
- Promote mutual understanding & respect on Shariah decisions globally

- **Facilitative legal environment**

Ensure conducive environment for Islamic finance transactions

- Equal tax treatment vis-a-vis conventional financial transactions
- Ongoing review of applicability / potential impediments of existing legal and statutory requirements on Islamic finance

Malaysia International Islamic Financial Centre (MIFC)



“To create a **vibrant, innovative and competitive international financial services industry** in Malaysia supported by **high caliber human talents, world-class infrastructure, and best international standards**”

World Class Islamic Financial Centre



Islamic Capital Market
(players & instruments)



International Business
(banking & retakaful)



Talent Development



Professional Service Providers

World Class Legal, Regulatory and Shariah Framework

MIFC
Community



Opportunities in Malaysia under the MIFC initiative

Building inter-linkages

Opportunities in Malaysia under the MIFC initiative

International Business Banking, Retakaful & Domestic Islamic Bank

International Islamic Bank (IIB)

- New licences with tax exemption status for international Islamic banking
- Licensed under the Islamic Banking Act 1983 (IBA), incorporate as a company or branch
- 100% foreign ownership allowed Business - wide range of Islamic banking business in Malaysia with residents & non-residents in foreign currency as well as limited ringgit transactions:

Domestic Islamic Bank

- Acquire up to 70% equity in domestic Islamic bank and maintain minimum USD1 billion paid-up capital

Retakaful

- Foreign currency or domestic retakaful licence (domestic retakaful licence for ringgit and non-ringgit business)

Islamic Capital Markets Instruments &

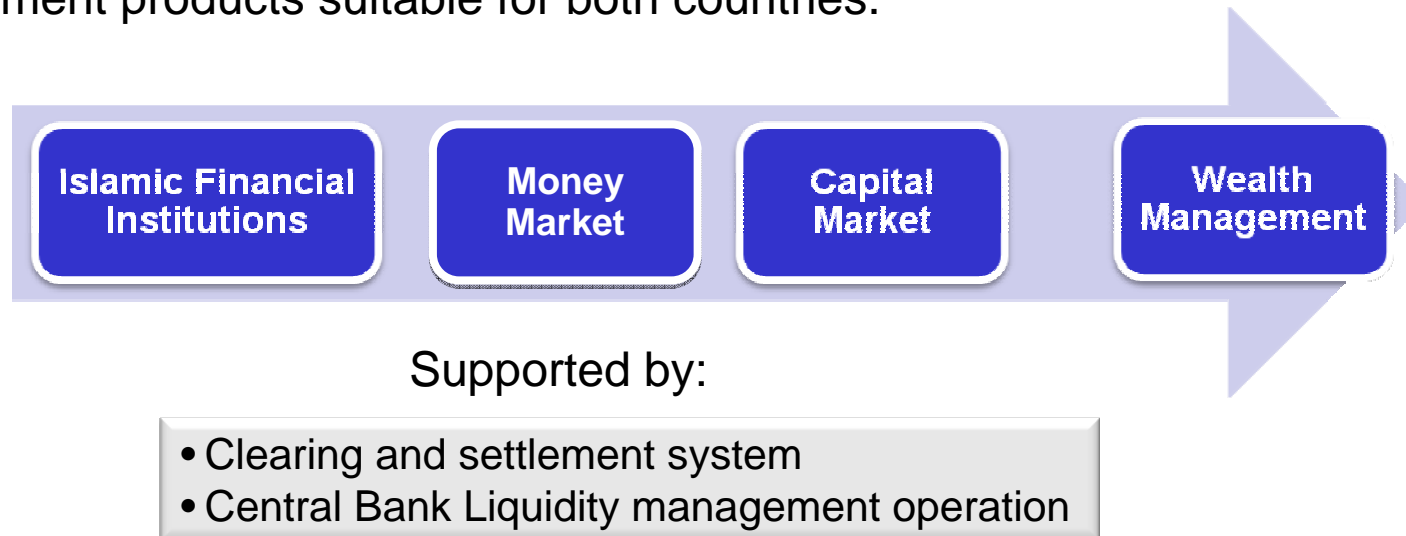
- New Islamic Fund Management Company licence
- Licensed under the Capital Markets and Services Act 2007(CMSA) Business – ringgit & non-ringgit management of retail & institutional investors, including establishing & distributing unit trust funds
- Incentives for layers and investors

Liquidity management and Wealth management

To support Islamic financial institutions in meeting their liquidity requirements

Potential collaboration:

- Live transactions for liquidity management between Islamic banks in Oman and Malaysia
- Industry task force on joint development of cross-border Islamic liquidity management products suitable for both countries.



Wealth and fund management:

- 18 Islamic fund management companies and a wide-ranging Islamic finance products

Sukuk issuance

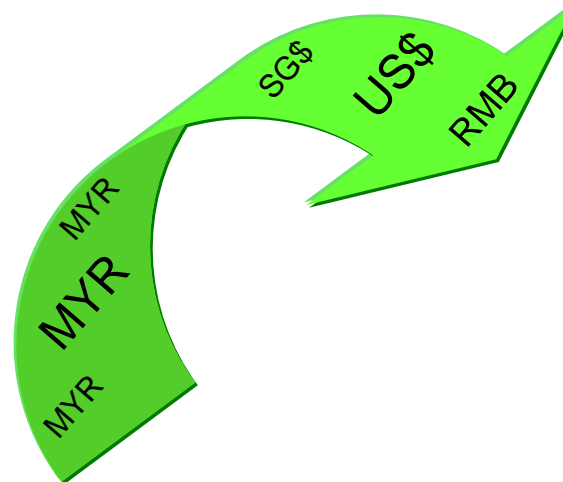
Opportunities for issuers to use Malaysia as fund-raising platform

- Cost effective and efficient time to market
- Supportive framework and facilitative approval process
- Deep & advanced sukuk market with active secondary market trading
- Large amount of issuances with wide range of tenure including longer tenure
- Broad range of innovative issuance
- Wide range of investor base

Sukuk issuance...continued

Malaysia - evolving into a multi-currency sukuk market

Selected Ringgit Sukuk Issuance by Foreign Entities



Notable Multicurrency Sukuk Issuance

Petronas USD1.5 bil (2009)

Khazanah Nasional

- Exchangeable sukuk - USD750 m, USD850m, USD550 m (2006, 2007, 2008)
- SGD1.5 bil (Aug 2010)
- RMB500 million (Oct 2011)

Government of Malaysia

- USD1.25 bil (2010) - 2nd global sovereign sukuk
- USD 2 bil (2011) Wakalah Global Sukuk – 3rd global sovereign sukuk

Islamic Development Bank USD500 mil (Oct 2010)

- USD500 mil (2010)
- USD 800 mil (2012)

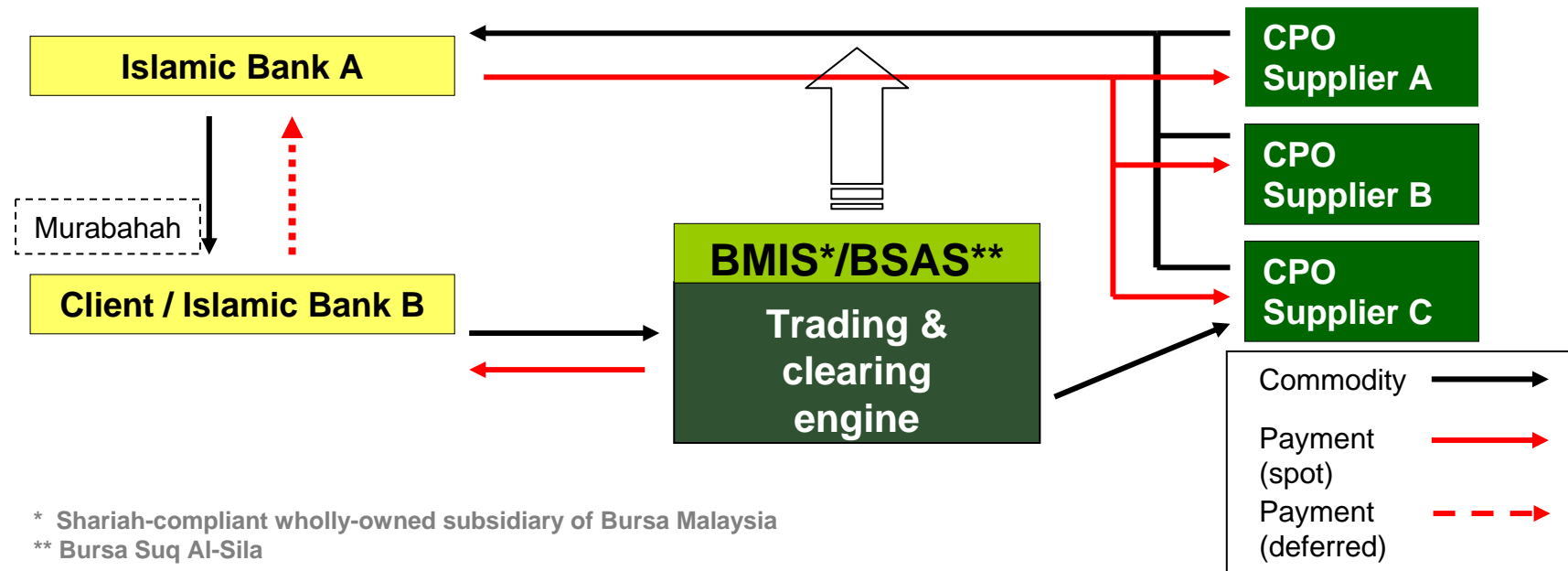
Nomura USD100 mil (July 2010)

Axiata Group RMB1 bil (2012)

- Largest RMB sukuk



Trading platform - Bursa Suq Al Sila (commodity murabahah house)



World's 1st Shariah-compliant international commodity trading platform

Objective - enhance liquidity management for Islamic financial institutions

Concept - Commodity Murabahah

Modus operandi –

- A party buys commodity at a certain cost and sells it to a customer at a cost-plus-profit basis.
- The customer then pays the amount & profit to the party on a deferred-payment basis.
- The customer then sells back the commodity to the commodity market on spot for cash.

Commodity/Currency - Crude palm oil, plastic resin & RBD palm olein / Ringgit Malaysia-denominated

Later - commodity will be expanded to other Shariah approved commodities & conducted in multi-currency denominated, hence provide more choices, access and flexibility for international financial institutions to participate in this market.