



## MALAYSIA ISLAMIC FINANCE REPORT 2015

Mainstreaming  
Islamic Finance  
within Global  
Financial Systems

Exclusive Strategic Partner



A MEMBER OF



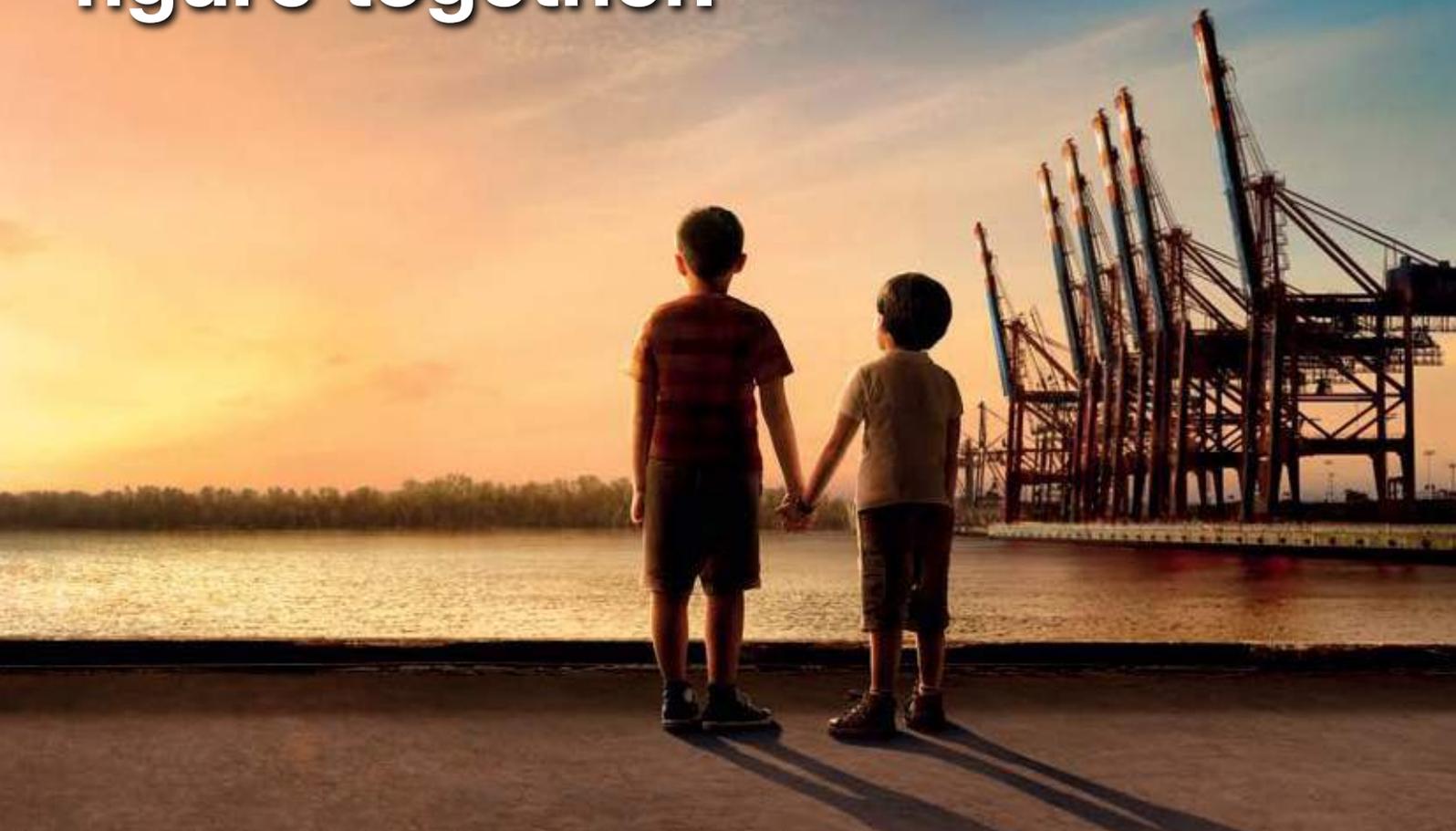
THOMSON REUTERS™



المجلس العام للبنوك  
والمؤسسات المالية الإسلامية  
General Council for Islamic  
Banks And Financial Institutions

# ASEAN CONDUCTS US\$598 BILLION IN TRADE.

## Let's increase that figure together.



ASEAN gives us the economies of scale to deliver products and services that compete with the world's best. From all corners of the region we draw on our people, knowledge and insights to serve and connect our customers. By harnessing the power of scale and diversity of the region, we stand ready to propel ASEAN into a new era of growth together.

 **CIMB BANK**  **CIMB NIAGA**  **CIMB THAI**  **CIMB ISLAMIC**

CIMB Group Sdn Bhd (706803-D)

ASEAN FOR YOU



## About CIBAFI

General Council for Islamic Banks and Financial Institutions (CIBAFI) is a non-profit institution that is the umbrella for Islamic financial institutions worldwide. It was founded by the Islamic Development Bank (IDB) and a number of leading Islamic financial institutions, CIBAFI is affiliated with the Organisation of Islamic Cooperation (OIC). Established on 16 May 2001, in the Kingdom of Bahrain, today CIBAFI is recognised a key piece in the international architecture of Islamic finance.

CIBAFI was established with the objectives of developing the Islamic financial services industry (IFSI) and promoting the industry in various fields through information and financial analysis, communication, awareness, human resources and rating of Islamic financial products.

CIBAFI was founded by Islamic Development Bank and 30 members. Now, after 13 years of operations, CIBAFI has 111 members. Membership is spread across 28 jurisdictions in the Middle East, Africa, Europe as well as South and Central Asia and includes Islamic financial institutions, multilateral banks, international standard setting organisations and other professional services firms.

## To this extent, initiatives of CIBAFI include:

- 1: Policy, Regulatory Advocacy
- 2: Research and Publications
- 3: Awareness and information sharing
- 4: Professional Development

President of Islamic Development Bank (IDB)  
Group Ahmed Muhamed Ali speaks during  
the "Third IDB 1440H Vision Commission  
Meeting" in Kuala Lumpur March 23, 2006.  
REUTERS/Zainal Abd Halim



## ABOUT THE ISLAMIC RESEARCH AND TRAINING INSTITUTE



A MEMBER OF



The Islamic Research and Training Institute (IRTI), a member of the Islamic Development Bank Group (IDBG), was established in 1401H (1981). The principal aim of IRTI is to undertake research, training and advisory activities in Islamic Economics and Islamic Finance to facilitate the economic, financial and banking activities in IDB member countries to conform to Shari'ah. A knowledge-based organization, IRTI, is considered to be one of the pioneers and key centers of excellence around the world in promoting and supporting the development and sustenance of a dynamic and comprehensive Islamic Financial Services Industry (IFSI), which supports the socio-economic development of IDB member countries and Muslim communities across the globe.

**VISION** To be the global knowledge center for Islamic Economics and Finance by 1440H (2020)

**MISSION** To inspire and deliver cutting edge research, capacity building, advisory and information services in the area of Islamic Economics and Finance

### IRTI SERVICES

#### ADVISORY AND CONSULTANCY

IRTI provides comprehensive advisory and consultancy services in the fields of Islamic Finance and Economics with global outreach to the public and private sectors. Backed by over three decades of industry experience, IRTI's advisory and consultancy services add real value to the clients' businesses. In addition to IRTI's renowned experts, IRTI utilizes industry experts, affiliate partners and IDB Group members entities' experts to provide advisory and consultancy services to clients. IRTI's consultancy services include (but not limited to): setting up regulatory framework, developing new Islamic financial products and services to cater to the market needs, Shari'ah research, Shari'ah toolkits, Shari'ah guidelines, introduction of Islamic

banking windows in conventional banks, conversion to Islamic banking, Shari'ah auditing exercises, Shari'ah advisory and technical support for sukuk issuance etc.

#### RESEARCH

IRTI is a catalyst in the advancement of the Islamic Economics and Islamic Finance fields. Currently IRTI's research agenda is focused on five clusters, namely: Islamic Financial Institutions and Financial Sector Development, Islamic financial products development, Financial Stability and Risk Management, Economic development in OIC member countries, and Human development in light of Maqasid Al Shari'ah.

#### INFORMATION AND KNOWLEDGE SERVICES

IRTI effectively and efficiently creates, captures and disseminates knowledge using traditional and modern information systems and programs. These programs include, but not limited to; the internet, social media, e-learning, distance learning, voice and video conferences.

#### ISLAMIC FINANCIAL INDUSTRY INFORMATION CENTER (IFIIC)

IFIIC is a portfolio of online applications and databases with relevant data about the Islamic Financial Industry. Components of the IFIIC are the following: Islamic Banking Information System (IBIS, [www.ibisonline.net](http://www.ibisonline.net)), Shariah and Who's Who Databases.

# Introduction

This report presents the continuing advancement of Islamic finance in the country where the industry is considered to be the most developed in the world.

This level of development, as measured by the ICD-Thomson Reuters Islamic Finance Development Indicator (IFDI), considers quantitative indicators as well as Governance, CSR funds disbursed, Knowledge, and Awareness. What the IFDI does not do is impose its own qualitative criteria as to the extent of how 'Islamic' the industry is, but is prescriptive only in its deference to industry standards as recommended by infrastructure bodies the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

This report continues where the IFDI leaves off to also qualitatively assess the development of Malaysia's Islamic finance industry as it transitions from being Shariah-compliant to Shariah-based wherein Islamic financial products and services and the industry's end-to-end value chain are meant to be distinctly dissimilar from conventional finance, and characterised by the introduction of native innovations

## REPORT HIGHLIGHTS

1. Retail consumer banking and insurance survey
2. IFSA 2013: Impact and gaps to be addressed by IFIs
3. Growth scenarios for Islamic banking and takaful up to 2019
4. Role of Islamic finance in social development
5. Malaysia's regional and global Islamic finance opportunities
6. Interview with Tan Sri Dr. Zeti Akhtar Aziz, Governor, Bank Negara Malaysia
7. Shariah-compliant securities as catalyst to the development of the Islamic Capital Market by Datuk Ranjit Ajit Singh, Chairman, Securities Commission Malaysia
8. Interview with Muzaffar Hisham, CEO, Maybank Islamic
9. Interview with Badlisyah Abdul Ghani, CEO, CIMB Islamic
10. Malaysia's potential role in developing a global sukuk market by Prof. Datuk Rifaat Ahmed Abdel Karim, CEO, IILM

Malaysia Islamic finance snapshot 2013 (most recent full-year data available as of writing)

	MALAYSIA	% OF GLOBAL TOTAL	GLOBAL LEADER (ABSOLUTE NUMBERS)
<b>Total Islamic finance assets (banking, takaful, Other IFIs, sukuk and other Islamic capital market)</b>	US\$423.29 billion	25.53%	Malaysia
<b>No. of Islamic financial institutions</b>	76	7.65%	Saudi Arabia (99)
<b>Islamic banking assets (for Malaysia, includes Development Financial Institutions)</b>	US\$170.28 billion	14.02%	Iran (US\$319.01 billion)
<b>Takaful assets</b>	US\$8.596 billion	30.88%	Saudi Arabia (US\$11.05 billion)
<b>Disclosed CSR Funds</b>	31	7.99%	UAE (85)
<b>Education Institutions</b>	44	9.22%	Malaysia
<b>Research Papers (2011-2013)</b>	421	30.89%	Malaysia
<b>No. of Shariah Scholars</b>	188	22.46%	Malaysia
<b>News Articles</b>	2,626	18.12%	UAE (3,006)
<b>Seminars &amp; Conferences</b>	52	22.51%	Malaysia

Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014

# ABOUT THOMSON REUTERS

We are the leading source of intelligent information for the world's businesses and professionals, providing customers with competitive advantage. Intelligent information is a unique synthesis of human intelligence, industry expertise and innovative technology that provides decision-makers with the knowledge to act, enabling them to make better decisions faster. We deliver this must-have insight to the financial and risk, legal, tax and accounting, intellectual property and science and media markets, powered by the world's most trusted news organization.

## KNOWLEDGE SOLUTIONS POWERING DECISION MAKING

Thomson Reuters is an integrated knowledge services provider that assists the Islamic Finance industry through providing solutions that enhance transparency, clarity and accessibility of Islamic Finance to the global audience of businesses and professionals. We are proud to have been at the heart of Islamic banking since the first commercial Islamic bank was launched in 1975.

Our knowledge solutions help you gain clarity and transparency in the rapidly emerging Islamic finance industry by providing you with data services, research products and consulting services.

## DATA SERVICES

Thomson Reuters Eikon and Zawya products provide access to a full spectrum of all relevant Islamic asset classes and content sets to give users the best of class research capabilities.

## RESEARCH

Built on the back of the world's most extensive data capabilities, Thomson Reuters leverages its global network to provide primary source intelligence on markets, industries and institutions relevant to Islamic finance.

## CONSULTING

Thomson Reuters can provide bespoke service harnessing our global knowledge network combined with our deep expertise in Islamic finance.

## ISLAMIC FINANCE GATEWAY COMMUNITY

Islamic Finance Gateway (IFG) Community is the one dedicated knowledge Gateway for professionals from across different countries to converge and interact on industry issues that matter in order to generate actionable outcomes to shape and speed up the industry's growth.

To join the community:  
[online.thomsonreuters.com/ifg](http://online.thomsonreuters.com/ifg)

TO VIEW OUR IFG RESEARCH SOLUTIONS: <http://www.zawya.com/ifg-publications/>

IFG@THOMSONREUTERS.COM

Connect with Us:

 Facebook.com/IFGateway

 Twitter.com/IFGateway

 [bit.ly/LI\\_IFGateway](http://bit.ly/LI_IFGateway)



# Contents

<b>INTRODUCTION</b>	5
<b>FOREWORD</b>	8
<b>EXECUTIVE SUMMARY</b>	10
<b>01 COUNTRY OVERVIEW</b>	19
Country Background	20
Business and Investment Environment	54
Socioeconomic Development	64
<b>02 ISLAMIC FINANCE DEVELOPMENT AND RECENT ACTIVITY</b>	75
Islamic Finance Timeline in Malaysia	76
Malaysia's Islamic Finance Environment	82
Financial Sector Eco System	94
<b>03 SUPPLY AND DEMAND FOR ISLAMIC FINANCE</b>	113
Asset Growth Scenarios	114
Retail Consumer Banking and Insurance Survey	118
<b>04 BANKING SECTOR DEVELOPMENT AND RECENT ACTIVITY</b>	143
Banking Sector Landscape and Profile	144
Regulations Development	158
<b>05 INSURANCE SECTOR DEVELOPMENT AND RECENT ACTIVITY</b>	171
Insurance and Takaful Sector Landscape and Profile	172
Regulations Development	186
<b>06 CAPITAL MARKET DEVELOPEMNTS AND RECENT ACTIVITY</b>	197
Capital Markets Overview and Development	198
Malaysian Sukuk Markets Overview and Development	218
Malaysian Islamic Fund Markets Overview and Development	237
<b>07 THE ROLE OF ISLAMIC FINANCE IN SOCIAL DEVELOPMENT</b>	249
Overview and Development of SME	250
Overview and Development of Zakat and Awqaf	260
<b>08 THE RACE TO BE THE WORLD'S ISLAMIC FINANCE HUB</b>	279
Malaysia's Global Position	280
Malaysia's Regional Position	298
<b>APPENDIX</b>	316
<b>ACKNOWLEDGEMENT</b>	324
<b>CONTRIBUTION &amp; INTERVIEWS CONDUCTED</b>	326



## LEADERSHIP ARTICLES

Malaysia's role and contributions to intra-OIC trade **34**

Malaysia's Green investment climate and opportunities **44**

KL's \$8bln financial district: If you build it, will they come? **58**

Overview: Government initiatives and policies in the development of Islamic finance in Malaysia **84**

Islamic Finance Education, Talent And Professional Training In Malaysia: Issues And Solutions **88**

Malaysia's 'international standard curriculum' for Islamic Finance **92**

Shariah and civil law: the Law Harmonisation Committee of Malaysia **96**

Impact of Shariah governance and regulations on the Malaysian Islamic financial ecosystem **106**

Malaysia's IFSA: Gaps to be addressed by Islamic Financial Institutions **164**

Shariah-compliant securities as catalyst to the development of the Islamic Capital Market **214**

Malaysia's Potential Role in Developing a Global Sukūk Market **226**

Should Islamic Banks do Private Equity in Malaysia? **244**

Islamic Microfinance: Case Study of Amanah Ikhtiar Malaysia **254**

What's the best model to go global? **286**

An overview of Islamic finance in Southeast Asia **300**



## EXCLUSIVE INTERVIEWS

WITH

**TAN SRI DR. ZETI AKHTAR AZIZ**

Bank Negara Malaysia  
Governor  
26

WITH

**MR. MUZAFFAR HISHAM**

Chief Executive Officer,  
Maybank Islamic Berhad  
146

**T**he fifth in our series of Islamic Finance Country Reports (IFCR), the Malaysia Islamic Finance Report 2015 is designed to provide a thorough assessment of the evolution and development of the Islamic finance industry in Malaysia in line with the greater national agenda of vision 2020. Malaysia's overarching ambition is to become a high-income nation by 2020. This Report provides an overview and an assessment of the initiatives and measures taken by the government and policy makers to make Malaysia the global Islamic finance hub. In addition, it evaluates the contribution of Islamic finance and the broader Islamic economy to their economic goals.

The exponential and progressive growth of Islamic finance has helped Malaysia diversify its economy towards supporting sustainable economic growth and performance. The Report shows that Malaysia's fallout from the global financial crisis was limited which contributed to the economy performing relatively well in recent years. Islamic finance assets have contributed to this achievement by sustaining an impressive double-digit growth to reach US\$426.407 billion in September 2014. This development can be attributed to Malaysia's integrated and comprehensive approach to developing its Islamic financial industry, which has facilitated the active engagement of regulators and private sector industry players. Despite the fall in oil prices the Report also expects economic growth to be sustained in 2015, driven mainly by private domestic demand and favourable exports, supported by the country's fiscal consolidation measures and the new 6% goods and services tax (GST).

This Report provides an overview of major financial sector developments in 2013 and 2014. It also includes the outcome of a retail banking consumer survey, conducted in August 2014, and perspectives and insights from key players in the industry including key regulators and practitioners. The results of these interviews and surveys have revealed strategic insights that demonstrate possible opportunities for the financial services sector.

The Report also analyses Malaysia's Islamic finance proposition as a potential global marketplace for Islamic finance and a best practice model. The Report reveals that the current snapshot of macroeconomic and Islamic finance development favours Malaysia as the world's Islamic finance hub. Malaysia has been building its capacities beyond its domestic market; the country was instrumental in the establishment of the Islamic Financial Services Board (IFSB) in 2003, whose mandate is to promote soundness and stability of the Islamic financial industry by issuing prudential standards and guiding principles, and

the Malaysia International Islamic Financial Centre (MIFC) national initiative, launched in 2006, enhances Malaysia as an Islamic finance base with global capabilities and connectivity.

By identifying and assessing the distinct characteristics underlying Malaysia's Islamic finance industry, the Report continues to evaluate if these characteristics can be replicated and benchmarked by other regional markets, such as the Middle East and North Africa.

Lastly, this Report presents Islamic investment opportunities in Malaysia by providing an in-depth assessment of various business sectors

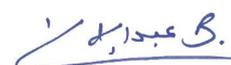
It gives us great pleasure to invite you to discover the Malaysia Islamic Finance Country Report 2015. Enjoy the report!



**Dr. Mohamed Azmi Omar**  
Director General  
IRTI




**Dr. Sayd Farook**  
Global Head Islamic  
Capital Markets  
Thomson Reuters

**Mr. Abdelilah Belatik**  
Secretary General  
CIBAFI



# Executive Summary

## The role of Islamic finance in Malaysia: Success for the capital market but what value to households?

Islamic finance is a strategic industry for Malaysia for the same reasons the financial sector is critical to the functioning of any economy – it provides: jobs, credit, liquidity, risk management services, and investment intermediation to allocate savings and funds to their most productive uses. Islamic finance has also ticked other boxes for Malaysia: it provides Muslims the option to use financial services that adhere to their religious beliefs; it has diversified the country's overall financial system; it has attracted Shariah-sensitive investors and funds into the country; it will spur new growth areas, chief of which are the Islamic Economy sectors; and it has given Malaysia a distinct competitive advantage as an Asian Islamic finance centre. All of these have been made possible by successive governments, since 1981, that have continued to fully support and encourage the use of Islamic finance through tax incentives, business-friendly policies and initiatives, and enabling and robust regulatory, supervisory and surveillance frameworks shaped especially by the central bank, Bank Negara Malaysia, and Securities Commission Malaysia.

After 30 years of government-led industry building, growth numbers are most evident for the capital market with the state, state-linked and private sector businesses seeing the economic merits of being Shariah-compliant. This is most evident in the sukuk market – from 1996 to 2014 64% of total sukuk issuance in Malaysia was sovereign. The number jumps to 79% if quasi-sovereign issues are included. Most sovereign papers serve as instruments to help manage and control liquidity in the Islamic finance market. But at the retail and household level the take-up rate for Islamic finance is nowhere near as impressive. At the end of 2013 the Islamic capital market (ICM) formed 56.4% of the overall capital market but Islamic banking assets only reached 21% of total banking assets and takaful only made up 10% of the whole insurance sector.

The services sector accounts for 55% of GDP and financial services, which includes Islamic finance, is

a leading sub-sector. Looking ahead, the questions that are being asked of Malaysia's Islamic finance industry are:

1. How can it continue to improve to serve the diverse needs of businesses as the economy moves towards becoming a high-income nation by 2020?
2. How will it achieve the aim of making the country an international Islamic finance hub?
3. Can it appeal to households beyond the captive Shariah-sensitive market?
4. How can it provide a larger portion of society access to the nation's increasing wealth?

Malaysia's responses to these issues is to further liberalise, internationalise and strengthen the country's Islamic finance industry in a way that would make it distinctly dissimilar from the conventional system by transforming it from being 'merely' Shariah-compliant to being 'Shariah-based'. This report examines what this entails and its implications especially on Islamic banking and takaful.

Islamic financial assets in Malaysia as % of total financial sector, 2013 (most recent full-year data available as of writing)

SECTOR	% OF TOTAL FINANCIAL SECTOR ASSETS IN MALAYSIA
Islamic banking	21%
Takaful	10%
<b>Capital Market (ICM total = 56.4% of overall capital market)</b>	
Listed companies	71%
Equity market capitalisation	60.5%
Sukuk outstanding	49.67%
Islamic funds	16.7%

Data source: Bank Negara Malaysia, Securities Commission Malaysia

## Changing for growth: Islamic Economy potential and IFSA 2013

Malaysia is the global leader in the Islamic Economy, which is made up of seven major sectors – food, finance, clothing/fashion, travel, media/recreation, pharmaceuticals, and cosmetics. These sectors pose substantial growth opportunities for Malaysia's Islamic finance sector, and in this report we highlight two growth sectors – health travel, which raked in RM690 million in revenue in 2013, and green technology, which is contributing to product innovation and a more diverse asset base for investments. New guidelines for Sustainable and Responsible Investment (SRI) Sukuk were introduced in August 2014 that will help fundraising for the health and green technology sectors. Further, green financing has also been introduced and since 2010 more than RM800 million has been allocated as Shariah-compliant financing under the Green Technology Financing Scheme.

For the lagging retail and household demand for Islamic financial products and services, changes embodied in the Islamic Financial Services Act 2013 are designed to privilege customer protection, financial inclusion, and move Islamic finance to become more risk-sharing, which is hoped to translate into public perception of Shariah-compliant products as more authentically Islamic and also ethical.

In our assessment, the takaful sector will be undergoing the most changes, and the sector has until 2018 to sort out the biggest policy change – separation of family and general takaful business lines (Note: this also pertains to the conventional insurance sector under the Financial Services Act 2013).

In Islamic banking, the reclassification of deposits into principal-guaranteed Islamic deposits and non-guaranteed Investment accounts was the biggest change for consumers and Islamic banks

alike. This is part of the Central Bank's diversification strategies to expand the scope of the Islamic banking business in order to cater to a wider range of customers.

We believe this change will increase transparency (because of additional prudential disclosure requirements for Investment accounts) and inclusion, and encourage Islamic banks to innovate new products. It also reflects a more risk-sharing approach to Islamic banking. This reclassification moves together with plans for the Investment Account Platform to serve SMEs. It is still too early to tell what the migration numbers to Investment accounts would be like and this is one development that will be most closely watched. Our interviews in this report with the central bank Governor and the CEOs of Maybank Islamic and CIMB Islamic reveal their insights on this change.

The most recent development in the Shariah framework for Islamic finance is the IFSA 2013, which goes even further to emphasise the importance of end to-end Shariah governance.

To further strengthen Shariah governance, a key strategy that was recently implemented is the development of Shariah standards and operational standards that specify underlying Shariah principles of each contract and address sound prudential measures, respectively. These standards aim to enhance clarity that will in turn promote greater legal and operational certainty and infuse Shariah-driven innovations in Islamic finance.

The importance of Shariah compliance, as one of the regulatory objectives under IFSA, warrants for serious enforcement that has led to the introduction of specific penalties for Shariah non-compliance.

## Our assessment of the headline changes in Islamic finance in Malaysia

## TAKAFUL

POLICY/INITIATIVE	GOAL/IMPACT		
	Increase transparency	Innovate new products	Increase Consumer Protection
'Consumer takaful contracts' that make it more difficult for takaful operators to cancel takaful certificates notwithstanding misrepresentation by customers	√ Terms & Conditions of takaful policies would have to be very clearly and transparently explained to consumers		√
Dedicated and separate family and general takaful businesses by 2018	This will increase transparency in the financial strength of each operator	√ It's expected that operators will introduce new products to strengthen each separate business line	√
Operators must appoint an in-house Actuary and there's a shift in duties and functions of this Actuary, where the Board of Directors will also take on more responsibility	√		√ This will push up levels of Corporate Governance, which means increased customer protection
New prudential requirements vis-à-vis maintenance of various funds, assets and risk management, among others. In case of deficiency in the risk fund, the provision of Qard hasan is compulsory	√		√

GOAL/IMPACT			
Increase (Financial and Wealth) Inclusion	Shariah-based (with the aim of being more risk-sharing, which would translate into public perception of increased 'authenticity' of Islamic products)	Liberalisation	Increase international linkages
√			
√			
	√		

## Our assessment of the headline changes in Islamic finance in Malaysia (continued)

## ISLAMIC BANKING

POLICY/INITIATIVE	GOAL/IMPACT		
	Increase transparency	Innovate new products	Increase Consumer Protection
By June 30, 2015, reclassification of Islamic deposits into Islamic deposits (principal guaranteed) and Investment accounts (not guaranteed), with new disclosure requirements for the latter	√	√	
Investment Account Platform which will serve as a central marketplace to finance SMEs	√	√	

## ISLAMIC CAPITAL MARKET

POLICY/INITIATIVE	GOAL/IMPACT		
	Increase transparency	Innovate new products	Increase Consumer Protection
Revised screening methodology for equities in line with global standards	Better alignment with global methods will yield closer performance comparisons between Islamic funds in Malaysia and elsewhere		
Retail access to sukuk		√	
Private retirement scheme		√	√
Extension of tax incentives for wakalah and ijarah sukuk until 2018			
Removal of sukuk credit rating requirements from 2017			
ASEAN CIS Funds Passporting framework involving Malaysia, Singapore and Thailand		√	

GOAL/IMPACT			
Increase (Financial and Wealth) Inclusion	Shariah-based (with the aim of being more risk-sharing, which would translate into public perception of increased 'authenticity' of Islamic products)	Liberalisation	Increase international linkages
√	√		
√	√		

GOAL/IMPACT			
Increase (Financial and Wealth) Inclusion	Shariah-based (with the aim of being more risk-sharing, which would translate into public perception of increased 'authenticity' of Islamic products)	Liberalisation	Increase international linkages
√	√		
√		√	
√		√	
	Better alignment with global consensus away from mura-bahah and bai bithaman ajil	√	√
		√	√
√		√	√

Our assessment of the headline changes in Islamic finance in Malaysia (continued)

INDUSTRY-WIDE		GOAL/IMPACT		
POLICY/INITIATIVE	Increase transparency	Innovate new products	Increase Consumer Protection	
Financial Ombudsman	√		√	
Heavier statutory penalties for Shariah non-compliance for Shariah Committee, senior management and Board of IFIs	√		This will push up levels of Corporate Governance, which means increased customer protection	

**Our growth projections for Islamic banking and takaful up to 2019**

We’re projecting two growth scenarios for Malaysia’s Islamic banking sector for the next five years – base scenario and a higher optimal scenario. On the base case scenario we project growth at an average 13% year-on-year. This will push up Islamic banking assets from US\$141.77 billion at the end of 2013 (excluding Development Financial Institutions) to US\$296.29 billion in 2019 if sustained favourable conditions are met. At the higher optimal level, assets will grow an average 18% until 2019 to reach US\$385.51 billion or 28.56% of total banking assets. In other words, at optimal speed, we expect Islamic banking assets to more than double after five years.

Islamic banking growth will be driven by opportunities for Islamic banks to finance the development of expansion projects that tap into the real economy. At the retail and household level, our consumer retail survey findings reveal that Islamic subsidiaries of conventional banks have gained customer trust; this will create more demand for existing conventional banks to offer Islamic solutions. Our survey also reveals that Islamic banks have gained momentum in maintaining customer relationships, and that a

higher level of satisfaction was expressed by Islamic banking users compared to conventional banking users. Further, a high number of survey respondents, both Islamic banking and conventional banking users, expressed concerns about interest-based (riba) transactions. The changes made to strengthen products and processes to be more Shariah-based will be able to respond positively to these concerns.

Similar to our projections for Islamic banking, there are two growth scenarios for takaful. At the base case scenario contributions will grow an average 12.59% year-on-year for the next five years to reach US\$4.11 billion by 2019 from US\$2.02 billion in 2013. At the higher optimal level, contributions will grow an average 18.2% year-on-year to reach a market share of 17.96% of total insurance premiums by 2019, equal to US\$5.51 billion.

Takaful growth will be driven by changing social, demographic and financial trends, such as growing incomes and a greying population. Further, expansion on infrastructure projects under the Economic Transformation Programme also demands necessary

GOAL/IMPACT			
Increase (Financial and Wealth) Inclusion	Shariah-based (with the aim of being more risk-sharing, which would translate into public perception of increased 'authenticity' of Islamic products)	Liberalisation	Increase international linkages
	√		

insurance and takaful coverage. Our retail financial services survey reveals that the potential demand for general takaful far exceeds that for family takaful. However, there is a low level of understanding of

the need for family takaful, or even the Islamic authenticity of family takaful. The changes made to strengthen transparency, inclusion and Islamic authenticity will address this issue.

### Projected growth for Islamic banking and takaful to 2019

	BASE CASE SCENARIO			OPTIMAL SCENARIO		
	GROWTH YOY	2019 PROJECTED ASSETS	% TOTAL MARKET SHARE	GROWTH YOY	2019 PROJECTED ASSETS	% TOTAL MARKET SHARE
<b>Islamic banking</b> 2013 = US\$141.77 bln assets 21% market share	13%	US\$296.29 bln	25.56%	18%	US\$385.51 bln	28.56%
<b>Takaful</b> 2013 = US\$2.02 bln contributions 10% market share (assets) 0.6% penetration	12.59%	US\$4.11 bln	15.56%	18.2%	US\$5.51 bln	17.96%
<b>TOTAL ASSETS</b> 2013 = US\$143.79 bln		US\$300.4 bln			US\$391.02 bln	



# COUNTRY OVERVIEW

---

## COUNTRY BACKGROUND

- 23 Economic growth is expected to accelerate in 2015
- 26 Exclusive Interview with Bank Negara Malaysia Governor Tan Sri Dr. Zeti Akhtar Aziz
- 32 The service sector contributed 55.2% to GDP in 2013
- 34 Malaysia's role and contributions to intra-OIC trade
- 44 Malaysia's Green investment climate and opportunities
- 50 Foreign trade plays a major role in Malaysia's economy

## BUSINESS AND INVESTMENT ENVIRONMENT

- 54 The Malaysian government launched Vision 2020 in 1991 to outline a broad plan to achieve developed economy status by 2020
- 58 KL's \$8bln financial district: If you build it, will they come?
- 61 The sizable magnitude of foreign direct investment (FDI) has been a contributing factor to Malaysia's economic growth
- 61 A key government policy is to attract export-oriented FDI

# Country Background

## One of the most dynamic countries in the Asia Pacific region

Malaysia is an open middle-income country strategically located along the Strait of Malacca and southern South China Sea and geographically close to the high growth economies of China, Indonesia and India. Malaysia is a federation that comprises 13 states and three federal territories. These are divided between two regions, with 11 states and two federal territories on Peninsular Malaysia and the other two states and one federal territory in East Malaysia. The majority of the population lives in Peninsular Malaysia, as well as the predominantly forested areas of Sabah and Sarawak, across the South China Sea on the northern coast of Borneo. Malaysia's climate is tropical and often humid.

The Federation of Malaya, established from the British-ruled territories of peninsular Malaysia in 1948, became independent from British rule on August 31, 1957 under the leadership of Tunku Abdul Rahman, who became the first prime minister. The British colonies of Singapore, Sarawak and Sabah (the latter two are collectively called North Borneo) joined the Federation to form Malaysia on September 16, 1963. Later, the Independence of Singapore Agreement 1965 between the Government of Malaysia and the Government of Singapore granted independence to Singapore with effect from 7 August 1965. Malaysia is an open middle-income country strategically located along the Strait of Malacca and southern South China Sea and geographically close to the high growth

economies of China, Indonesia and India. Malaysia is a federation that comprises 13 states and three federal territories. These are divided between two regions, with 11 states and two federal territories on Peninsular Malaysia and the other two states and one federal territory in East Malaysia. The majority of the population lives in Peninsular Malaysia, as well as the predominantly forested areas of Sabah and Sarawak, across the South China Sea on the northern coast of Borneo. Malaysia's climate is tropical and often humid. The Federation of Malaya, established from the British-ruled territories of peninsular Malaysia in 1948, became independent from British rule on August 31, 1957 under the leadership of Tunku Abdul Rahman, who became the first prime minister. The British colonies of Singapore, Sarawak and Sabah (the latter two are collectively called North Borneo) joined the Federation to form Malaysia on September 16, 1963. Later, the Independence of Singapore Agreement 1965 between the Government of Malaysia and the Government of Singapore granted independence to Singapore with effect from 7 August 1965.

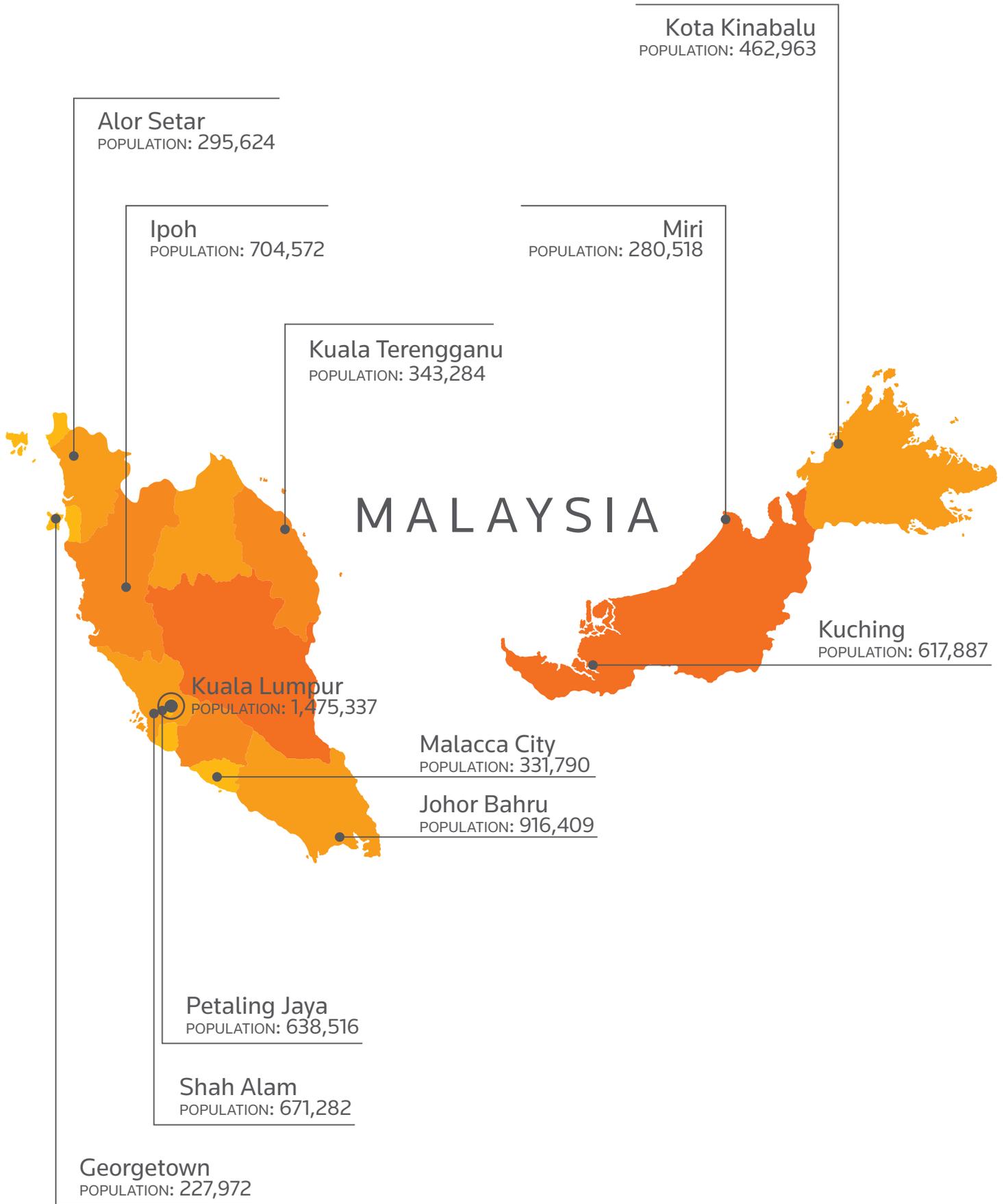
Malaysia's population stood at 30.261.7 million as at Q2 2014, with 62% Bumiputera (i.e. indigenous people of Malaysia made up of Malay Bumiputera and Other Bumiputera), 21.8% Chinese, 6.5% Indian, 0.87% others and 8.72% non-Malaysian citizens.

## Exchange rate pegged to USD

The currency of Malaysia is the Malaysian Ringgit (formerly the Malaysian Dollar) and it is divided into 100 sen (cents). The ringgit is issued by the central bank, Bank Negara Malaysia. In September 1998, BNM pegged the ringgit to the US Dollar during the Asian financial crisis. On July 21, 2005, BNM

announced the end of the peg to the US dollar immediately after China's announcement of the end of its renminbi peg to the US dollar. As of 19 January 2015, the Malaysian Ringgit stands at USD 1 = RM 3.5668.





## Economic Performance Overview

**Malaysia emerged stronger from the 1997-1998 Asian financial crisis.** Macro-fundamentals were strengthened especially through broad-based financial sector reforms and capacity building.<sup>1</sup> There was continued focus on privatisation and promotion of private sector investment. The crisis caused GDP to contract 7.4% in 1998, after consistent economic expansion averaging 9% per year since 1987. To try to stabilise its Ringgit and control outflows during the crisis, Malaysia first increased interest rates and then imposed a comprehensive set of restrictions in September 1998. The economy began regaining pre-crisis GDP levels only in the mid-2000s.

**The economy has performed relatively well in recent years.** Average GDP growth was over 4.7% since 2006. The Malaysian government has implemented a fiscal consolidation programme after an increase in government debt following the global financial crisis.

**Fluctuations in recent decades are mainly due to heavy reliance on exports.** Exports represented 73.1% of GDP in 2013. Total foreign trade is significantly higher than the size of GDP and was valued at RM1.369 trillion (US\$410 billion) in 2013. Malaysia's economic performance is affected by the movement of external demand and commodity prices. Its main export is electronic products (components) and raw commodity products such as palm oil.

**Fallout from the global financial crisis was limited.** The economy contracted only 1.5% in 2009 due to the slowdown of the world economy in 2008 compared to the 7.4% slump in 1998 during the Asian financial crisis. In 2010, Malaysia experienced strong recovery achieving a growth rate of 7.4%, which continued at a more moderate rate of 5.1% in 2011, 5.6% in 2012 and 4.7% in 2013.

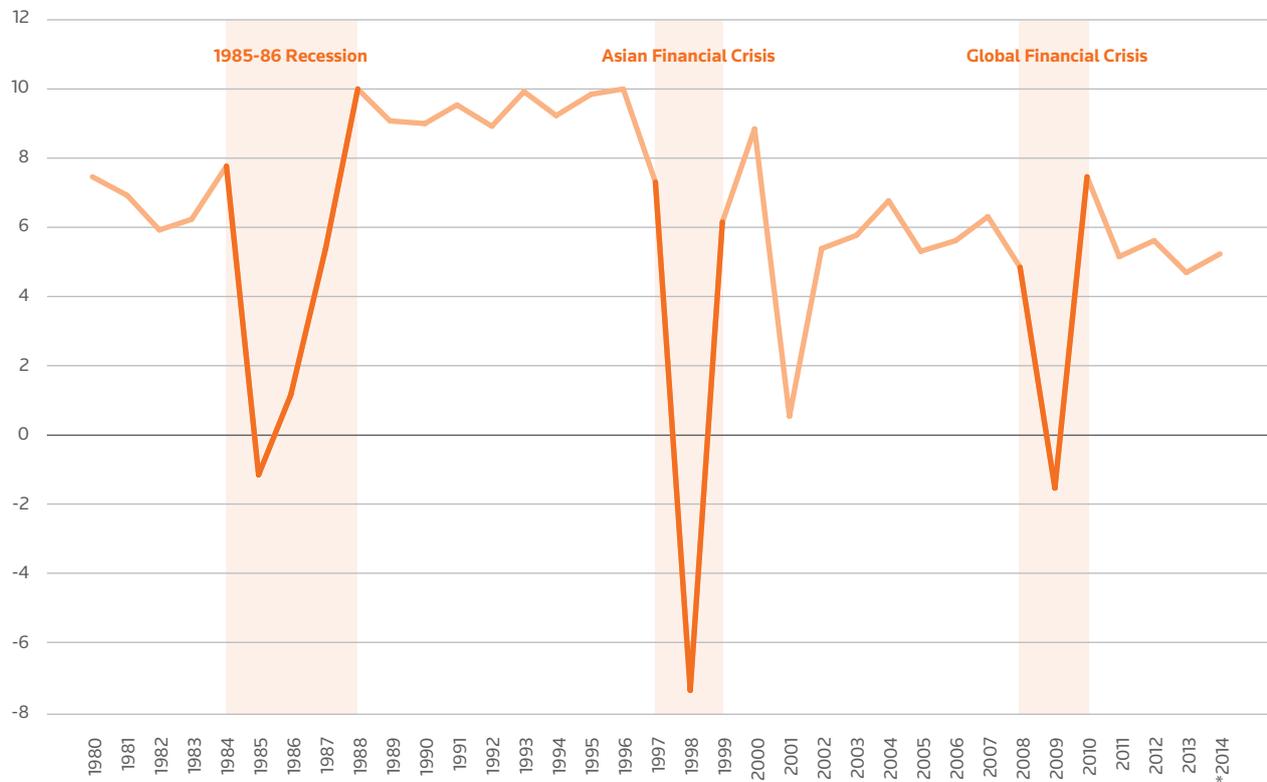
**Economic growth forecast for 2015 has been cut due to low global crude oil prices.** On January 20, 2015 the government cut its 2015 GDP growth forecast to 4.5-5.5% from 5-6% amid sharply falling global crude oil prices. 30% of Malaysia's revenues come from oil. Growth will be driven mainly by private domestic demand, exports supported by the country's fiscal consolidation measures and high levels of employment. Positive growth prospects are also underpinned by the various multi-year investment projects that are estimated to be RM189 billion. It is expected that the weak ringgit (which hit a five-year low in January 2015 due to falling crude oil prices) will help boost exports and tourist arrivals especially with a huge push from the Malaysia Year of Festivals 2015 campaign.

**The goal of US\$15,000 GNI per capita by 2020 is progressing.** 2010 – US\$8,150, 2013 – US\$10,400 (World Bank GNI current US\$ Atlas method). Gini coefficient of income inequality improved from 0.441 in 2009 to 0.43 in 2012 (0=perfect equality). However, while growth in consumption is positive, it has been slower for the poorest 40% than for the population as a whole, said the UN Human Development Report 2014. Further, the first ever Malaysia Human Development Report 2013 found that while much progress has been made in narrowing income gaps between groups, overall household income inequality remains high and segments of society may be excluded from actively participating and receiving an equitable share of benefits.

**New 6% goods and services tax (GST) kicked in Apr 1, 2015.** GST replaces the Sales and Services tax, and will expand the tax base. Some items will be exempt, including: essential basic goods such as rice, sugar, and cooking oil; and sale and rental of property. Subsidies for fuel and other items will continue to be reduced progressively. A national minimum wage (RM900 per month in Peninsular Malaysia and RM800 per month in Sabah and Sarawak) came into effect in January 2013.

<sup>1</sup> Bank Negara Malaysia, Annual Report 2010 (Kuala Lumpur: BNM)

## GDP Growth



Source: International Monetary Fund, World Economic Outlook Database  
 Note: Data for 2014 are forecasts

## GDP Growth Rate

	AVERAGE 1996-2005	2006	2007	2008	2009	2010	2011	2012	2013	AVERAGE 2006-2013
Vietnam	7.1	7	7.1	5.7	5.4	6.4	6.2	5.2	5.4	6.05
Indonesia	2.6	5.5	6.3	6	4.6	6.2	6.5	6.3	5.8	5.90
Singapore	5.3	8.9	9	1.9	-0.6	15.1	6	1.9	4.1	5.68
Philippines	4.1	5.2	6.6	4.2	1.1	7.6	3.6	6.8	7.2	5.27
Malaysia	4.7	5.6	6.3	4.8	-1.5	7.4	5.1	5.6	4.7	4.72
S. Korea	4.8	5.2	5.1	2.3	0.3	6.3	3.7	2	2.8	4.72
Turkey	4.3	6.9	4.7	0.7	-4.8	9.2	8.8	2.2	4.3	3.91

Source: International Monetary Fund, World Economic Outlook Database



Migrant workers cut grass by hand outside Tuanku Mizan Zainal Abidin Mosque in Putrajaya. REUTERS/Olivia Harris

## Exclusive Interview

### Tan Sri Dr. Zeti Akhtar Aziz Bank Negara Malaysia Governor



Dr Zeti Akhtar Aziz was appointed Governor of Bank Negara Malaysia in May 2000. She is a founding member of the Bank for International Settlements (BIS) Asian Consultative Group for Asia, and the first co-chair of the Financial Stability Board (FSB) Regional Consultative Group for Asia.

Dr Zeti received her Bachelor of Economics from the University of Malaya and her PhD in Economics from the University of Pennsylvania.

**Q:** Islamic finance is often associated with adding value to the real economy and fostering sustainable growth. How successful is Malaysia's model in this regard? To what extent has Islamic finance contributed to the stability of the Malaysian financial sector?

**A:** The progressive development of Islamic finance has enabled Malaysia to diversify the overall financial system towards supporting more sustainable economic growth performance. Islamic banking assets have demonstrated a consistent double-digit growth rate annually since the year 2000 and currently represents about a quarter of Malaysia's total banking assets. Similarly, the sukuk market has become a vibrant component of the local bond market, commanding a 57 percent market share and

attracting both issuers and investors from other parts of the world. From January 2012 to September 2014, 12 foreign corporate issuers have issued sukuk in the Malaysian marketplace.

The process of Shariah screening and additional scrutiny for Shariah compliance provides additional safeguards in governing the overall operation of Islamic financial institutions. This, in turn, translates into greater public confidence on the ability of Islamic financial institutions to manage their operations effectively. The nature of risk-sharing activities and the close association between Islamic finance and the real economy provides the potential for the financial solutions to enhance the resilience of the financial system. The involvement of Islamic financial institutions

as business partners with clients under risk-sharing contracts requires them to exercise greater due diligence to ascertain that the financing decisions are prudent and is commensurate with the underlying risk. From a macro perspective, sharing of profits and losses encourages a positive relationship with the underlying economy and translates into continuous management of the risk of defaults and probability of systemic contagion emanating from the business ventures.

**Q:** At the Islamic Investment Summit in June 2013, you commented that greater macro-prudential measures are needed to address the close link between Islamic finance with the real economic sector, and should include heightened surveillance over developments in the real estate and commodity markets. Why are these required, and how does this translate into the Malaysian context working towards 2020?

**A:** Macroprudential measures are typically designed to minimise incentives or create disincentives for excessive risk-taking in specific and targeted segments of the economy. In calibrating and designing such macroprudential measures, an important consideration therefore is to prevent an over-adjustment or an over-correction in the targeted segments. Given the close link between such sectors with many other parts within the economy and with the financial system, especially in Islamic finance, such

over-adjustment can precipitate stress within Islamic financial institutions and even to the broader financial system. When not well-managed, this can also lead to stress in the broader economy in the subsequent rounds.

Therefore, in assessing risks to financial stability, it is crucial for central banks to develop an understanding on the risk transmission map and the contagion channels within the economy and the financial system. This would allow for the early identification of potential risks and appropriate formulation of policy responses that focus on managing the transmission channel that poses the strongest link to the other parts of the financial system and economy.

In addition, this needs to be complemented with a greater infusion of macro-level issues in the conduct of microsurveillance and supervision to ensure that risk-taking behaviours of financial institutions are at appropriate levels and are commensurate with institutional-level risk management infrastructure and capability.

**Q:** What are the weaknesses and gaps in the Malaysian Islamic financial sector and how could they be addressed and strengthened? The Islamic Financial Services Act 2013 came into force on 30 June 2013. After slightly more than a year of implementation, are you satisfied with its progress? How far have Islamic financial institutions been able to meet the requirements of the regulations?

**A:** The Islamic Financial Services Act 2013 (IFSA) provides the platform for end-to-end Shariah compliance and governance for the Islamic financial sector. This new legislation provides for a comprehensive Islamic finance regulatory framework that supports the application of Shariah financial contracts for Islamic financial products, and is a key link between legal and regulatory practices with Shariah. The increased focus on Shariah contracts is also expected to spur product innovation and diversification. Moving forward, we will see Islamic financial institutions become more focused in their operations, and offering a greater range of products to best meet the changing demands of a modern economy.

A major change under IFSA is the separation of Islamic deposit and investment accounts. It allows for Islamic banks to have an expanded role of investment intermediation in addition to their current role of credit intermediation. Islamic banking institutions have been given a two-year transition period up to June 2015 to meet this requirement of separating Islamic deposit and investment accounts. This process has already begun, with several institutions already having in place new deposit and investment products based on the appropriate Shariah contracts. The adoption of this new business model will involve a different set of skills and risks. Meeting these requirements will reinforce consumer trust and confidence.

**Q:** Some consider LTV<sup>2</sup> caps to be primarily structural measures; how successful have they been in Malaysia, and what other macroprudential tools have had the most impact?

**A:** The Central Bank had already since the 1990s relied on macroprudential measures to manage build-up of financial imbalances. This was well before the Asian Financial Crisis. However, based on our experience, macroprudential tools also need to be complemented by other measures to strengthen its effectiveness. This includes supervisory, fiscal and other structural measures. In the deployment of macroprudential measures, the Central Bank has adopted a targeted and progressive approach in order to minimise unintended spillovers on the broader economy. The measures also extend beyond the LTV ratio to also include responsible lending guidelines and extensive financial education programmes for households.

As a result of these measures, the annual growth of household debt has moderated for the sixth consecutive quarter to 10.3 percent from more than 15 percent in 2010. There is now improved affordability assessments and underwriting practices being adopted by the financial institutions. The mandate and capacity

of the Bank to respond to the build-up of imbalances in the financial system and excessive risk-taking by financial institutions has also been significantly strengthened with the introduction of the new legislative and governance framework under the Central Bank of Malaysia Act 2009, and the Financial Services Act 2013 and the Islamic Financial Services Act 2013 (IFSA).

---

*The progressive development of Islamic finance has enabled Malaysia to diversify the overall financial system towards supporting more sustainable economic growth performance.*

---

**Q:** What would be the impact on Malaysia and the global Islamic finance industry of a merger such as the one proposed between CIMB, RHB and MBSB? *(Editor's note: This question was posed as negotiations were ongoing for the proposed merger between the three financial institutions. In mid-January 2015 it was officially announced that plans for the merger had been scrapped.)*

**A:** Any mergers involving the Islamic banking institutions would be a commercial decision by its shareholders and not be a

policy-driven initiative. Merger of this nature would result in as increased market capitalisation of Islamic banking institutions and will further enlarge potential growth opportunities. Additionally, the larger capital base will also result in an increase in Islamic banks' single counterparty exposure limit (SCEL), extending their ability to offer higher-value products involving large investments and allow for the offering of products to finance large projects in key economic areas such as the aviation, oil and gas sectors. It would be, however, up to the relevant parties to decide on the business focus and deliverables of such mergers. The Bank will, on its part, ensure the orderly conduct of the process and ensure no disruptions to banking operations. It is envisaged that our Islamic financial system will have intermediaries with different scale of operations, similar to conventional finance that focuses on different offerings to the economy. A diversified financial structure is highly relevant to a highly diversified economy that has strong international linkages.

**Q:** Some have highlighted that a 'mega Islamic bank' could exert a negative impact on market competition. What is your opinion on this?

**A:** A mega Islamic bank will not result in a negative effect on market competition, given that an Islamic bank with such scale and size would engage in new business activities including

<sup>2</sup> The loan-to-value (LTV) ratio is a financial term used by lenders to express the ratio of a loan to the value of an asset purchased.

at the international level. This could also include areas such as wholesale banking which has so far been underserved by Islamic banks. The recommendation under the Financial Sector Blueprint 2011-2020 to issue Islamic banking licences to institutions with specialised expertise is aimed at supporting the growth of cross-border wholesale and investment banking activities that are currently underserved by the current institutions. The establishment of a mega Islamic bank would not only enhance our global interlinkages with other economies, but also strengthen and reinforce Malaysia's position as an international Islamic financial hub.

**Q:** The issues of moral hazard and 'too-big-to-fail' have also been highlighted vis-à-vis a 'mega Islamic bank', with worries about government bailouts and public funds used for banks in distress. What are your views on these concerns?

**A:** Following the series of financial meltdowns and disruptions experienced during the recent global financial crisis, the Islamic financial industry has fared relatively well in comparison to the impact on conventional banks. This is because Islamic finance has the distinct characteristics associated with Shariah-compliant financial features. These requirements ensure the channelling of funds goes into real economic activities, which reduces the risks associated with highly leveraged activities or speculative derivative activities.

The practice of risk-sharing in Islamic finance also strengthens the incentives for Islamic financial institutions to conduct the appropriate due diligence, reinforced by high standards of disclosure and transparency, and more prudent risk management practices.

This is reinforced by our rigorous regulatory and supervisory regime. The issuance of the new legislation, including IFSA, is part of the regulatory reform to further enhance the regulatory and supervisory framework in Islamic financial system.

**Q:** With regard to Islamic finance, Malaysia has been a strong participant and initiator of cross-border dialogue between regulators, and between regulators and international bodies such the International Monetary Fund (IMF) and the Bank of International Settlements (BIS) with a view to enhancing cross-border channels within a strong and stable regulatory and supervisory framework. How has internationalisation in Islamic finance in 2014 progressed, and how internationalised do you think it will be in 2020? What more needs to be done in the five years leading up to 2020?

**A:** From the onset, Malaysia has collaborated with other jurisdictions and international standard-setting organisations to generate dialogue amongst jurisdictions and to enhance the sound global development of Islamic finance. Malaysia was a part of the

group of pioneering central banks involved in the establishment of the Islamic Financial Services Board (IFSB). We also actively support organisations such as the International Accounting Standards Board (IASB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). These organisations serve as a platform for the discussion of contemporary issues and provide greater understanding on how Islamic finance would fit into the current financial landscape in terms of products, players, regulations and standards. In addition, engagement with such organisations enables greater coordination between global standard-setting bodies in determining and implementing international standards to address issues pertaining to the industry.

Today, significant progress has also been achieved by the IFSB and the International Islamic Financial Market (IIFM) in promoting the adoption of standards and common documentation across jurisdictions. In particular, IFSB has reported a higher adoption of its prudential standards, with implementation by 13 regulatory and supervisory authorities worldwide, with more expected to do so in future.

These efforts have facilitated the growth and development of Islamic finance, culminating in the internationalisation of the sector today. At present, new jurisdictions, including major international financial centres,

are beginning to adopt Islamic finance — both in sukuk issuance and the development of an Islamic financial sector—which will expand the offering of Shariah-compliant products and services. Going forward, the challenge for the industry globally is to establish financial linkages across jurisdictions, which will ultimately involve greater standardisation and harmonisation.

Another new focus for Islamic finance would be new growth areas such as green technology financing, socially responsible financing and also the halal industry. Given the common values of sustainability and ethics, Islamic finance may also have a catalytic role in these sectors. The industry as a whole should be proactive in positioning itself to have a major role in these new areas, including having the financial capacity and the ability to assess risks and business viability relevant to these sectors.

**Q:** Malaysian households are among the most highly indebted in Asia. Household borrowing for houses, automobiles, and other home and personal expenditures increased at an average annual rate of 12.1 percent over 2003-2013 to reach the equivalent of 86.8 percent of GDP in 2013. How much does Islamic financing contribute to household debt and what policies will be put in place to mitigate the negative impacts of household borrowing on the Malaysian economy?

**A:** Malaysia household indebtedness has now stabilised following a series of measures that have been implemented since 2010. These include a wide range of macro and microprudential measures and supervisory interventions. Of significance is its effect on personal financing which has now moderated significantly. For the most part, household loans have been for the purchase of houses and vehicles. Therefore it is mainly for the accumulation of assets. Malaysia's relatively young population and the intensification of urbanisation has been a major factor accounting for this trend. It is also supported by strong income growth during this period and low unemployment levels which has stabilised at 3 percent. It is also worth noting that the level of financial assets held by households is also high at 192.1 percent of GDP.

---

*Another new focus for Islamic finance would be new growth areas such as green technology financing, socially responsible financing and also the halal industry. Given the common values of sustainability and ethics, Islamic finance may also have a catalytic role in these sectors.*

---

About one third of such financing is in the form of Islamic finance. Households have been free to choose the form of financing. This is essentially based on the product offerings by financial institutions. Consumer financing in Malaysia is highly competitive and households are able to undertake a comparative shopping exercise before obtaining such financing. Islamic financing offers a wide range of innovative products for the household sector that are at competitive pricing. The impaired loans for the households have remained low. Prudent underwriting standards have been adopted and the loans have generally been extended to creditworthy borrowers. On the whole, household balance sheets have remained healthy.

**Q:** Most credit is held by Malaysian high net worth individuals, but continued hike in rates could carry negative impact on household budgets, harming low-paid workers the most. How will this issue be managed?

**A:** Interest rates must be at an appropriate level to ensure low and stable inflation and sustainable economic growth. Interest rates that are kept too low for a prolonged period can however encourage excessive risk taking behaviour by households and businesses, and lead to the build-up of financial imbalances. Such imbalances would increase the risk of future financial crisis and economic recessions, ultimately hurting the welfare of Malaysian households. Interest rates must

also be appropriate to provide depositors with a reasonable return on their savings. This is important for a high savings nation like Malaysia and in particular for segments of society that depend on the income from savings for their livelihood, such as pensioners.

When households enter into a loan arrangement, there will be an affordability test. In addition, as part of the financial literacy programme, borrowers will be informed of the effect of interest rate changes on their obligations. For socio-economic reasons, this will continue to be important when extending loans to this segment of the community. Since the implementation of the Guidelines on Responsible Financing in 2012, further improvements were observed in banks' conduct of affordability assessments in assessing a borrower's debt repayment capacity. This was supported by the continued access to real time credit information on borrowers via the Central Credit Reference Information System (CCRIS). As such, credit has been extended to borrowers that can afford to repay it. For borrowers experiencing financial difficulties, there are institutional arrangements for debt counselling and restructuring to provide avenues for borrowers to seek assistance to better cope with their debt obligations.

**Q:** Recent changes in subsidies have caused an increase in the prices of food, transport and electricity which caused annual inflation to rise and turned real

interest rates negative. Further, the Goods and Services Tax (GST) will come into effect in April 2015. How should all these challenges be tackled?

**A:** The subsidy adjustments and the implementation of the GST are structural reforms that are essential to strengthen the overall resilience of the economy by removing distortions and encouraging more efficient use of fiscal resources. These reforms are expected to lead to some price increases to above our long-term average of 3 percent. Our assessment is that the increase in inflation will be temporary as subdued external price pressures, the absence of excessive wage pressures and the moderation in consumption demand would contain the spillover effects and limit the risk of second-round inflation. This increase is therefore expected to be temporary. Inflation is expected to trend to its long-term average in 2016, when the impact of adjustments and the GST lapse.

Meanwhile, the Government has also undertaken several initiatives to address challenges arising from these price increases. The first is the introduction of a more targeted financial assistance to help the vulnerable groups to cope with the consequent higher cost of living. Second is the ongoing efforts to contain the increase in prices. These include the active enforcement to minimise profiteering; the improvement to domestic food production and

distributional efficiency to ensure stable food prices, and measures to enhance market competitiveness, such as enforcing the *Competition Act 2010* and empowering consumers with information on prices through an online portal and access to affordable necessities through designated stores.

## Major Industries Overview

**1. The service sector contributed 55.2% to GDP in 2013.** The government expects the sector to grow by 3.5% in 2014 compared to 3.4% in 2013, supported by strong growth in consumer spending. Tourism and banking are major sub-sectors. Malaysia's Tourism Vision 2020 aims to attract 35 million tourists. The real value of international tourism receipts rose by 1.3% in 2013 and gains of 1% are expected by the end of 2014. The banking sector is stable and well-capitalised with non-performing loans ratio of just 1.4%.

A number of public and private investors have kick-started plans for a new metropolis at the southern tip known as Iskandar Malaysia. The project will include a modern port, tourism facilities and an industrial complex. Singapore, whose Central Business District is only an hour's drive from Iskandar Malaysia, is the biggest investor. The project is expected to require US\$109 billion over 20 years and has a planned population of 3 million by 2025.

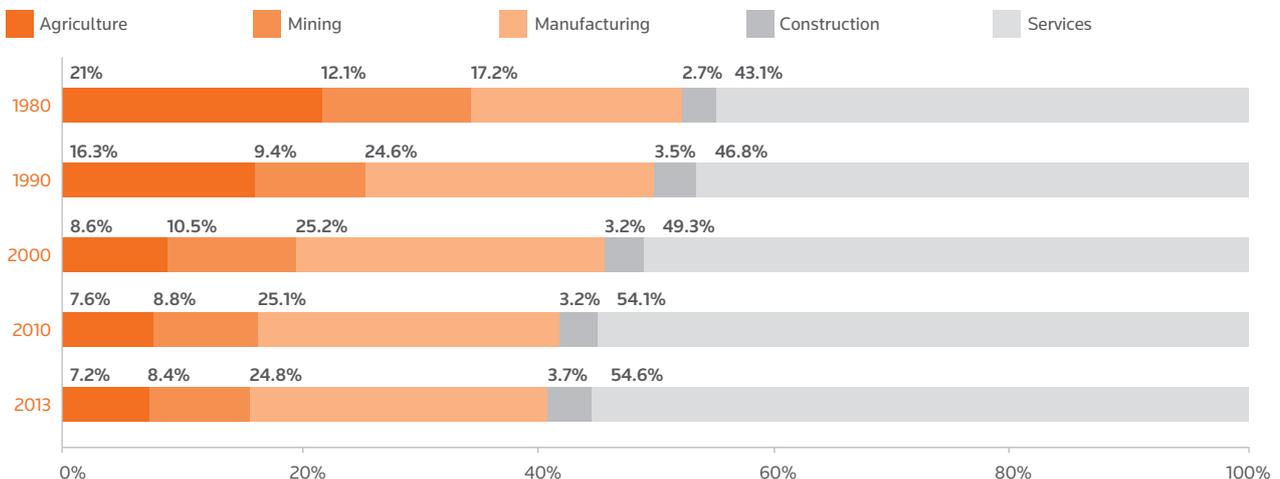
**2. Manufacturing contributed 24.5% to GDP in 2013.** The sector employs roughly 16% of the labour force. Manufacturing is predominately made up of export-oriented producers of electronic components.

Indian firms have invested \$1.1 billion in a number of manufacturing projects in Malaysia; after concluding a free trade multilateral agreement between Malaysia and India. Over 50% of Foreign Direct Investment (FDI) inflows go to the manufacturing sector and the gross output grew by 2.8% in 2013. Malaysia should take advantage of the positive growth momentum to focus on future movement up the manufacturing value chain. Bank Negara Malaysia expects the manufacturing sector to grow at 6.2% in 2014 compared with 5.9% in 2013.

**3. Palm oil is the biggest component of the agricultural sector.** It covers more than 70% of agricultural land and employs 13% of the country's labour force. Exports of palm oil are growing by 10% per annum. The government's Tenth National Plan<sup>3</sup> calls for agriculture to grow by 3.3% per year in 2010-2015. Some agricultural subsidies have been removed as part of the fiscal consolidation programme but revitalisation in the production of plantation commodities is driving growth in the sector.

3 Malaysia Economic Planning Unit <http://www.epu.gov.my/en/>

## Structure of GDP 1980-2013 (%)



Source: Department of Statistics, Malaysia – detail breakdown can be found in <http://www.statistics.gov.my/>

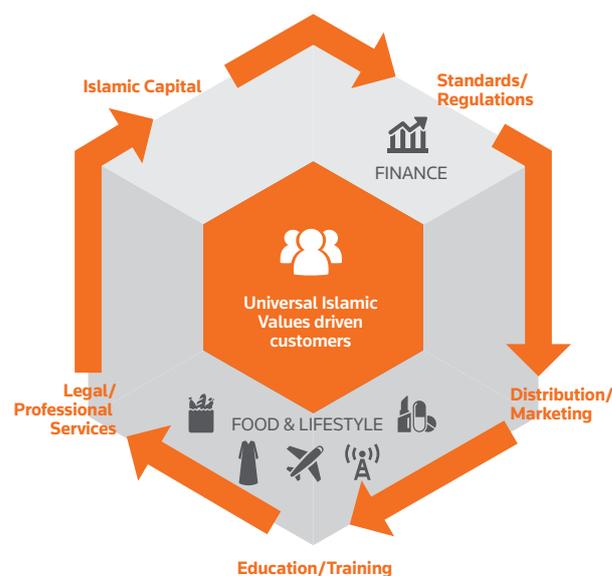
Focus: Halal Sectors



There are seven major Islamic economy sectors, as detailed in the Thomson Reuters State of the Global Islamic Economy Reports of 2013 and 2014, where Malaysia leads the universe of countries as the world's most developed Islamic economy ecosystem. The underlying point of union and driver for these sectors is the common set of potential customers.

A potential halal food and pharmaceuticals consumer is also a potential Islamic finance consumer and a potential consumer for the rest of the Islamic Economy sectors. The business owner in one of these sectors will need to leverage on common Islamic values in order to improve efficiency and scale. The infographic on this page is a snapshot of the Islamic Economy in Malaysia as per the latest Global Islamic Economy Indicator (GIEI) report which ranked Malaysia as global leader.

The report also identified five areas of connectivity; the most common is Islamic capital, which all segments are seeking.



\*1 point = If Country has a recognized Halal Certification body;  
 1 point = If Country that have Hotel(s) rated by CrescentRating  
 & 1 point = If Country has some Government halal standards

Source: Thomson Reuters State of the Global Islamic Economy Report 2014/2015 <http://www.zawya.com/ifg-publications/>



## Leadership Article



**By Dr. Ahmet Suayb  
Gundogdu, IDB Group**

Dr. Ahmet Suayb Gundogdu is Manager at the Corporate and Structured Finance Department of the International Islamic Trade Finance Corporation (ICTF) of the Islamic Development Bank Group. He holds a PhD in Islamic Finance from University of Durham, UK. He was pursuing his PhD in Economics at Virginia Tech, USA, before joining the IDB Group. In addition to trade finance, he has work and research experience in many areas of international trade.

## Malaysia's role and contributions to intra-OIC trade

Malaysia has been a prominent member of the Organisation of Islamic Cooperation (OIC) from its establishment in 1969 and the country's economic progress has been a model to other OIC member countries seeking to diversify their own economies and push for export-led growth. The country continues to play an important role in the development of the OIC and its member countries.

### Historical overview

Malaysia was an active leader in the formation of the Organisation of the Islamic Conference (OIC, renamed Organisation of Islamic Cooperation in 2011), and went on to initiate OIC affiliates, specialised institutions and subsidiary organisations. During the initial stage of the OIC's formation, Malaysia lobbied for OIC observer status in the United Nations and hosted the fifth Islamic Conference of Foreign Ministers in Kuala Lumpur in 1974. In addition to institution building, Malaysia has been an active mediator among OIC member countries as early as the time of the OIC secretary general Tengku Abdul Rahman (1971-1974) who mediated the armed conflict between two OIC member countries.

Since the establishment stages of the OIC, Malaysia has been elected to various committees and has led ambitious economic and financial programmes. This is evidence of the confidence fellow OIC member states have in Malaysia, and also reflects the country's attachment to

solidarity and collective efforts in pursuit of common objectives for the prosperity of all OIC countries.

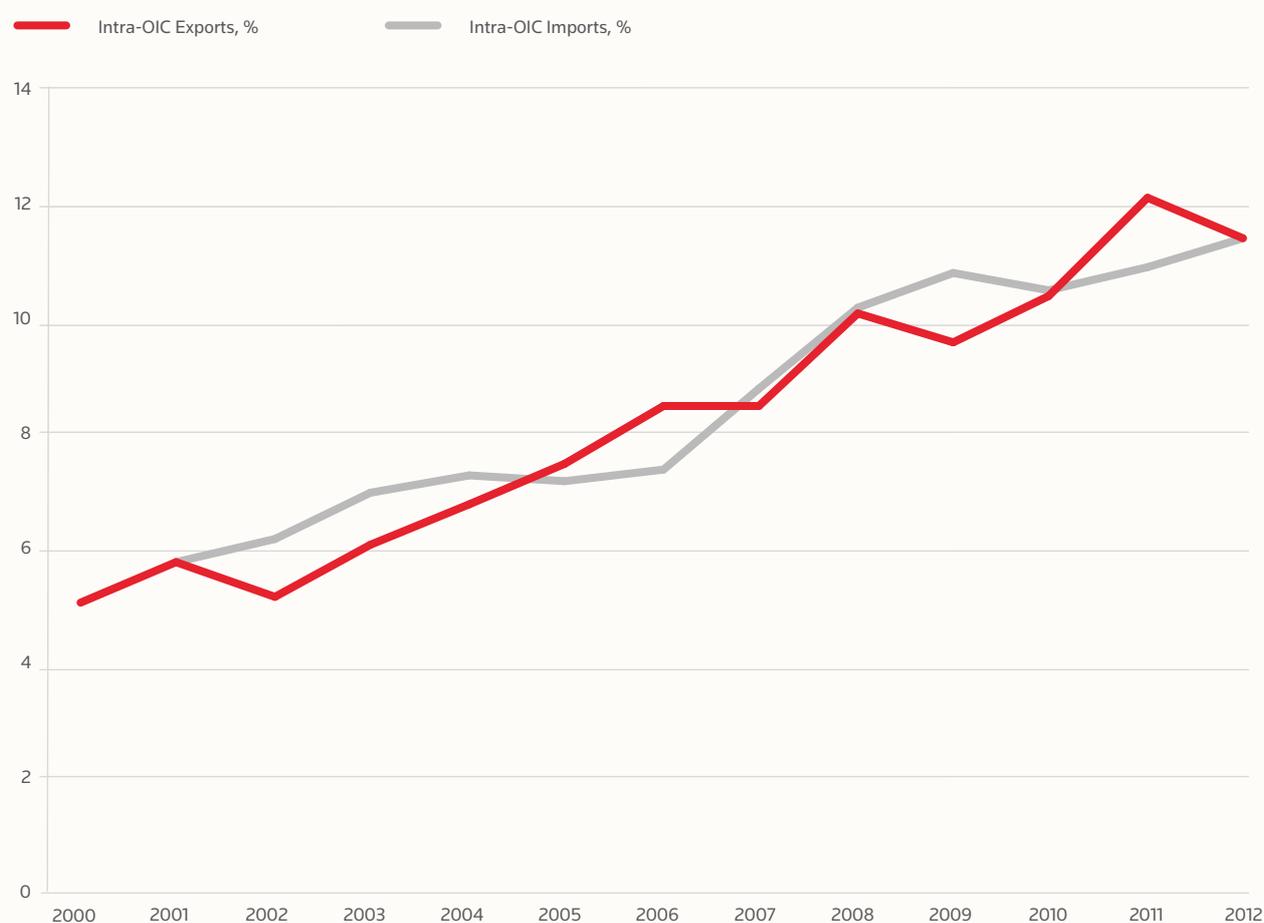
After the Cold War, in 1993 Malaysia proposed the formation of a new joint strategy for OIC member countries for more effective institutions. The following year, Malaysia urged for planning to alleviate socio-economic difficulties in less developed countries through zakat for food aid. Malaysia has also contributed other ideas and proposals such as the Islamic Gold Dinar for Multilateral Trade. In 2005 the country was lead supporter of the Makkah declaration which led to the OIC Ten-Year Program of Action designed to foster economic cooperation among member countries and increase intra-OIC trade.

### Intra-OIC trade

Malaysia's trade with OIC countries has been flourishing since 2000 – it reached 11.4% in 2012 – but its intra-OIC trade fares poorly compared with Iran (18%), Pakistan (34.5%), Turkey (36%) and UAE (26%). With intra-OIC exports of about US\$28 billion and intra-OIC imports of US\$25 billion, Malaysia still accounts for less than 10% of the aggregate US\$742 billion intra-OIC trade.

Malaysia's dual banking system – Islamic and conventional – is comprehensive and has played a crucial role in the success of the country in international trade. Islamic banking by its nature is transaction-based and international trade.

### Malaysia's Intra-OIC Trade Figures



Source: Basendin

### Role of Islamic finance

Islamic finance is a comparative advantage for economic success not only for Malaysia but also for other OIC countries, and Malaysia's approach to promoting Islamic finance could be a model for OIC countries to develop intra-OIC trade.

Malaysia's dual banking system — Islamic and conventional — is comprehensive and has played a crucial role in the success of the country in international trade. Islamic banking by its nature is transaction-based and international trade transactions provide excellent Islamic finance opportunities. Today total trade of OIC countries has exceeded US\$4.1 trillion and intra-OIC trade reached US\$742 billion. Since 2004 alone, intra-OIC trade more than tripled from US\$205 billion. Such incremental increase necessitates a sound financial system to sustain the pace of growth.

Initiatives such as the Malaysia-based International Islamic Liquidity Management Corporation (IILM), established in 2010 by central banks, monetary agencies and the Islamic Development Bank, have contributed to a stronger Islamic financial services industry. There is a subtle relationship between international liquidity management and international trade as the needs of international liquidity management arises partly from cross-border payment for international trade. The work of the IILM is promising to drive intra-OIC trade.

### Trade promotion

From the 1990s (albeit interrupted by the global financial crisis in 2008) Malaysia's exports grew more than fivefold to US\$265 billion. One of the drivers of Malaysia's success is the institutional support from the Ministry of International Trade and Industry (MITI), and particularly Malaysia External Trade

Development Corporation (MATRADE). MATRADE is the national Trade Promotion Organisation (TPO). It was established in 1993 with the vision of "Positioning Malaysia as a Globally Competitive Trading Nation". In addition to its remit to foster Malaysia's trade, MATRADE has been an active leader supporting TPOs of other OIC countries in the form of capacity-building and joint activities. MATRADE's service to OIC has been well-recognised and it was the first TPO to receive the Islamic Solidarity Prize in 2008.

MATRADE is mandated with business functions to:

- Promote, assist and develop Malaysia's external trade,
- Formulate and implement export marketing strategies and trade promotion activities,
- Undertake commercial intelligence and market research and create a comprehensive database of information for the improvement and development of Malaysia's trade,
- Organise training programmes to improve the international marketing skills of Malaysian exporters,
- Promote, facilitate and assist in the services areas related to trade.

### Trade facilitation: Malaysia's single window

Malaysia's trade growth can also be attributed to higher port efficiency and improvements in custom procedures which expedite cross-border trade. Malaysia has contributed, and has the potential to further contribute, to OIC countries in trade facilitation including: port efficiency, custom valuation and procedures, single window and standard and conformity assessment.

Single Window for international trade is a system to enable single submission of data/information, application for permits, supporting documents such

---

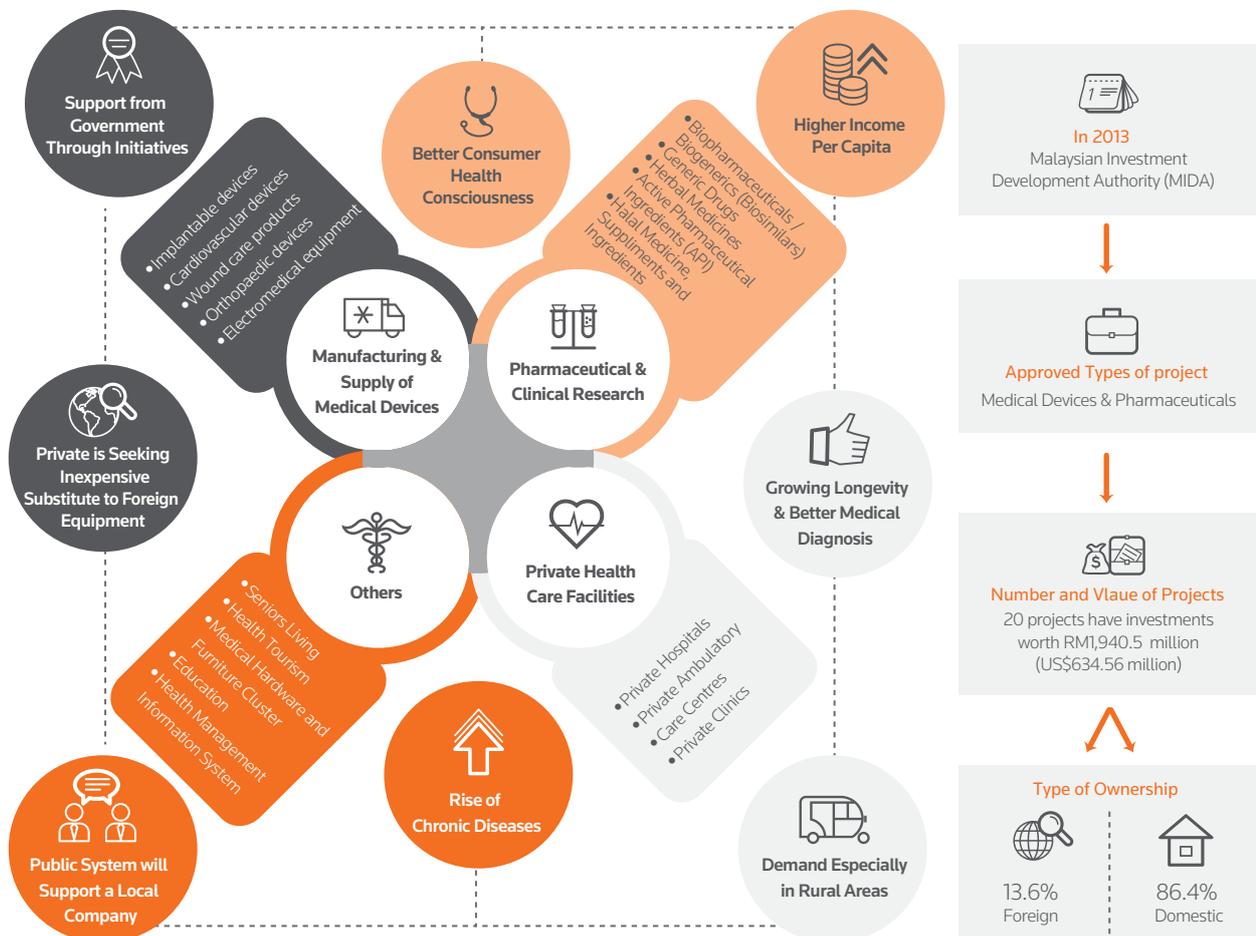
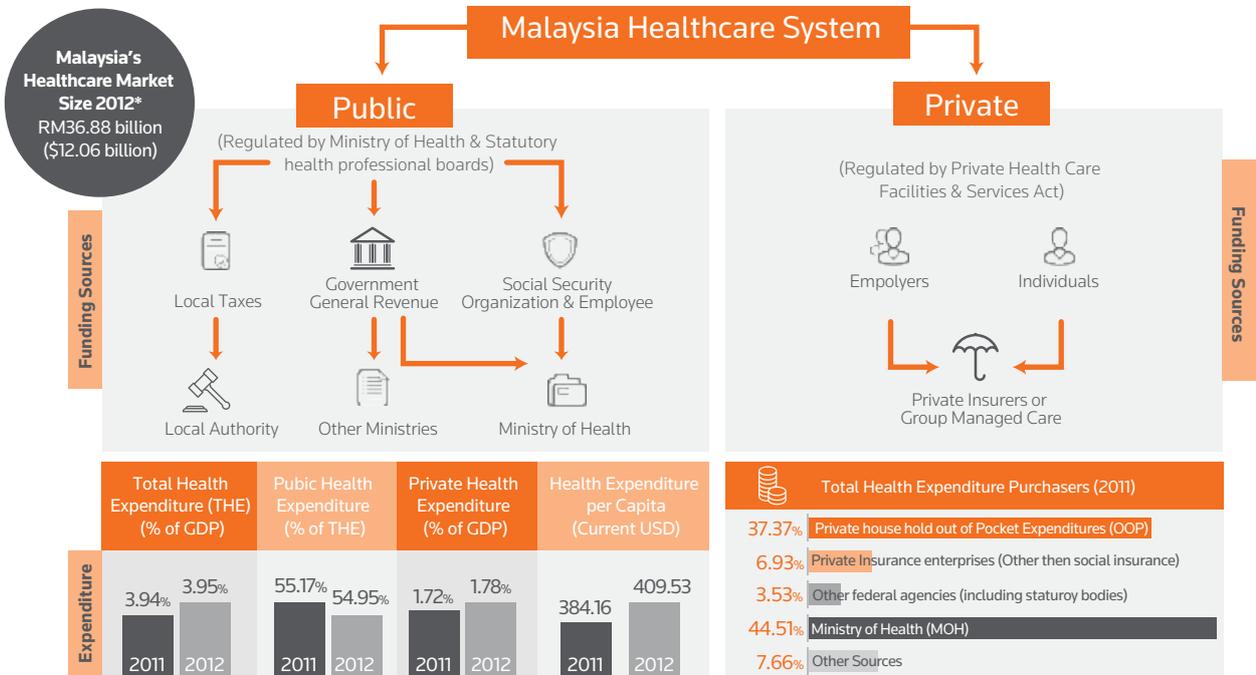
*Today total trade of OIC countries has exceeded US\$4.1 trillion and intra OIC trade reached US\$742 billion.*

---

as phytosanitary certificates; single clearance by the public authorities for cross-border trade and payment of duties.

Malaysia's Dagang.Net is a successful single window system that serves as a model to other OIC countries. Dagang.Net was established in 1989 with the aim of becoming a community builder through e-commerce and business facilitation. Dagang.Net has performed 275 million electronic transactions and RM1.8 billion worth of custom duty payment in Malaysia. It also plays an important role in the Electronic Data Interchange for Administration, Commerce and Transport Committee for necessary legal arrangement with government to enable e-commerce. Malaysia's experience and expertise via these initiatives puts it in a good position to develop and integrate single windows of OIC countries.

## Growth Sector Analysis: Health



\*Based on Population and Health Expenditure Per Capita, IMF, Worldbank

Healthcare is one of Malaysia's 12 National Key Economic Areas (NKEAs) and the private sector has shown a favourable growth working alongside the government-run healthcare system. This growth is clearly supported by the rise of private household out-of-pocket expenditure that is the second biggest source of health expenditure (37.37% in 2011) after the declining share of Public Health Expenditure (44.51% in 2011). With a high level of out-of-pocket health expenditure and a low contribution from private insurance (6.93% in 2011), healthcare is a growth segment for takaful.

**Health travel:** Health or medical travel is a sector prominent enough to warrant its own Malaysia Healthcare Travel Council (MHTC), managed by the Ministry of Health. Malaysia is becoming a popular destination for Gulf Cooperation Council (GCC) citizens as the country caters for Halal tourism and offers competitive medical pricing.

There are several initiatives designed to strengthen the health travel sector:

**Liberalisation:** An announcement was made in 2012 that private hospitals and private ambulatory services can be 100% foreign-owned. Foreign medical and dental practitioners are also allowed to practise in private hospitals.

**Tax exemptions:** Companies that are licensed by the Ministry of Health are tax exempted equivalent to a 100% investment tax allowance for 5 years. These companies should be new or existing ones that are spending capital engaged in expansion and refurbishment of healthcare facilities for qualified healthcare travellers meeting certain criteria and who should make up at least 5% of the company's total patients.

**Incentives for pharmaceuticals:** Drug companies are encouraged to set up operations in Malaysia through incentives which include a 10-year tax holiday, duty exemptions, freeing of equity restrictions and customised incentives for investments.



A man watches a Malaysia Airlines jet at Kuala Lumpur International Airport. REUTERS/Olivia Harris

## SNAPSHOT: HEALTH TRAVEL

### Earning power (revenue):

2010 RM379 million, 2013 RM690 million

### Market size of health

#### travellers:

2011 583,000, 2012 671,000, 2013 770,134

### Top health travellers to

#### Malaysia, 2013:

Indonesia 437,157, India 27,146, Japan 22,294, China 21,010, Libya 18,912

### GCC health travellers to Malaysia:

10,000 in 2012, 11,000 in 2013

Source: Medical Healthcare Travel Council, Malaysia and local media

## ISLAMIC ECONOMY OPPORTUNITIES

**Pharma:** Malaysia was the first in the world to launch, in 2012, Halal Pharmaceuticals Guidelines (MS 2424) for the manufacturing and handling of halal pharma in a bid to boost halal pharma exports. To lure investors, incentives for Halal Parks were initiated by the Halal Industry Development Corporation (HDC). There is 100% income tax exemption, and exemption from import duties and double deduction on expenses incurred when obtaining quality standards. The market for halal pharma is huge — Muslim consumers globally spent \$70 billion on pharma in 2012, according to our State of the Global

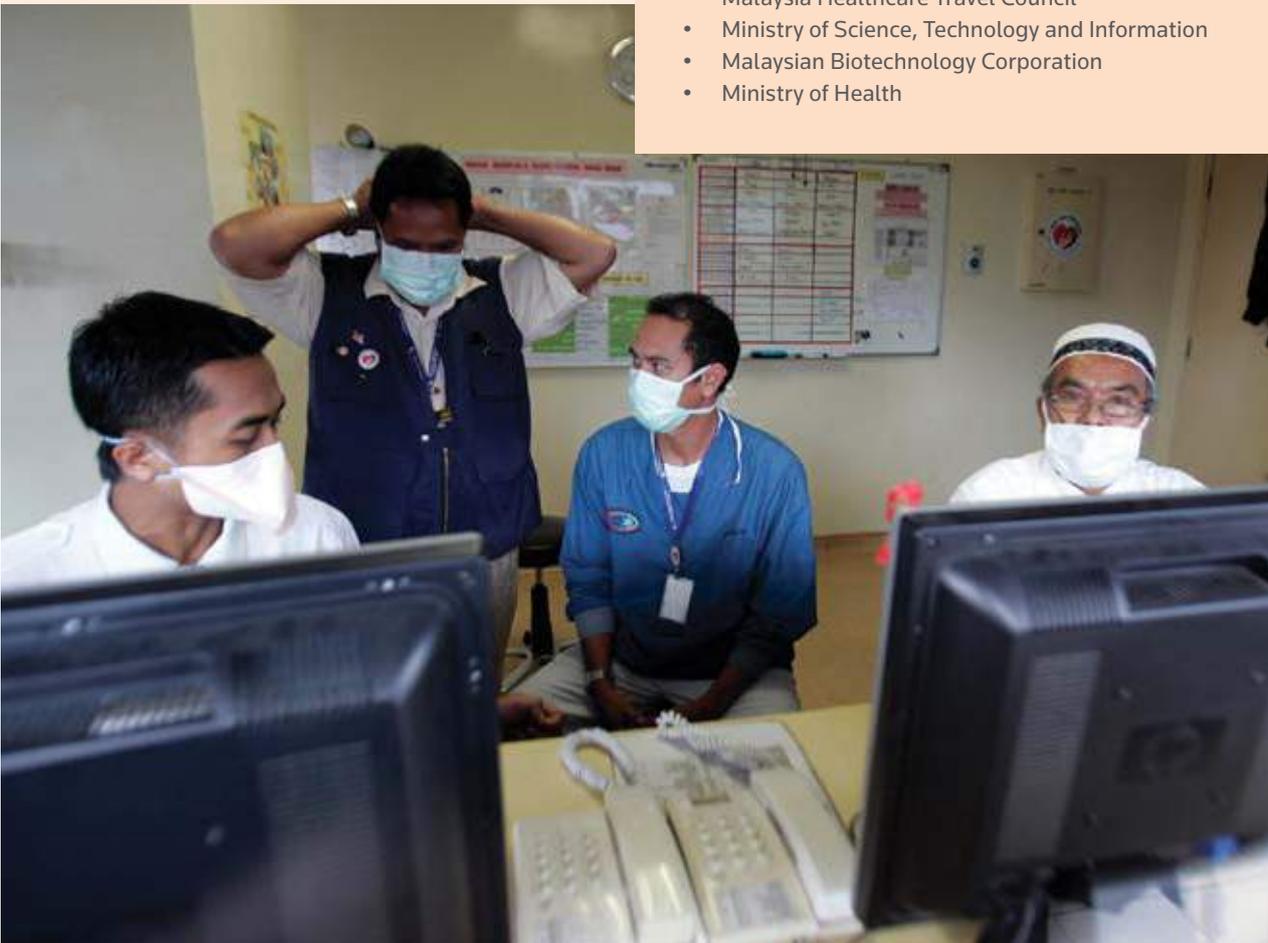
Islamic Economy 2013 report. This expenditure is expected to reach \$97 billion by 2018.

**Halal bioeconomy:** HDC leads the way in building Malaysia's Islamic bioeconomy with plans, announced in Q3 2014, for a halal vaccine facility in a JV with Saudi firm AJ Pharma. AJ Biologics Sdn Bhd invested RM120 million in the pioneering venture. HDC expects the first halal vaccines for meningitis, hepatitis and meningococcal disease in 3 years.

Malaysia has a Biotechnology Policy which has attracted RM18.52 billion in capital investments. The Malaysian Biotechnology Corporation confers 'BioNexus' status to qualified international and local biotech companies that are then eligible for fiscal incentives, grants and other guarantees to assist growth. There have been 225 BioNexus companies since 2005 and they have collectively earned RM548.8 million in revenue.

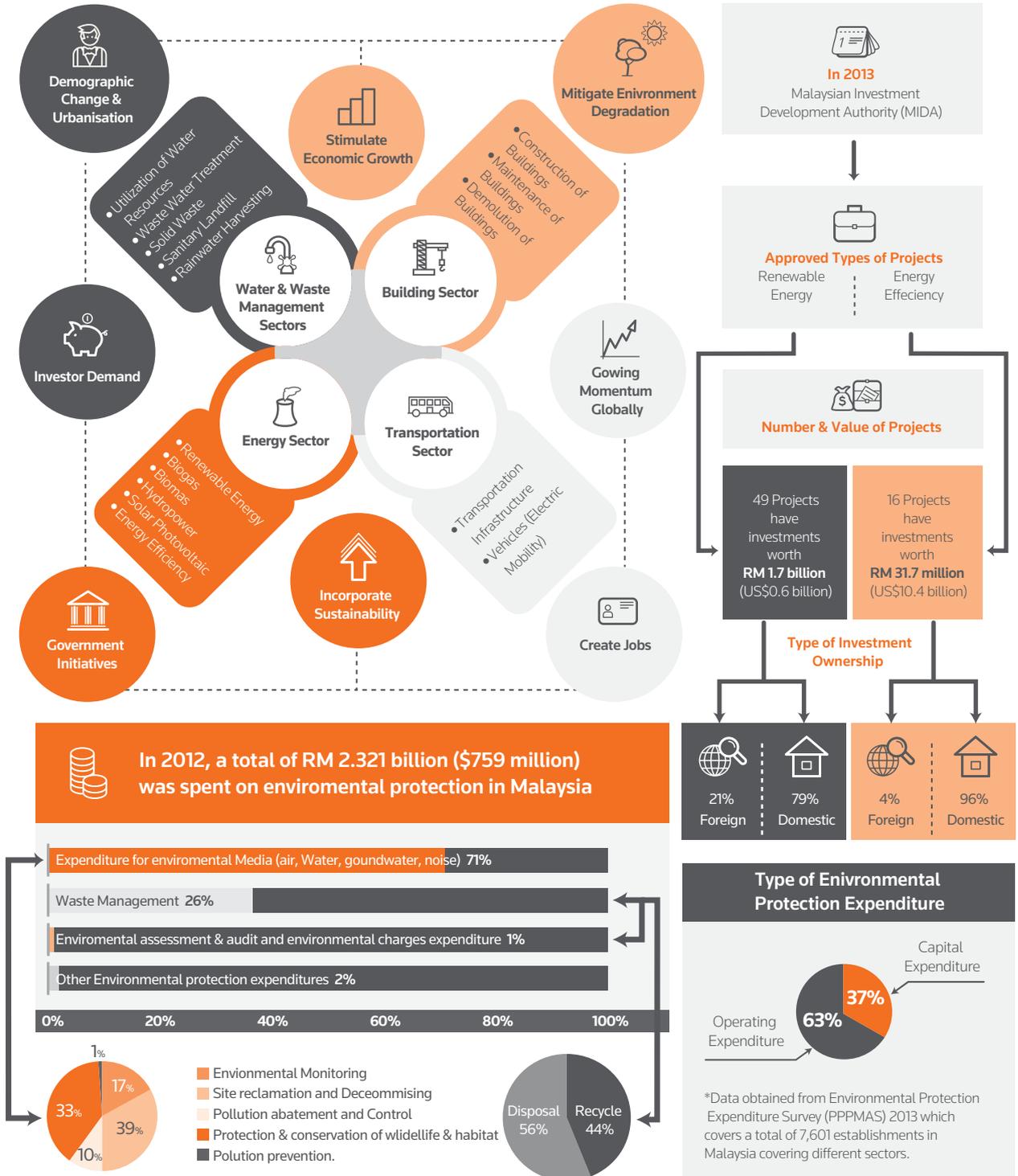
### KEY NATIONAL BODIES:

- Halal Industry Development Corporation (HDC)
- Malaysia Healthcare Travel Council
- Ministry of Science, Technology and Information
- Malaysian Biotechnology Corporation
- Ministry of Health



A man watches a Malaysia Airlines jet at Kuala Lumpur International Airport. REUTERS/Olivia Harris

## Growth Sector Analysis: Green Technology



\*Data obtained from Environmental Protection Expenditure Survey (PPPMAS) 2013 which covers a total of 7,601 establishments in Malaysia covering different sectors.

The Business Services sector is another National Key Economic Area (NKEA) that was identified to transform Malaysia into a high-income (US\$15,000 per capita) economy by 2020. The aim is to grow the sector's GNI contribution to RM78.7 billion (US\$25.76 billion) by 2020. The sector's projects are divided into two themes: 1) Projects that accelerate the growth of differentiated sectors, and 2) Projects that develop future growth of certain segments.

**Push for Green Technology:** In line with global trends, Green Technology is considered to have a high future growth which in turn supports more exports and job creation. The sector is aimed to contribute RM7.24 billion (US\$25.76 billion) by 2020. Specific targets were set by the government in this sub-sector, under the National Green Technology Policy launched in 2009. For example, 5% of the country's energy needs should be renewable in 2015 and 11% by 2020. Green technology impacts several sectors including energy, building, water and waste management, and transportation.

**Jumpstart by the Government:** To incorporate Green Technology into the local industry, the Ministry of Energy, Green Technology and Water was set up in 2009 and a Green Technology-focused council was established headed by the Prime Minister. Further,

GreenTech Malaysia was created to catalyse the deployment of the industry.

**Feed-in Tariff (FiT):** In order to ensure that Renewable Energy producers generate investment returns to ensure sustainability, a Renewable Energy Act (with a FiT mechanism) was established. Electricity generated by renewable sources can be sold at fixed premium prices for a certain time. Bonus FiT also applies when certain conditions are met. This is monitored by the Sustainable Energy Development Authority.

**Green Building Index:** As an opportunity for energy services companies that provide green services to potential clients, this incentive gives the certified environmentally friendly building owners tax exemptions for the additional capital expenditure in obtaining GBI certificates. This is in addition to other tax incentives such as sales tax incentive, rebates and import duty.

**National Automotive Policy 2014:** Originally introduced in 2006, this policy seeks to transform the domestic automotive industry to increase global and regional presence. The latest revised policy focuses more on green initiatives especially with Energy Efficient Vehicles (EEVs). Strategic investments supported by customised incentives are aimed at issuing manufacturing licenses for EEV vehicles.

## ISLAMIC ECONOMY OPPORTUNITIES

### Green Technology Financing

**Scheme:** As you will read in the following pages, Malaysian Green Technology Corporation (GreenTech Malaysia) has a Green Technology Financing Scheme (GTFS) with an allocation of RM3.5 billion (\$1.14 billion). Financing (through Islamic and conventional banks) under the GTFS offers 2% rebate on interest/profit rates and a 60% guarantee

on loan facilities. To date Islamic financing accounts for about RM800 million since 2010.

**SRI Sukuk Framework:** The Securities Commission introduced a framework and guidelines for Sustainable and Responsible Investment (SRI) Sukuk in August

2014 that now makes capital market fundraising easier for green technology companies.

**Green mortgage:** Consumers can take advantage of Bank Muamalat's 'green mortgage', launched in 2013, for the country's Solar Photovoltaic Feed-in Tariff (FiT) plan.

## KEY NATIONAL BODIES:

- Ministry of Energy, Green Technology and Water
- Green Technology Corporation (GreenTech Malaysia)
- Green Technology and Climate Change Council



A man demonstrates how to use the "Automatic Wudu Washer" during its launch in Kuala Lumpur. REUTERS/Bazuki Muhammad



## Leadership Article



**By Ir Ahmad Hadri Haris, CEO,  
Malaysian Green Technology  
Corporation**

Ahmad Hadri is the CEO of Malaysian Green Technology Corporation (GreenTech Malaysia), a not-for-profit organisation under the purview of the Ministry of Energy, Green Technology and Water Malaysia. He graduated in Mechanical Engineering with honours from the University of Manchester Institute of Science and Technology in the United Kingdom and is a registered professional engineer with the Board of Engineers, Malaysia.

### Malaysia's Green investment climate and opportunities

Since 2009, the Malaysian Government has recognised, and prioritised its efforts to capitalise on the game-changing potential of green technology as a source for socio-economic growth. To support this drive, the Government restructured the Ministry of Energy, Water and Communications to form the Ministry of Energy, Green Technology and Water (KeTTHA) to ensure a well-defined portfolio to focus on the development and advancement of green technology. This was further supported with the introduction of the National Green Technology Policy in July 2009, which focuses on four key pillars: Energy, Environment, Economy, and Social.

Malaysian Green Technology Corporation (GreenTech Malaysia) reports to the Ministry of Energy, Green Technology and Water and is tasked with coordinating and leading initiatives focusing on the development and promotion of green technology as a strategic engine for socio-economic growth and to position Malaysia as a hub for green technology, under 5 key focus areas:

## Green Technology Policy



Launched By the Malaysian Prime Minister on 24 July 2009

## Green Technology Policy: Goals



1. Developing sustainable and widespread green technology markets
2. Strengthening local green technology industry
3. Enhancing human competency and capacity in green technology applications
4. Formulating support policies and financing frameworks to promote green technology growth
5. Promoting and creating awareness on green technologies

GreenTech Malaysia has adopted a flagship approach to meeting the challenges of the focus areas and to achieve the aspirations of the government.

**Green Malaysia Plan**

Under the Green Malaysia Plan Flagship, the organisation is focused on:

1. Developing the green technology industry and ensuring economic growth in harmony with environmental sustainability
2. Identifying, nurturing and funding green ventures that will have a measurable and sustainable impact on the economy and environment
3. Driving the adoption of green technology to

achieve Malaysia’s goal of creating green communities by 2030

**Green Technology Master Plan effective 2015**

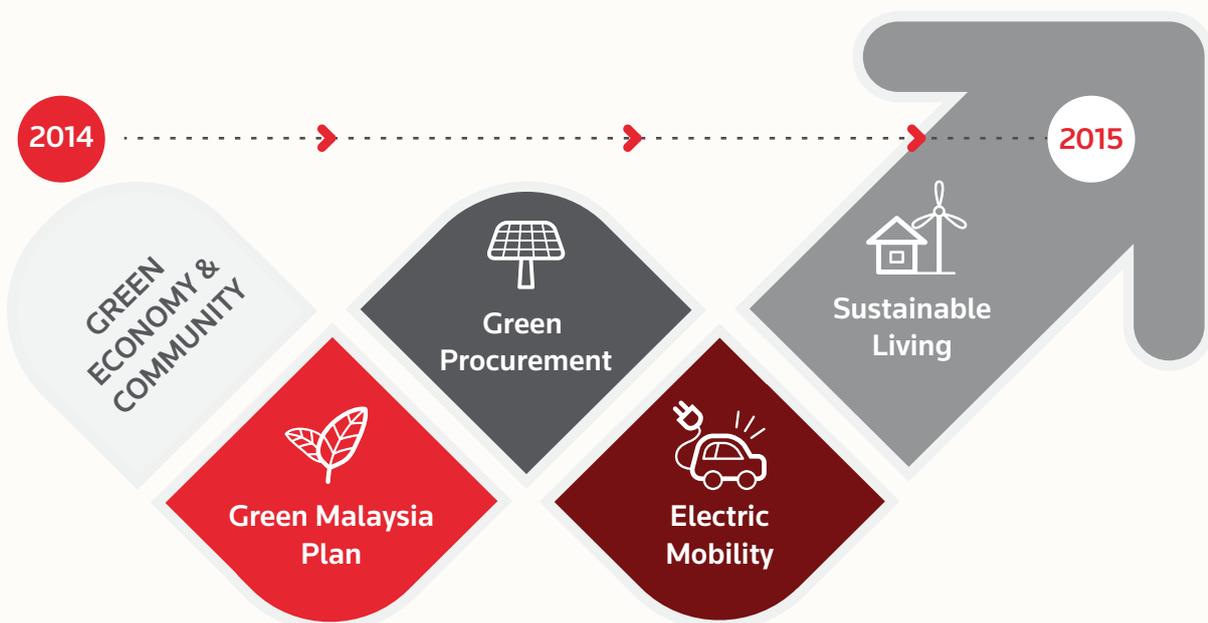
One of the key initiatives under this Flagship is the development of the national Green Technology Master Plan (GTMP), which serves as a detailed action plan to guide Government departments, policy makers, industry and non-governmental organisations towards transforming Malaysia into a low carbon and resource-efficient economy.

It is envisioned that once the Master Plan takes effect in 2015, it will provide the much-needed direction the industry needs to further propel the growth of green technology in the country.

**Green procurement, investmeace, income tax exemption**

Efforts are focused on promoting the adoption of green procurement practices in Malaysia’s public and private sectors to achieve the goals set out in the Green Malaysia Plan. Green procurement encourages the sourcing and/or purchasing of certified green

Greentech Malaysia 2014: Flagship Approach



goods that have a reduced environmental impact in comparison to conventional products or services.

As part of the initiatives there is provision of an investment tax allowance for the purchase of green technology equipment and income tax exemption for new companies entering the field of green technology services and systems provision.

To facilitate these benefits and to further promote the adoption of green procurement, GreenTech Malaysia will be introducing the MyHIJAU Mark and MyHIJAU directory (hijau is Bahasa Malaysia for 'green'), which recognises certified products, equipment and systems, and approved service and systems providers that have met local and international environmental and ecological standards, and providing access to tax incentives.

### **Transition to electric vehicles**

The electric mobility flagship aims to encourage Malaysia's transportation sector to gradually migrate from internal combustion engines to electric vehicles as a viable option for land transportation in line with the Government's vision to position Malaysia as a model of Electric Mobility for the region, leading growth in Electric Vehicle (EV) use and infrastructure development; and a dynamic international marketplace for EVs, EV components and EV infrastructure.

To facilitate this transition, GreenTech Malaysia has been charged with the development of the national Electric Mobility Blueprint, which will detail a strategic roadmap and supporting initiatives to achieve Malaysia's target. The Electric Mobility Blueprint targets to roll out 2,000 electric buses, 100,000 electric cars, 100,000 electric scooters and motorcycles, as well as the installation of 125,000 charging stations nationwide by 2020.

The Blueprint comprises three key areas of focus:

1. Electric Vehicles in Public and Private Transportation
2. Electric Vehicle Ecosystem
3. Electric Vehicle Economy

As part of its commitment, the Malaysian Government has approved the formation of a Sustainable Mobility Fund (SMF), which aims to support the adoption of electric buses by operators during the early stages. The RM70 million SMF, which will be overseen by GreenTech Malaysia, aims to fund the deployment of up to 50 electric buses to be rolled out by 2015.

As per GreenTech Malaysia's mandate to raise awareness and drive participation from the public for electric mobility, the organisation will be participating in the nation's first electric vehicle car sharing programme, COMOS, as well as supporting the rollout of national EV charging infrastructure.

Pushing for resources beyond the confines of the country's borders, GreenTech Malaysia is also actively engaging with international vehicle, bus and battery manufacturers to position Malaysia as an attractive investment destination and market.

### **Sustainable Living**

The Sustainable Living Flagship aims to transform local communities into green habitats and the nation into a thriving ecological sustainable economy by 2030.

GreenTech Malaysia is working with a number of local city and town authorities in the implementation of the Low Carbon City Framework and Assessment System (LCCF), which was jointly developed with the Ministry of Energy, Green Technology and Water. The LCCF aims to facilitate the development of a baseline study of a city's carbon intensity and formulates applicable initiatives to reduce the level of carbon dioxide (CO<sub>2</sub>) generated by cities focusing on four key areas: Urban Environment, Urban Infrastructure, Urban Transportation and Urban Building.

Current local council and city authorities partnered with GreenTech Malaysia include the Petaling Jaya City Council, Subang Jaya Municipal Council, Iskandar Regional Development Authority and Hang Tuah Jaya Municipal Council.

### Raising investors' green awareness

In the bigger scheme of things, GreenTech Malaysia recognises that business and public awareness initiatives will continue to play an important role in encouraging the growth of the sector. One initiative undertaken on an annual basis is the co-organisation of the International Greentech & Eco-products Exhibition and Conference (IGEM) together with the Ministry of Energy, Green Technology and Water. Since its inception in 2010, IGEM has recorded potential business leads of about RM4.34 billion, the highest estimated yearly amount reported in 2011 being RM1.35 billion.

### Funding and financing green initiatives

Three major Green financing initiatives are currently in place: Green Technology Financing Scheme (GTFS), Socially Responsible Investment (SRI) Sukuk, and Environmental, Social and Governance (ESG) Index.

#### Green Technology Financing Scheme (GTFS)

With a total allocation of RM3.5 billion, financing under the GTFS offers an attractive 2% rebate on interest/profit rates and a 60% guarantee on loan facilities. As of August 2014, the GTFS had financed 148 green projects raising RM1.9 billion from 23 financial institutions. These initiatives have created over 2,000 green jobs and generated RM3.83 billion worth of green investments, avoiding about 2.3 million tonnes of CO<sub>2</sub> annually.

Of the total amount financed under GTFS, Islamic financing facilities account for over 40% or RM792.8 million. This a marked increase in Islamic financing facilities granted between 2010 and October 2013, which stood at RM267 million.

The GTFS mandate expires in December 2015, and GreenTech Malaysia is exploring the feasibility of establishing a Green Investment Corporation (GIC) to continue Malaysia's transition into becoming a greener economy. GIC would be a Shariah-compliant based financial organisation that will act as a catalyst for private and institutional investments in green technology, where GIC would provide funding, including through the issuance of sukuk, to projects, as well as leverage on private capital to scale up investments in green technology.

Based on our estimates, it is envisioned that the introduction of GIC could contribute about RM11 billion to national GDP, creating 23,000 green jobs, as well as being instrumental in reducing 8.4 million tonnes of carbon emissions annually.

In the longer term, it is envisioned that GIC's operations should not be limited to Malaysia alone, but should extend to the ASEAN region, gradually moving west towards India, the Middle East, and Europe, where demand for green technology is high.

#### SRI and ESG frameworks in place for investors

In August 2014, the Securities Commission (SC) introduced Malaysia's Sustainable and Responsible Investment Sukuk framework, to promote socially responsible financing and investment and to enhance the country's value proposition as a centre for Islamic finance and sustainable investments.

#### ESG Index

Initiatives aimed primarily at investors are also being developed, including the formation of an Environmental, Social and Governance (ESG) Index which will list companies that demonstrate high

---

*With such huge market potential coupled with the Government's commitment to a 40% reduction in carbon emissions intensity of GDP by 2020 [...] green technology will certainly continue to be prioritised as the strategic engine of growth for Malaysia's socio-economic development.*

---

accountability, transparency and sustainability. The ESG Index will enable green investors to channel their funds into eligible companies that comply with the green economic growth and developmental requirements along with upholding sound social and good governance.

### **Outlook: Malaysia's Green Growth**

Recent research commissioned by GreenTech Malaysia indicates that Malaysia's cumulative demand for green funds will continue to increase at a CAGR of 15% between 2013 and 2030, increasing 11 times from RM6.7 billion to RM76.2 billion. This suggests that the annual green investment requirement would range from between RM2.3 billion to RM7.1 billion over that period.

With such huge market potential coupled with the Government's commitment to a 40% reduction in carbon emissions intensity of GDP by 2020, based on 2005 levels, green technology will certainly continue to be prioritised as the strategic engine of growth for Malaysia's socio-economic development.

## Foreign Trade

### 1. Foreign trade plays a major role in Malaysia's economy.

Malaysia registered a net trade surplus of RM70.63 billion in 2013, marking the 16th successive year of total trade surplus since 1998. Total trade in 2013 increased by 4.55% and was valued at RM1.369 trillion (\$433 billion) compared to RM1.31 trillion in 2012. Exports contributed RM719.81 billion and imports RM646.19 billion in 2013. Total exports grew by 2.4% and imports increased by 7%. The increase in manufacturing activities, growing investments together with higher consumer spending, led total imports to increase by 7% in 2013 to reach RM649 billion.

### 2. Trade partnerships are growing but they're not fully exploited.

An Economist Intelligence Unit report in 2014 found that 52% of companies in Malaysia have limited or no understanding of one or more free trade agreements (FTAs). Nonetheless, Malaysia has concluded several regional and bilateral FTAs and several more are still under negotiation. In April 2014, Malaysia and Turkey signed an FTA to boost their bilateral trade to an annual \$5 billion, up from \$1.5 billion in 2013. Malaysia also concluded negotiations with Australia on an FTA which came into effect in January 2013. The annual value of bilateral trade is expected to reach \$15 billion by 2015. Malaysia also expects to receive better concessions for exports of palm oil, cocoa, textiles and apparel, which were all excluded in the Southeast

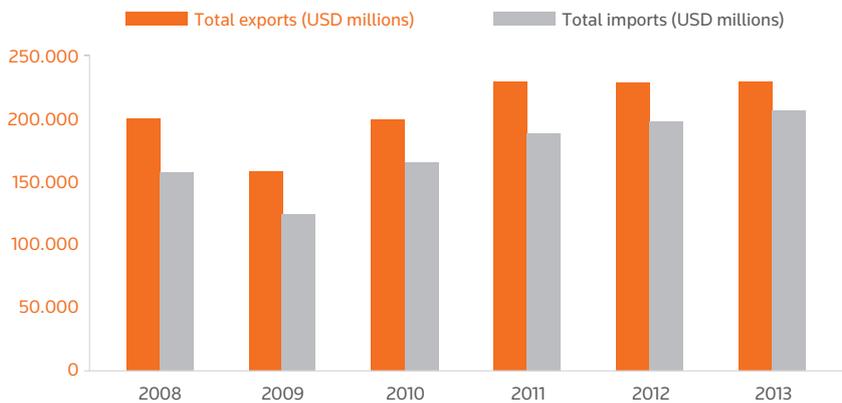
Asian regional pact. Malaysia is also negotiating FTAs with the EU, TPS — Organisation of Islamic Cooperation and the members of the Trans-Pacific Partnership (TPP).

### 3. Malaysia works with a relatively diverse set of foreign markets.

Singapore and the U.S., and recently China, are Malaysia's

most important trade partners. The movement of the Chinese economy is key to the performance of the Malaysian economy. However, given the positive trajectory (albeit slowing growth) of the Chinese economy forecasted for the near-term, the Malaysian economy will continue to benefit from Chinese economic growth.

### Total foreign trade 2008 – 2013 (Exports, Imports)



Source: Department of Statistics Bank Negara Malaysia

### Trade Structure (% of total trade 2013)

EXPORTS	% OF TOTAL	RANK	% OF TOTAL	IMPORTS
Singapore	13.95	1	15.5	China
China	13.47	2	14.9	Singapore
Japan	11.08	3	12.3	Japan
United States	8.07	4	8.9	United States
Thailand	5.55	5	6.1	Thailand
Indonesia	4.60	6	5.1	Taiwan, China
Hong Kong	4.34	7	4.8	Korea
Australia	4.05	8	4.5	Indonesia
Korea	3.63	9	4.0	Germany
India	3.58	10	4.0	Vietnam

## Public Finance and Fiscal Deficit

### 1. Malaysia's debt-to-GDP ratio grew substantially since the 2008 financial crisis as the country was forced to undertake significant fiscal incentive measures.

Federal government debt rose to 56% of GDP at the end of 2013, up from 53.3% at the end of 2012 and 39.8% at the end of 2008. The 2013 reading is above the country's self-set legal debt ceiling threshold of 55% of GDP. In addition, it is far above the Asian average (32% of GDP) and that of emerging countries (33.8% of GDP). Given that Malaysia is

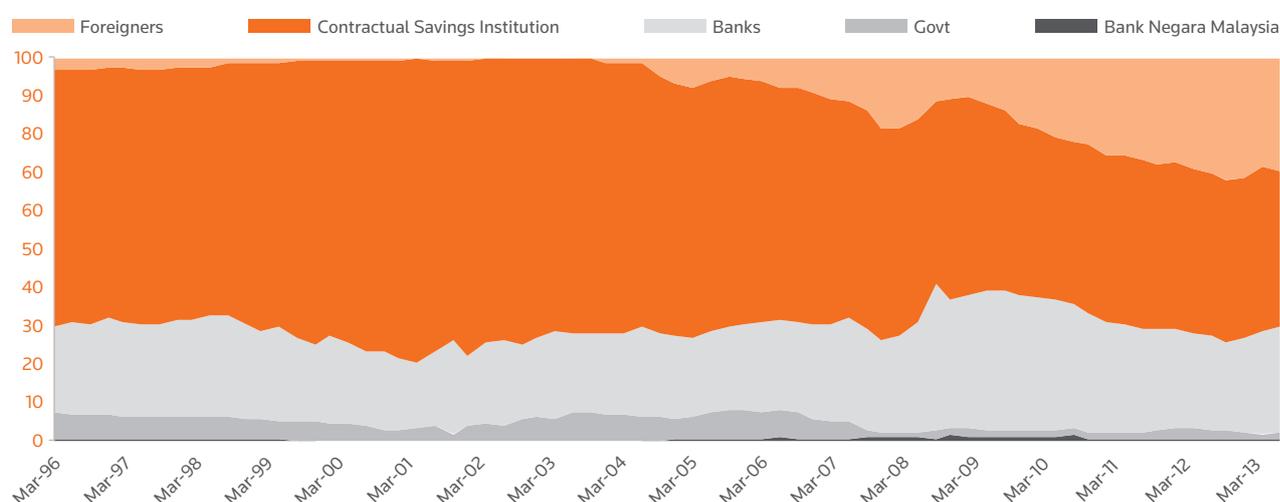
a highly commodity-dependent economy and that the state-owned oil company, Petronas, makes up a significant share of its income, part of the increase in debt-to-GDP ratio can be attributed to the shortfall of oil prices following the aftermath of the global financial crisis in 2008. This is not in itself dangerous but it limits the government's ability to counteract future crises. Nonetheless, the government carries minimal external debt with over 95% of debt raised in the domestic market.

### General Government Gross Debt (% of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
Thailand	42.0	38.3	37.3	45.2	42.6	41.7	44.3	45.9
Malaysia	41.5	41.2	39.8	50.8	51.1	51.6	53.3	56.0
Indonesia	39.0	35.1	33.2	28.6	24.4	24.0	23.6	23.1
Philippines	51.6	44.6	44.2	44.3	41.9	41.9	39.7	38.0
Singapore	86.4	85.6	96.3	101.5	111.0	108.2	104.3	101.0
Asia	34.4	34.8	31.4	31.4	40.8	34.4	32.2	30.7
G-20	36.5	35.4	33.0	34.6	39.9	35.5	33.7	32.4

Source: IMF World Economic Outlook Database

### Malaysia Government Securities Investor Base (% of total securities)



Source: Asian Development Bank, Asian Bonds

## 2. Fiscal deficit was maintained for a long period with the exception of the mid-1990s.

The budget deficit was reduced to 3.9% of GDP in 2013. However, the general government budget deficit widened to 4.7% of GDP in 2012 (one of the region's largest budget shortfalls) from 3.8% in 2011, led by a 19% rise in spending on public wages in a pre-election year. The deficit is estimated to fall to 3.5% of GDP in 2014 and 3% in 2015 as government outlay will be trimmed with sugar, flour and fuel subsidies to be further reduced. Malaysia aims to offset the budget deficit by 2020. However, the path to achievement of targets remains unclear. In particular, the shape of a new goods and services tax (GST), to be introduced in April 2015, has yet to be fully determined. The GST by itself is unlikely to deliver the targeted reduction in the deficit or boost revenue; spending measures would probably be required. It remains to be seen whether these will materialise. Sustained heavy public sector deficits could increase the chances of the current account moving into deficit, which in turn could increase the possibility of disruptive volatility in portfolio capital flows.<sup>4</sup>

## 3. Warnings on Malaysia's sovereign credit rating.

Consistent economic growth over the years has led to a positive long-term credit rating by the major rating agencies. However, in spite of the stability in Malaysia's access to finance, the high debt-to-GDP ratio and more recently since Q4 2014, the impact of low oil prices have made credit ratings agencies ring alarm bells. In 2013, Fitch Ratings changed the country's outlook from "A- (Stable)" to "A- (Negative Outlook)", explaining that "prospects for budgetary reform and fiscal consolidation to address weaknesses in the public finances have worsened." Following the January revision of 2015's budget and the widening of the fiscal deficit target to 3.2% from 3%, Fitch reported that it is "more likely than not to downgrade the ratings within the next 12-18 months." Standard & Poor's said the prolonged slump in oil prices could undermine both Malaysia's fiscal consolidation and its revised economic growth

forecast but that Malaysia's credit rating will remain at a stable "A-" for the next year or two.

## 4. The banking sector is stable but there's a worrying surge in household debt.

The financial industry, particularly the banking sector, has shown resilience in recent years and has remained well-capitalised, profitable and liquid. Non-performing loans have declined to 2% of total loans in Q1 2013. Credit growth has accelerated since 2010 and household debt rose to 86.8% of GDP at the end of 2013, up from 81.3% at year-end 2012 and 60.4% at year-end 2008, posing serious risk to financial stability. The central bank has warned that easy monetary conditions could lead to a broader build-up of economic and financial imbalances. More than half of the growing household debt comes from mortgages, while personal and credit card loans account for only 21%. It has helped drive a real estate boom in parts of the country, with national house prices increasing 11.9% in 2013 and Kuala Lumpur prices surging 30% in three years.

## 5. Easy credit in Malaysia pose a critical risk.

Strong credit growth and rising consumer debt has raised Malaysia's vulnerability to possible external shocks, such as a debt crisis in China or a sudden rise in U.S. interest rates. In July 2014, Malaysia's central bank increased key interest rates for the first time since May 2011 amid signs inflation rates were rising faster than expected. The central bank increased its policy rate by 25 basis points to 3.25%. Research firm Oxford Economics said in a report in June 2014 that Malaysia's rising debt levels together with a high level of government bonds held by foreigners made it the "riskiest" economy in Southeast Asia. Foreign investors constitute a large segment of the holders of Malaysian government bonds, up from nearly zero before 2005. The share of domestic government securities held by non-residents was 26.8% at end-March 2014, although this figure has been stable in a range of 24%-28% since end-2011. Local bidders, including the state Employee Provident Fund (EPF), could potentially buffer any volatility in foreign participation, although a withdrawal of foreign capital could still be temporarily disruptive and could drive a decline in foreign reserves. However, risks are currently contained

<sup>4</sup> Reuters, Fitch Affirms Malaysia at 'A-', Outlook Remains Negative — July 23, 2014

by high bank capital buffers, ample international reserves, and sound monetary and financial policies, and the central bank has taken action to stabilise household credit growth.

### 6. Inflation is climbing after years of moderate stability.

Malaysia's inflation continued to rise, with the consumer price index (CPI) increasing 3.3% in July 2014 to 109.9 compared with 106.4 in the same period in 2013. The increase was caused by the reduction of subsidies on fuel, electricity and sugar that was

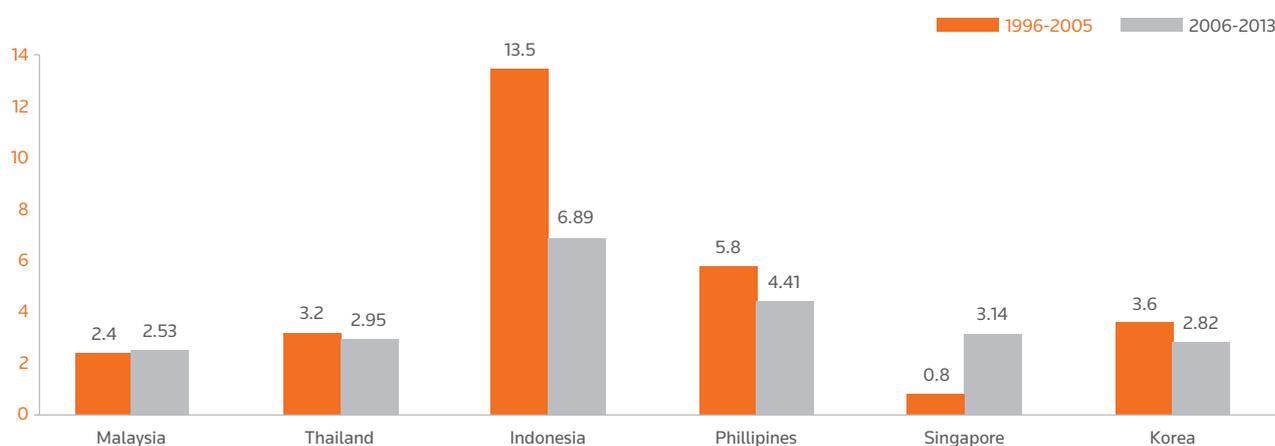
introduced in 2013. Inflation is also set to increase with the implementation of the goods and services tax (GST) in April 2015. Nonetheless, Malaysia has been running a structurally low inflation and the annual growth of the CPI has only surpassed 5% on two occasions since the early 1990s. Inflation in Malaysia averaged 3.71% from 1973 until 2014 due to prudential monetary policy, inflation targeting, stable exchange rate and government intervention through the price control. Malaysia enjoys low inflation rates compared to its ASEAN neighbours.

### Malaysia Inflation Historical Trend Line



Source: International Monetary Fund, World Economic Outlook Database, Bank Negara Malaysia

### Regional Average Inflation Rate



Source: IMF World Economic outlook Database, April 2014 and IRTI calculation

# Business and Investment Environment

## Economy Prospects and Potential

**1. To make economic progress achievable and measurable the Malaysian government launched Vision 2020 in 1991 to outline a broad plan to reach developed economy status by 2020.** Vision 2020 aims to increase real GDP eightfold between 1990 and 2020, increase GDP per capita by a factor of four and maintain an average 6% annual growth. Impressively, real GDP increased by eightfold in 1997 ahead of schedule. However, the Asian financial crisis led to a sharp fall of real GDP the following year in 1998. Malaysia has done well since 1970 and economic growth has been substantial enough to ensure per capita income is larger than Indonesia, the Philippines and Thailand.

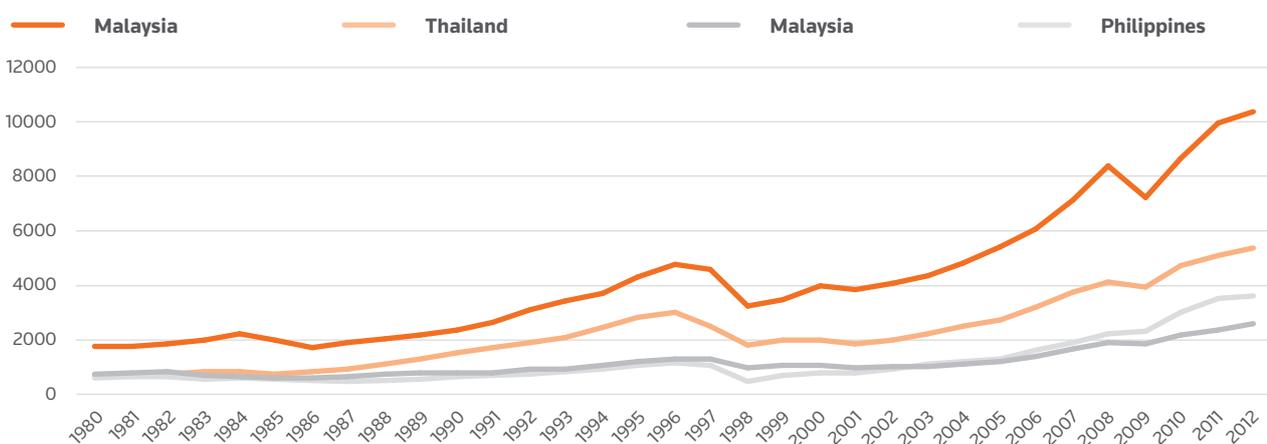
**2. The Malaysia Economic Transformation Programme (ETP) launched on 25 September 2010, aims to keep real GDP growth rate between 5% and 6% per year until 2020.** However, the domestic market may not be large enough to support these growth rates, forcing the country to rely more on exports to achieve the ETP's ambitious targets. This is a difficult exercise to manage since a major reason underpinning ETP is to help the country reduce its reliance on exports. The ETP is expected to create a total of 3.3 million jobs by 2020, and over 90% of the Plan's required investment will originate

from the private sector. Infrastructure upgrades should boost productivity. Potential output is estimated to have risen to 5 – 5.5%.

**3. Private investment is estimated to be RM189 billion or 18% of GDP by end 2014.** Oil and gas, textiles and real estate development were the main beneficiaries. Growth of the real value of private final consumption was 7.4% in 2013 and gains of 6.5% are expected for full-year 2014. Private consumption is underpinned by healthy labour market conditions and sustained income growth. Consumer spending could be even stronger were it not for the reduction of subsidies.

**4. The government also aims to increase the development of value-added additions in the manufacturing sector to boost the expansion of the service sector.** The service sector, which made up 55.2% of GDP in 2013, has a target to make up 60% of GDP by 2020. Aggressive development is imperative for key industries such as Islamic finance, communication technology, tourism and biotechnology. These key areas are expected to cost RM1.419 trillion (US\$447 billion). Malaysia must focus on improving the country's lower-skilled and lower-educated labour force to support these industries.

GDP per Capita, Malaysia, Thailand, the Philippines, Indonesia, and 1980-2013



Source: IMF World Economic Outlook Database

Malaysia's Economic Transformation Programme (ETP) is achieved through implementing 12 National Key Economic Areas (NKEAs) that will contribute significantly to GNI. Each NKEA has Entry Project Points (EPPs).

ETP has also defined 6 Strategic Reform Initiatives (SRIs) which are policies that will drive Malaysia competitive globally.



### Strategic Reform Initiatives (SRIs)



\*The above chart illustrates Malaysia 12 National Key Economic Areas (NKEAs), for more information, please visit <http://etp.pemandu.gov.my>

Malaysia is a highly open economy and its performance is largely dependent on external economic conditions. To mitigate the adverse impact of global economic slowdown and maintain stable economic growth, the Malaysian government has been trying to boost growth through domestic demand and public sector spending. Steps were undertaken to reinforce Malaysia's macroeconomic fundamentals and implement structural changes. The government is taking steps to strengthen the social safety net by enhancing the existing cash transfer programme to lower income groups to mitigate the impact of fiscal consolidation on the poor.

### World Bank Ease of Doing Business

TOPICS	DB 2015 RANK (OUT OF 189)	DB 2014 RANK (OUT OF 189)	CHANGE IN RANK
Starting a Business	13	16	- 3
Dealing with Construction Permits	29	43	+ 14
Getting Electricity	27	21	- 6
Registering Property	75	35	- 40
Getting Credit	23	1	- 22
Protecting Investors	5	4	- 1
Paying Taxes	32	36	+ 4
Trading Across Borders	11	5	- 6
Enforcing Contracts	29	30	+ 1
Resolving Insolvency	36	42	+ 6
Overall Doing Business Rank	18	6	- 12

Note: Data from the World Bank's Doing Business 2015.

Malaysia's overarching ambition is to become a high-income nation by 2020. The government and policy makers aim to move economic sectors up the value chain by adding greater value-added industries in the economy. However, this will require enforcing stricter intellectual property rights. While intellectual property rights laws are in place, court enforcement of these laws has been relatively insufficient. To promote investments, Malaysia has a set of incentives including 10-year compensation on Venture Capital initiatives (including Guidelines and Best Practices on Islamic Venture Capital) and investment incentives in certain regions. The country's ETP includes initiatives promoting private investment by reducing the state's intervention in the economy by divesting its stakes in over 30 companies. Privatisation to date has led to huge IPOs of two enterprises — Felda Global Ventures Holdings Bhd and Integrated Healthcare Holdings Bhd. In July 2014, Reuters news reported a proposed divestment of Kulim (Malaysia) Berhad's equity interest. (Kulim has a diversified portfolio primarily focused on plantations and its related industries.)



Malaysian ringgit bills are seen among other currency notes in this photo illustration taken in Singapore. REUTERS/Edgar Su



## Leadership Article



**By Professor Christine Ennew  
and Dr Nafis Alam**

Professor Christine Ennew is Pro-Vice-Chancellor and Provost, at University of Nottingham Malaysia Campus.

Dr Nafis Alam is an Associate Professor of Finance and Director of Centre for Islamic Business and Finance Research (CIBFR) at the University of Nottingham's Malaysia Campus.

### KL's \$8bln financial district: If you build it, will they come?

Malaysia is widely recognised as a global leader in Islamic finance and the country's authorities are now fortifying and building on that position with the aim to become the "indisputable global hub for Islamic finance." There are numerous policies and new regulations — such as the Islamic Financial Services Act 2013 and projects under the Economic Transformation Programme — already in place to push the envelope. An \$8 billion new financial district in Kuala Lumpur is one of the major developments.

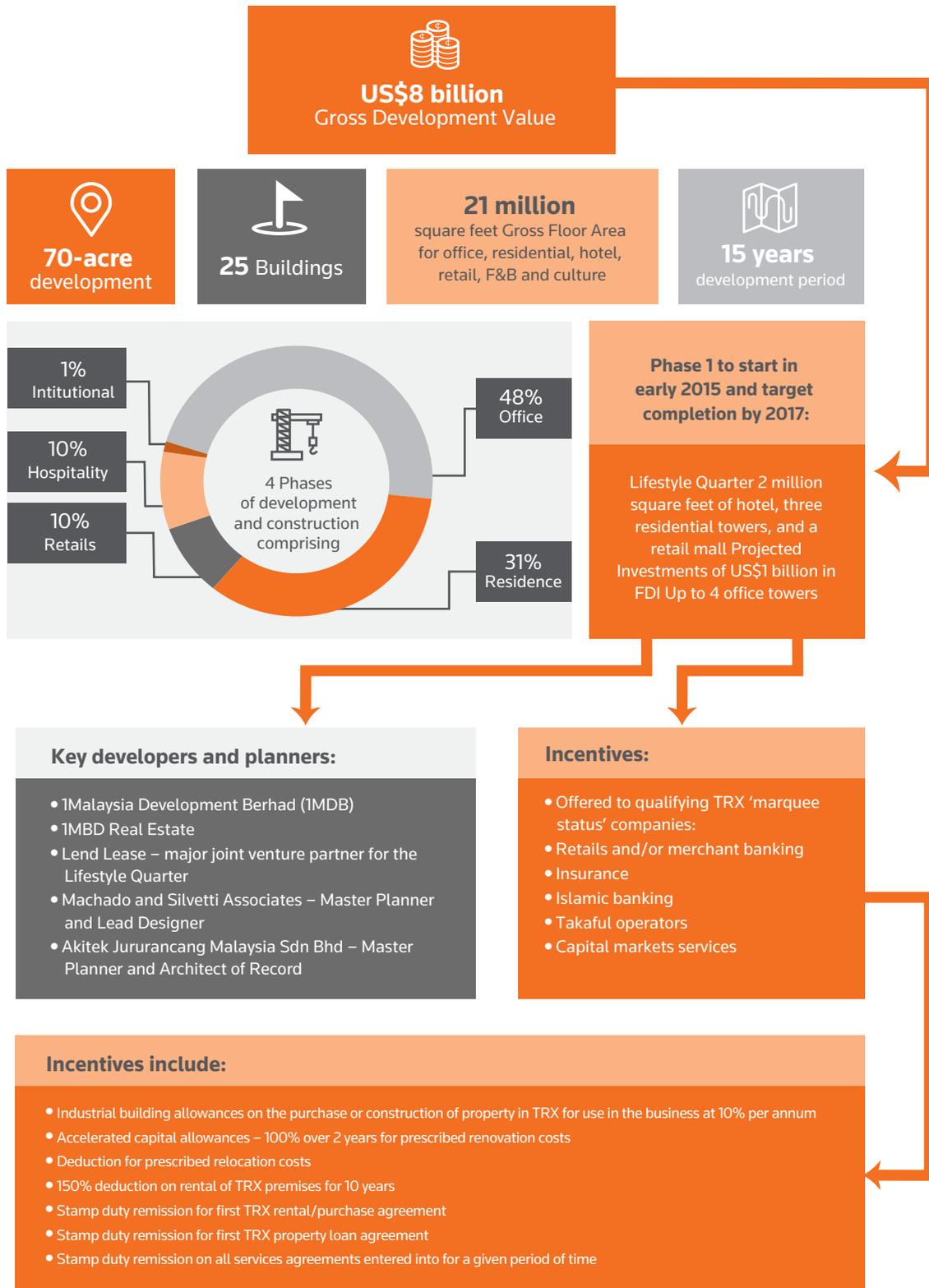
The world's top financial centres have iconic centralised and consolidated financial districts. New York has Wall Street, London has the City, Hong Kong and Singapore have their Central Business Districts. Malaysia announced plans to transform the country's capital Kuala Lumpur into a major financial centre in a bid to raise its profile and spark greater international trade and investment. This fast-track development strategy, which centres on real estate, is favoured among developing and advanced developing countries; for example Turkey is building its own Istanbul International Financial Centre and Morocco its Casablanca Finance City. Both also have eyes to become regional Islamic finance centres.

Malaysia's hope for a bright financial future lies with its Tun Razak Exchange (TRX). Phase 1 of construction was launched in 2013. The proposed new financial district covers 70 acres and features 25 buildings with gross development value of US\$8 billion. The TRX is one of the country's projects under the Economic Transformation Programme (ETP), a national roadmap with a multitude of programmes designed to advance Malaysia's international competitiveness and more than double per capita income to US\$15,000 by 2020.

For the Malaysian authorities, the argument for the TRX extends beyond their desire for an iconic financial district like those found in the top financial centres in order to become a high-income nation by 2020; the TRX also looks to deliver on the aspirations for Greater KL to drive rapid growth in parallel to upgrading the city's liveability ranking to the top 20 in the world. The Malaysian government believes this huge project is the foundation on which Malaysia can compete with global financial superpowers such as London, Singapore and Hong Kong. In a way, there is the understanding that a global financial centre is not the result of technical financial prowess per se; it both grows out of and has a pivotal role to play in a fluid city ecosystem. It may be too much to ask for a real estate project to be the main driver of the development of a city but the TRX's size, scale and reach does promise to substantially change the landscape of Kuala Lumpur.

If Malaysia's ambition to be a global financial heavyweight is to be achieved by 2020, the country must leverage on its position as a leading Islamic finance hub and be the magnet and source of Shariah-compliant investments. Malaysia's Islamic finance ecosystem already thrives without a centralised and consolidated financial district. The TRX project and its multiplier effects, hopes the Malaysian government, will push the industry to the next level, and help differentiate Malaysia from the established global financial centres.

## Tun Razak Exchange (TRX)



Source: Tun Razak Exchange

## Malaysia FDI and Investment Trends

**The sizable magnitude of foreign direct investment (FDI) has been a contributing factor to Malaysia's economic growth in the last two decades.**

However, FDI into Malaysia has been on the decline, and Malaysia's share of total ASEAN FDI has fallen steadily over time. At the same time, established investors from many different countries and regions are continuing to reinvest. Malaysian firms, particularly government-linked companies, are also becoming major outward investors, and Malaysia is now a net outward investor on an annual basis.

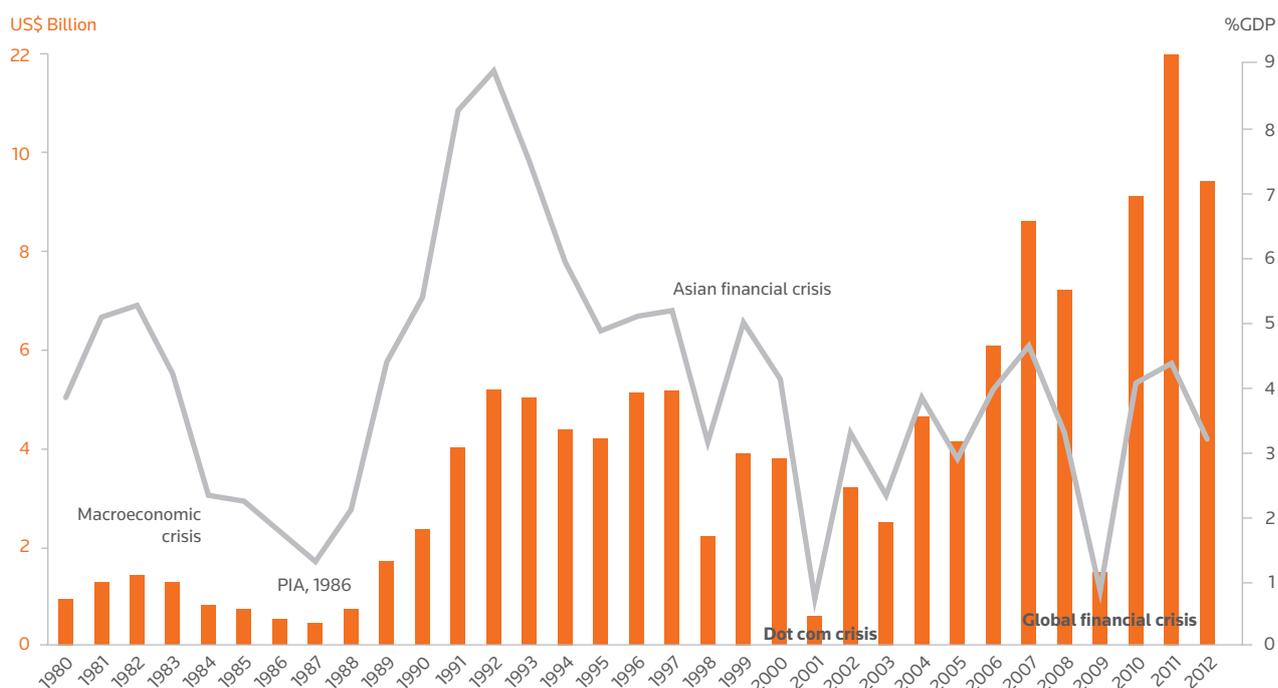
**A key government policy is to attract export-oriented FDI.**

Foreign investors are currently somewhat omnipresent in the manufacturing sector, particularly in the electric and electronics sector. In comparison to other relatively open economies, Malaysia's overall performance and its ability to attract FDI have been affected by downturns in the global or regional economy. Inflows of FDI fell in 1998, 2001 and 2009 but recovered quickly in each case. FDI inflows in Malaysia are now at record levels in nominal terms. Having recovered from a decreasing trend in 2009, Malaysia's FDI has gradually risen ever since.

**The government's economic liberalisation policy has also played a role.**

Liberalisation was especially welcomed from the mid-1980s after the Promotion of Investment Act (1986) that opened the economy for export-oriented production and introduced a new round of pioneer status tax holidays, tax allowances for expansion projects, tax exemptions for export-oriented firms, and liberal regulations for firms operating in the Free Trade Zones.

## FDI's Long Term Trends in Malaysia



Source: World Bank

## FDI in Malaysia by Country and by Sector

**Overall, Malaysia gains advantage from diversified sources of FDI.** 34% of funds come from Europe and 41% from Asia. The largest investor in Malaysia is Singapore, followed by Japan and the U.S. Large investors in the 1980s, such as Chinese Taipei, have diverted elsewhere in the wake of higher costs of doing business in Malaysia which has grown hand-in-hand with rising per capita income levels.

**Almost half of FDI are in manufacturing and a quarter in finance (including holding companies).** Within manufacturing, for instance, the electronics sector has traditionally occupied the largest share; it accounts for 40% of foreign investment over the past five years and 47% overall. This distribution demonstrates both the role of Malaysia as a popular location for production in global value chains in the electronics industry, as well as policies which favour investment in export-oriented manufacturing and which traditionally restricted access to the service sector.

**FDI in services has increased rapidly, attracting 42% of total inflows from 2008 to 2010 compared to 15% in the 1990s.** Among the subsectors of services, financial services including Islamic banking, have received the largest share of FDI as the government pushed strong initiatives to make Malaysia a hub for Islamic finance. Foreign investment in mining and quarrying, including oil and gas, is mostly undertaken in the form of production sharing agreements with Petronas, the state-owned petroleum company.

Another approach to assess the importance of different investors within the Malaysian economy is to look at cross-border mergers and acquisitions (M&As) involving Malaysian firms as targets. Singapore and Japan retain the same leading positions as with the FDI data, but many emerging market investors figure more prominently in the M&A data, notably Saudi Arabia, the United Arab Emirates and India.

### FDI Stock in Malaysia by country, 2013

COUNTRY	%
Singapore	18.1
Japan	14.7
USA	8.6
Netherlands	7.9
Switzerland	4.8
Others	45.9

Source: Department of Statistics, Malaysia

### FDI Stock in Malaysia by sector, 2013

SECTOR	%
Manufacturing	45.6
Finance, Insurance	21.3
Mining and quarrying	7.9
Information and Communication	7.8
Wholesale and Retail Trade	7.2
Agriculture	2.5
Construction	0.6
Other services	7.1

Source: Department of Statistics Malaysia



An investor monitors stock market prices in Kuala Lumpur. REUTERS/Bazuki Muhammad

### Cross border M&As involving Malaysian firms as targets, 2001-2011

RANK	ACQUIRER NATIONALITY	VALUE (US\$ MILLION)	No.	% SHARE
1	Singapore	7,670	356	23.2
2	Japan	5,839	85	17.7
3	UAE	3,927	14	11.9
4	Saudi Arabia	3,490	6	10.6
5	Hong Kong, China	2,199	44	6.7
6	South Korea	1,790	16	5.4
7	Australia	1,624	38	4.9
8	Germany	924	20	2.8
9	United Kingdom	866	41	2.6
10	India	708	20	2.1
	<b>Subtotal</b>	<b>29,037</b>	<b>640</b>	<b>87.9</b>
	<b>Total</b>	<b>33,043</b>	<b>835</b>	<b>100.0</b>

Source: Dealogic

# Socioeconomic Development



Muslim boys are seen in a class of an Islamic school where they live and study the Koran in the village of Lam Mai in the troubled Yala province. REUTERS/Damir Sagolj

## Malaysia has made great strides in meeting most of its Millennium Development Goals (MDGs).<sup>5</sup>

Having achieved most of the MDG targets at the collective level, Malaysia now faces a dual

challenge if it is to achieve all MDGs by 2015 and realise its ambition of becoming a developed nation by 2020. It needs to make further progress on the MDGs for which it is still not on track nationally. It simultaneously needs to focus action on identified areas of priority at the disaggregated level. Malaysia can be congratulated on its progress so far, but policy makers and the Malaysian people should be encouraged to turn their attention, urgently, to cover the remaining distance by addressing the outstanding issues highlighted in this report.

<sup>5</sup> At the start of the new millennium, 189 world leaders came together at the United Nations in New York in an attempt to agree on ways to ensure a better future for everyone on our planet. That Millennium Summit resulted in the "UN Millennium Declaration", protecting norms, ethics and doctrines on human rights, fairness and democracy that the world's political leaders agreed on for the very first time. It also provided the impetus for the UN, World Bank and others to translate the principles and values of the Declaration into the Millennium Development Goals (MDGs). They comprise eight global, time-bound development goals, with targets to be achieved by 2015.

## Key Socio-economic Indicators

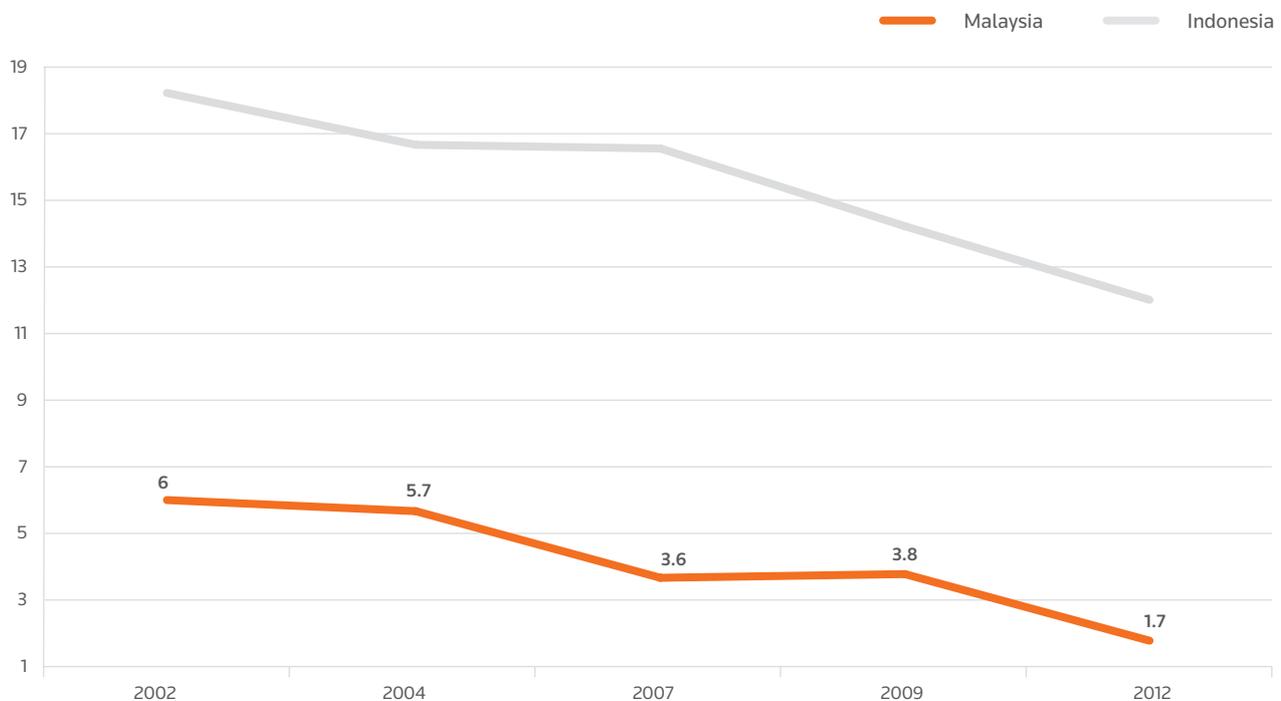
	INDICATOR NAME	1990	2004	2011/2013
<b>MDG 3: Promote gender equality and empower women</b>	Proportion of seats held by women in national parliaments (%)	5.1	9.1	10.4
<b>MDG 6: Combat HIV/AIDS, Malaria and other diseases</b>	Incidence of tuberculosis (per 100,000 people)	127	87	80
<b>EDUCATION: MDG 2: Achieve universal Primary Education, MDG 3: Promote gender equality and empower women</b>	Primary education, teachers & % female	120,505 & 57	180,682 & 67	234,797 & 69
	Secondary education, teachers & % female	75,328 & 51	148,824 & 64	193,506 & 68
	Literacy rate, adult total (% of people ages 15 and above)	82.92	N.A.	93.12
	Primary completion rate, total (% of relevant age group)	87.86	96.46	99.2
	Ratio of girls to boys in primary and secondary education (%)	101.98	105.13	107.3
<b>EMPLOYMENT &amp; LABOUR FORCE</b>	Employment in agriculture (% of total employment)	26	14.6	12.6
	Employment in industry (% of total employment)	27.5	30.1	28.4
	Labour force, total	7,056,530	10,736,943	12,717,901
	Unemployment, total (% of total labour force)	4.5	3.5	3
<b>LIFE EXPECTANCY: MDG 4: Reduce child mortality</b>	Life expectancy at birth, female (years)	72.6	75.7	77.2
	Life expectancy at birth, total (years)	70.8	73.5	74.8
	Mortality rate, infant (per 1,000 live births)	14.3	7.1	7.3
<b>POPULATION DEMOGRAPHICS</b>	Population & Female (% of total)	18,211,097 & 49	25,365,089 & 50	29,239,927 & 51
	Population ages 0-14 (% of total)	37	31	27
	Population ages 15-64 (% of total)	59	65	68
	Population ages 65 and above (% of total)	4	4	5
	Rural population (% of total population)	50.2	33.5	26.6
	Urban population (% of total population)	49.8	66.5	73.4

Source: World Bank Development Indicators and UNICEF Statistics

**Industrial diversification has alleviated poverty substantially and the country's gender gap continues to drop; it ranks 107 of 142 countries, according to the World Economic Forum's Global Gender Gap Report 2014.** Since 1970, Malaysia has progressively transformed from an agriculture-oriented economy to a more diverse one with manufacturing and services taking the lead. Agriculture, which accounted for more than 20% of GDP in 1985, dropped to 7% in 2012, surpassed by other sectors including services (55.2%, 2013) and manufacturing (24%). Between 1995 and 2012, the frequency of cumulative Malaysian poverty was

scaled down from 9% to 2% and urban poverty narrowed from 3% to 1%, according to the UN Food and Agriculture Organisation. Rural poverty, once a major concern, has been reduced from 15% to 3%. The poorest state, Sabah, has experienced the highest cutback in poverty, from 19% in 2009 to 6% in 2012. The number of people living in life-threatening poverty (those unable to meet their basic food needs) dropped from 0.7% in 2009 to 0.2% in 2012. By moving away from agriculture, Malaysia has seen significant urbanisation. Between 1970 and 2010, urban population increased from 27% to 71%.

Poverty headcount ratio at national poverty line (% of population)

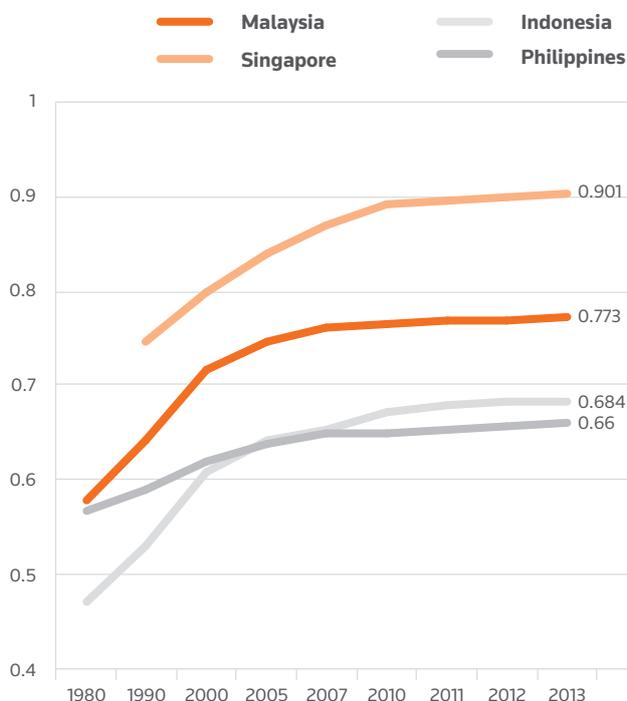


Source: World Bank Development Indicators, no data available for 2013

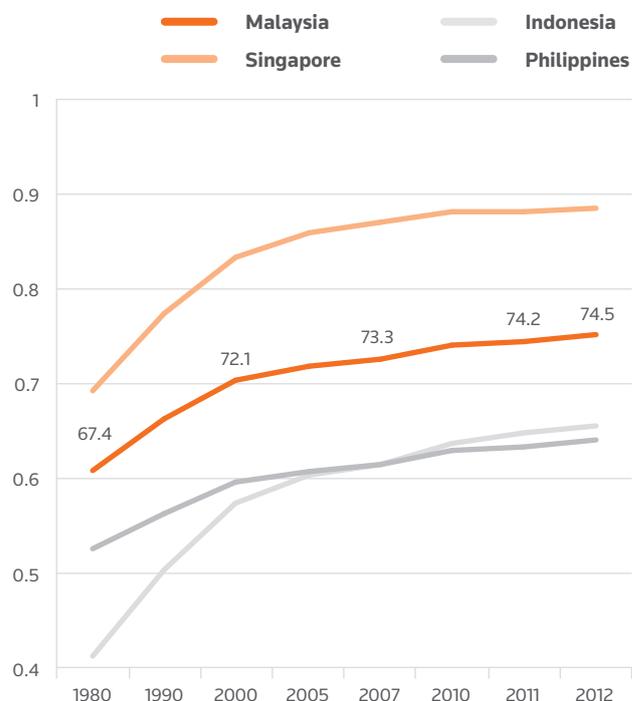
**Malaysia enjoys High Human Development, as measured by the UNDP – Human Development Report 2014.** With an HDI value of 0.773 (2013), the country is ranked 62nd out of 187 countries and territories, ahead of Mauritius and behind Antigua and Barbuda. Malaysia's HDI value increased from 0.563 to 0.769 between 1980 and 2012, a rise of 37% or average annual increase of about 1%. 49 countries enjoy a Very High Human Development including neighbours Singapore (9<sup>th</sup>, 0.901) and Brunei (30<sup>th</sup>, 0.852), and key Islamic finance centres Saudi Arabia (34<sup>th</sup>, 0.836), UAE (40<sup>th</sup>, 0.827) and Bahrain (44<sup>th</sup>, 0.815). Ceteris paribus, if Malaysia continues to improve at the same rate of 1% per year it would be ranked in the Very High category by 2020.

**Income distribution has not improved proportionately with increases in GDP per capita.** While GDP per capita increased 75% from RM15,498 (2002) to RM27,113 (2010) income inequality, as measured by the Gini coefficient, only improved 0.46 to 0.44 from 2002 to 2012 (0=perfect equality). In terms of income distribution, the top 10% of the population in 2012 controlled 31.94% of income and the bottom 50% held 21.46%; the gap between them has remained steady for the past 30 years. (Data from the UN Malaysia Human Development Report 2013)

### Human Development Index



### Life Expectancy at Birth

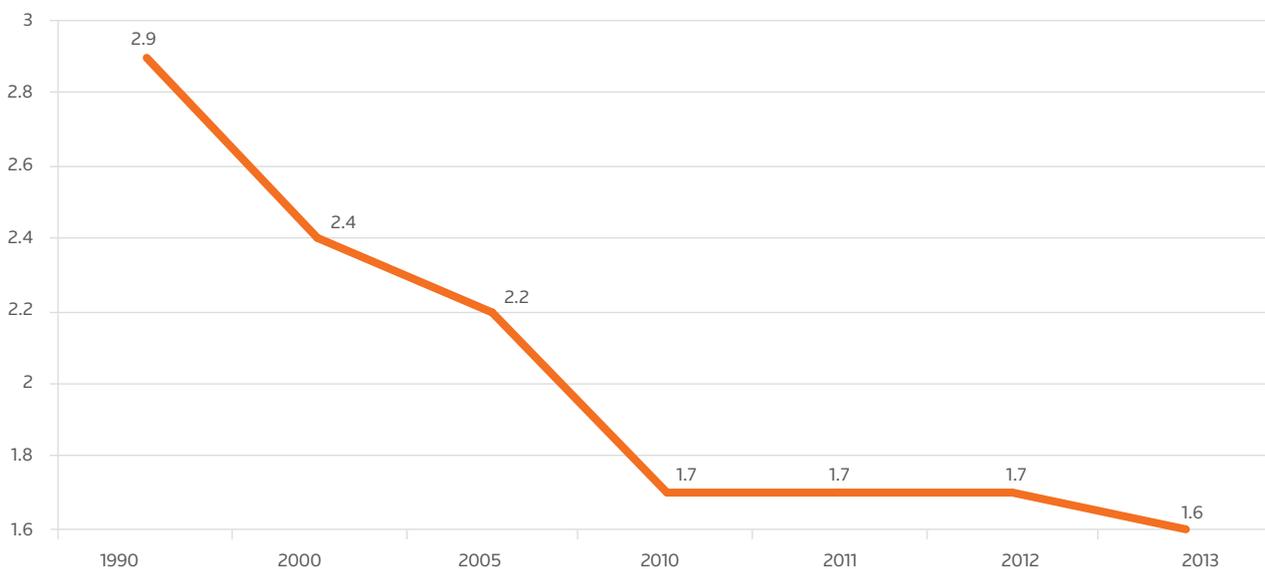


Source: International Human Development Indicators

**The population crossed the 30 million mark in Q3 2013 but growth is on the downtrend due to a lower fertility rate.** At the end of Q2 2014, Malaysia's population reached 30.261.7 million, which is an increase of 346,400 people compared to the same period in 2013. 48.47% of the population are women. Malaysia displays an adequate population density, with 90 people per square km and it was ranked 105th in global density population in 2013. According to estimates by the United Nations, Malaysia's total fertility rate stood at 2.96 births per woman at the turn of the 21st century. It is estimated that the fertility rate will have fallen to 2.58 births in 2014. This is consistent with Malaysia's Statistics Department forecast that between 2010 and 2040, the annual population growth rate will decrease from 1.8% to 0.6% with the population hovering around the 38.6 million mark.

**The rising median age will impact the labour force.** Malaysia's population is still relatively youthful, with an estimated median age of 27.7 but this will rise to 29.9 in 2020, 33 by 2030 and 36 by 2040. The country is already shifting gears for a bigger greying population that will push up health-care costs, and impact the structure of the tax base, the size of the labour force and productivity levels. A close eye is focused on manual labour-intensive sectors that may open up the floodgates even more to migrant workers especially after the ASEAN Economic Community comes into force, currently set for the end of 2015.

#### Average annual population growth rate (%)



Source: International Human Development Indicators

## EDUCATION BLUEPRINT 2013-2025 TO SYSTEMATICALLY DEVELOP THE EDUCATION SECTOR

Malaysian students trail their peers in Singapore in the latest edition of PISA (Programme for International Student Assessment), but have achieved marginal improvement in mathematics<sup>6</sup>. Nevertheless, the World Bank also points out that Malaysia already has a notion of how to arrest the decline; the Malaysian Education Blueprint 2013 – 2025 that was launched in November, 2013, aims to swing the performance of Malaysian students from their current place in the bottom third of the PISA<sup>7</sup> ranking to the top end. It contains headway in the direction of a school-based management system that would encourage greater independence, although, noted the World Bank, it lacks specificity as to how such a system would operate. The blueprint also outlines plans to raise the profile of the teaching profession as well as entry requirements, but, as the World Bank suggests, the Education Ministry should instead prioritise attempts to entice “high ability” applicants to become teachers. The World Bank further suggested an upgrade of Malaysia’s teacher training colleges, noting “weaknesses in essential skills” in the current set of graduates from such institutions.

6 Malaysia Economic Monitor, High-Performing Education, December 2013, The World Bank

7 PISA (The Programme for International Student Assessment): is a worldwide test/study by the Organization for Economic Co-operation and Development (OECD) in member and non-member nations of scholastic performance on mathematics, science, and reading of 15 years old school pupils.

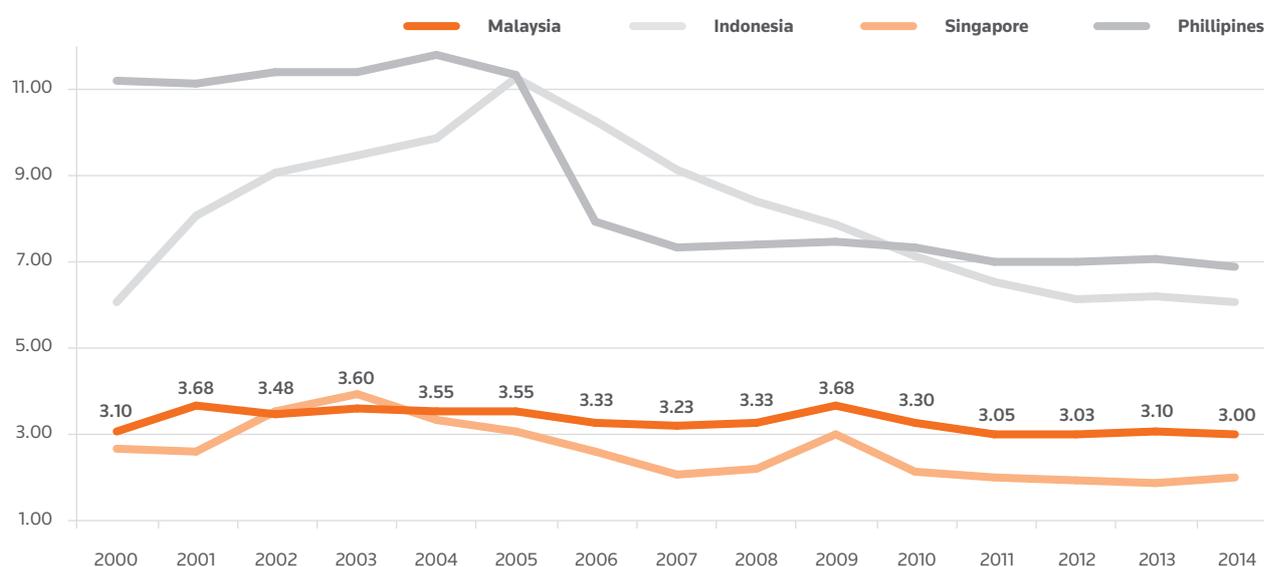
### Unemployment is on a

**downward trend.** Malaysia’s unemployment rate fell from 3.68% in 2009 to 3.3% in 2010 to 3.05% in 2011 to 3.03% in 2012. However it jumped to 3.1% in 2013. The IMF projects the new trend to be downward to 3% at the end of 2014.

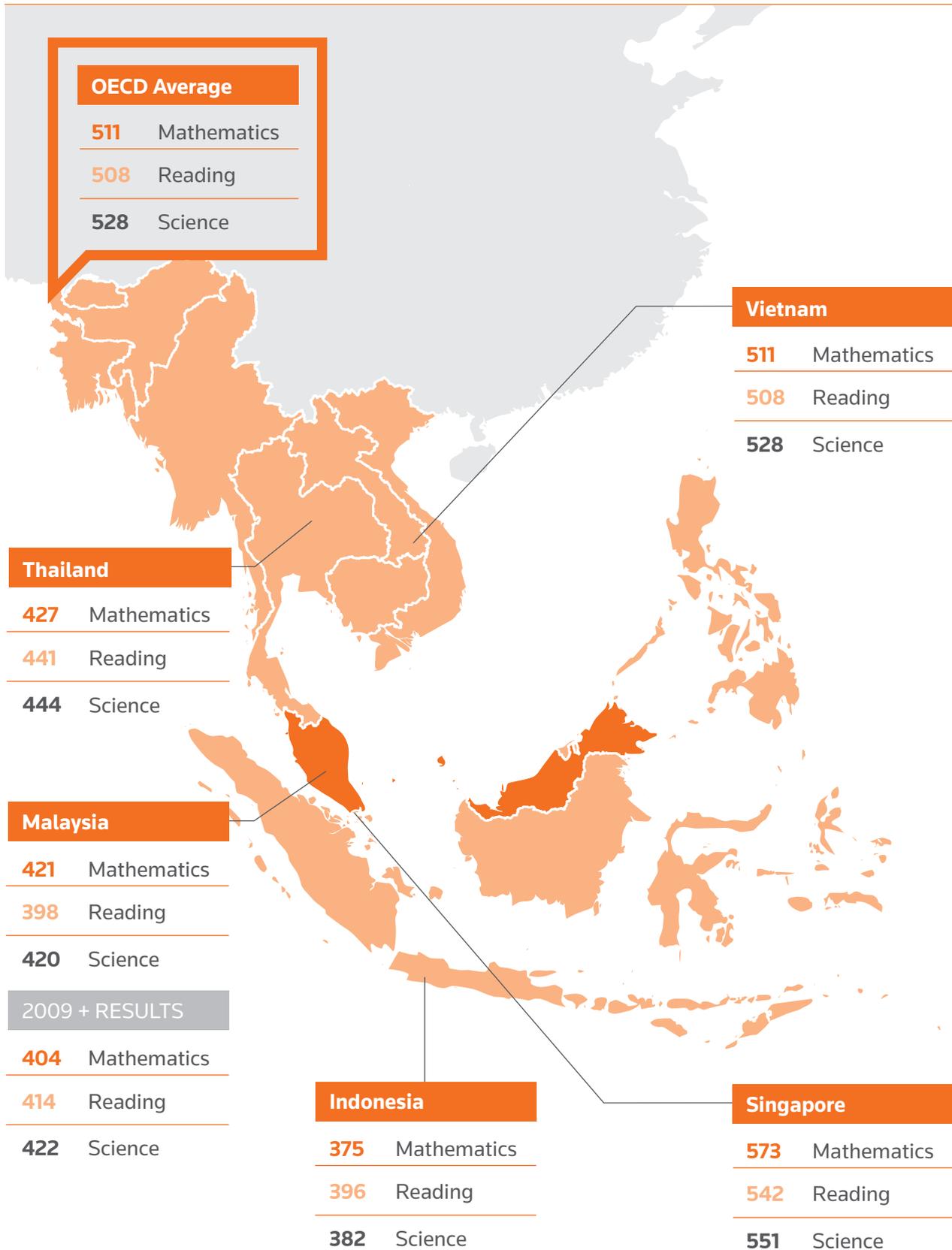
### More jobs are added as the labour market picks up.

Employment progression has been fast outside the manufacturing sector and payments have moved even higher. By building human capital and improving the quality of education, Malaysia has been leveraging its human assets and natural resources on future investments. Malaysia is undertaking a strategy to enhance the qualifications of its labour force, improve the flexibility of the labour market and ease the weakness of social protection and employment relations.

## Unemployment Rate during 2000-2014



How Malaysia Compares to its Neighbours (PISA SCORE 2012)



## Measuring the Global Gender Gap Rankings by region, 2014

COUNTRY	OVERALL SCORE	OVERALL RANK
Philippines	0.7814	9
New Zealand	0.7772	13
Australia	0.7409	24
Mongolia	0.7212	42
Singapore	0.7046	59
Lao PDR	0.7044	60
Thailand	0.7027	61
Bangladesh	0.6973	68
Vietnam	0.6915	76
Sri Lanka	0.6903	79
China	0.6830	87
Indonesia	0.6725	97
Brunei Darussalam	0.6719	98
Japan	0.6584	104
Maldives	0.6557	105
Malaysia	0.6520	107
Cambodia	0.6520	108
Nepal	0.6458	112
India	0.6455	114
Korea, Rep.	0.6403	117
Bhutan	0.6364	120
Fiji	0.6286	122
Iran, Islamic Rep.	0.5811	137
Pakistan	0.5522	141

Source: International Monetary Fund, World Economic Outlook Database

**More work is needed towards gender equality.**<sup>8</sup> Over the past 10 years, Malaysia has taken several legal and administrative steps to eliminate discrimination against women but it ranks poorly on two global benchmarks that measure gender equality – the UNDP’s Gender Development Index (GDI) as part of its Human Development Index and the World Economic Forum’s Global Gender Gap Rankings. Both measure gaps instead of levels.

On the UNDP GDI (which was newly-introduced in 2014) Malaysia ranked 91st out of 148 countries and territories on a score of 0.935 in 2013 (where 1 is gender equal).

On the 2014 WEF Ranking, Malaysia was 107th out of 142 countries with a score of 0.652. This is a demotion in ranking from 102nd in 2013, 100<sup>th</sup> in 2012 and 97<sup>th</sup> in 2011.

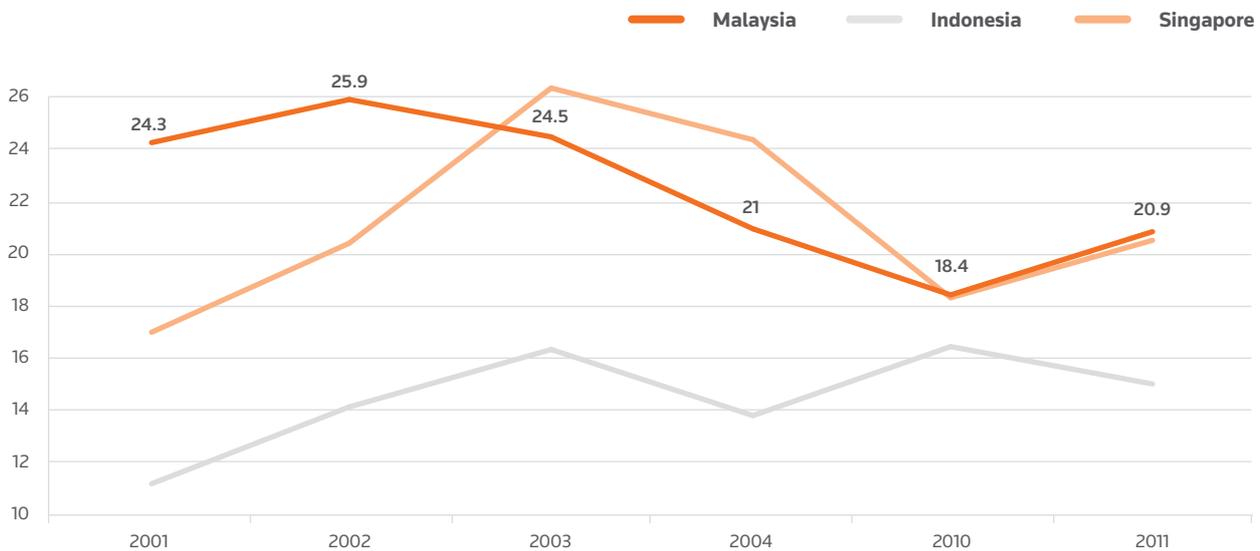
The gap between the two rankings boils down to the more detailed WEF scoring vis-à-vis economic participation and opportunity across three concepts: the participation gap, the remuneration gap and the advancement gap. The UNDP GDI only considers GNI per capita separately for men and women. Additionally, the UNDP GDI does not consider political empowerment which is factored into the WEF Ranking. On its declining equality level, the WEF Global Gender Gap Report 2014 states that Malaysia is one of 5 countries with the highest negative percentage change on the Educational Attainment subindex but the country is also one of the top 5 performing countries on the wage equality for similar work indicator.

8 UN Human Development Index and World Economic Forum 2014

**There is high public expenditure for basic education.** The Malaysian government has addressed the need to invest heavily in education as the country moved towards becoming a knowledge-based economy. Malaysia's public expenses from preschool through to secondary as a percentage of GDP was more than twice that of other ASEAN countries in 2011 (3.8% versus 1.8%), and 1.6% higher than the Asian Tiger economies of Japan, Singapore, South Korea, and Hong Kong (MoE 2013). It was also

marginally higher than the OECD average of 3.4%. The expenses on education as a percentage of total government spending was also high in comparison with regional peers Singapore and Indonesia (See Figure 7). Further, a large share of public investment in education goes towards teacher compensation and incentives (UNESCO 2013). In terms of wages, the ratio of teacher pay to per capita GDP is projected at 1.1 times for seasoned teachers (OECD average: 1.2 times).

#### Public spending on education, total (% of government expenditure)





A worker cleans up a pool inside the Tuanku Mizan Zainal Abidin mosque in Putrajaya. REUTERS/Samsul Said



# ISLAMIC FINANCE DEVELOPMENT & RECENT ACTIVITY

---

## ISLAMIC FINANCE TIMELINE IN MALAYSIA

- 76 From the 1950s: Demands for greater incorporation of Islamic values
- 78 Key milestones of Malaysia's Islamic financial services industry development

## MALAYSIA'S ISLAMIC FINANCE ENVIRONMENT

- 82 Snapshot of Malaysia's Islamic Finance Development according to ICD – Thomson Reuters Islamic Finance Development Indicator

## FINANCIAL SECTOR ECOSYSTEM

- 95 Select related associations, other regulatory and infrastructure bodies based in Malaysia
- 103 Development of Shariah ecosystem

# Islamic Finance Timeline In Malaysia

## From the 1950s: Demands for greater incorporation of Islamic values

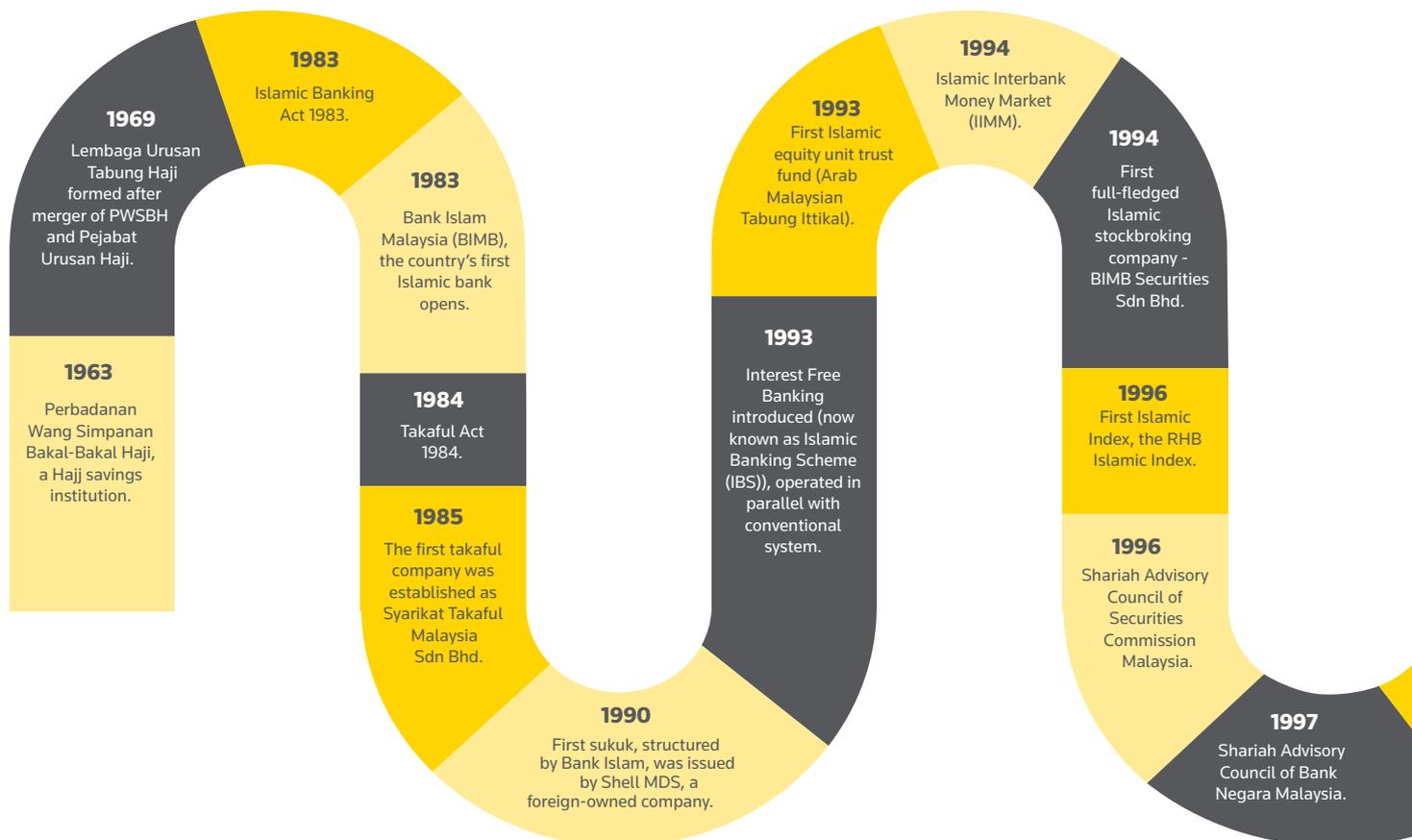
While many recall that the world's first practical experience in Islamic banking began in Egypt with the introduction of interest-free banking by the Mit Ghamr Savings Bank in 1963, Malaysia paved its own way for Shariah financing in the same year with the establishment of Tabung Haji, the national Hajj savings institution. Yet, Malaysia only earned the accolade as one of the early pioneers of Islamic finance after a couple of decades when Islamic values were adopted within the state policy in 1981 under the then new Prime Minister Dr. Mahathir Mohamad's administration.

Calls for a return to "Civilisational Islam" or Islam Hadari (which was officially introduced later in the

2000s) in the 1950s escalated after Malaysia gained independence from the British. But many, including Malaysia's first three prime ministers (1957-1981), preferred secular development policies, within a legacy colonial administrative framework, that were deemed to be safe as such policies could avoid crossing any fault lines. However, during the period of the New Economic Policy (NEP) (which was introduced in 1971) the calls for the inclusion of Islamic values re-surfaced.

Several initiatives were undertaken in the 1970s, including financial and non-financial Islamic cooperatives (some still stand today). Demands on the ground for

## Historical Roadmap

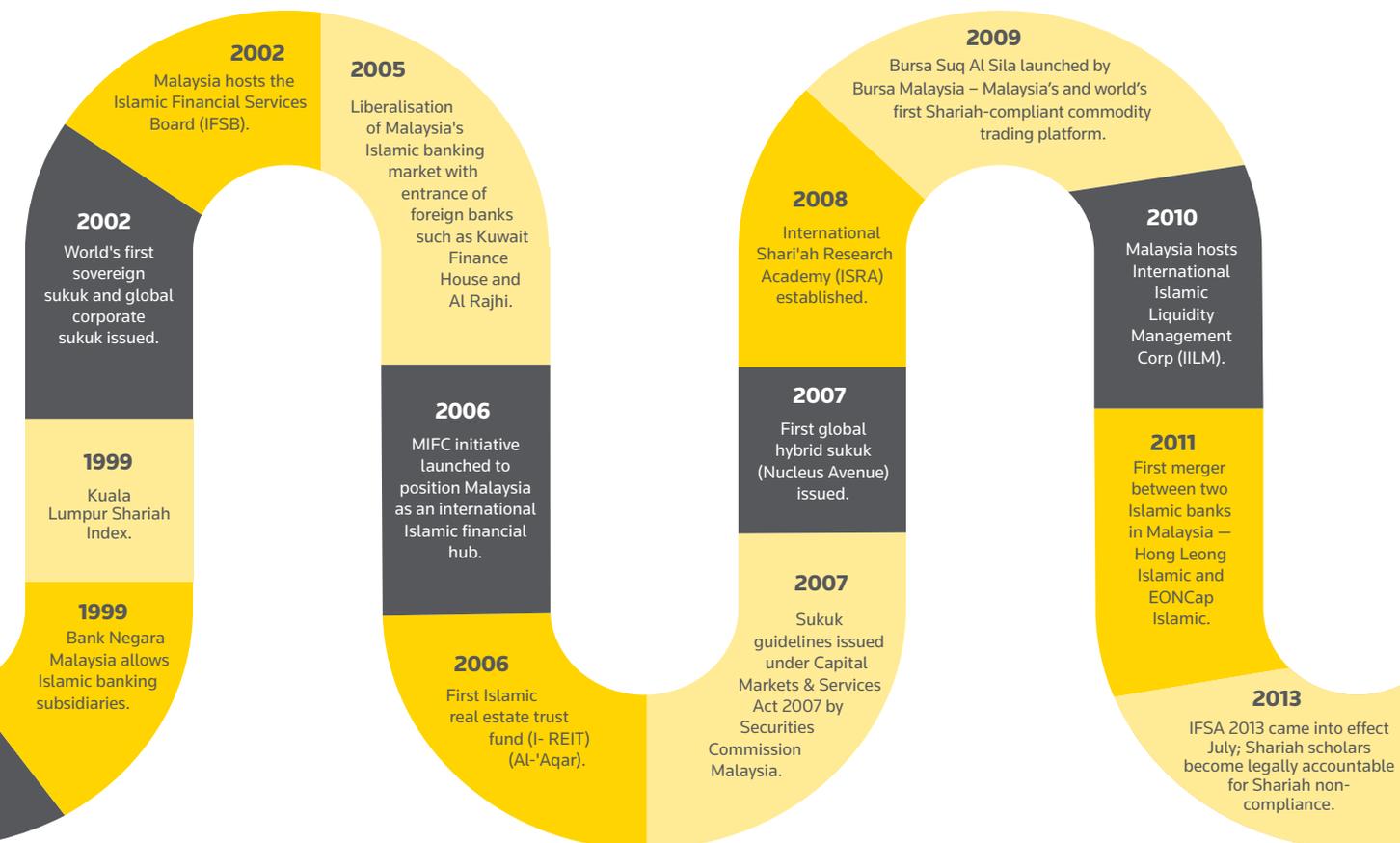


Malaysia's own Islamic bank grew louder firstly with the success of Tabung Haji and secondly as Islamic financial institutions in the Middle East were established. Former Prime Minister Tunku Abdul Rahman (1963-1970) played a leading role in the establishment of the OIC (1969) and the IDB (1975) and his involvement in these two Islamic institutions further fanned the flames in Malaysia for an Islamic bank.

Two separate resolutions were passed — at the National Bumiputera Economic Congress in 1980 and at a seminar hosted by the Universiti Kebangsaan Malaysia in 1981 — requesting the government establish an Islamic bank, and for Tabung Haji to lead the implementation of that Islamic bank. In response the government set up a

special committee to study all relevant aspects of the requests. This resulted in the Islamic Banking Act 1983 and the eventual launch of Bank Islam in 1984, as well as the Takaful Act of 1984 and the opening of Syarikat Takaful Malaysia in November of the same year.

Islamic values were not only incorporated through Bank Islam and Syarikat Takaful Malaysia, but also through other types of institutions such as the International Islamic University of Malaysia (IIUM) that encourages Islamic educational priorities as well as support infrastructure for Islamic finance.



## Key milestones of Malaysia's Islamic financial services industry development

The development of Malaysia's Islamic financial services industry has been gradual and structured.

### 1980s: The foundation as set by 1 bank and 1 takaful operator

The Islamic Banking Act 1983 and Takaful Act 1984 provided legal and regulatory bases for the development of the Islamic financial services industry. Further, the Banking Act 1979 was replaced with the Banking and Financial Institutions Act 1989 (also known as BAFIA 1989). This amendment was made to allow Islamic banks to carry out trading activities as part of the requirements of the relevant Shariah contracts.

For the operation of Islamic financial products by conventional banks, an order under Section 32 was issued on 1 March 1993 to allow all banks, finance companies and merchant banks to engage in the following forms of trade which are otherwise prohibited:

- a. The sale of property at a price which includes a profit margin;
- b. The sale of property on a deferred payment basis at a price which includes a profit margin, so long as such trade is not conducted on the basis of interest.

### 1990s: Expanding the Islamic banking sector and building the capital market

**Banking** — With the increase in popularity of Bank Islam and a decade of experience in Islamic banking, the 'Interest Free Banking Scheme (also known as Skim Perbankan Tanpa Faedah)' was introduced in 1993 by Bank Negara Malaysia. This initiative, which came in the form of a set of guidelines, was to disseminate and promote Islamic banking on a wider scope by allowing licensed institutions under the Banking and Financial Institutions Act 1989 (BAFIA) to offer Islamic banking services using their existing infrastructures and brand name.

The purpose of the guidelines was to facilitate the participation of licensed institutions in the initiative, through a set of standard and comprehensive rules to assist the licensed institutions in carrying out their IFBS operations in a systematic way; and to ensure

that the operations undertaken by the licensed institutions would be fully Shariah-compliant.

In 1998, Bank Negara Malaysia changed this term to the 'Islamic Banking Scheme (also known as Skim Perbankan Islam)' which has further increased the visibility and awareness of Islamic banking and finance and pushed up the penetration and take-up rate.

**Capital market** — Away from banking the capital markets also needed to be developed, in part to support the management of IFIs liquidity and to meet increasing demand for IFIs to have their own wider and deeper range of products and services to shift completely away from leveraging on the treasury of conventional institutions. The Securities Commission (SC) was set up in 1993 as the sole regulatory body for capital markets, with the Islamic capital market on the agenda. The Securities Commission was quick out of the blocks; in 1996 it established its Shariah Advisory Council, and the country's first Islamic Index was born — the Dow Jones-RHB Islamic Malaysia Index. But even before these advancements, Malaysia issued its first sukuk — a RM125 million corporate issue — from Shell MDS Sdn Bhd in 1990 — structured by Bank Islam.

**Industry infrastructure** — As the industry expanded the Association of Islamic Banking Institution of Malaysia (AIBIM) was established in 1996, primarily to promote and represent the interests of member Islamic banks and to render, where possible, advice or assistance as may be deemed necessary and expedient to members. AIBIM assists the regulator to introduce more unified market norms and has worked towards issuing standard practice documents (e.g. in 2009 AIBIM successfully launched the Standard Wakalah Placement Agreement for deposit placements by corporate customers and interbank placements). AIBIM also promotes education and training in Islamic banking so as to create awareness among the public and to upgrade Islamic banking expertise in Malaysia. In pursuing its objectives, AIBIM works in co-operation with other similar associations in the country and elsewhere in the world.

### 2000s: Liberalisation and Internationalisation

**Banking** — In the early 2000s the Malaysian Islamic financial services industry opened its doors to foreign IFIs, particularly from the Middle East, to enter the rapidly-growing Malaysian sector. The issuance of licenses to foreign IFIs was to promote healthy competition in the local market and to push the industry to a greater level. Kuwait Finance House (Malaysia) Berhad was granted a licence in 2005 followed by Al Rajhi (the Saudi bank's first foreign branch outside the Kingdom) in 2006.

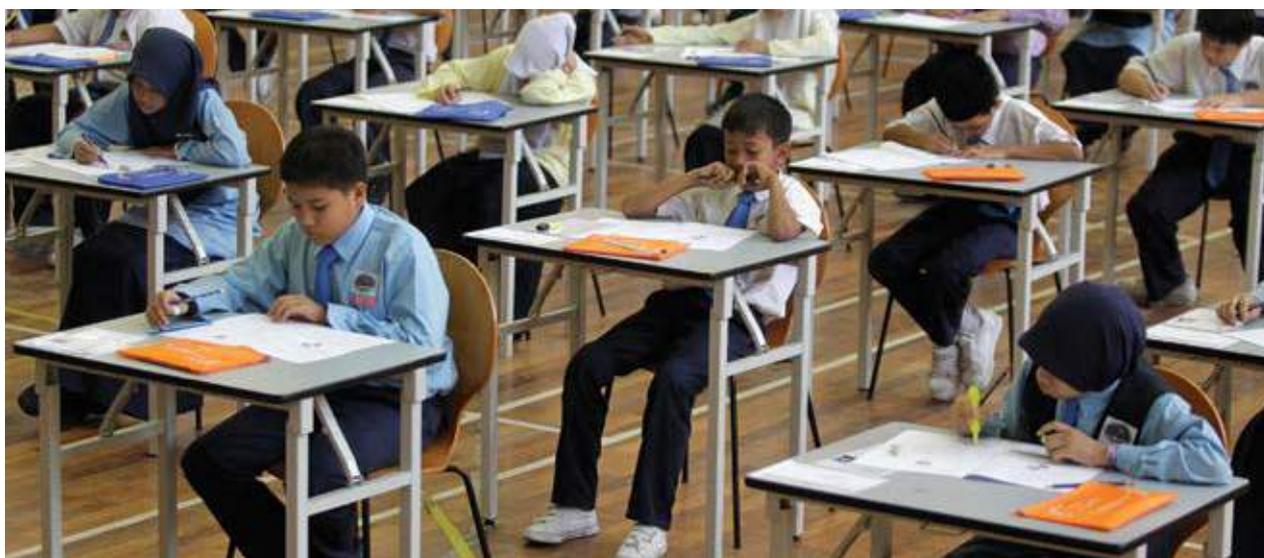
**Capital market** — Malaysia's Capital Market took great strides in the 2000s with the introduction of many new instruments both conventional and Islamic. In the Islamic Capital Market, Malaysia pioneered the development of the global sukuk market with the launch of the first sovereign 5-year global sukuk worth US\$600 million in 2002.

As sukuk issuances and structures became more sophisticated, the SC took the initiative to regulate the market. The very first SC guidelines for sukuk issuance were released in 2004 and as the sukuk market evolved rapidly, revised guidelines were issued in December 2012. The most recent guidelines were released in early 2014 and in August the same year a new set of guidelines were issued for Socially Responsible Investment (SRI) sukuk.

The SC released the world's first guidelines for Islamic REITs in 2005 and in 2007 introduced two new benchmark Islamic indices – the FTSE Bursa Malaysia EMAS Shariah Index and the FTSE Bursa Malaysia Hijrah Shariah Index. Malaysia's first Islamic ETF was launched in 2008, three years after the first conventional ETF product was released in the country. (The first-ever Islamic ETF in the world was launched in 2007 by BNP Paribas.) In the same year the SC also released guidelines for Islamic Venture Capital. (Details about Malaysia's ICM can be found in the dedicated ICM section.)

**Industry infrastructure: Domestic** — To further strengthen Malaysia's international position, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched in 2006. MIFC promotes Malaysia as a centre for the offering of Islamic financial products and services in the global marketplace by facilitating the growth of investments in Islamic financial markets and by connecting international Islamic financial centres.

To further expand industry infrastructure, in August 2009, the Bursa Suq Al-Sila (BSAS) was launched. BSAS is a web-based end-to-end Shariah-compliant commodity trading platform to facilitate Islamic liquidity management and financing by Islamic banks. The trade offered by the trading platform involves only sale and purchase of real physical assets.



Students sit for their examinations at a school in Putrajaya outside Kuala Lumpur. REUTERS/Bazuki Muhammad

**Industry infrastructure: Global** — Malaysia has also been building its capacities beyond its domestic market. In 2003 the country showed its commitment to the development of Islamic finance at the global level by hosting the international prudential standard-setting organisation, the Islamic Financial Services Board (IFSB). The IFSB's mandate is to promote soundness and stability of the Islamic financial industry by issuing prudential standards and guiding principles. As at April 2014, IFSB's 184 members comprise 59 regulatory and supervisory authorities, eight international inter-governmental organisations, 111 financial institutions and professional firms as well as six self-regulatory organisations (Industry Associations and Stock Exchanges) operating in 45 jurisdictions.

**Education and Research** — Human capital development is key to the continued advancement of and innovation for the industry and in the 2000s many Islamic finance-specific education and training institutions were established. Since 2001, regular courses for finance professionals have been conducted by industry-owned Islamic Banking and Finance Institute Malaysia (IBFIM). In 2005 the International Islamic University Malaysia opened its Institute of Islamic Banking and Finance (IIBF). In the following year, BNM established the International Centre for Education in Islamic Finance (INCEIF), the world's only dedicated university for Islamic finance and spearheads the development of Islamic finance. Apart from IIBF and INCEIF there are numerous undergraduate and post-graduate Islamic finance programmes and courses offered by universities across the country. In order to fill the gap for Islamic capital market entry-level professionals the Securities Commission and the Securities Industry Development Corporation launched the Islamic Capital Market Graduate Training Scheme in 2009.

To further research, in 2008 BNM announced the establishment of the International Shari'ah Research Academy for Islamic Finance (ISRA). ISRA promotes applied research in the area of Shariah and Islamic finance and also serves as a repository of knowledge for Shariah views or fatawa and undertakes studies on contemporary issues in Islamic finance. ISRA further contributes to strengthening human capital

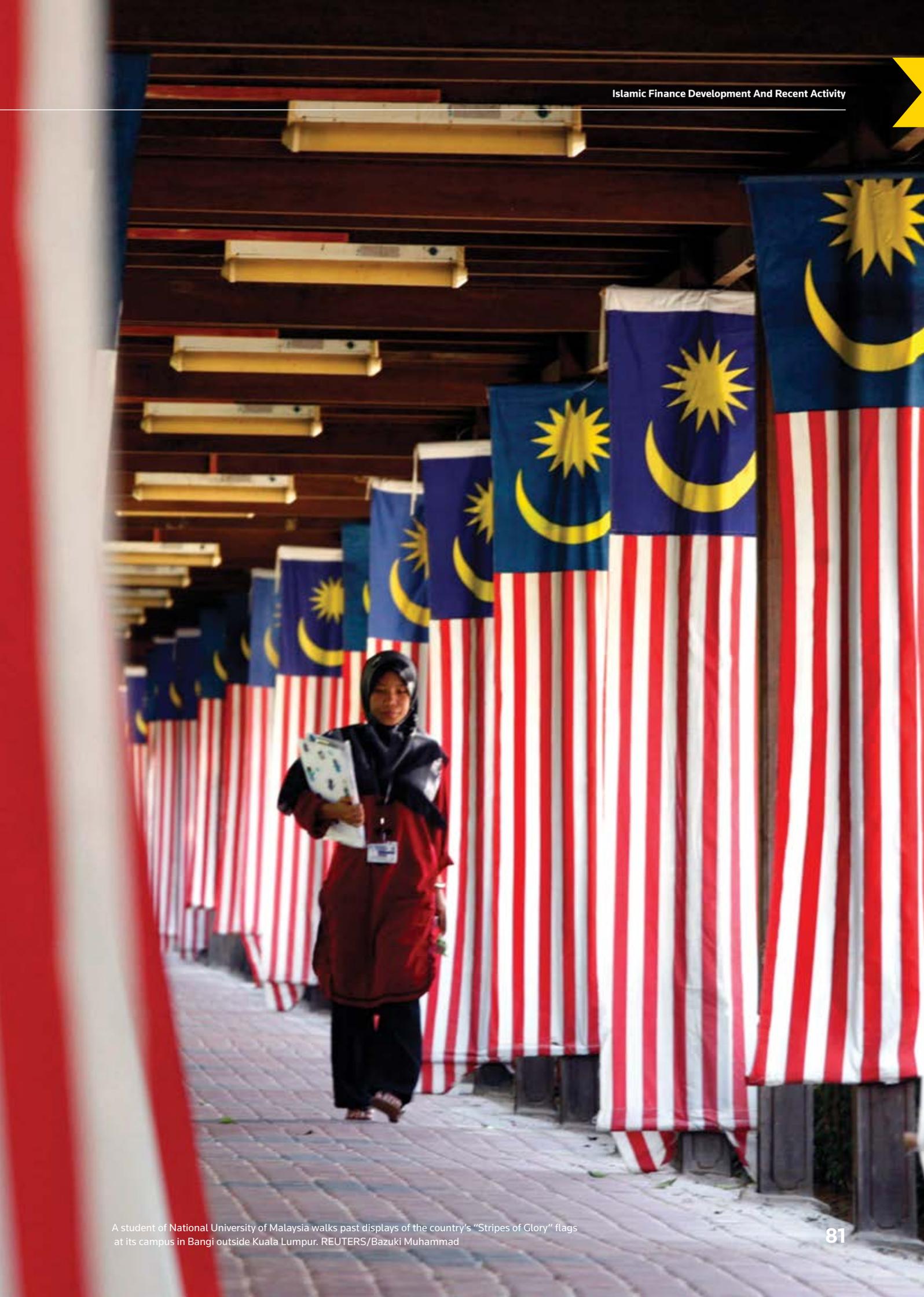
development in the areas of Shariah where it will provide a platform for greater engagement amongst practitioners, scholars, regulators, and academicians via research and dialogue, both in the domestic and international environment.

#### 2010s: Global linkages

**Industry infrastructure: Domestic** — The Law Harmonisation Committee was established in 2010 with a main objective to create a conducive legal system and infrastructure that supports and caters to the growing development of the Islamic finance industry. The committee is mandated to undertake objective reviews of relevant laws, recommend appropriate changes to provide legal recognition to Shariah contractual features, and enhance the legal certainty of financial transactions based on Shariah principles.

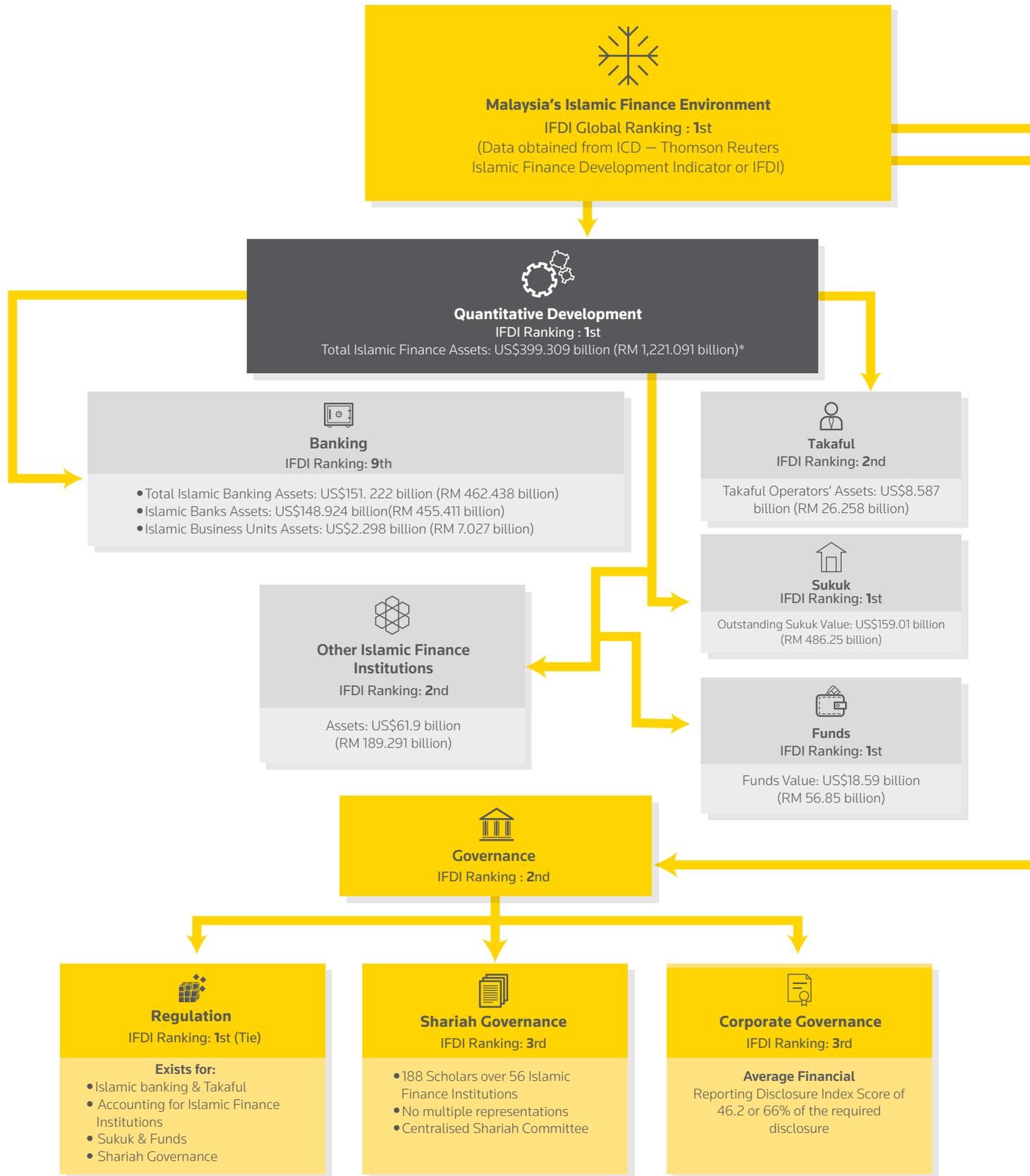
**Industry infrastructure: Global** — The International Islamic Liquidity Management Corporation (IILM) set up shop in Kuala Lumpur in October 2010. IILM's current shareholders are from the central banks and monetary agencies of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Turkey, the United Arab Emirates and the Islamic Development Bank. IILM issued its inaugural sukuk — a USD denominated short-term 3-month sukuk of \$490 million, rated A-1 by Standard & Poor's — in Aug 2013.

**Capital Market:** The Securities Commission continues to roll out new products and instruments to further deepen market access and liquidity to cater to Malaysians' changing needs. In 2012 the Private Retirement Scheme (PRS) was introduced to cater to the long-term saving needs of the general public and in the same year the framework for retail bond and sukuk was also released. The first retail sukuk was a RM300 million sale from state-owned DanaInfra Nasional in February 2013 for the Mass Rapid Transit (MRT) project. Another notable new asset class is the SRI Sukuk whose guidelines were introduced in August 2014.

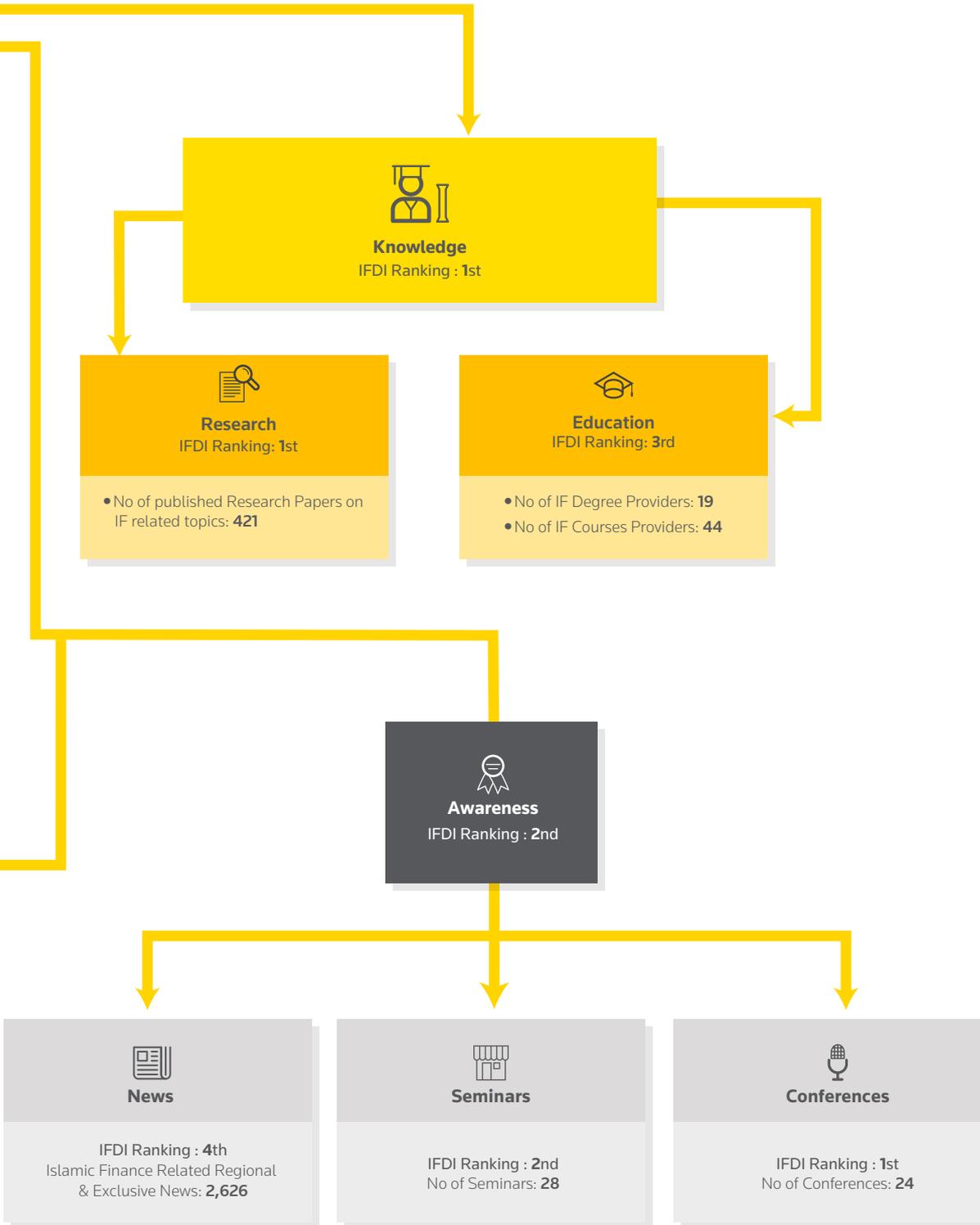


A student of National University of Malaysia walks past displays of the country's "Stripes of Glory" flags at its campus in Bangi outside Kuala Lumpur. REUTERS/Bazuki Muhammad

# Malaysia's Islamic Finance Environment



\*Data obtained for Islamic banking and Takaful represent the latest data reported by Bank Negara Malaysia (BNM) (Monthly Statistical Bulletin - September 2014), while Sukuk and Funds represent the FYE 2014 data obtained from Thomson Reuters. Other Islamic Financial Institutions Assets are obtained from ICD-Thomson Reuters Islamic Finance Development Indicator's data for the FYE 2013.





## Leadership Article



### Turkhan Ali Abdul Manap

Dr. Turkhan Ali Abdul Manap is currently a Senior Economist at IRTI-IDB. Prior to joining IRTI, he was an Associate Professor of Economics in International Islamic University Malaysia (IIUM). He obtained his PhD in Economics from IIUM, MBA (Finance) from National University Malaysia and Bachelor (Engineering) from Dalian University of Technology, China. His academic papers appear in numerous referred journals. He is the team-leader of Islamic Finance Country Report and Co-Editor of Islamic Economics Studies (English). His research interests include macroeconomics, (Islamic) capital market, financial stability and stress testing for Islamic financial institutions. He is member of the Malaysian Economic Association and East Asia Economic Association.

## Overview: Government initiatives and policies in the development of Islamic finance in Malaysia

Islamic finance has witnessed tremendous growth over the last four decades and Malaysia, as a pioneer of this fast-growing industry, has developed a comprehensive Islamic financial system that competes with and compliments the parallel conventional financial system.

The Malaysian government has played an important role in the development of Islamic finance in Malaysia by providing it with a strong regulatory and legal infrastructure that is more advanced than most other Muslim countries. From a robust foundation and framework has sprung the Islamic finance ecosystem made up of financial institutions such as Islamic banks, takaful operators, commercial banks, investment banks, securities companies, and fund management companies, as well as ancillary professional companies such as rating agencies, accounting firms and legal firms. Additionally, Malaysia has played a pivotal role in pioneering the global sukuk market and is the world's biggest sukuk market, accounting for 60% of total sukuk issuance globally.

### 1970s – 1990s

The success of Islamic finance in Malaysia was not achieved overnight. It developed gradually and progressively with the government setting its blueprint from the 1970s to successfully transition domestically-developed Islamic finance into a full-fledged dual banking system by 2020.

From the 1960s the government has responded to the evolving demands of the market. The majority of the population in Malaysia

is Muslim, many of whom did not take part in the government's economic programmes in the 1960s and 1970s due to concerns that loans might be *riba*-based and not compliant with Shariah. The initial step towards Islamic finance was the establishment of Tabung Haji in 1963, which started as a Muslim Pilgrims Savings Corporation and evolved into a non-banking financial institution.

20 years after the establishment of Tabung Haji, the enactment of the Islamic Banking Act of 1983 (Act 276) enabled the founding of Bank Islam Malaysian Berhad (BIMB), the first full-fledged Islamic bank in the country. Within two years after the establishment of BIMB, Malaysia opened its first takaful operator, Syarikat Takaful Malaysia, based on the enactment of Takaful Act (1984). In 1993, conventional banks ventured into new territory when, through the Banking and Financial Institutions Act 1989 (Act 372), the Interest-free Banking Scheme was introduced to allow them to operate Islamic windows.

### Development in the 2000s

The country's 10-Year Financial Sector Master Plan, the first of which was launched in 2001, articulates the government's goals to serve as a catalyst for growth. In support of these goals, the government has taken steps to liberalise its financial sector, including initiatives to increase the cap on foreign investment in local Islamic banks, investment banks, conventional insurance and takaful operators from 49% to 70% (April 2009).

Market liberalisation and tax incentives have been used to attract foreign banks in the development of Islamic banking in Malaysia. As part of the government's liberalisation plans for the Malaysian financial

sector, the central bank, Bank Negara Malaysia (BNM) announced in April 2009 that it would issue up to two new licenses for Islamic banking.

Regulations and oversight were further strengthened with the Central Bank of Malaysia Act 2009 which provides comprehensive provisions for heightened surveillance, pre-emptive actions and expanded resolution powers to facilitate the swift and orderly resolution of a financial crisis. It also allows BNM to take appropriate intervention measures to avert risks that stem from unregulated entities. The act also provides comprehensive details for the function of the Shari'ah Advisory Council. The Act has strengthened the central bank's independence and authority, and mandated the central bank and other government agencies to promote Malaysia as the global Islamic Financial Centre and enhance its international status.

More recently, regulators introduced the Islamic Financial Services Act (2013). The IFSA replaced both the Islamic Banking Act (IBA) 1983 and Takaful Act 1984 (Section 282). The objective of this landmark act is to ensure that Shariah and operational guidelines are duly observed by Islamic financial institutions and in cases of non-compliance, penalties are levied. The main feature of this act is to provide a clear guideline on the treatment of deposit accounts and profit sharing investment accounts, with only the former to be covered under deposit insurance.

Other initiatives such as the establishment of the International Islamic Money Market and Bursa Suq Al-Sila (trading platform to manage liquidity and financing) add to the industry infrastructure.

The Malaysian government is also actively involved in international collaborations. In 2002, as a host,

---

*The Act has strengthened the central bank's independence and authority, and mandated the central bank and other government agencies to promote Malaysia as the global Islamic Financial Centre and enhance its international status*

---



Malaysia with 16 other central banks organised and set up the Islamic Financial Services Board (IFSB), an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry.

To sustain the growth of Islamic finance financial innovation and engineering requires tremendous investments in research, an adequate supply of talent and expertise, and greater use of technology in Islamic finance. The government has taken steps to build capacity by funding research and training institutes. Currently, Malaysia has more than 20 Islamic financial research institutions and over 10 public universities offer Islamic finance related courses at the undergraduate and postgraduate levels in addition to professional courses.

### **Regional and global linkages**

In August 2006, the government launched the Malaysia International Islamic Financial Centre (MIFC) to promote Malaysia as a regional hub for Islamic finance in Southeast Asia. Malaysia has thus emerged as a major player in the field. Malaysia's strategic location has allowed it to facilitate links between East and West, as well as intermediate the flow of funds between Southeast Asia and the Middle East.

In summary, the achievements of Islamic finance in Malaysia have been made possible by the Malaysian government with over 30 years of efforts to promote the industry alongside the conventional system. The successful experience of Islamic banking in Malaysia has important implications for other countries keen to develop Islamic finance in their respective jurisdictions.



## Leadership Article



**By Dr Amat Taap Manshor,  
CEO, Finance Accreditation  
Agency**

Dr. Amat Taap Manshor is CEO, Finance Accreditation Agency. He obtained his Ph.D. in Management from the Multimedia University Malaysia in 2002. He is also a holder and a member of the Chartered Institute of Personnel & Development (CIPD) UK and an Accredited Competency Professional (ACP) of the Institute of Leadership & Management, UK.

### Islamic Finance Education, Talent And Professional Training In Malaysia: Issues And Solutions

The current economic reality of tougher regulations, technological advances, demographic shifts, digital lifestyles and work style revolutions, is putting greater emphasis on establishing a larger pool of competent Islamic finance professionals to meet the increasing market share of the Islamic Financial Services Industry (IFSI). Islamic finance currently contributes 11% of total employment to the IFSI worldwide, and one million professionals are estimated to be required by 2020.<sup>1</sup>

In Malaysia, the growing momentum of IFSI suggests that a significant portion of the remaining workforce of 56,000 to be employed by the Financial Services Industry (FSI) by 2020<sup>2</sup> will comprise Islamic finance professionals. Through the Economic Transformation Programme (ETP), student enrolment in Islamic finance is aimed at 54,000 by 2020 from the current 6,000.<sup>3</sup> The ETP also targets to increase the number of employable Islamic finance graduates from 64.8% to 80% by 2015. The recent establishment of the Financial Services Talent Council will be pivotal in developing, attracting and

1 Malaysia International Islamic Financial Centre (MIFC), *Human Capital Development: Sustaining the Growth of Islamic Finance*, MIFC, 2013.

2 Bank Negara Malaysia, *Financial Sector Blueprint 2011-2020*.

3 Economic Transformation Programme (ETP), *EPP7: Building an Islamic Finance and Business Education Centre*, 2013.

retaining talent in the sector through engagements with the FSI, the private sector, as well as education and training institutes.

A report on Global Islamic Finance Education 2013 by Yurizk indicates that, whilst the Asian region hosts about 43% of the global Islamic finance education and knowledge service providers, Malaysia ranks behind Pakistan as the second highest Islamic finance education provider with over 86 institutions offering Islamic finance education, of which 48 are academic institutions. Malaysia ranks highest amongst 38 providers for professional development programmes including certification, training, seminars and workshops.<sup>4</sup> These include notable institutions including Islamic Banking and Finance Institute Malaysia (IBFIM), International Islamic University Malaysia (IIUM) and the International Centre for Education in Islamic Finance (INCEIF). Apart from academic programmes, a number of professional-based and certification programmes are offered to cater to the needs of the IFSI.

Malaysia is also recognised to be at the forefront of Islamic finance research with the setting up of the International Shari'ah Research Academy for Islamic Finance (ISRA) to promote applied research in the area of Shariah and Islamic finance. ISRA acts as a repository of knowledge for Shariah views and undertakes studies on contemporary issues in the IFSI.

Attempts have been made to professionalise Islamic finance practitioners through the setting up of The Association of Chartered Islamic Finance Professionals (ACIFP). Besides serving as a professional membership body, ACIFP also aims to conduct Continuous Professional Development programmes for its members.<sup>5</sup>

### Problems and challenges

Despite much effort spent on Islamic finance education and training, there remains numerous

challenges to be addressed, particularly in integrating education and training with the requirements of the IFSI, as well as streamlining the standards between academic and training programmes. Programme Standards for Muamalat and Islamic finance have since been developed through the Malaysian Qualifications Agency (MQA) for academic programmes. However, this is not the case for professional-based learning and certification programmes. While professional-based and certification programmes enjoy a larger industry participation and feedback, academic programmes have a larger audience of future practitioners. This creates a gap in terms of fulfilling the competency requirements of the IFSI. The current scenario requires closer collaboration between academia and the IFSI as envisaged by Bank Negara Malaysia<sup>6</sup> in order to bridge this gap.

The matter is made more complicated by the fragmentation of Islamic financial regulations and the extreme variation with which Shariah principles are interpreted and implemented within and amongst jurisdictions. This considerable variation creates obstacles to effective training and knowledge transfer. This is particularly an issue for countries implementing Islamic finance without a Global Shariah Advisory Council. It is evident that although the Islamic Financial Services Board (IFSB) has been issuing standards and principles relating to the IFSI, collaboration amongst member countries remains insubstantial. This provides little help in designing and developing education and training curriculum based on globally benchmarked standards.

### Solutions

The aforementioned challenges point to two conclusions. One, although some of the challenges are specific and local in nature, they are to a certain degree universally intertwined. For instance, education and training could be received by Islamic finance professionals in Malaysia but who practice

<sup>4</sup> Yurizk, *Global Islamic Finance Education 2013 Special*.

<sup>5</sup> The Association of Chartered Islamic Finance Professionals, <http://www.acifp-global.org/>

<sup>6</sup> Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Launching of IBFIM's Islamic Finance Qualification Framework & Progression Route (IFQFPR) 'Talent Development in Islamic finance over the next decade', Kuala Lumpur, 14 December 2014.

*Malaysia ranks highest amongst 38 providers for professional development programmes including certification, training, seminars and workshops.<sup>4</sup> These include notable institutions including Islamic Banking and Finance Institute Malaysia (IBFIM), International Islamic University Malaysia (IIUM) and the International Centre for Education in Islamic Finance (INCEIF).*

across jurisdictions with different interpretation of Shariah principles. Hence, a global approach presents a more practical solution in addressing the issues. Second, there is a need for an international accreditation body for the IFSI. Although many countries have their own respective quality assurance agencies in higher education (the MQA, in the case of Malaysia), the absence of a subject-specific and professional accreditation body for finance (or more specifically, Islamic finance) does not allow quality assurance and standardisation of Islamic Finance programmes across jurisdictions to be made possible. Such a setup is viewed as timely and highly critical in view of the unprecedented developments in the IFSI where availability and capacity of talent become a key concern.

#### **Finance Accreditation Agency at a Glance**

Formed in August 2012, the Finance Accreditation Agency (FAA) is an international and independent quality assurance and accreditation body for the FSI. FAA is mandated to contribute to the FSI through the following functions:

- Establish quality assurance and accreditation framework and criteria;
- Accredite programmes, institutions and individuals that fulfil the set criteria and principles;
- Promote and implement recognition of learning standards and practices;
- Maintain and administer the Finance Qualification Structure for the FSI;
- Register and maintain FAA approved training providers and/or accredited learning programmes and qualifications, institutions and individuals in the FSI;

- Seek global recognition of learning and qualifications;
- Facilitate the recognition and articulation of learning programmes and qualifications through mutual recognition initiatives; and
- Seek accreditation and strategic alliances with world-renowned accreditation agencies and relevant institutions.

In line with its vision of becoming a global leader in ensuring quality learning in the FSI and its mission to inspire and promote the highest quality in continuing education and professional development for the FSI through its globally benchmarked accreditation framework, standards and practices, FAA provides national and international financial institutions and practitioners with an effective way to regularly and consistently examine and improve quality of learning offered to financial institutions. This is to ensure that learning programmes provided by education and training institutions meet globally acceptable levels of quality.

FAA adopts a vigorous accreditation process to enhance the competencies of Islamic finance professionals through its various products and services. The FAA Programme Accreditation is guided by the FAA Quality Framework (FQF), FAA Learning Criteria (FLC) and industry competency requirements so as to ensure that education and training programmes meet the requirements of the IFSI.

The FAA Learning Standards (FLS) were developed to make it possible for Islamic finance professionals to practise across jurisdictions. Termed as minimum standards, they enable learning programmes in

various sectors of Muamalat, Takaful, Islamic Capital Market and Islamic Corporate Programmes to be designed, developed and delivered across jurisdictions, thereby reducing the differences in programme offerings. The FLS maintains a high degree of flexibility in allowing the different interpretations of Shariah principles to be acknowledged and covered, taking into account the requirements of different standard-setting bodies such as IFSB and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). As such, participants are expected to be appreciative of the different settings and accommodate the differences in their job functions.

The substantial involvement of IFSI practitioners locally and internationally in the development and moderation of the FLS signify international recognition and industry relevant standards. To some extent, prominent academics have been involved in the moderation of the FLS in order to ensure that the FLS is aligned with academic programme standards for Muamalat and Islamic Finance.

Related to the FQF and FAA Programme Accreditation initiatives is the development of a Finance Qualification Structure (FQS). Taken together with the FQF, FLC and FLS, the FQS harmonises and integrates all qualifications (in this context, the IFSI) into a single framework. This integration allows for mutual recognition of the FQS from other accrediting bodies, both locally and abroad. A more direct implication is the recognition of Islamic Finance programmes across jurisdictions.

The FAA Recognition of Learning (FRL), through the FAA Individual Accreditation initiative, allows individuals in the IFSI to be mapped to the FQS based on their competency levels (knowledge, skills and applications), thus facilitating their movements in the IFSI. The FQS not only allows Islamic Financial Institutions (IFIs) to determine the suitability of training programmes for their employees, it also facilitates the career and academic mobility of IFI employees.

### **Moving Forward**

Islamic finance will continue to draw significant attention from regulators and practitioners due to

its continuous and unprecedented growth. Although growth figures and demand dynamics vary from country to country and from institution to institution, there is a consensus that the sector lacks Islamic finance professionals as current competencies are largely characterised by the education and training programmes received.

It is against this backdrop that FAA was formed, with the mandate to overcome the issues and challenges in developing human resources in the IFSI. To achieve its mandate, FAA cannot function in isolation without the support of regulators, training providers (including academic and training institutions), IFIs and IFSI practitioners. At the same time, a paradigm shift is required to recognise the role accreditation can play in contributing to the development of human capital in the IFSI. FAA is envisaging a bigger role in the near future, particularly with the emergence of many subject-specific accreditation bodies across the world to support national quality assurance agencies. Being the only accreditation agency in Finance, and Islamic finance in particular, it has what it takes to be the *de facto* accreditation agency for this sector.



## Leadership Article



**By Emmy Abdul Alim**

Emmy Abdul Alim is Editor for Thomson Reuters Islamic Finance Gateway.

### Malaysia's 'international standard curriculum' for Islamic Finance

Malaysia has been leveraging its position as a leading centre for Islamic finance to attract students to its universities and specialist institutes but must now put more weight on improving the quality of its courses and academic qualifications to remain competitive.

The shortage of an expert and skilled Islamic finance talent pool has been an issue for the industry worldwide. The primary challenge has been to develop students within a robust critical framework that can produce graduates who are equally competent in theory and market practice. As part of national efforts to internationalise its education sector and become the global hub for Islamic finance, Malaysia has committed public resources and mobilised industry representatives to design an 'international standard curriculum' for Islamic finance and help local institutions develop globally recognised Islamic finance and business programmes.

A draft curriculum has already been drawn and as of this writing is seeking review from local and foreign academics and industry representatives. At the same time, the quality of professional training courses is also being addressed, as is developing globally recognised industry accreditation.

Malaysia may be regarded as a leader in Islamic finance but the quality of its education system is far from 'world class'. Its universities are poorly considered in world rankings which are dominated by American Ivy League varsities and Britain's Oxbridge and Russell

Group. University Malaya, which sits in the 301-400 ranking range according to the **Academic Ranking of World Universities** 2014 (up from the 401-500 range in 2013), is Malaysia's top institution, and no Malaysian varsity ranks in the **Times Higher Education World University Rankings Top 400** for 2013-2014 or 2014-2015.

Specialist Islamic finance institutes (which are excluded from the two most cited global ranking of universities) – most notably INCEIF and the International Islamic University Malaysia's Institute for Islamic Banking and Finance (IIBF) (it should be noted here that the Islamic Banking and Finance Institute Malaysia (IBFIM) does not have university status and is not registered to confer degrees) – have successfully leveraged on Malaysia's competitive advantage and expertise in Islamic finance to stand out but the two alone cannot support Malaysia's aim of attracting 54,000 Islamic finance (local and international) students by 2020 from the current enrolment of 6,000. Malaysia's education sector needs to develop strength in depth in order to outdo the UK and become world leader in Islamic finance education. (see Thomson Reuters Islamic Finance Development Indicator (IFDI) education sub-indicator under the overall Knowledge Indicator)

The 'international standard curriculum' plan is an efficient one for three reasons. Firstly, it is meant to address existing gaps and weaknesses found in Islamic finance degrees worldwide and will be positioned as the only curriculum that will be relevant to the global Islamic finance industry coming from arguably the world's most complete Islamic finance ecosystem.

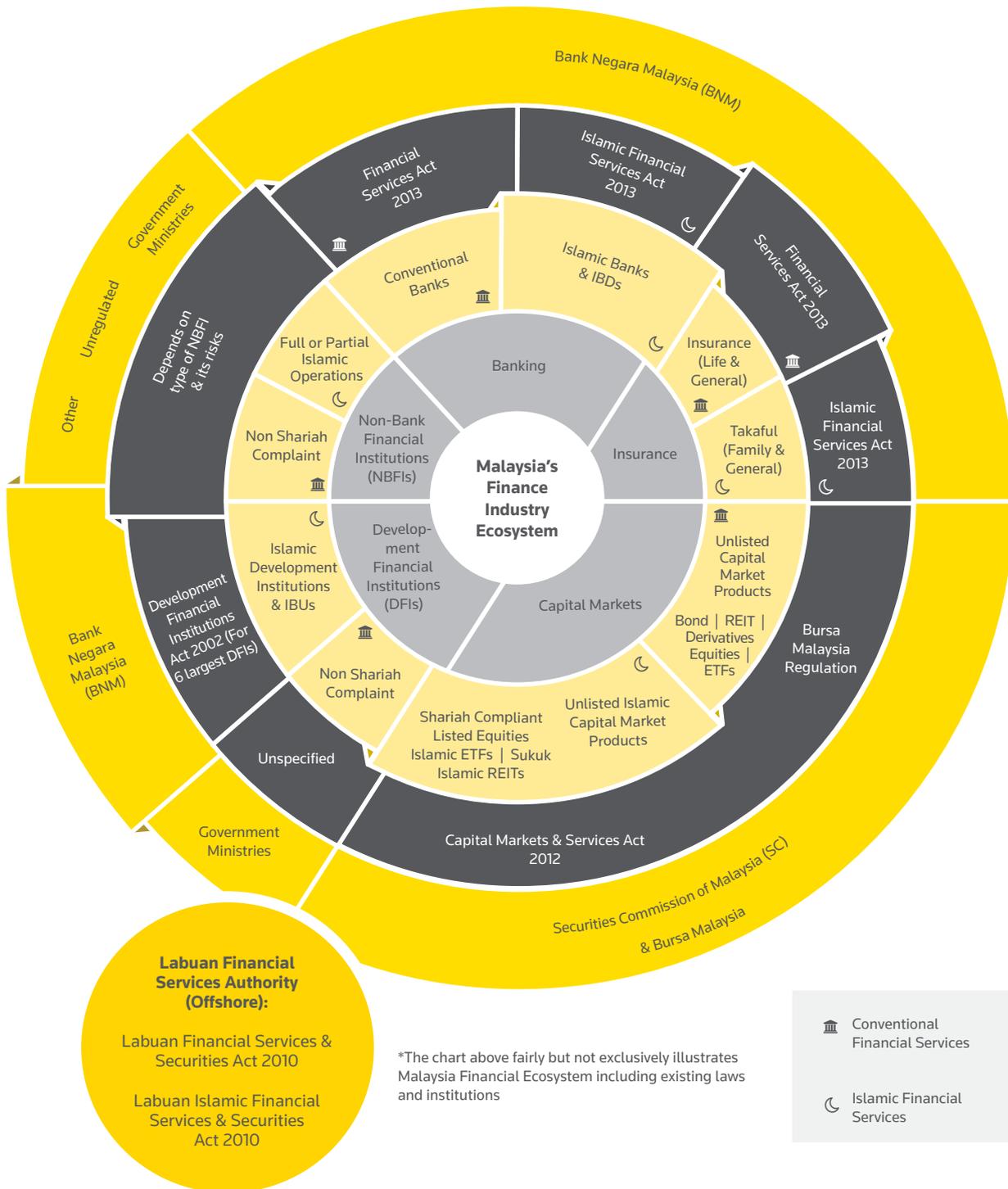
Secondly, it is a solution to resource-strapped local universities which can ill-afford the time and money to separately develop more globally-competitive curricula.

Thirdly, if the curriculum meets its qualitative objectives it would also alleviate the issue of a limited talent pool for the teaching of Islamic finance in universities.

The latter two benefits are similar to those Malaysia has enjoyed under the Shariah oversight system for Islamic finance, in which two apex Shariah Advisory Councils provide the rulebooks for Islamic banking and takaful, and capital market. This centralised system has addressed the lack of experienced and expert Shariah advisors and instilled a level of public confidence and trust in Islamic financial institutions.

However, as under Malaysia's Shariah oversight system, a standard curriculum will tie the hands of individual universities and teaching faculty, limit diversity and make innovation a bigger challenge within the Islamic finance education sector. To avoid this, the standard curriculum must be drawn following clear consensus between whose lines enough space is left to allow for individual colours and textures to thrive.

# Financial Sector Ecosystem



\*NBFIs are institutions that undertake financial intermediation and they could be either co-operative societies, building societies, factoring, leasing companies, pension funds, pawnbrokers, social security organisations or others.

## Select related associations, other regulatory and infrastructure bodies based in Malaysia

### Governmental & Regulatory Bodies

Bank Negara Malaysia Shariah Advisory Council (SAC)	Securities Commission Malaysia Shariah Advisory Council (SAC)	Malaysia International Islamic Financial Centre (MIFC)
Financial Reporting Foundation (FRF)	Malaysia Deposit Insurance Corporation (PIDM)	Inland Revenue Board (IRB)
Financial Mediation Bureau (FMB)	Finance Accreditation Agency Berhad (FAA)	Labuan International Financial Exchange (LFX)
	Malaysian Accounting Standards Board (MASB)	

### Local Associations

Association of Islamic Banking Institutions Malaysia (AIBIM)	Malaysian Takaful Association (MTA)	Life Insurance Association of Malaysia (PIAM)
General Insurance Association of Malaysia (LIAM)	Malayan Commercial Banks Association (MCBA)	Malaysian Association of Asset Managers (MAAM)
Joint Insurance Takaful Council (JITC)	Malaysian Insurance & Takaful Brokers Association (MITBA)	Malaysian Investment Banking Association (MIBA)
The Association of Banks in Malaysia (ABM)	Association of Development Finance Institutions of Malaysia (ADFIM)	

### Training, Research and Educational Institutions

Islamic Banking and Finance Institute Malaysia (IBFIM)	International Centre for Education in Islamic Finance (INCEIF)	International Shari'ah Research Academy for Islamic Finance (ISRA)
IUM Institute of Islamic Banking and Finance	Institute of Bankers Malaysia (IBBM)	Malaysian Insurance Institute (MII)
	Securities Industry Development Corporation (SIDC)	

### Rating Agencies

Malaysian Rating Corporation Berhad (MARC)	RAM Rating Services Berhad	International Islamic Rating Agency (IIRA)
-----------------------------------------------	----------------------------	--------------------------------------------

### International Islamic Finance Organisations based in Malaysia

The Islamic Financial Services Board (IFSB)	International Islamic Liquidity Management Corporation (IILM)
------------------------------------------------	------------------------------------------------------------------

\*The chart above presents public or private institutions that support the development of Islamic finance in Malaysia. The above list may not be inclusive but only include institutions available in public sources



## Leadership Article



**By Nik Norzrul Thani and Liya Saffura Ab Rashid, ZICO Law**

Datuk Dr. Nik Norzrul Thani is the Chairman and Senior Partner of Zaid Ibrahim & Co. as well as the Deputy Chairman of the Law Harmonisation Committee.

Liya Saffura Ab Rashid is an associate of Zaid Ibrahim & Co.

### Shariah and civil law: the Law Harmonisation Committee of Malaysia

The success and rapid growth of Islamic finance is owed to, inter-alia, the effective legal and regulatory framework provided by regulators. A legal and regulatory framework which is effective for ensuring a resilient development of the Islamic financial services industries would be characterised by: (i) an enabling environment that accommodates and facilitates the development of the industry; (ii) a clear and efficient system that preserves enforceability of Islamic financial contracts; and (iii) a credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions.<sup>7</sup>

It is therefore imperative that for Islamic finance to flourish, jurisdictions should evolve whilst being dynamic and flexible to ensure a progressive and efficient ecosystem for Islamic finance. Towards this end, Malaysia established the Law Harmonisation Committee (LHC) which aims to, inter-alia, address and provide solutions to the legal and structural impediments to make Malaysia a jurisdiction that recognises and

<sup>7</sup> Datuk Dr Nik Norzrul Thani Nik Hassan Thani, Dr Aida Othman, "The Effectiveness of the Legal and Regulatory Framework for Islamic Financial Services," *Islamic Financial Services Board Report* (2008): pg. 18

accommodates the tenets of both the Shariah and common law within the Islamic finance architecture.

### Why the Law Harmonisation Committee?

Despite Malaysia's enabling environment for Islamic finance, there is still a dichotomy between the Shariah and civil law that is applicable in Malaysia. In order to accommodate a Shariah compatible legal and regulatory framework, Bank Negara Malaysia, the country's central bank, established the LHC in 2010, headed by Tun Abdul Hamid Mohamad, the former Chief Justice of Malaysia (November 2007 to October 2008), supported by members of the legal fraternity, the Attorney General's Chambers (AGC), the Securities Commission Malaysia (SC) and the International Shariah Research Academy for Islamic Finance (ISRA), apart from BNM.

The underlying objectives in establishing the LHC are as follows:<sup>8</sup>

- To position Malaysia as the reference law for international Islamic finance transactions;
- To achieve certainty and enforceability in the Malaysian law in regard to Islamic finance contracts; and
- For Malaysian laws to be the law of choice and Malaysian dispute resolution institutions as the forum for settlement of disputes for cross-border Islamic financial transactions as part of creating a conducive legal system for the Islamic finance industry.

### Harmonising Shariah and English common law

Islamic financial institutions have to work in the context of English common law principles as such law is applicable in Malaysia. Contracts such as mudharabah, ijarah and wadiah have to be interpreted in line with relevant legislation and applicable common law principles that are used to interpret or supplement the legislation.

It should be noted that Islamic financial institutions are conscious of potential conflicts and have in fact

structured their financial operations to accommodate common law principles, as long as these are not against Islamic teachings and principles.

Bank Negara Malaysia places great importance in ensuring that the overall Islamic financial system operates in accordance with Shariah principles through a two-tier Shariah governance infrastructure comprising two vital components: a centralised Shariah advisory body at BNM and an internal Shariah Committee formed in each respective Islamic financial institution.

The Shariah Advisory Council of Bank Negara Malaysia (SAC) is a body established under section 51 of the Central Bank of Malaysia Act 2009 that has positioned the SAC as the apex authority for the determination of Islamic law for the purposes of Islamic financial business. The mandates of the SAC, among others, are to ascertain the relevant Islamic law on any financial matter and issue a ruling upon reference made to it, as well as to advise the Bank and the Islamic financial institutions concerned on any Shariah issues relating to Islamic financial business operations, activities or transactions.

At the industry level, the duties and responsibilities of the internal Shariah Committee in advising the respective Islamic financial institutions on Shariah matters were further deliberated in the Guidelines on the Governance of Shariah Committee for the Islamic financial institutions issued in 2004. The guidelines are now superseded in light of new developments in Islamic finance as well as higher expectation of the key stakeholders of the Islamic financial institutions pertaining to the Shariah compliance process<sup>9</sup> through the "Shariah Governance Framework for Islamic Financial Institutions" which was made effective starting from 1 January 2011.

The challenges facing an Islamic finance practitioner are therefore enormous — the documentation must be Shariah-compliant whilst being in accord with

<sup>8</sup> The Law Harmonisation Committee Report 2013, Bank Negara Malaysia, pg. 5.

<sup>9</sup> Shariah Governance Framework for Islamic Financial Institutions, Bank Negara Malaysia, pg. 1

Malaysian law generally. This essentially means that any document that is to be used in an Islamic finance transaction has to comply with both:

- Islamic law (or in the words of Islamic Financial Services Act 2013, it must “not involve any element which is contrary to the Shariah”) and
- all other laws, such as the Contracts Act 1950 and Bills of Exchange Act 1949.<sup>10</sup>

An Islamic finance transaction must be valid under Islamic law and also under the civil law for it to be enforceable in the civil courts. Thus, a contract may be valid under Islamic law, yet it could fail in the civil courts for want of, for instance, the consideration in the common law sense and, therefore, be unenforceable. The converse situation may take place as well.

Accordingly, documents or instruments to be used in Islamic finance transactions have to be:

- in accord with Islamic law;
- in accord with the existing civil law; and
- structured in such a way (e.g., as to form, manner of execution, registration) to be enforceable in the civil courts.

Given that Islamic law is not readily ascertainable (from an Islamic finance practitioner’s point of view, in comparison to the position of the civil law), the gargantuan nature of the task becomes obvious. This problem was realised at the outset when finance documents were first drafted for use by Islamic financial institutions, and a great deal of caution was exercised to ensure their compliance with the above-stated requirements. Over the years, these documents have been modified and improved upon.<sup>11</sup>

### Legal issues addressed by the LHC

The LHC identified the following issues that have been recommended as requiring amendments:<sup>12</sup>

- Legal recognition to Shariah permissibility of imposing late payment charge on judgment debts in Islamic financial cases
- Improving access to financing (especially Islamic financing) involving reserve lands<sup>13</sup>
- Recognition of Islamic finance transactions under the National Land Code 1965: Legal recognition of Shariah principles to facilitate provision of Islamic finance under the National Land Code 1965

Facilitating the use of collateralised commodity murabahah in short-term Islamic financial market instruments: Clarifying requirements for registration of collateral under Companies Act 1965.

### Legal recognition to Shariah permissibility of imposing late payment charge on judgment debts in Islamic financial cases

Previously, judgment creditors which are Shariah-compliant institutions had refrained from claiming interest on late payment as the practice could be seen as *riba*. The Shariah Advisory Council (SAC) of BNM recognised this situation and following deliberations on the issue, ruled that Shariah-compliant financial institutions may claim such sum as it is deemed a late payment penalty charge on judgment debts based on the combination of the principles of *gharamah* (penalty) and *ta’widh* (compensation).<sup>14</sup> Subsequently, the LHC took a pro-active step to recommend for the relevant provision in the Rules of Court to be amended to reflect the imposition of late payment charges for Islamic financial cases.

The LHC recommended a number of sub-rules to be included in the new provision. It includes the imposition of *ta’widh* and *gharamah* as components of late payment charge for Islamic financing cases, wherein the judgment creditor will only be entitled to *ta’widh*. In the event the amount of late payment

10 See Mohamed Ismail Shariff “The Development of Islamic Banking in Malaysia” *Malayan Law Journal* 1 cxlv (1998)

11 *Ibid.*

12 *Ibid.* Report op. cit. 10

13 Section 5 of the National Land Code 1965 provides the definition to the term “reserved land” which “means land for the time being reserved for a public purpose in accordance with the provisions of section 62 of the same Code or of any previous land law”; in this respect, section 62 gives the power of reservation of lands to the State Authority.

14 *Ibid.*, Report op. cit. 17

charge exceeds the rate of ta'widh, the balance, or gharamah, which serves as a deterrent from delay of payment, will be channelled to charitable organisations as approved by the SAC. This additional sub-rule further eliminates any possibility for the new provision to be non-Shariah-compliant. The proposal was approved by the Rules Committee and came into force together with the new Rules of Court on 1st August 2012.<sup>15</sup>

As elaborated in the provision, the defaulting parties will not be charged interest – rather, the Islamic financial institutions would have the leverage to impose late payment charges enabling the process to be Shariah compatible. The positive impact on the industry resulting from this innovation is that these late payment charges can be used to cover the legal and other related expenses sustained from the execution of the judgment in addition to compensating the actual loss incurred from the delay of settling the judgment debt. This mechanism ensures that financial transactions are conducted according to the principles of market efficiency without compromising Shariah principles.

### Improving access to financing involving reserve lands

Another facet of Islamic finance that was given priority for further enhancement is the access to financing involving reserve lands. In previous years, there were a number of limitations found in the law<sup>16</sup> which affect the financier's legal interest as well as the transfer of ownership undertaken in accordance with Shariah requirements, whenever a transaction involving a reserve land is concluded based on Islamic finance. These limitations impeded the use of reserve lands for Islamic financing. As such the LHC recommended that institutions licensed or within the purview of BNM, the SC and the Labuan Financial Services Authority (Labuan FSA) be allowed to protect their rights through the ability to realise their security so that Islamic financing can be extended to those having or who intend to have

reserve lands without compromising the original objective of the creation of these reserve lands. To this end, the LHC proposed the following provision to be inserted in the "definition" section of the relevant Enactments.<sup>17</sup>

- *Notwithstanding any provision in this Enactment [or Code] or any other written law but subject to subsection (2), the restrictions of land dealings in this Enactment [or Code] shall not apply to a person carrying out a scheme of financing who is licensed or approved as the case may be by the Central Bank of Malaysia, the Securities Commission Malaysia or the Labuan Financial Services Authority.*
- *Provided always the non-application shall cease to apply upon termination of such scheme of financing referred to in subsection (1).*

Subsequently, the recommendation was accepted-in-principle at the No.1/2012 Land Administrators' Meeting on 17 May 2012 at Department of Director General of Lands and Mines (DGLM), Kuala Lumpur.<sup>18</sup>

### Recognition of Islamic finance transactions under the National Land Code 1965 (NLC)

The review by the LHC on this issue arose from the Consultation Paper (CP) issued by DGLM on the "Review of the National Land Code 1965 – In Transforming the Legal, Administrative and Procedural Framework for Enhancement of Land Administration Delivery System in Peninsular Malaysia".<sup>19</sup> It was noted that the objectives of the review were to enhance efficiency of land administration delivery system, achieve a trusted and pro-enterprise business environment and to serve as a building block for implementing an Electronic

<sup>15</sup> *Ibid.* pg. 20

<sup>16</sup> See Report pg. 24 – 27

<sup>17</sup> State enactments for Pahang, Perak, Negeri Sembilan, Selangor, Kelantan, Kedah, Perlis, Johor, Federal Territories and Terengganu, National Land Code (Penang and Malacca Titles) Act 1963, Sabah Land Ordinance (Cap. 68) and Sarawak Land Code (Chapter 81)

<sup>18</sup> *Ibid.* pg. 28

<sup>19</sup> The CP was issued on 1 February 2012 and is available at <http://www.kptg.gov.my/en/jkptg-online/laman-berita-terkini/540-kertas-perundingan-kajian-kanun-tanah-negara-1965.html>

Land Administration System. DGLM agreed to consider the recommendations in enhancing the efficiency of NLC in the conduct of Islamic finance-related land dealings and as such, the LHC conducted two industry consultations<sup>20</sup> and formed the Land Laws Sub-Committee.<sup>21</sup>

The role of the Land Laws Sub-Committee is to identify impediments which may exist in current land laws for the conduct of Islamic finance-related transactions. The LHC put forth recommendations which cover Islamic finance specific areas as well as other areas that have an impact on Islamic finance. Detailed proposals are currently being deliberated by an industry Task Force in consultation with BNM and the LHC.

### Facilitating the use of collateralised commodity murabahah in short-term Islamic financial market instruments

The Islamic money market is an essential feature of the Islamic financial system as it provides Shariah-compliant liquidity management for Islamic financial institutions.<sup>22</sup> BNM recently introduced collateralised murabahah which essentially is a sale-based Shariah-compliant product that requires the underlying commodity to be collateralised. “The murabahah purchaser” will charge its securities to “the murabahah seller” in order to secure the future payment of the purchase price of the underlying assets.

As Islamic financial institutions are companies, Section 108 of the Companies Act 1965 is technically applicable if the institution acts as the murabahah purchaser and a charge needs to be created and registered with the Companies Commission of Malaysia (CCM). Once the murabahah is completed,

a discharge of charge will be needed. Although, in substance, the relevant provisions do not impede the conduct of collateralised murabahah, the application of the provision poses several challenges, and discussions with CCM indicate that, although technically applicable, the provisions are not meant to cover such Islamic financing products.

The LHC recommended for the inclusion of a provision in the Companies Act 1965 to exclude Islamic finance-based transactions. CCM has agreed to the recommendation and the proposed amendment has been reflected in the exposure draft of Companies Bill which was released for consultation on 2 July 2013. The Companies Bill is expected to be tabled in Parliament sometime this year.

Apart from the issues highlighted above, the LHC has also identified five other issues in which four have been found to not require any amendments and one is being highlighted for further research.

### Moving Forward – Transcending Borders

It is heartening to note that the establishment of LHC has been regarded as a positive step. In tandem with the endeavours by the LHC, it can be said that the objective of the LHC is arguably very ambitious.<sup>23</sup> This relates to the ongoing observation that English law has been the preferred law of reference for international Islamic finance transactions. Considering that English law has a long tradition of being the reference law for international contracts and English courts command enormous respect in the international arena for its impartiality and independence, one can argue that it is indeed ambitious to position Malaysia as “the reference law for international Islamic finance transactions” and for “*Malaysian laws to be the law of choice and Malaysian dispute resolution institutions as the forum for settlement of disputes for cross border Islamic financial transactions as part of creating a conducive legal system for Islamic finance industry*”.<sup>24</sup>

20 Preliminary feedback was obtained from Islamic banking industry on 9 November 2011 and further consultation was made on 30 April 2012

21 The Land Law Sub-Committee is headed by Y.M Tengku Dato’ Seri Hasmuddin bin Tengku Othman and comprises of 7 other members, namely Ms. Sally Chee (representative from Bar Council), Assoc. Professor Dr. Ainul Jaria Maidin (International Islamic University Malaysia), Professor Dr. Ashraf Md. Hashim (representative from ISRA), En. Mohd Shuhaimi Ismail (Islamic finance legal practitioner), Pn. Fadzilah Pilus (Islamic finance legal practitioner), En. Jasani Abdullah (representative from Association of Islamic Banks Malaysia) and En. Mohd Shukri Hj Ismail (former officer in DGLM)

22 *Ibid.* Report op. cit. 39

23 See Global Islamic Finance Report 2011, *BMB Islamic UK Limited*, (2011) pg. 167

24 *Ibid.* Report op. cit. 5

However, the LHC is simply offering a value proposition whereby parties to international Islamic finance contracts are comfortable that:

- The jurisdiction is neutral and impartial to all parties in the contract
- The Malaysian law offers absolute certainty and predictability with regard to Shariah issues, as the SAC is the final arbiter on such matters – which no other jurisdiction can offer
- The Malaysian courts and arbitration centre are competent in dealing with disputes arising from Islamic financial transaction contracts;

Thereafter there is no reason to reject the possibility of making Malaysian law the reference law for Islamic financial transaction contracts.<sup>25</sup>

In a nutshell, the current phase of the LHC's initiatives and efforts are focused on recommendations to overcome remaining legal impediments to the efficient conduct of Islamic finance in Malaysia as well as creating the awareness of the work of the LHC.

Undeniably, as Islamic finance activities venture beyond domestic boundaries, the development of a facilitative legal framework for cross-border transactions is of great importance. As an embodiment for positioning the Malaysian legal system in the eyes of the world, the LHC aims to create a supportive and reputable Shariah-compliant ecosystem to instil public and the international community's confidence to demonstrate Malaysia's metamorphosis to be the most optimum avenue for Islamic financial transactions in the future.

25 Global Islamic Finance Report 2011, *BMB Islamic UK Limited*, (2011) pg. 167

### Issues raised which do not necessitate amendments

NO.	HARMONISATION INITIATIVES	OUTCOMES	RELEVANT LAWS
1	Certainty of legal definition of sukuk	In relation to Capital Markets and Services Act 2007, existing legal recognition and statutory framework for sukuk is sufficiently supported by subsidiary legislative instruments	Capital Markets and Services Act 2007
2	Implications of Sale of Goods Act 1957 on sale based Shariah contracts	There is neither hindrance nor legal implication	Sale of Goods Act 1957
3	Implications of Partnership Act 1961 on profit-sharing Shariah contracts	Partnership Act 1961 poses no hindrance	Partnership Act 1961
4	Shariah compliance of current legislation on enforcement of guarantees against gratuitous guarantors	Correlation of "social guarantor" concept under Bankruptcy Act 1967 where elements of enforcement of kafalah have been adopted	Bankruptcy Act 1967

### Issues for further research

NO.	HARMONISATION INITIATIVES	OUTCOMES	RELEVANT LAWS
1	Implications of Contracts Act 1950, Civil Law Act 1956 and Specific Relief Act 1950 on Shariah contracts	<ul style="list-style-type: none"> <li>• Provisions of Contracts Act 1950, Civil Law Act 1956 and Specific Relief Act 1950 do not impede Islamic finance</li> <li>• However, clarifying the legal position of "wa'ad" and the Shariah position of making "wa'ad" legally binding is pending further Shariah research</li> </ul>	Contracts Act 1950, Civil Law Act 1956 and Specific Relief Act 1950



## Development of Shariah ecosystem

Malaysia's fiqhi stance is more in line with Al-Shafii school of jurisprudence, especially on matters related to laws of worship ('ibadah). Unlike in 'ibadah, with the law of transactions (mu'amalat) Malaysia is seen to have more flexibility and is more dynamic in opening itself to other fiqh schools.

**Centralised, two-tier model** — Malaysia's Shariah governance framework is a two-tier model. Countries that follow this practice are Bahrain, UAE, Indonesia, Malaysia, Pakistan and Sudan.

There are two national Shariah Advisory Councils — one for the capital markets (started 1996) that sits at the SC and the other for banking and takaful (started 1997) that sits at BNM. The SACs advise the regulators, pass rulings on acceptable products and services for the industry, and are the reference points for the court and/or arbitrator in cases related to Islamic finance. The SACs are mandated to perform an oversight role on Shariah matters related to IFIs business operations and activities which are to be achieved through the Shariah review and Shariah audit functions. Members of the SAC of BNM are not allowed to serve in the Shariah Committee of any financial institutions.

The industry's Shariah governance framework is regulated by the "Guidelines of the Governance of Shariah Committees for Islamic Financial Institutions" (BNM/GPS1) of Dec 2004, "Shariah Governance Framework for Islamic Financial Institutions" (BNM/SGF) of Dec 2011 and the Islamic Financial Services Act 2013.

At the industry level, a self-check and review tool is in place for Shariah supervisory boards or committees located at the individual IFIs. The roles and responsibilities of each body are clearly defined by BNM. A Shariah advisor cannot serve in more than one competing Shariah committee within one industry (Islamic banking and takaful are considered as different industries). The minimum number of Shariah Board members for IFIs increased from

3 to 5 in 2011, with a majority of the members to be scholars specialised in fiqh and the remaining 2 to be experts from a related professional field.

**IFSA 2013** — The Islamic Financial Services Act 2013 came into effect in July 2013. It further strengthens the regulation of IFIs in line with international best practices. It was enacted by the Parliament of Malaysia in March 2013 and repeals other previous acts the IBA 1983, Takaful Act 1984, BAFIA 1989 (and a few other Acts). IFSA 2013 holds IFI personnel responsible for upholding Shariah governance, including Shariah scholars, legally responsible for any Shariah non-compliance. Should any Shariah non-compliance be proved, the IFI's personnel responsible for upholding Shariah governance shall be liable to imprisonment not exceeding eight years or to a fine not exceeding RM25 million, or both. This penalty, if compared to IBA 1983 which sets only a fine not exceeding RM50,000 to Directors and managers of an IFI for similar offences, clearly shows the gravity accorded to Shariah compliance.

### Development of the Shariah Ecosystem in Malaysia

Malaysia's Shariah ecosystem for Islamic finance started with Bank Islam's Shariah Committee that was established the same time the bank opened its doors in 1983. Today, Malaysia's Shariah framework for Islamic finance is a two-tier model with the two national Shari'ah Advisory Councils (SACs) — one for Islamic banking and takaful established 1997 that sits at Bank Negara Malaysia and the other for the Islamic Capital Market established 1996 that sits at the Securities Commission — and individual Shariah committees at the financial institutional level.

Laws, regulations and policies that pertain to the Shariah framework in the Islamic finance industry have been introduced and implemented gradually taking into consideration market readiness.

### Restrictions to avoid conflicts of interest → greater need for more scholars

Scholars on the national-level SACs cannot serve in Shariah Committees at the industry level. Scholars at the industry level cannot be a member of a Shariah Committee in another Islamic financial institution of the same industry. For example, a scholar on the Shariah Committee of an Islamic bank cannot serve on the Committee of another Islamic bank but can be a member of the Committee of a takaful company and can also be a member of the Committee of a company in another industry, for example an Islamic funds management company. The spirit of this rule is to reduce conflict of interest and promote new Shariah advisors in the market. As a result, Malaysia has a very large pool of Shariah advisors for the Islamic finance industry, with more than 160 practising in the market.

### Greater emphasis on end-to-end Shariah governance → more diverse Shariah ecosystem

Prior to the most recent 2011 and 2013 changes in Shariah governance for the Islamic finance industry, Shariah Committees of Islamic financial institutions in Malaysia were required to consist of only three members, each of who would be qualified in Islamic jurisprudence or Islamic transaction/commercial law.

A change to the Shariah Governance Framework that came into effect in January 2011 required the Shariah Committee to be composed of five members, a majority (i.e. three) of whom would be qualified in Shariah while the remaining two would be experts in relevant backgrounds such as finance and law to support the depth and breadth of Shariah deliberations. This has brought directly into the Shariah ecosystem a more diverse range of expertise collaborating and exchanging ideas to further strengthen end-to-end Shariah governance.

The most recent development in the Shariah framework for Islamic finance is the IFSA 2013, which goes even further to emphasise the importance of end-to-end Shariah governance. IFSA 2013 holds Islamic finance institutions personnel (not just Shariah scholars) legally responsible for Shariah non-compliance. In the event of any proven Shariah violation, IFI personnel can be liable for imprisonment of up to eight years and/or a fine of up to RM25 million. This is significantly higher than the previous maximum penalty of a fine not exceeding RM50,000 as was laid out in the Islamic Banking Act of 1983.

### Human capital development

Restrictions on Shariah Committee membership across industries have resulted in a much bigger pool of Shariah advisors and the more recent emphasis on the importance of end-to-end Shariah governance — which directly includes roles and responsibilities within the Shariah ecosystem for non-Shariah scholars — has contributed to a more diverse talent pool that is focused on Shariah as the underlying and overarching principle in Islamic finance.

Malaysia's Shariah ecosystem has gained from a steady stream of Shariah graduates from local as well as overseas universities. This Islamic finance Shariah ecosystem has largely been dependent on the aspect of the country's formal education system that offers a full Islamic option from school-level madrasahs up to higher education postgraduate level (of note here is the role of the International Islamic University Malaysia which was established in 1983).

However, it has only been recently that – with the increasing sophistication of and demands on Islamic finance – the teaching and learning of Shariah in Islamic finance became a more specialised field of study.

The International Shari’ah Research Academy for Islamic Finance (ISRA) was set up in 2008 to promote applied research in Shari’ah and Islamic finance and in April 2011 the industry (supported by Bank Negara Malaysia) set up the Association of Shari’ah Advisors in Islamic Finance (ASAS).

The main objective of ASAS is to act as a governance and self-regulated body for Shariah advisors and experts in the market to ensure and enhance professionalism within the profession.<sup>26</sup> However, more importantly to remain a member, Shariah advisors would need to keep undergoing continuous learning and training to update their knowledge. Every member will need to earn at least 20 points each year in terms of professional development to remain a member.

At this stage, membership of ASAS is voluntary but there is an arrangement with Bank Negara Malaysia that in two-three years’ time, this requirement will become mandatory for all Shariah advisors. This means that they will need to meet minimum criteria to become a member. The organisation also offers a framework for continuous professional enhancement for people without Shariah background who want to learn Shariah and for those with Shariah background who need to learn other disciplines.

---

<sup>26</sup> Association’s portal: <http://asas.my>



## Leadership Article



**By Dr. Marjan Muhammad and Shabana M. Hassan, ISRA**

Dr Marjan Muhammad is currently the Director of Research, Research Affairs Department at the International Shari'ah Research Academy for Islamic Finance (ISRA). She obtained her Master's and PhD in Islamic Revealed Knowledge and Heritage (Fiqh and Usul al-Fiqh) from the International Islamic University Malaysia (IIUM).

Shabana M. Hasan is the Editor of ISRA Magazine and the Manager of the Advisory and Research Department of ISRA Consultancy Sdn. Bhd. She holds an MSc in Islamic finance (distinction) from the University of Durham, UK.

### Impact of Shariah governance and regulations on the Malaysian Islamic financial ecosystem

Islamic banking and finance prohibits riba, gharar, maysir and many others, in addition to adhering to other Shariah principles. Yet, in certain aspects it is similar to conventional finance in that both require proper governance and regulatory frameworks. It is noteworthy to point out that the achievements of the Islamic finance industry thus far have been impressive. However, in order to take Islamic finance to the next stage, a governance framework and an enabling regulatory infrastructure that privilege clear, transparent and robust Shariah governance designed for the industry's unique needs are of great importance. In Malaysia, improvements in Shariah governance and regulations are grounding the Islamic finance industry in the true spirit of Islamic banking and finance.

Shariah governance and regulations of the Islamic finance industry in Malaysia are guided by three comprehensive Acts: the Central Bank of Malaysia Act 2009 (CBMA), Shariah Governance Framework for Islamic Financial Institutions 2010 (SGF) and Islamic Financial Services Act 2013 (IFSA). They are briefly explained below.

**Central Bank of Malaysia Act 2009**

CBMA recognises the Islamic financial system in Malaysia by providing the legal foundation for its development in the overall Malaysian financial system. Importantly, it codifies Malaysia’s dual financial system due to the growing significance of Islamic finance in the financial system. Through the CBMA, the country’s apex Shariah body, the Shariah Advisory Council (SAC) on Islamic finance, was established by virtue of section 51. The SAC’s rulings (both the SAC at the central bank that overlooks banking and takaful and the SAC at the Securities Commission that overlooks the Islamic capital market) are legally binding and Malaysia’s courts and arbitrators must refer to and consult the SAC and their published rulings prior to any proceedings on Islamic finance matters.

which came into force in January 2011. This revised SGF repealed the Guidelines on the Governance of Shariah Committee for Islamic Financial Institutions (IFIs) which was issued in 2004. The SGF sets out the central bank’s expectations of an IFI’s Shariah governance structures, processes and arrangements so as to ensure that all its operations and business activities are in accordance with Shariah. The SGF also provides comprehensive guidance to the Board, Shariah Committee and management of the IFI in discharging its duties in matters relating to Shariah and outlines the other functions relating to Shariah: review, audit, risk management and research.

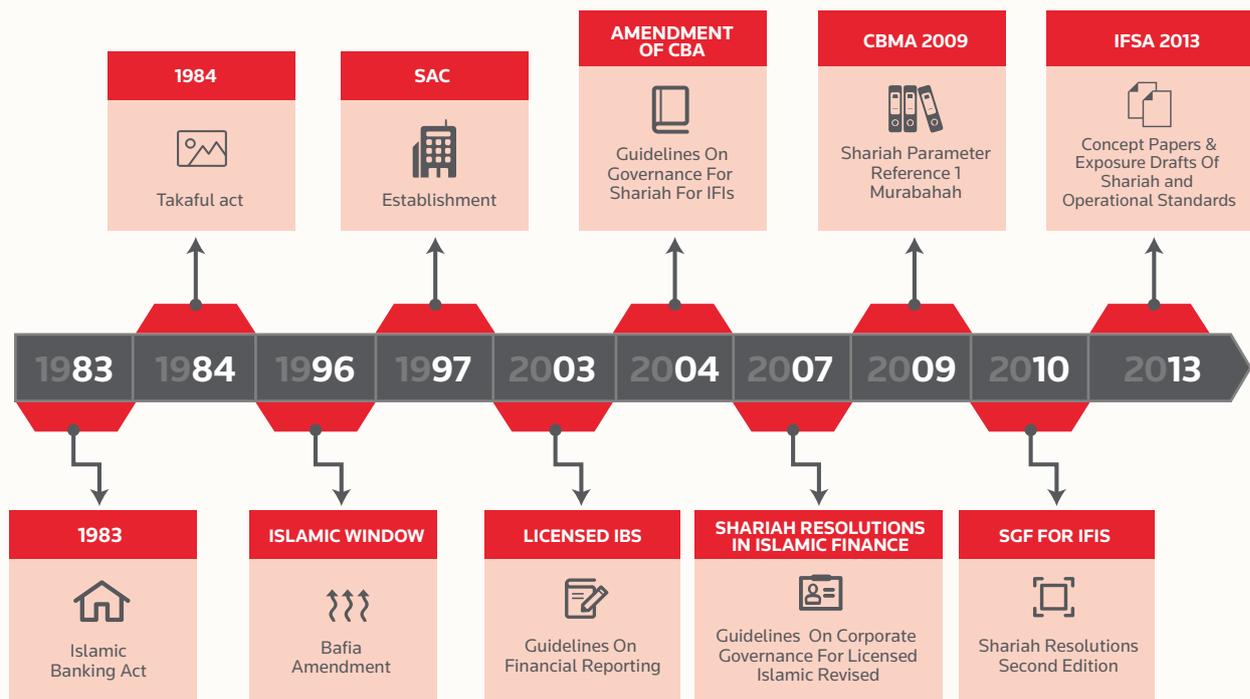
**Shariah Governance Framework 2010**

In addition to the CBMA, Malaysia has also adopted a reactive approach by issuing a revised SGF

**Islamic Financial Services Act 2013**

To further pave the way for the development and progress of an end-to-end Shariah-compliant regulatory framework for the conduct of Islamic financial operations and activities, Malaysia legislated the IFSA which came into force on 30 June

Evolution of Shariah Governance and Regulations in Malaysia



*Presently, Malaysia is the only country with a formalised Shariah governance framework (SGF) in place for its entire market. Unfortunately, there lacks of a standardised governance framework for product approvals in the international market, which opens the Islamic financial industry to Shariah arbitrage and adds risks to accepting Islamic finance in the global arena.*

2013. The IFSA repeals Islamic Banking Act 1983 and Takaful Act 1983, and amalgamates these separate laws into a single legislative framework for the Islamic finance industry. The IFSA marks another important milestone in the Malaysian Islamic financial landscape as it promotes financial stability and protects consumers' rights, as well as tightens Shariah compliance considerably. The law enforces statutory duty on IFIs to comply with the central bank's standards and manage Shariah non-compliant risks. The IFSA further entrenches the roles of Bank Negara Malaysia and the SAC as the country's Islamic finance Shariah regulator. Figure 1 depicts the historical evolution of Shariah governance and regulations of Islamic finance in Malaysia since the establishment of its first Islamic bank, i.e. Bank Islam Malaysia Berhad (BIMB) in 1983 until to-date.

### **Positive Impact of Shariah governance and regulations in Malaysia**

With the issuance of the SGF and the codification of Shariah compliance in the IFSA, Malaysia is now on a stronger foothold. Among the direct impacts of having a robust regulations for Islamic finance with the legislation of IFSA are as follows:

- Providing a refreshingly more strengthened foundation on which to establish regulations and Shariah governance that are transparent, effective and that simultaneously contribute to an efficient financial system that is resilient to future stresses.
- Providing regulators with greater oversight and thus is regarded as a broader way of Shariah law enforcement.
- Lifting what were previously only guidelines on Shariah compliance to statutory duties, and hence making licensed financial entities legally accountable for any breach of those duties.
- Widening the role, function and power of the BNM where it now has the authoritative power to issue directions to institutions, carry out interventions and remedial actions to prevent or reduce any risk that it deems may affect the financial stability of the country.
- Facilitating a more in-depth regulation on the shareholding of licensed persons and additionally a financial ombudsman scheme is introduced for the first time in Malaysia.
- Establishing more Shariah certainty and achieving greater Shariah standardisation when IFSA gives BNM the power to specify standards on Shariah matters. The Shariah standards that have been and will be issued progressively by BNM are complementary to those issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in both theoretical (i.e. Shariah standards) and practical (i.e. operational standards) dimensions of Islamic finance practices.
- Reflecting the recommendations of international Shariah governance and prudential standards for the industry. The standards will therefore minimise heterogeneous interpretations of fundamental Shariah rulings and resolutions and hence help to streamline the product offerings by IFIs.

It is noted that Malaysia's comprehensive legislations and guidelines have received a positive review from the joint International Monetary Fund – World Bank Financial Sector Assessment Program (FSAP).

### Future Challenges

Notwithstanding the bright future and prospects of Malaysia to be the international hub for Islamic finance, there are a few challenges waiting ahead. Among those challenges are:

#### **Lack of a standardised governance framework in international market**

Presently, Malaysia is the only country with a formalised Shariah governance framework (SGF) in place for its entire market. Unfortunately, there lacks of a standardised governance framework for product approvals in the international market, which opens the Islamic financial industry to Shariah arbitrage and adds risks to accepting Islamic finance in the global arena. Amid an environment of diverse Shariah interpretations and governance frameworks, key members of the Islamic Financial Services Board (IFSB) have no plans to establish a unified SGF. Instead each country continues to implement its own autonomous SGF according to its legal and economic needs.

#### **Reclassification of deposits under IFSA 2013 may not favour the banks**

A major change under the IFSA involves the requirement to distinguish deposits made for savings from those made for investments. This reclassification is meant to boost investor protection but may not be favourable to the banks. Instead it might impose a great challenge to the banks, which are used to mudarabah-based deposits as the main method of accumulating deposits. However as part of moving forward to achieve the true spirit of Islamic banking and expand the scope of the industry in order to cater to a wider range of customers, it is important for IFIs to keep to the tenet that mudarabah should be rightfully classified as an investment. Hence banks must now seek alternative solutions to this matter. The reclassification may look simple but its impact on the Islamic banking and finance industry

is significant. With the reclassification, capital flight from Islamic to conventional banks is now likely to be substantial if consumers do not agree to take on investment risks or uncertainty in the returns of deposits.

### References

- Khan, Iqbal Ahmad. (1999). "Developing the Country Framework for Islamic Finance". In *Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities* Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University, 1999. pp. 159-162.
- Miskam, S. and Nasrul, M.A., 'Shariah Governance in Islamic Finance: The Effects of the Islamic Financial Services Act 2013', *WCICK E-Journal of Integration Knowledge* 2013 (E-ISSN: 2289-5973).
- Shaharuddin, Amir. (2011). "Shariah Governance of Malaysian Islamic Banking Institutions". Paper presented at the *International Seminar on Issues and Challenges in Islamic Banking and Finance: Malaysia and Indonesia Experience* organized University Sumatera Utara on 26th February 2011, Indonesia.

**“Wealth, properly employed, is a blessing and a man may lawfully endeavour to increase it by honest means.”**

Hadith narrated by Bukhari

Wealth means different things to different people. It's the choice we make on how we achieve it, and what we do with it, that determines the quality of our wealth. At CIMB Islamic, we choose to create wealth through pure business and commercial transactions that follow the principles of Shariah.

Our deep understanding of the history and the principles of Islamic finance has enabled us to introduce many groundbreaking solutions that have directly changed the global landscape.

- ▶ ***The World's First Sukuk Issuance by the United Kingdom***
- ▶ ***The World's First Istisna' Sukuk***
- ▶ ***The World's First Musharakah Sukuk***
- ▶ ***The World's First Renminbi Sukuk***
- ▶ ***The World's First Islamic Residential Mortgage-Backed Securities***
- ▶ ***The World's First Fixed Rate Islamic Retail Deposit***

As one of the top players in the Global Islamic Banking & Finance industry, we take pride in innovating and crafting products that are wholly Shariah-compliant yet relevant to today's financial needs. Products that help shape everyday life and make an impact on the way we live.

For more information, log on to [www.cimbislamic.com](http://www.cimbislamic.com)  
or call +603 2261 8888

MALAYSIA INDONESIA SINGAPORE THAILAND



*Jawi is an adaptation of the Arabic script, used as an alternative form of writing for the Malay language in Malaysia. Here, the calligraphy version spells 'Perbankan Islam', which is Malay for Islamic Banking.*

CIMB Islamic Bank Berhad (671380-H)

ASEAN FOR YOU



**CIMB ISLAMIC**





## 03

# SUPPLY AND DEMAND FOR ISLAMIC FINANCE

---

## ASSETS GROWTH SCENARIOS

- 114 Projected Growth in Islamic Banking Assets
- 115 Factors that will push sustained growth in Islamic banking in Malaysia
- 116 Projected Growth in Takaful Contribution
- 117 Factors that will push sustained growth in takaful in Malaysia

## RETAIL CONSUMER BANKING AND INSURANCE SURVEY

- 119 Financial Services Providers' Perspective Analysis
- 128 Banking Perspective Analysis
- 136 Insurance Perspective Analysis
- 141 Survey Methodology

# Assets Growth Scenarios

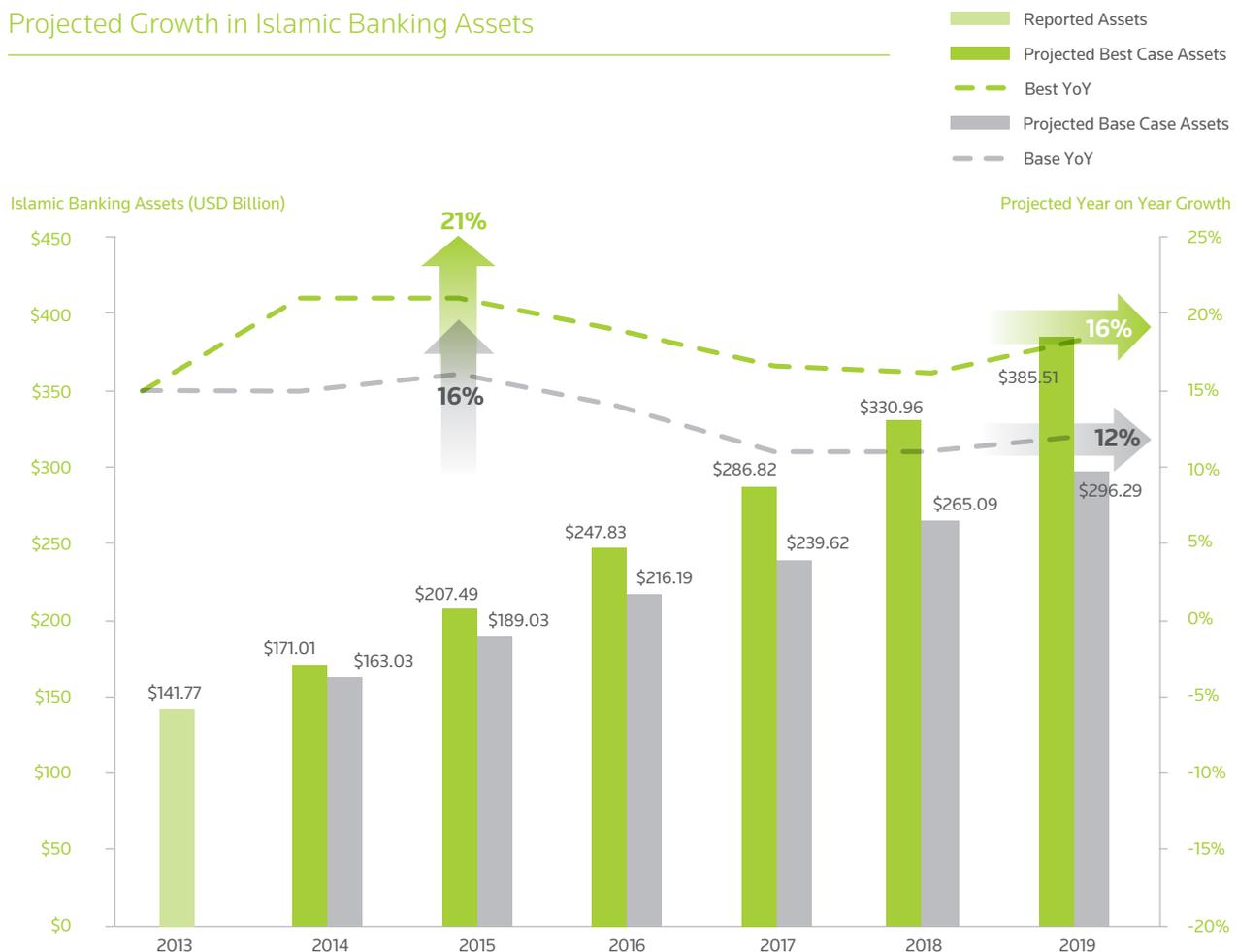
Within the next five years, the growth of Islamic banking assets is expected to have an average growth of 13% on a year-on-year basis. This is based on a base case<sup>1</sup> scenario. Thus, Islamic banking assets will grow from US\$141.77 billion at the end of 2013 to US\$296.29 billion in 2019 if sustained favourable conditions are met.

At an optimal level (best case<sup>2</sup>), assets will grow an average 18% until 2019 reaching US\$385.51 billion or 28.56% of total banking assets. In other words, Islamic banking assets are expected to more than double after 5 years. This growth will be driven by demand and supply factors locally and globally.

1 Assets base assumes no change in penetration of banking assets

2 Assets best case assumes growth of average penetration 2.57% each year

## Projected Growth in Islamic Banking Assets



### Share of Total Banking Assets (Best Case)

Year	2013	2014	2015	2016	2017	2018	2019
Share of Total Banking Assets (Best Case)	21.06%	22.56%	24.06%	25.56%	26.56%	27.56%	28.56%

### Share of Total Banking Assets (Base Case)

Year	2013	2014	2015	2016	2017	2018	2019
Share of Total Banking Assets (Base Case)	21.06%	22.06%	23.06%	24.06%	24.56%	25.06%	25.56%

## Factors that will push sustained growth in Islamic banking in Malaysia



## Areas for Further Development

 <b>Diversity &amp; Innovation</b>	 <b>Presence Abroad &amp; Regional Integration</b>	 <b>Retail Consumers' Preferences</b>	 <b>Social Responsibility</b>	 <b>Standardisation and Supervisory Cooperation</b>	 <b>Operational Flexibility</b>
Expand business reach of eligible international Islamic banks and issue licenses to institutions with specialised knowledge. Develop new products for Islamic repo transactions, hedging instruments, REITs, ETFs and foreign currency capital market investment products.	Facilitate more significant participation of Malaysian Islamic banks abroad as many key Islamic finance jurisdictions require trade linkages with Islamic banks. Also, support regional integration to support the Islamic banking sector under the ASEAN Economic Community.	Our survey shows that efforts should be devoted towards enhancing branch capabilities in terms of Islamic finance knowledge, as many customers emphasised that trusting the financial institution they deal affects their perception of the authenticity of the offered services.	Encourage the integration of socially responsible investments through Islamic banks as such ethical elements also attract non-Muslims.	Developing and promoting the wide adoption of standardised products in terms of documentation, agreements and practices. Engaging in cross-border arrangements to further support the global Islamic finance industry given Malaysia's strengths in this area.	Allow foreign institutions that are locally incorporated to deliver branch and non-branch channels subject to defined parameters.

With a penetration level of 0.6% at the end of 2013, it is expected that takaful contributions will witness an average growth of 12.59% for the next 5 years reaching total contributions of US\$4.11<sup>3</sup> billion in 2019. Despite the slowdown of growth in 2013, double-digit growth is still expected if risks to financial stability are maintained and managed that mitigates any material adverse implications.

At the best case<sup>4</sup> scenario, contributions will grow an average of 18.2% year on year to reach a market share of 17.96% of total Malaysian market premiums in 2019, equal to US\$5.51 billion. The contributions include both general and family takaful. Again, this means that contributions could double from 2013 to 2019.

3 Contributions base assumes no change in penetration of takaful contributions

4 Contributions best case assumes growth of average penetration 5% each year

### Projected Growth in Takaful Contribution



#### Share of Total Insurance Premiums (Best Case)

Year	2013	2014	2015	2016	2017	2018	2019
Share (%)	13.16%	13.96%	14.76%	15.56%	16.36%	17.16%	17.96%

#### Share of Total Insurance Premiums (Base Case)

Year	2013	2014	2015	2016	2017	2018	2019
Share (%)	13.16%	13.56%	13.96%	14.36%	14.76%	15.16%	15.56%

## Factors that will push sustained growth of Takaful in Malaysia



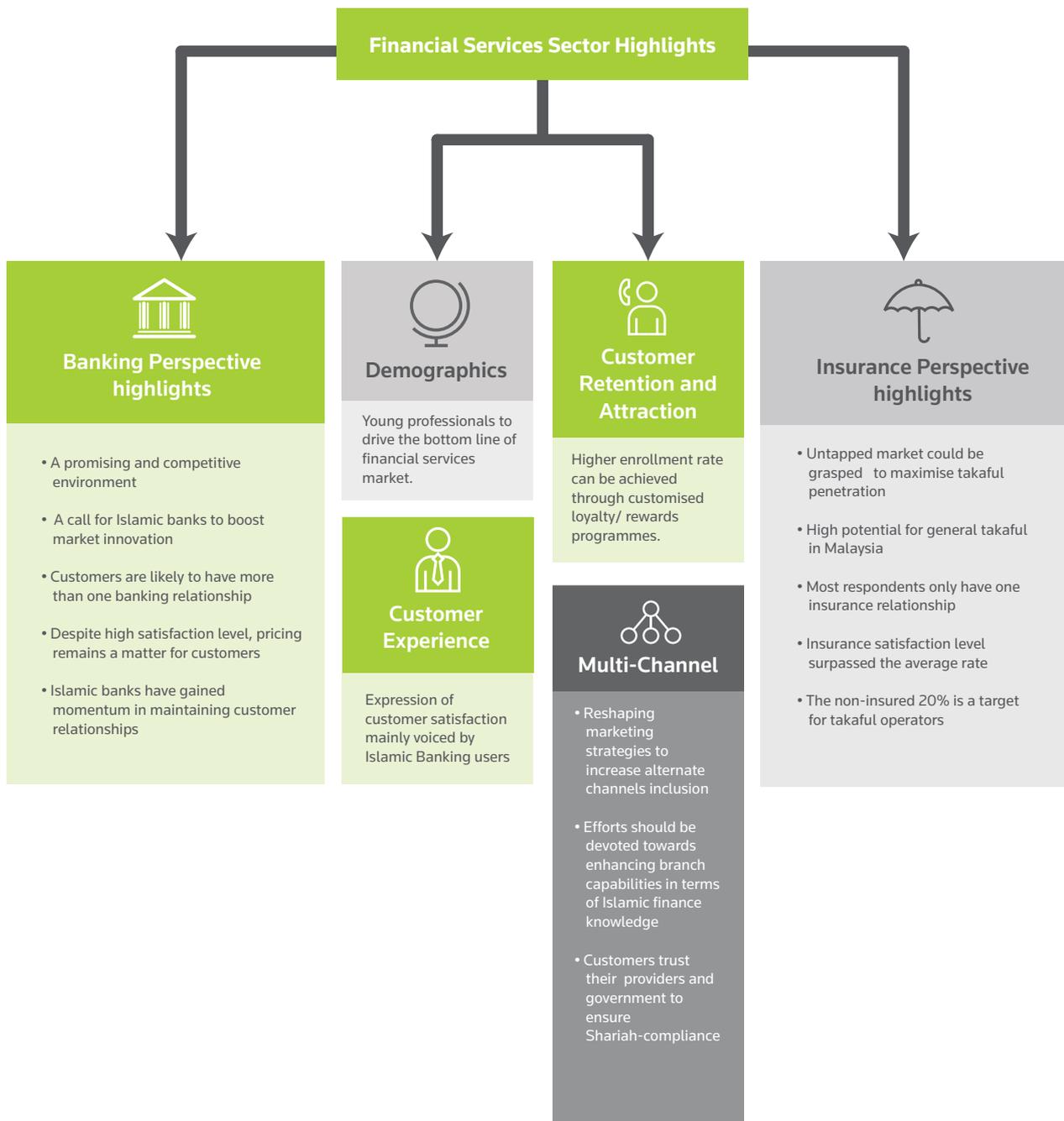
## Areas for Further Development

 Diversity & Specialised Alliances	 Delivery Channels & Awareness	 Resources & Staffing	 Retakaful	 Retail Consumers Preferences
Licenses should be issued for institutions with specialised knowledge and products like microtakaful and products that address the retirement gap issues. Also, encourage strategic agreements between foreign and domestic operators that have specialized expertise in medical and health insurance.	Encourage product offerings through alliterative delivery channels like retailers, digital applications and mobile technology ensuring that such applications are updated when it comes to products and supporting functions. Also, raise more awareness especially among Malay-Muslim populations through community-based distribution means as only 30% know of takaful offering.	Provide further specialised training to close the gap for required job competencies for takaful operators. There is also a concern that many professionals at the senior management level are from insurance background with little familiarity with key Shariah issues thus raises the need for professionals with Shariah background.	Despite the overcapacity of retakaful operators in Malaysia, it is experiencing slowdown due to mismatched risk appetite. Retakaful awareness for Shariah scholars need to be structured for them to understand its technical aspects.	Our survey revealed that there is an untapped insurance market that could be grasped by takaful operators with high potential for general takaful in the country.

# Retail Consumer Banking And Insurance Survey

Our exclusive retail consumer financial services survey results reveal a number of growth opportunities for the Islamic financial sector in Malaysia. Analysing

the survey results revealed strategic highlights that demonstrate possible opportunities for the financial services sector.



## Financial Services Providers' Perspective Analysis

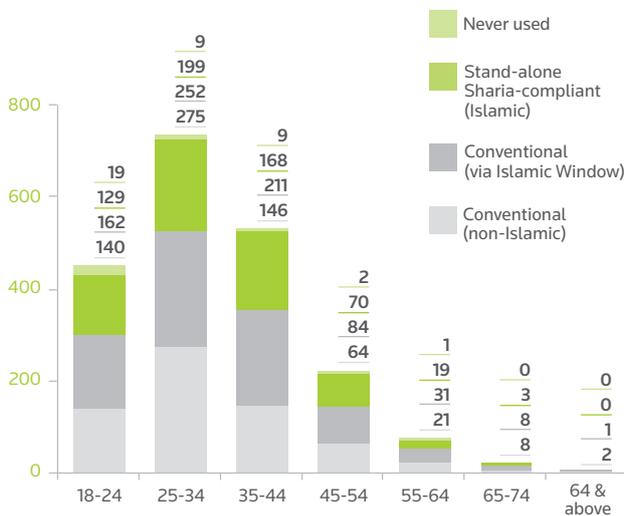


### DEMOGRAPHICS

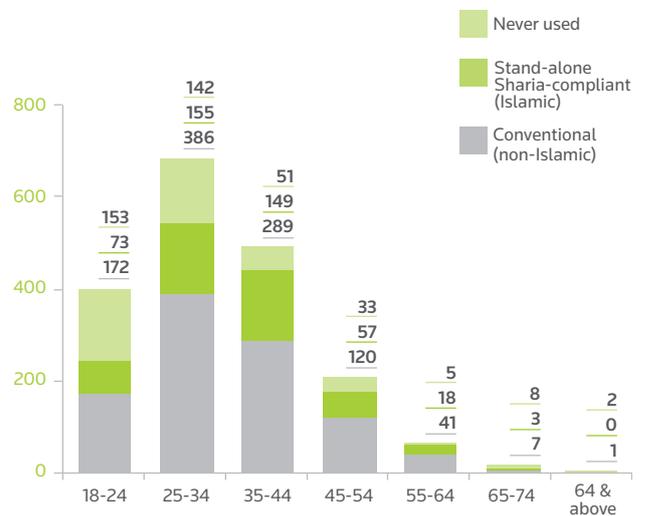
**Young professionals to drive the bottom line of financial services market:** By absolute numbers, the 25-44 age group is the most valuable growth driver for Malaysia's financial services sector

#### By age group

What type of banking service providers do you currently use or have used in the past?

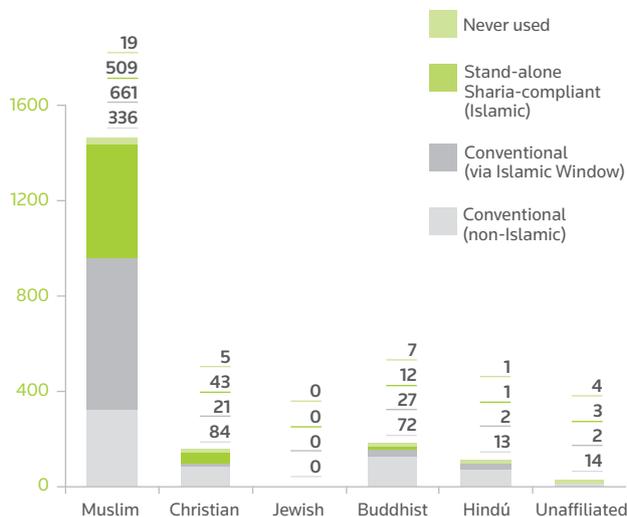


What type of insurance service providers do you currently use or have used in the past?

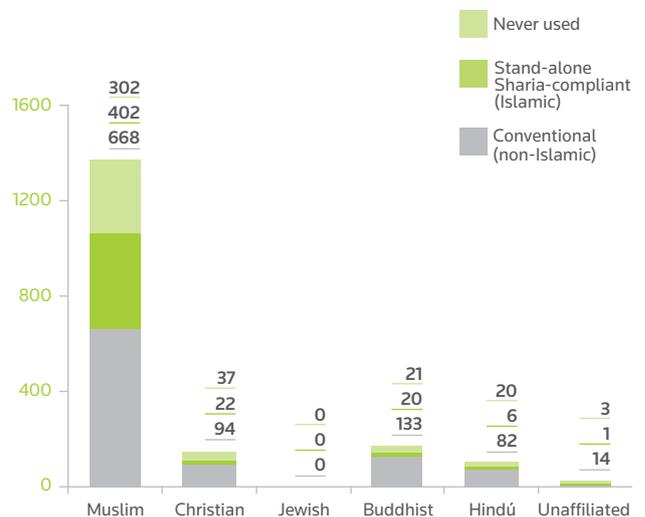


#### By major faith groups

What type of banking service providers do you currently use or have used in the past?



What type of insurance service providers do you currently use or have used in the past?



**By age group:** Malaysia's median age stands at 27.7 years (CIA 2014 estimate) and 25-44 year olds in the country represent approximately 31.2% of the population (Department of Statistics Malaysia, Q2 2014). Approximately 62.5% of our survey sample size of 1,858 are in the 25-44 age group. From the survey, the 25-34 age group, followed by the 35-44 age group, are the biggest users of financial services. By absolute numbers, this large demographic is the most valuable growth driver for Malaysia's financial services sector.

This is a highly competitive demographic wherein young people are at the start of the lucrative financial customer lifecycle involving new careers, marriage and starting families, which generally necessitate big financial decisions about buying property, cars, getting serious about savings, starting to plan for children's quality of life, education and upbringing, and planning for medical and healthcare, and retirement. With changes happening in the Islamic banking and takaful sectors to meet the requirements of the Islamic Financial Services Act 2013, financial institutions must reach and inform these 25-44 year-olds of the new products and services and their consumer rights that will affect their mid- to long-term financial stability.

Analysing banking customers, 421 respondents between the ages of 25 and 44 deal with conventional banks when using banking products/ services, while the majority of the survey respondents (830 respondents) deal with standalone Shariah-compliant banks or Islamic windows of conventional banks. Moving to insurance customers, 675 respondents between the ages of 25 and 44 deal with conventional insurance providers, while only a minority — 304 respondents — deals with standalone Shariah-compliant (takaful) providers.

**By major faith groups:** A very large proportion of the survey sample — 73.7% — is Muslim. (*Note: The demographic composition of survey respondents by faith group does not reflect that of the national population. According to Census 2010 Muslims made up 61.3% of the population, which is 12.4% lower than the survey*

*sample of Muslims.*) Among the Muslims, 33% use standalone Shariah-compliant banks and a higher 43% use Islamic windows of conventional banks. This highlights that the concept of Islamic windows is well-received by the public since its introduction in 1993, when Malaysia emerged as the first country to offer the dual banking system. Therefore, the growth opportunities for banks could lie in Islamic services offered through Islamic subsidiaries and windows, to exploit consumer trust and confidence in this dual system. From our survey, 41.8% of Christians, 27% of Buddhists and 33.1% of Hindus use Shariah-compliant banking services, reiterating that growth demographics for Islamic finance are not limited to the Muslim population.

Malaysia's Islamic banking and takaful selling points have primarily pivoted on the Shariah-compliant offering (while remaining competitive with conventional finance) in order to reach the majority-Muslim population. Moving forward, and in line with the bigger global industry dialogue, reaching beyond the Muslim demographic would require financial services providers to reposition Islamic financial products/services for a broader-based appeal, e.g. as sustainable ethical products.

**Insurance:** From the insurance perspective, 49% of Muslims deal with conventional insurance providers, with a much lower 29% using standalone Shariah-compliant (takaful) providers. A large group of 22% of Muslim respondents use no insurance or takaful, presenting a growth market for takaful operators.



**CUSTOMER RETENTION AND ATTRACTION**

**Higher enrollment rate can be achieved through customised loyalty/ rewards programmes:** Gifts and rewards programmes mainly valued by customers with a monthly household income between RM1,001 and 4,000. (Note: This is below the average monthly household income of RM5,000 in 2013.)

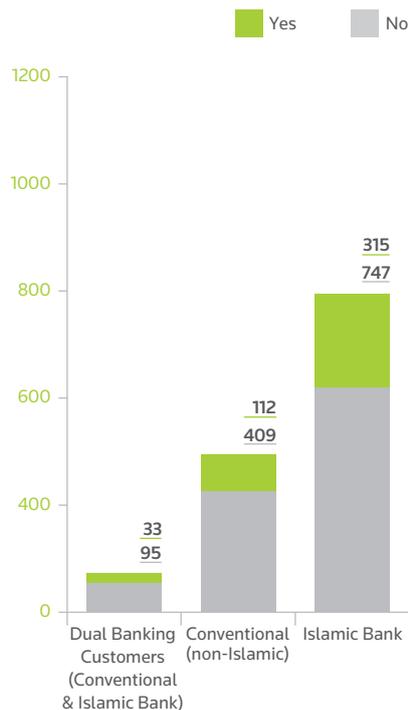
Gifts and rewards were the most valuable features of loyalty programmes chosen by customers (741 respondents). Such programmes are mainly valued by lower to middle-income customers with a monthly household income in the range of RM1,001 – 4,000, who make up 48% of all respondents who chose gifts and rewards. Similarly, price discount on products and services, air miles and hotel reward points and premium and priority services were all valued by customers in the same income group, representing 47%, 53% and 48%, respectively of all respondents who chose these programmes.

Loyalty programmes are among one of the most crucial tools for financial services providers to retain

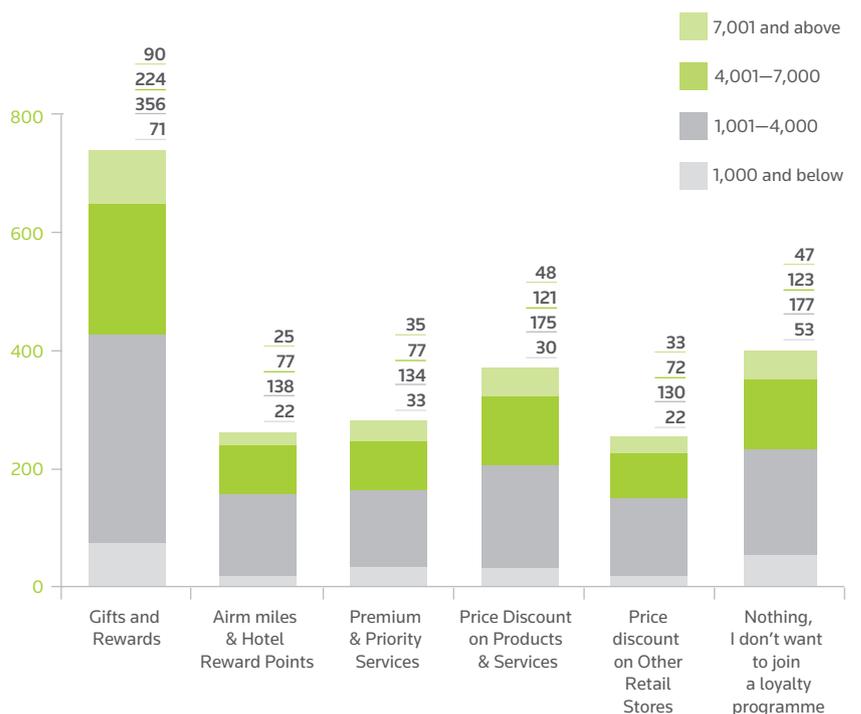
customers and attract new ones. 27% of survey respondents enrolled with a bank loyalty/ rewards programme, representing 460 respondents across different types of banking users. Users of Islamic banks are the largest among the survey sample to sign up with loyalty/ rewards programmes (69%), followed by users of conventional banks (24%).

As the majority of survey respondents have not been enrolled with a bank loyalty/ rewards programme, developing such programmes should be on banks’ priority lists. These programmes may be considered to be cost drivers for banks but they are worthwhile to attract new customers and retain existing ones who are not even interested in what is being offered.

Have you enrolled with a bank loyalty/rewards programme?



What do you or would you value the most from a loyalty or rewards programme?





**CUSTOMER EXPERIENCE**

**Expression of customer satisfaction mainly voiced by Islamic banking users:** Strong relationships between Islamic users and their main financial services provider is another challenge to new customer recruitment.

Respondents show a high level of satisfaction towards their main financial services providers, with 65% saying they have never changed their main financial services providers. Islamic banking customers were the largest group (666 respondents) followed by conventional banking customers (355).

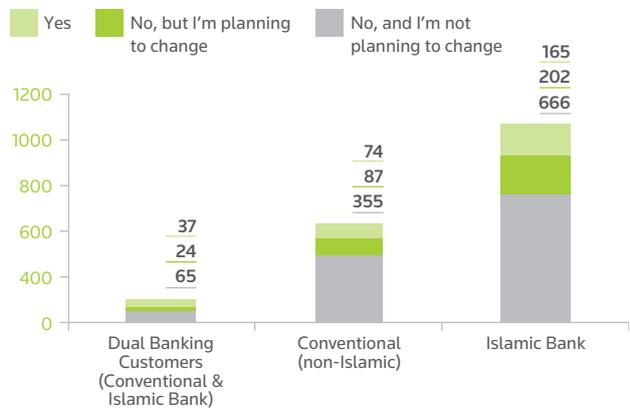
A large proportion of the surveyed customers (35%) also said they never changed or would not change their main financial services provider when asked what would make them change providers. Switchover rates may be low but survey respondents

pointed out some concerns that made them or would make them change their main financial services providers: high fees or charges (38%), interest-based (Riba) transactions (31%) and poor range of products and services (21%).

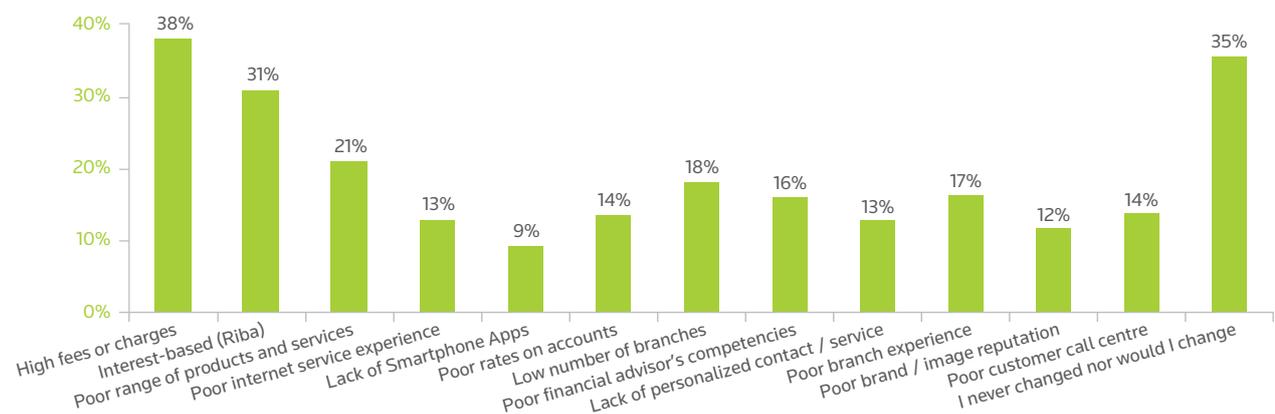
Financial services providers have the opportunity to capitalise on these concerns to differentiate themselves in the market by offering products with more competitive rates, extending their operations to offer Shariah-compliant products and introducing unique concepts in products/ services.

Have you ever changed your main banking and insurance service providers?

Have you ever changed your main banking and insurance service providers?



What made you or would make you change your main financial service providers?





**MULTI-CHANNEL**

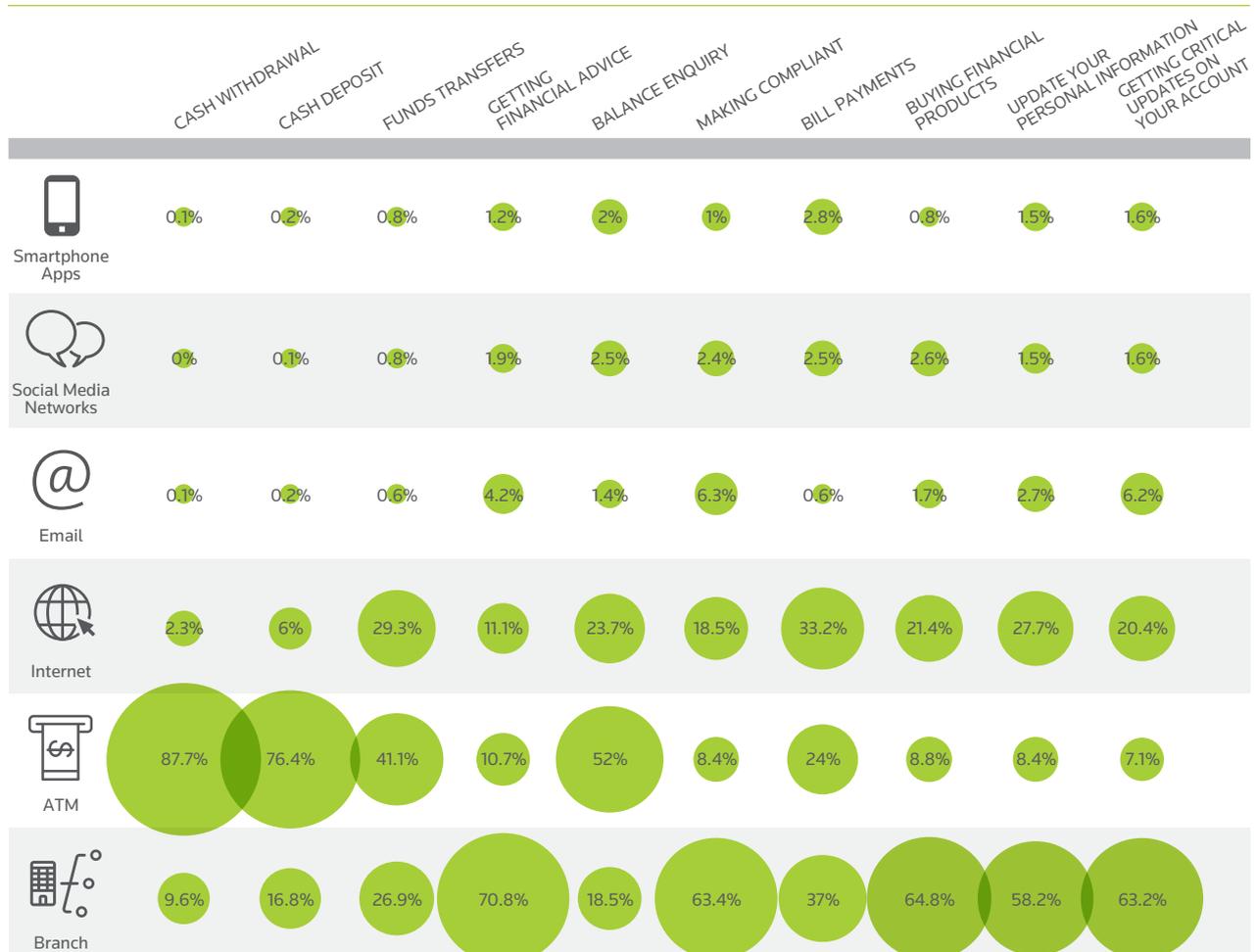
**Reshaping marketing strategies to increase alternate channels inclusion:** Internet banking and mobile apps haven't made significant headway

As financial services providers transform the way they conduct business operations, customers now have cross-channels to choose from when carrying out financial services activities. The most preferred channels were ATMs, branches and online banking across all financial services transactions. The use of ATMs dominates specific transactions such as cash withdrawal (87.7%), cash deposit (76.4%) and balance inquiry (52%). This is not surprising as customers are moving towards more accessible channels to conduct their frequent transactions to avoid long queues and waiting times. Over time, financial services providers should enhance ATM capabilities and include

more transactions that can be conducted through this channel.

Even with the advanced technology and changing business environment, branches remain prominent channels for conducting financial transactions. The survey results show that the type of transactions conducted at branches has undergone a gradual shift. As more transactions are now conducted through ATMs, branches are now less crowded. According to the survey, 64.8% of respondents use branches to buy financial products, 63.4% use them to lodge complaints, 63.2% to get critical updates on accounts and 58.2% to update personal information.

What is your most preferred channel for carrying out the following financial services and activities?



Although Malaysia’s financial sector is relatively mature and various avenues have been explored by financial services providers to engage their customers, our survey showed that the use of advanced

technology channels such as online banking, social media networks and Smartphone Apps is limited.



Areas that financial services providers need to focus on to increase customer interaction with advanced technology



Given the limited use of online and mobile channels, financial services providers need to reshape their marketing strategies to better inform their customers about their technological competencies. Customers are also looking for a high level of security and privacy when conducting transactions while using technology. Therefore, financial services providers should take bold steps in developing security procedures that are transparent to their customers. Despite the high cost of developing technology infrastructure, financial services providers should value the long-term returns that they will gain by reducing operational costs and position themselves as customer-focused innovators.

Daily interaction with financial services providers is mostly conducted via the internet (17.6%). As

online banking (internet) is the most convenient channel for daily financial services transactions, this presents an opportunity for providers to strengthen their relationships with young customers, who value the internet the most. On a weekly basis, customers use ATMs the most (36.3%), while branches are most frequently used on a monthly basis (32.1%). Given the familiarity and simplicity of these channels, they are pointed out as the most frequently used channels on a daily, weekly and monthly basis.

There is a very low uptake for mobile-based Smartphone apps, which are rarely used (23%) and almost never/never used (40.5%).

How often do you interact with your financial services provider through the following channels?



**Efforts should be devoted towards enhancing branch capabilities in terms of Islamic finance knowledge:**

Customers shun third party ads and communications. Direct advertising and communications by financial services providers are most preferred by customers. Brochures/ billboards, branches, and bank/insurance companies websites are most preferred by customers willing to learn about new products and services, and new promotions.

Despite the availability of various simple marketing channels, a marginally higher 19% of

customers still prefer face-to-face personal interaction in physical branches of financial services providers to get information about Islamic finance (banking/ takaful) concepts and the role of Shariah scholars. Connecting with customers to know about Islamic finance/ Shariah aspects will require financial services providers to have well-qualified human resources to deliver such information. Front line staff are the key drivers towards delivering better quality and reflecting greater customer experience.

What is your preferred channel for obtaining information on the following items?

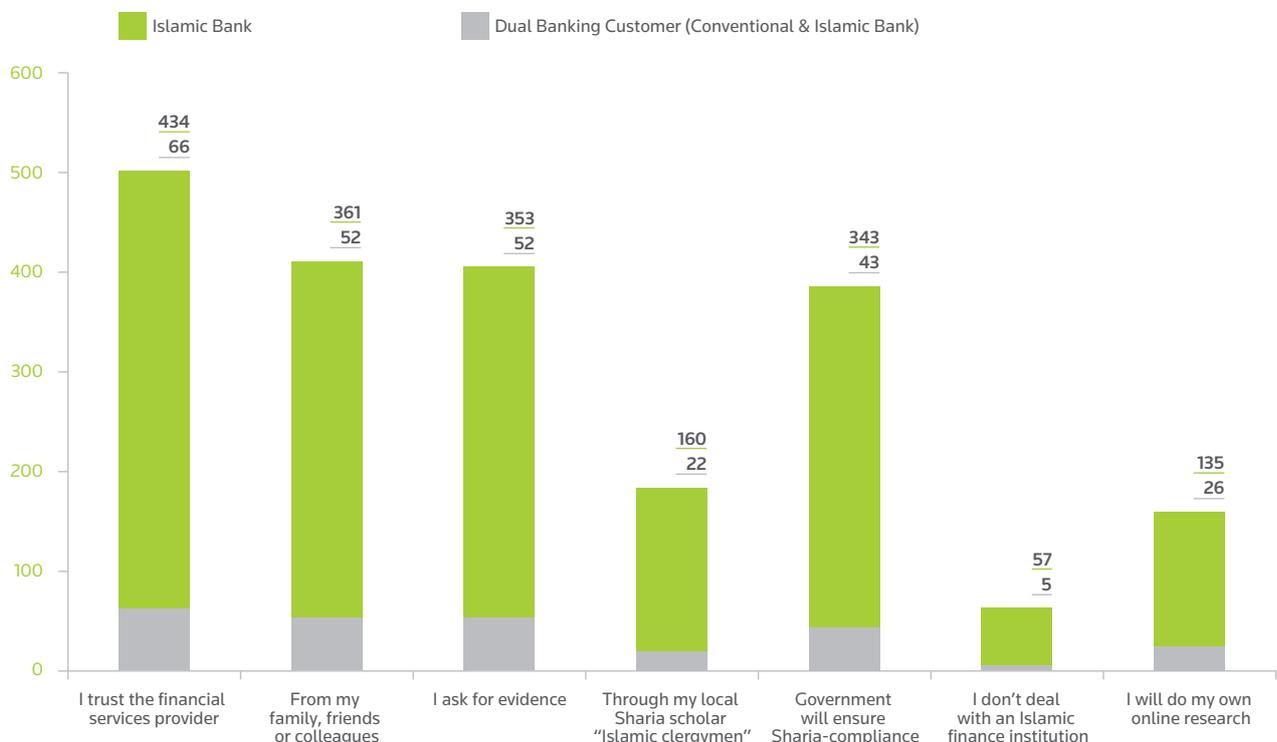


### Customers trust their providers and government to ensure Shariah-compliance

27% of survey respondents display a high level of trust in their financial services providers, in a way that convinces them about the authenticity of Islamic financial services transactions. This is higher than the number of respondents who would turn to their family and friends or look to the government to ensure Shariah compliance, although the proportion of those looking to the former – 22% – and the latter – 21% – are high in combination.

Word of mouth is an unpaid channel in which customers can ensure the Shariah compliance of financial products and services. 413 of survey respondents consult their families, friends and colleagues to ensure the authenticity of Islamic financial services. This requires financial services providers create dynamic and positive impressions on their customers about the authenticity of the offered Islamic financial products and services which will ultimately be shared with other customers.

If dealing with an Islamic financial services provider, how would you ensure the Shariah-compliance of the products and services you buy?



### Banking Perspective Analysis

**A promising and competitive environment:** High level of acceptance of Islamic windows

Malaysia was the first country to introduce Islamic windows in 1993. Our survey results show a high level of confidence in Islamic windows: 37% of respondents currently use or have used Islamic windows of conventional banks. 32% of respondents are

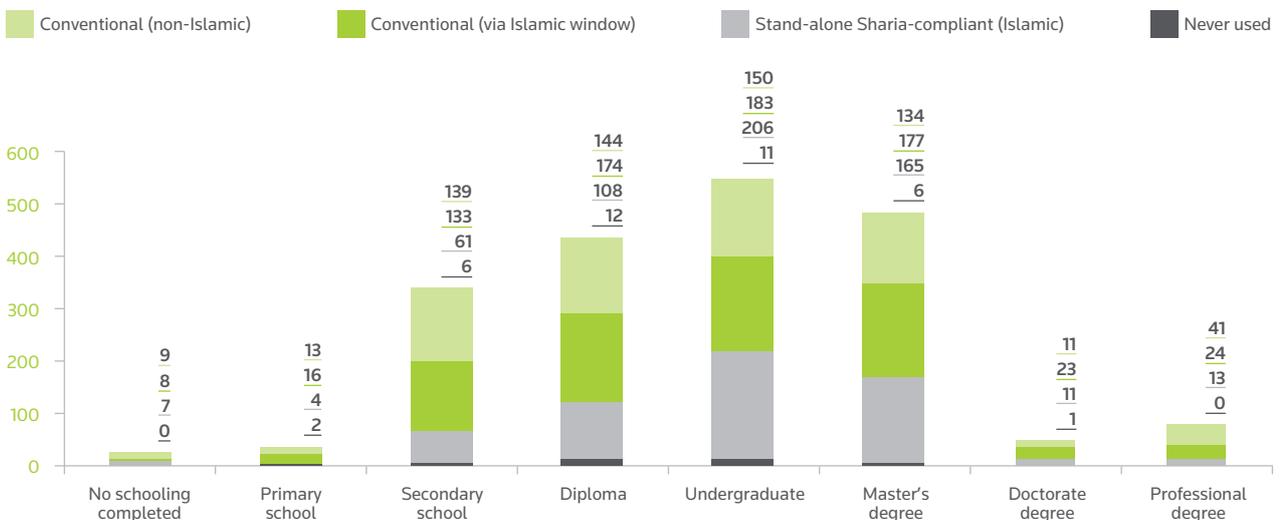
using/ have used conventional banks and 29% use standalone Shariah-compliant banks.

With such a high level of acceptance of Islamic windows, potential new conventional market entrants could position themselves to capture a larger market share given their ability to leverage their existing customer base and infrastructure.

What type of banking service providers do you currently use or have used in the past?



What type of banking service providers do you currently use or have used in the past?



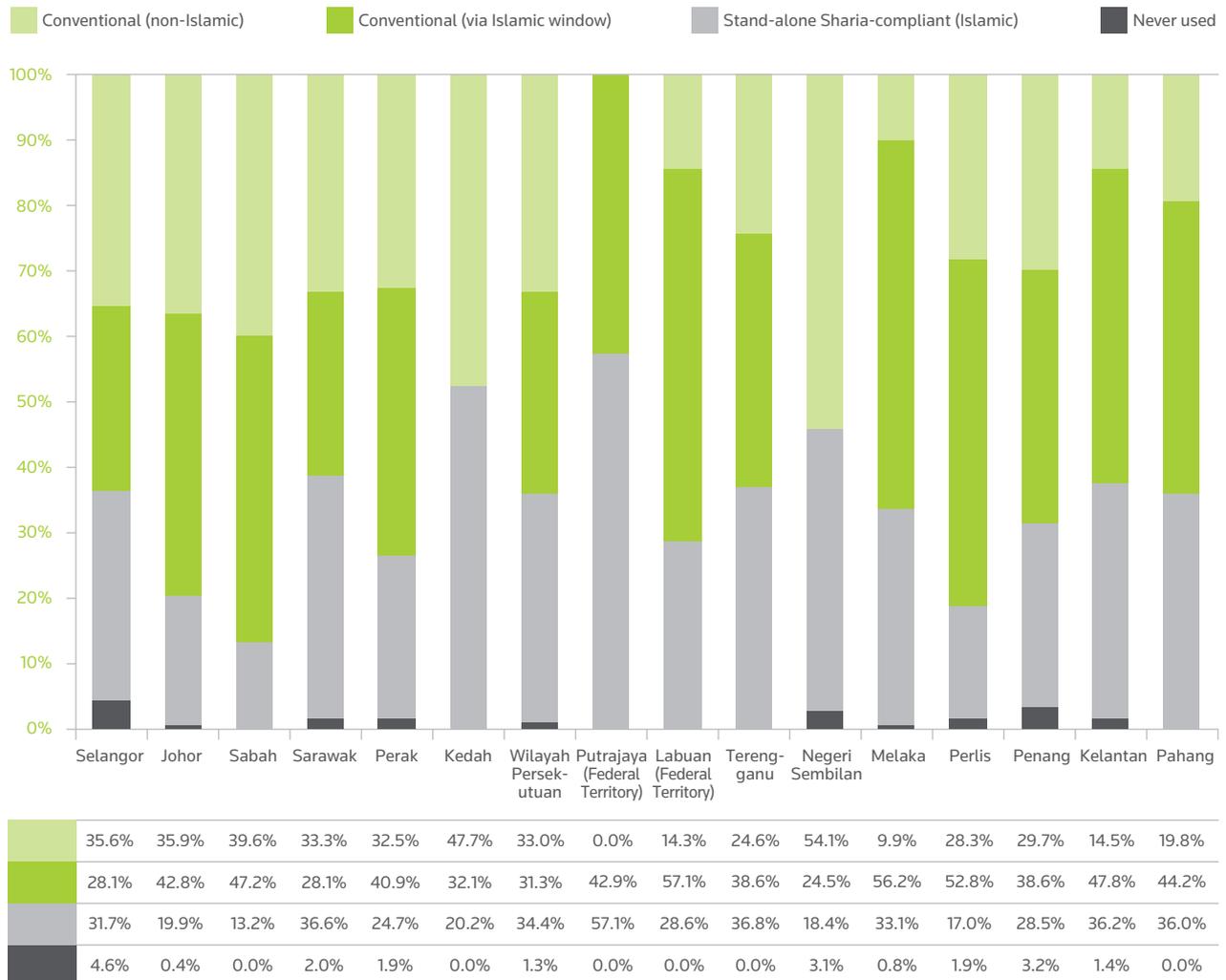
(The demographic composition of survey respondents by education level does not reflect that of the national population. 56% of survey respondents are tertiary educated. This is higher than national average by more than 100%. Census 2010 puts Malaysians aged 20 years and over with higher education (including trade and technical skills institution, post-secondary and tertiary) at 21.6%.)

**By education:** Of those who use banking services (98.1% of all survey respondents), undergraduate degree holders make up the biggest proportion of users for standalone Islamic banks (35.83%), Islamic windows (24.8%) and conventional banks (23.4%). 27% of all survey respondents have an undergraduate degree as their highest qualification. On the other end of the spectrum, respondents with no schooling completed and only primary school qualifications (total 3% of all survey respondents) were the lowest proportion of users for conventional banks (3.43%), Islamic windows (3.25%) and standalone Islamic banks (1.9%).

**By location:** Putrajaya respondents were 100% Islamic banking users (57.1% standalones, 42.9% windows). This is perhaps unsurprising considering strong government support for Islamic banking, and Putrajaya as the seat of government and the district primarily populated by government offices. Melaka was second (89.3%: 33.1% standalones, 56.2% windows) followed by Labuan (85.7%: 28.6% standalones, 57.1% windows); Labuan is Malaysia’s offshore financial centre.

The fewest number of Islamic banking customers were found in Negeri Sembilan (42.9%: 18.4% standalones, 24.5% windows), Kedah (52.3%: 20.2%

What type of banking service providers do you currently use or have used in the past?



standalones, 32.1% windows) and Selangor (59.9%: 31.7% standalones, 28.1% windows). The highest number of respondents using conventional banks were found in Negeri Sembilan (54.1%), Kedah (47.7%) and Sabah (39.6%).

The top 3 states that most favoured standalone Islamic banks were Putrajaya (57.1%), Terengganu (36.8%) and Sarawak (36.6%). The top 3 states favouring Islamic windows were Labuan (57.1%), Melaka (56.2%) and Kelantan (47.8%).

The highest number of respondents who never used any banking services were found in Selangor (4.6%), Penang (3.2%) and Negeri Sembilan (3.1%).

#### Muslims who only use conventional banks

Muslims are considered primary captive users of Islamic finance and understanding the profiles of Muslims who only bank conventionally is important if Islamic banks are to win new customers. 13% (234) of total survey respondents are Muslims who only use conventional banks. (A marginally higher 15.8%, or 294 respondents, are people of other faiths who only use conventional banks.)

From the survey, there is no typical profile of the Muslim who only uses conventional banks. The biggest group is the 18 to 44-year age bracket who make up 83.76% of all Muslims who only use conventional banks. (Note: 84% of total survey respondents are in this age bracket. This is not representative of the national population; as at Q2 2014 41.4% of Malaysians were aged between 20 and 44, according to the Department of Statistics).

By age brackets, the Muslims who only use conventional banks were: 18-24 (23.93%), 25-34 (36.75%), and 35-44 (23.08%). Of these 18 to 44-year olds, 39.8% have a monthly household income between RM1,001 and RM4,000, 21.43% between RM4,001 and RM7,000, 11.73% on RM7,000 and above, and 9.69% on RM1,000 and below. The average monthly household income was RM5,000 in 2013.

Of the 234 Muslims who only bank conventionally 55.56% are female. By education level, 4 groups combined make up 88% of the Muslims who only use conventional banks: Secondary School (20.5%), Diplomas (13.25%), Undergraduate degrees (11.54%), and Master's degrees (10.68%). (Note: See explanation of survey respondents' demographic profiles at the end of this chapter.)

The bad news for Islamic banks looking to lure this group of Muslims is that a majority (84.62%) is either very satisfied (14.96%) or satisfied (69.66%) with their main bank. Of the very satisfied, 45.71% have been with their main bank for more than 10 years and 28.57% for 3-5 years. Of the satisfied, 43.56% have been with their main bank for more than 10 years and 29.45% for 3-5 years.

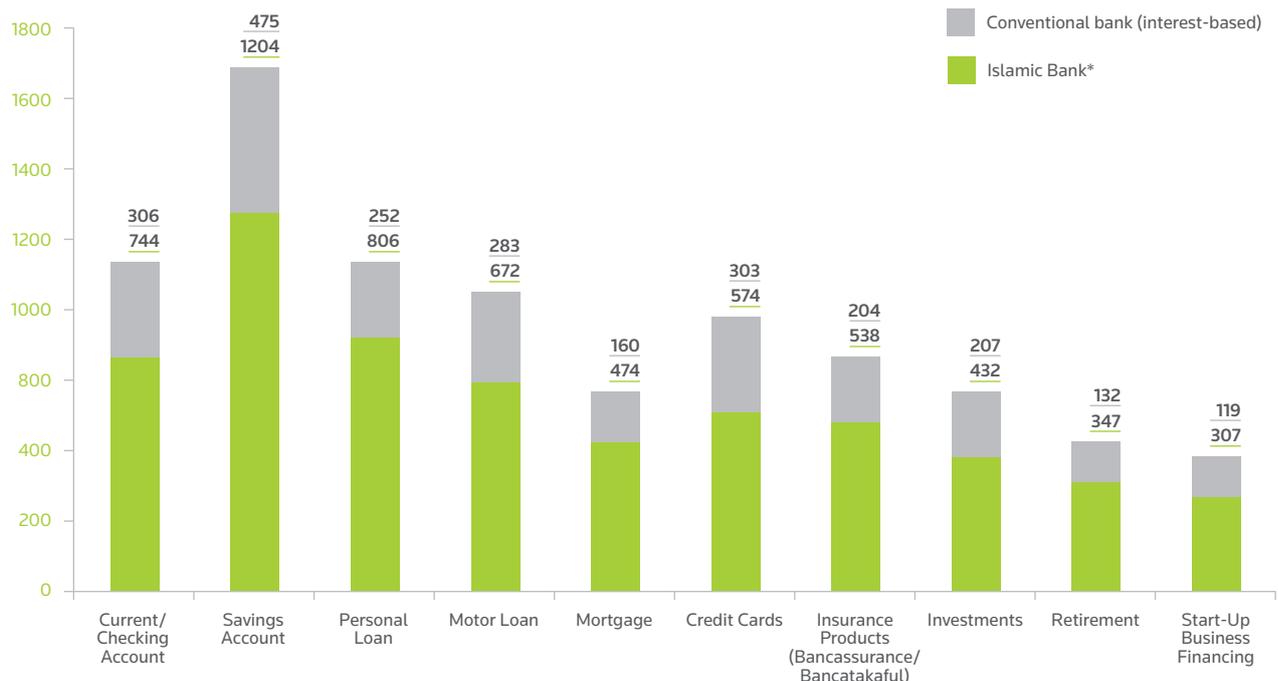
54% of the very satisfied would not change their main bank but the rest would switch because of interest (riba) (31.4%) and high fees and charges (22.86%). 39.26% of the satisfied would not change their main bank but the rest would switch because of interest (riba) (28.8%), high fees and charges (19.63%) and poor range of products and services (17.9%).

### A call for Islamic banks to boost market innovation

The majority of customers use/ would use Islamic banks for financial products and services. The most popular product/service is the saving account, chosen by 90%, or 1,679 respondents. Of those respondents, 71.7% use/ would use Islamic banks, while only 28.3% use conventional banks. Other most popular products/ services were personal loans (56.9%, 1,058 respondents) and current/ checking accounts (56.5%, 1,050 respondents).

The demand for Islamic banking by survey respondents far exceeds that for conventional banking in all categories of retail banking products/ services. This should encourage Islamic banks to be more innovative in delivering products/ services in line with customers' needs. Given that most of the banking services users are young, Islamic banks could develop their offerings in a way that is directly tailored to the demographic's needs. The Malaysian market has already started to pave the way for Islamic banking solutions that are differentiated from conventional products with the reclassification of Islamic deposits under IFSA 2013, in which Islamic deposits will be reclassified into either Islamic deposits accounts or migrated to investment accounts. The reclassification will force a sharp differentiation from conventional banking and lay bare the competition to offer customers a wider range of products.

What type of bank do you use/ would use mostly for the following products and services?



\* Including standalone Islamic banks, Islamic subsidiaries of banking groups & Islamic banking divisions.

THOMSON REUTERS

EIKON™



## Seek More. Profit More.

Connect to the information, tools, and people you need to succeed.  
Anywhere, anytime.

Discover more profitable opportunities. Thomson Reuters Eikon® gives you access to the best mix of financial content and market-moving Reuters news, filtered by need, delivered at speed, and displayed graphically, so it's easy to view, act on – and profit from. Via desktop or mobile, it lets you see and seize opportunities first – across assets, across liquidity venues, across the globe.

**Try Thomson Reuters Eikon Free.**

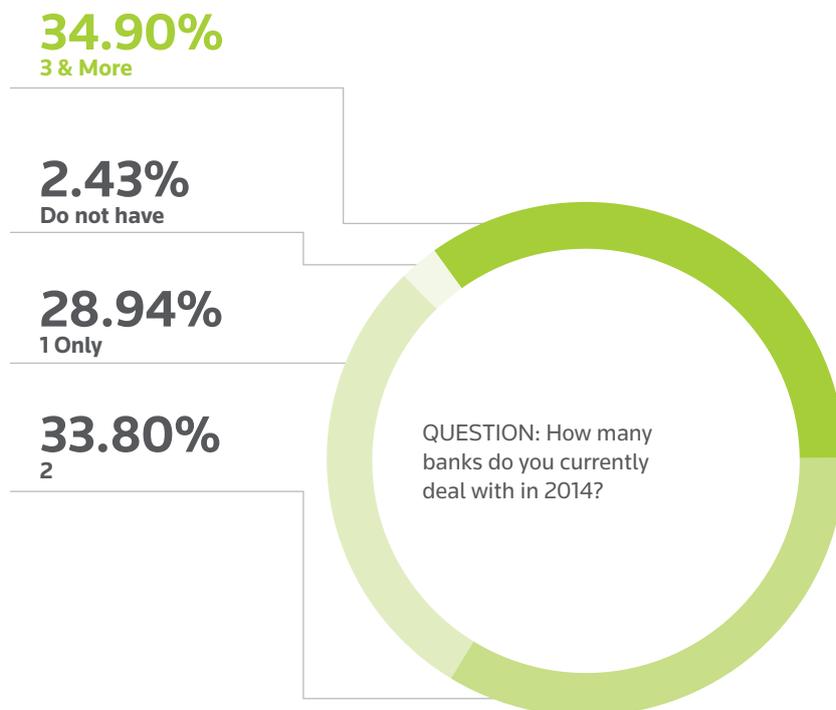
For more information or a free Eikon trial, go to: [thomsonreuterseikon.com](http://thomsonreuterseikon.com)



### Customers are likely to have more than one banking relationship

Using more than one bank is clearly on the rise in mature markets; this is a growth opportunity for banks. In a relatively mature banking market such as Malaysia customers use specific banks for specific products. This shows up in the survey: approximately 69% of survey respondents maintain more than one banking relationship. Respondents have displayed a high level of satisfaction with their main financial services provider as we learnt from two survey questions: 65% of respondents said they have never changed their main financial services provider, and in answer to another question on what would make them move away from their main financial services provider 35% said they never changed and would not change their main financial services provider. High fees and charges (38%), interest-based products (31%), and poor range of products and services (21%) were the most-cited reasons for moving away from a main financial services provider. Banks should be ready to create new business opportunities to cope with this changing business environment where customers chase the best products and services from a range of providers. The sector is moving towards more personalised services, more advanced technology and attractive rates and incentives.

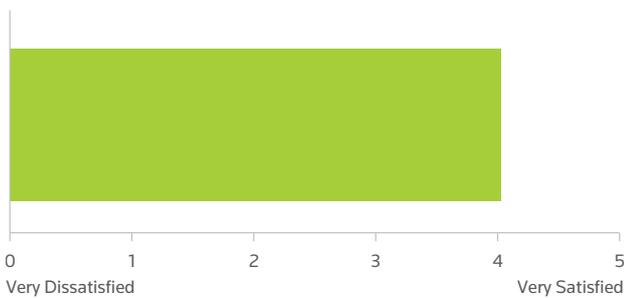
How many banks do you currently deal with in 2014?



### Despite high satisfaction level, pricing remains a matter for customers

Measuring the level of satisfaction is imperative to improve and further develop the Islamic banking sector. In Malaysia, customers display a high level of satisfaction with their main banking provider and hence there is an opportunity for differentiation. Although respondents have shown a high level of satisfaction, banks need to focus on further enhancement and create alternative products with

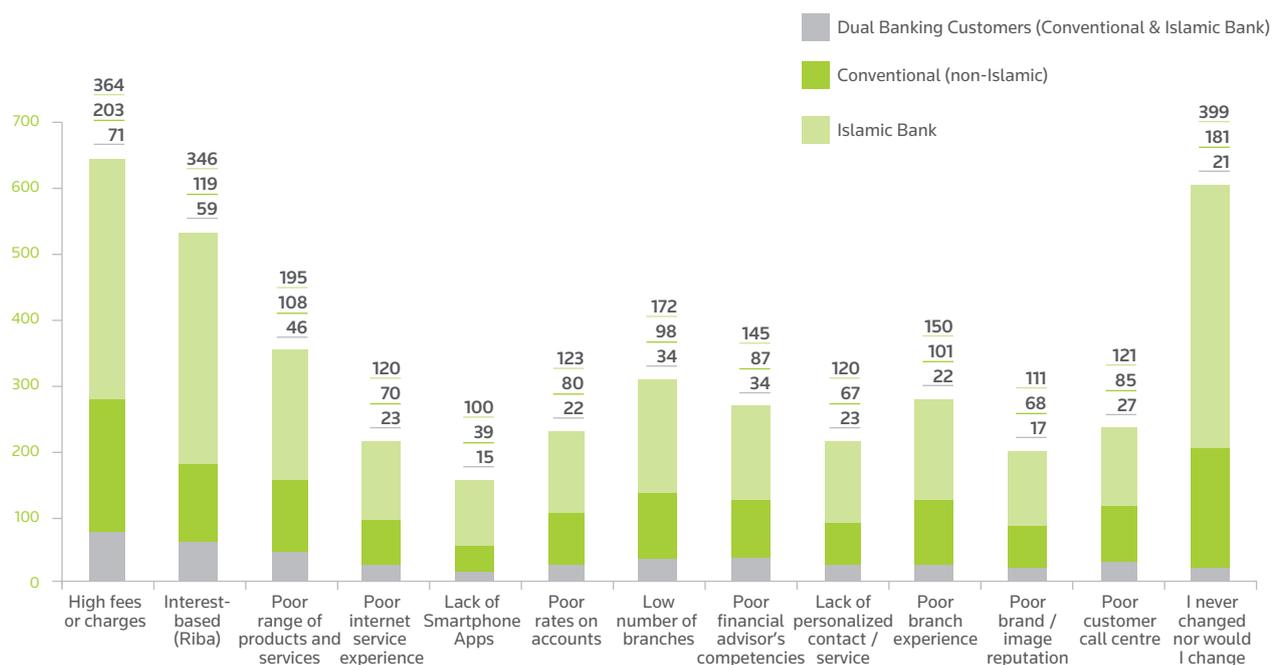
#### How satisfied are you with your main banking providers?



reasonable fees/ charges, diversified offerings, and better network coverage.

A substantial number of Islamic banking customers – 399, or 66% of all respondents – said they have never changed or would never change their main banking provider. Despite this encouraging number, Islamic banking customers are still concerned about high fees or charges, poor range of products and services and low number of branches. Further, charging interest was another concern for Islamic banking customers; these may push them to change their main banking providers down the line. Customers who use either conventional banks or two types of banks (Islamic banks and conventional ones) expressed high concern about interest (Riba), represented by 178, or 34%, saying that they would change their main banking provider due to this reason. This creates an opportunity for Islamic banks/ windows to capture the dissatisfied customers of interest-based banks through clear marketing messages about the authenticity of Islamic banking transactions.

#### What made you or would make you change your main banking service providers?



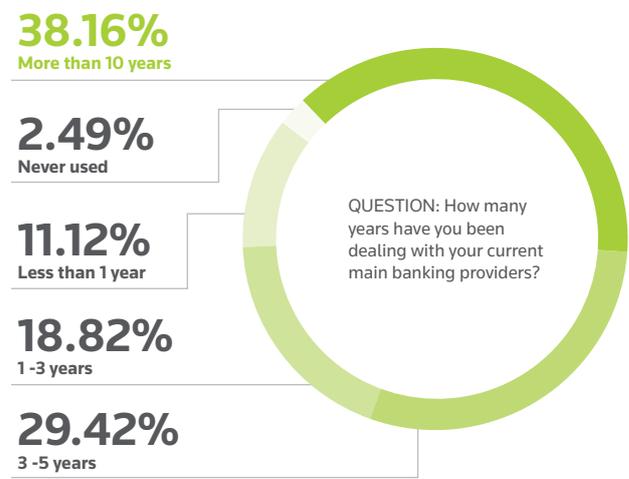
**Islamic banks have gained momentum in maintaining customer relationships:** most customers locked in to providers they signed on with when in their 20s and 30s

Our findings reveal that 38.2% of banking customers have stayed with their main bank for more than 10 years. This is a substantial foundation to build upon, especially for banks' long-term profitability. Of those who have maintained this long-term relationship, 55% are aged between 35 and 54.

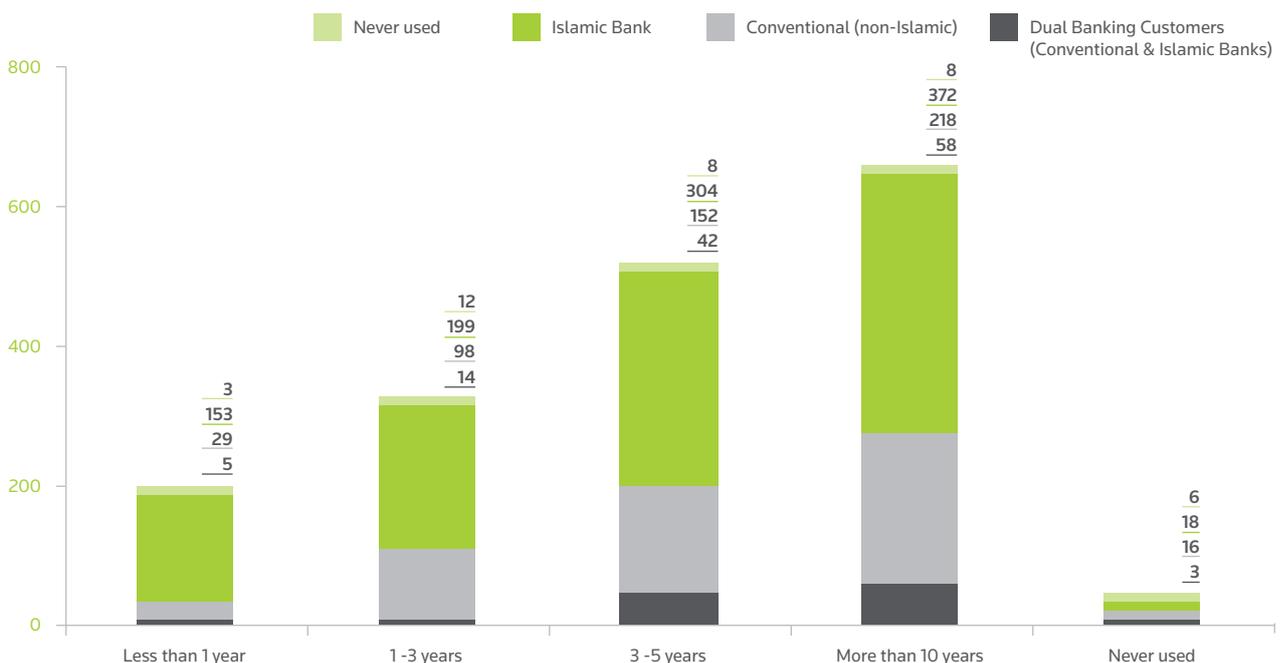
Whereas customers with 3- to 10-year relationships with their main banking providers represent a larger slice (approximately 68%), around a quarter of respondents have just established relationships with their main banking providers and maintained accounts for less than 3 years. The next step for this group will be the critical factor of success for banks to sustain and strengthen these relationships possibly through more attractive loyalty/ rewards programmes. Loyal customers have the potential to become the bank's biggest ambassadors.

The expansion of Islamic banking in Malaysia has gained customer confidence; this is clearly represented in our survey findings. Out of the customers who have maintained the same main banking providers for more than 10 years 372 respondents, or 57%, are mostly Islamic banking customers.

How many years have you been dealing with your current main banking providers?



How many years have you been dealing with your current main banking providers?



**Insurance Perspective Analysis**

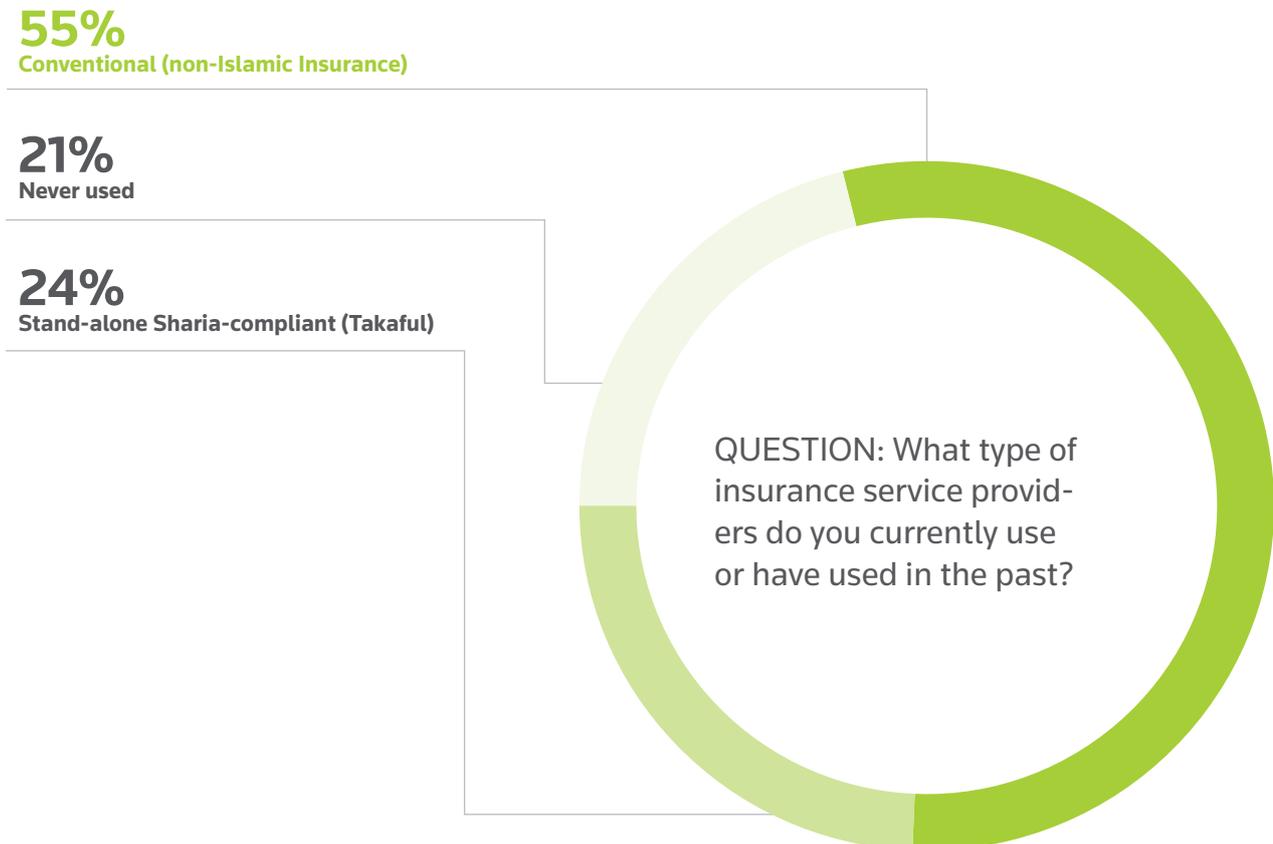
**Untapped market could be grasped to maximise takaful penetration**

The insurance industry in Malaysia is relatively small and has a very low penetration rate. In 2013 total conventional insurance premiums and takaful contributions as a percentage of GDP was 4.8%; 4.2% of which was conventional insurance and a much lower 0.6% for takaful. However, with economic progress, increasing financial literacy and rising incomes there is a significant opportunity for takaful.

Among the survey respondents, 55% are using / have used insurance products from conventional providers, while a significantly lower 24% are using / have used products from takaful providers, reflecting the low penetration level in the takaful sector.

A considerable percentage of the survey respondents (21%), have never used insurance products therefore highlighting a growth opportunity for takaful operators. There is room for takaful providers to capture this untapped market through various strategies, including well-defined product distribution through bancatakaful and micro-takaful as well as explicit brand strategies that will enhance awareness and promote takaful as a brand. The Malaysian government has already issued a concept paper for life insurance and family takaful that introduced a set of initiatives that will be put in place to promote diversified delivery channels and hence make insurance/ takaful accessible to customers.

What type of insurance service providers do you currently use or have used in the past?



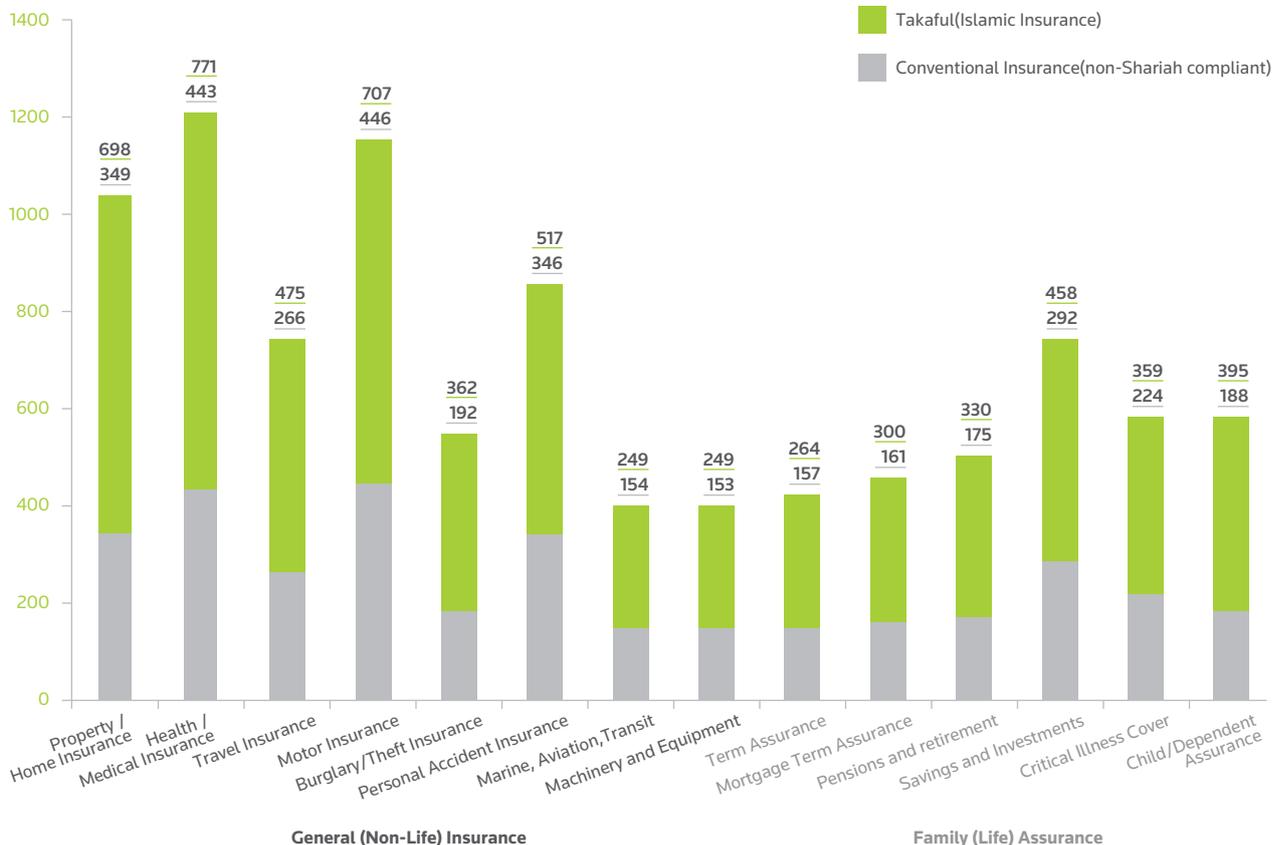
**High potential for general takaful in Malaysia**

The majority of customers use/ would use takaful providers when making choices about insurance products and services. The most popular product/ service is health/medical insurance, chosen by 65%, or 1,214 respondents. Of this group, 63.5% use/ would use takaful providers, while only 36.5% lean towards conventional insurance providers. Other most popular products/ services were motor insurance (1,153 respondents) and property/ home insurance (1,047 respondents).

the need for family takaful or even to the Shariah-compliance and Islamic authenticity of family takaful. With the introduction of the IFSA 2013, takaful operators that run dual takaful businesses are required to split their operations into either family or general takaful businesses. When this is fully in place, a more specialised takaful market will be created and more dedicated attention can be diverted to the family takaful sector.

As expected, the potential demand for general takaful far exceeds the demand for family takaful. This may point to a lack of financial knowledge of

What type of insurance provider do you use/would use for the following products and services?



**Most respondents only have one insurance relationship**

More than half (53%) of respondents deal with one insurance provider only. This is more typical in the insurance market than the banking market, where respondents hold multiple accounts across banks.

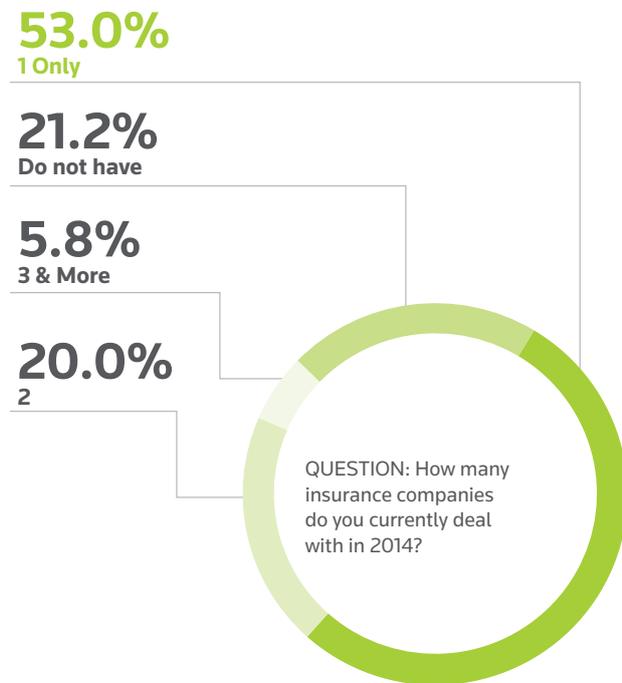
The usage of insurance services is primarily determined by the respondent’s age. More insurance products will be needed by customers as they mature; hence they will reach out to more than one insurance company to find what best fits their needs given increasing insurance costs; this may result in multiple insurance relationships. Our survey showed that multi-insurance customers are concentrated mostly between the age group of 25 and 64, identified by 88% of respondents. 334 (equivalent to 21.2%) of survey respondents have never used insurance services and from this group 77% are young customers aged between 18 and 34. This age group could be targeted through customised products in line with their needs and spending power.

**Insurance satisfaction level surpassed the average rate**

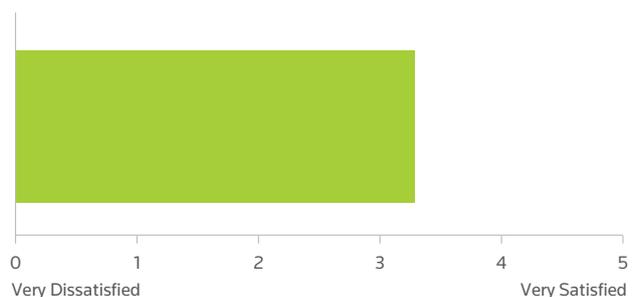
Measuring satisfaction levels is important as it is a leading indicator of customer intention to continue to stay with specific financial services providers. According to the survey, customers display a relatively high satisfaction level towards their main insurance provider and therefore, an opportunity for differentiation exists. Insurance/ takaful providers should rigorously and continuously study existing customers’ behaviours in order to personalise their products and services to fit their individual preferences.

With Malaysia’s aim to ensure high level of customer satisfaction and protection, a notable step was taken by authorities with the incorporation of the Financial Mediation Bureau in 2004 under the initiative of Bank Negara Malaysia. The Bureau acts as an alternative dispute resolution channel to resolve complaints between the Financial Service Providers (FSPs) and their customers. Further, a Financial Ombudsman is in the planning stages.

How many insurance companies do you currently deal with in 2014?



How satisfied are you with your main insurance providers?



**The non-insured 20% is a target for takaful operators**

Our findings reveal that 40.6% of survey respondents have maintained relationships with their main insurance provider for 3 to more than 10 years. For 3-5 year relationships, 49% of respondents were aged between 35 and 54 years old. 59.3% of survey respondents have been dealing with their providers for a period of up to 3 years or have never used insurance products/ services.

The survey reveals that there is a more recent higher take-up rate for takaful; the majority of takaful customers have been with their takaful provider for less than 5 years – 22% or 78 respondents have been with their takaful providers for a period of 3-5 years, 26% or 95 respondents for 1-3 years and a larger group of 41% or 108 respondents have only very recently established takaful relationships (less than 1 year). Despite the more recent higher take-up rate, takaful awareness in Malaysia amongst individuals is still lacking, especially in a market where there are well-established conventional players.

How many years have you been dealing with your current main insurance providers?

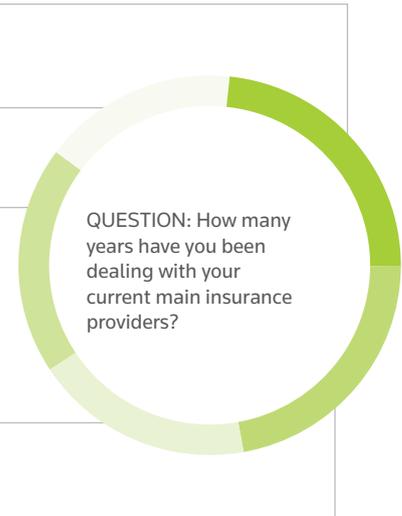
**22.0%**  
3 -5 years

**23.4%**  
1 -3 years

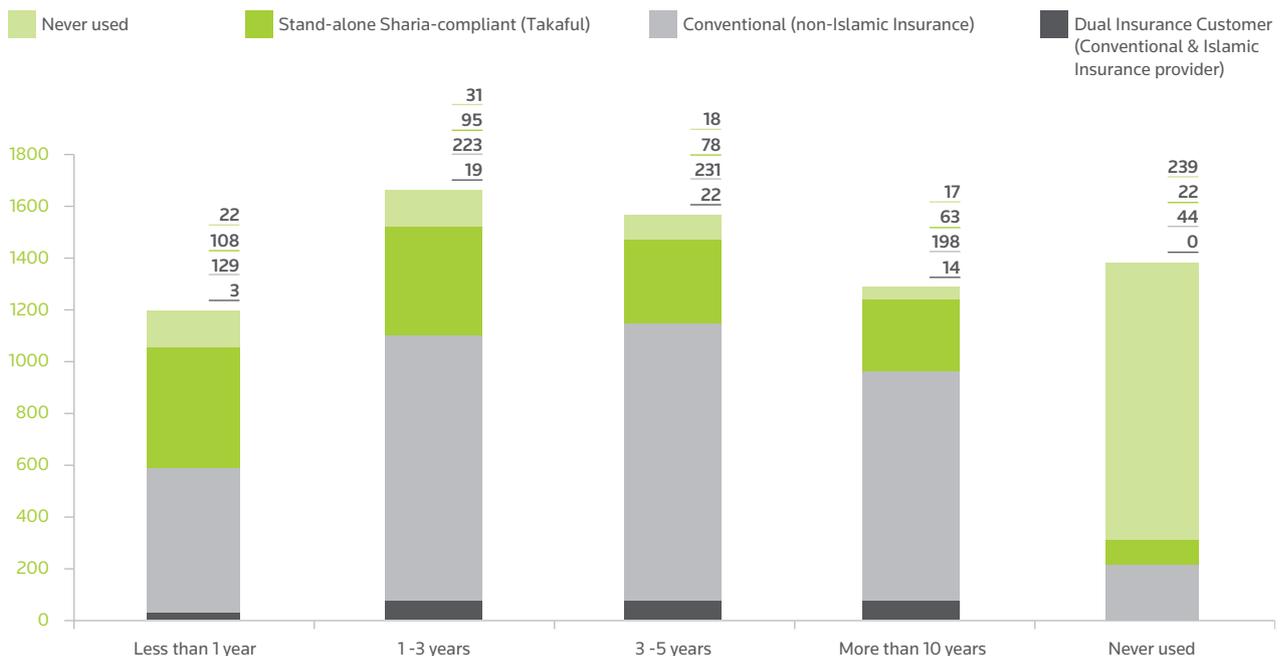
**16.5%**  
Less than 1 year

**19.4%**  
Never used

**18.6%**  
More than 10 years



How many years have you been dealing with your current main insurance providers?

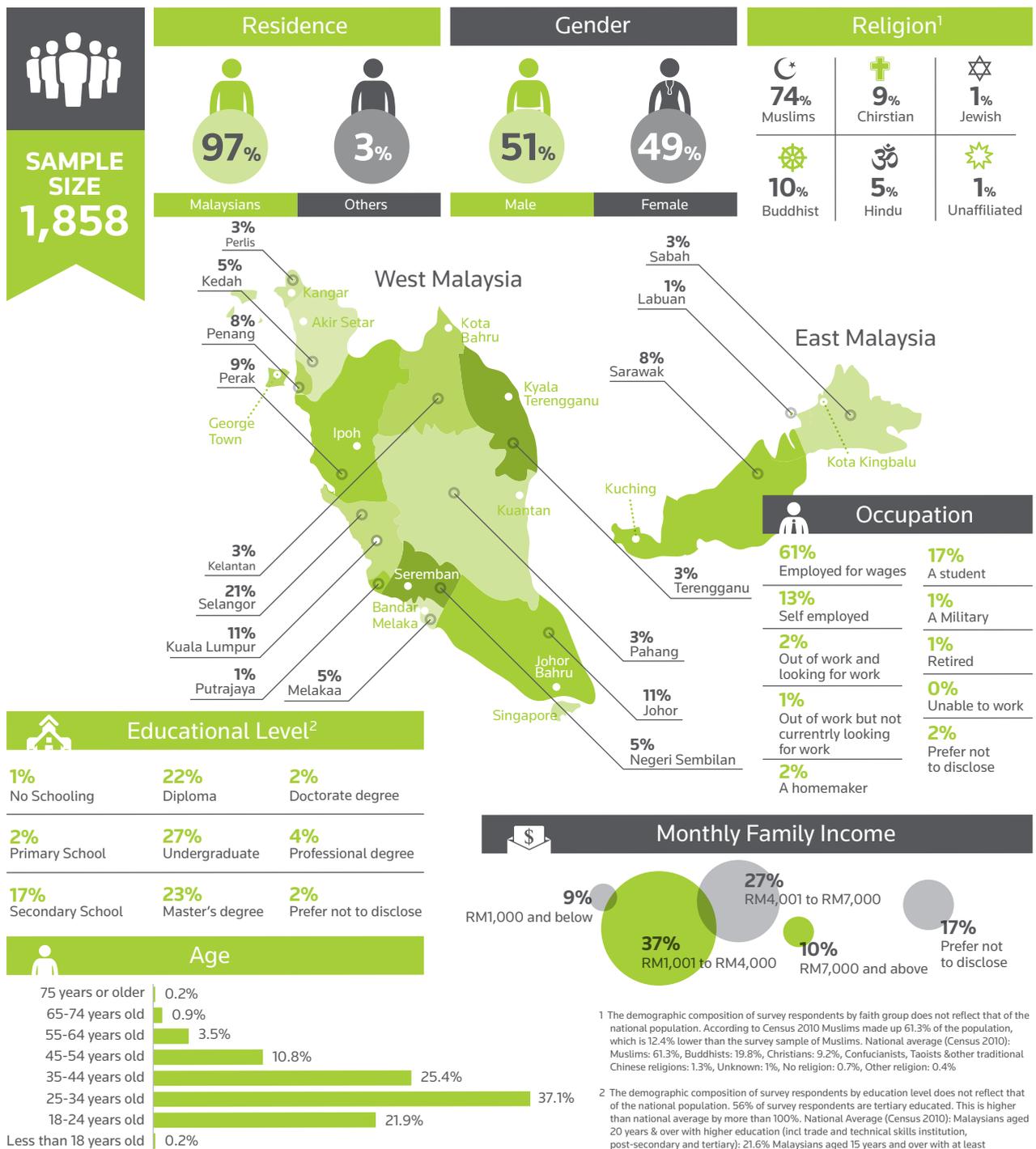




## Survey Methodology

The consumer financial services survey was conducted in August 2014 in collaboration with International Islamic University Malaysia (IIUM). The survey was distributed to a sample of Malaysian residents over 18 years old. Apart

from responses to the survey questions, we also gathered economic and demographic data about respondents' age, gender, religion, educational level, place of residence, occupation and monthly family income.



75 years or older	0.2%
65-74 years old	0.9%
55-64 years old	3.5%
45-54 years old	10.8%
35-44 years old	25.4%
25-34 years old	37.1%
18-24 years old	21.9%
Less than 18 years old	0.2%

<sup>1</sup> The demographic composition of survey respondents by faith group does not reflect that of the national population. According to Census 2010 Muslims made up 61.3% of the population, which is 12.4% lower than the survey sample of Muslims. National average (Census 2010): Muslims: 61.3%, Buddhists: 19.8%, Christians: 9.2%, Confucianists, Taoists & other traditional Chinese religions: 1.3%, Unknown: 1%, No religion: 0.7%, Other religion: 0.4%

<sup>2</sup> The demographic composition of survey respondents by education level does not reflect that of the national population. 56% of survey respondents are tertiary educated. This is higher than national average by more than 100%. National Average (Census 2010): Malaysians aged 20 years & over with higher education (incl trade and technical skills institution, post-secondary and tertiary): 21.6% Malaysians aged 15 years and over with at least secondary school qualifications: 67.8%

# BANK NEGARA MALAYSIA





## 04

# BANKING SECTOR DEVELOPMENT AND RECENT ACTIVITY

---

### BANKING SECTOR LANDSCAPE AND PROFILE

- 145 Top 5 commercial banks by assets (latest FYE)
- 148 Sector Size and Growth
- 156 Sector Performance

### REGULATIONS DEVELOPMENT

- 158 Achieving aspirations: Financial Sector Blueprint 2011 – 2020
- 160 Regulatory framework aligned with omnibus of guidelines
- 162 Guidelines to implementation process: the IFSA outlook
- 169 Basel III for Islamic banks in Malaysia

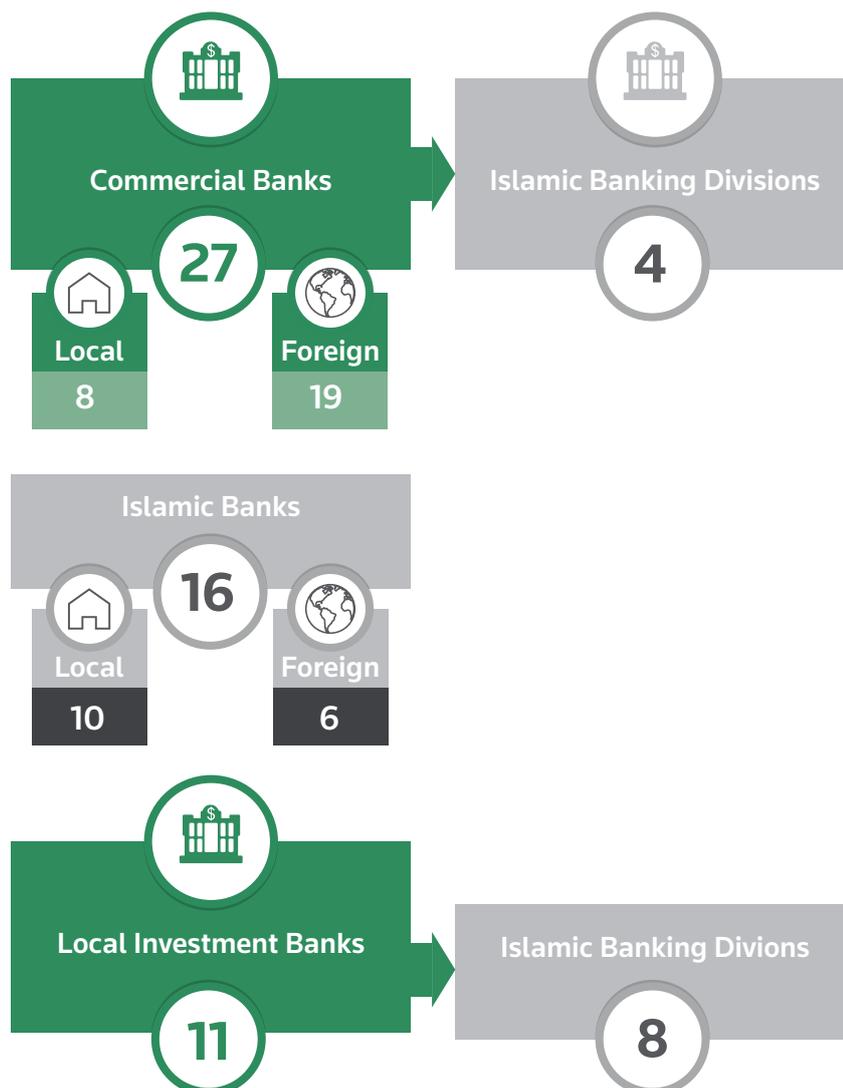
# Banking Sector Landscape And Profile

Malaysia's Islamic banking system is represented by a network of standalone Islamic banks, Islamic subsidiaries of banking groups, and Islamic banking divisions (IBDs). The IBDs are arms of foreign commercial banks incorporated in Malaysia or for Islamic units of investment banks, and such windows represent the desire of these financial institutions to tap and offer products in the Islamic finance market to a growing interested consumer base and pool of international investors. Once the activities of Islamic windows expand through existing branch networks, the banks may consider segregating IBDs

into subsidiaries if the profits of this business line are sustainable and not overstated (i.e. overhead costs are borne by the parent bank).

Well-known international banks such as BNP Paribas and Deutsche Bank chose to dip their toes into the Islamic banking market in Malaysia while HSBC established a fully Shariah-compliant subsidiary and continue operations in Malaysia despite scaling down Islamic operations globally. This chapter explores these different models and presents the progress of IBDs and Islamic banks separately.

## Banking Institutions in Malaysia



Source: Bank Negara Malaysia, BNM Monthly Statistical Bulletin (Except for Islamic Banking Divisions)

## Top 5 commercial banks by assets (For FYE 2013)

### Conventional banks

 <b>Malayan Banking Berhad</b>	 <b>RM397.779 billion (US\$130.078 billion)</b>
<p><b>"Malaysia's Regional Financial Services Leader, serving over 22 million customers"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1960</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 2,200</li> </ul>	
 <b>Public Bank Berhad</b>	 <b>RM252.839 billion (US\$76.718 billion)</b>
<p><b>"A premier banking group in Malaysia, with 47 years of growth"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1966</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 258</li> </ul>	
 <b>CIMB Bank Berhad</b>	 <b>RM234.604 billion (US\$76.718 billion)</b>
<p><b>"Bringing ASEAN to the world, by offering a holistic banking experience and specialised services"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1974</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: Over 1,000</li> </ul>	
 <b>RHB Bank Berhad</b>	 <b>RM145.574 billion (US\$47.604 billion)</b>
<p><b>"The fourth largest fully integrated financial services group in Malaysia"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1997</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 210 conventional &amp; Islamic</li> </ul>	
 <b>Hong Leong Bank Berhad</b>	 <b>RM145.500 billion (US\$47.580 billion)</b>
<p><b>"Hong Leong Bank today has a strong heritage, leading market positions and a well-recognised business franchise and brand"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1968</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 329 local and global</li> </ul>	

### Islamic banks

 <b>Maybank Islamic Berhad</b>	 <b>RM125.057 billion (US\$40.895 billion)</b>
<p><b>"The largest Islamic Banking player in the Asia Pacific region"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 2008</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 16 dedicated branches &amp; co-located at more than 400 Maybank branches</li> </ul>	
 <b>CIMB Islamic Bank Berhad</b>	 <b>RM49.423 billion (US\$16.162 billion)</b>
<p><b>"The global Islamic banking and finance franchise of CIMB Group, ASEAN's leading universal banking franchise"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 2003</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: Co-located with CIMB bank branches nationwide</li> </ul>	
 <b>Bank Islam Malaysia Berhad</b>	 <b>RM42.811 billion (US\$14 billion)</b>
<p><b>"Being the pioneer in the industry, Bank Islam has played a leading role in promoting the expansion of Malaysia's brand of Islamic finance into other markets, especially in the region"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1983</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 133</li> </ul>	
 <b>Public Bank Islamic Berhad</b>	 <b>RM34.473 billion (US\$11.273 billion)</b>
<p><b>"One of the key players in the Islamic banking industry"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 2008</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 256</li> </ul>	
 <b>Bank Muamalat Malaysia Berhad</b>	 <b>RM21.076 billion (US\$16.892 billion)</b>
<p><b>"In line with its vision to become the preferred Islamic financial services provider, the Bank has set distinguished examples in the industry as one of the leading Islamic banks"</b></p> <ul style="list-style-type: none"> <li>• Year of Establishment: 1999</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 64</li> </ul>	

## Exclusive Interview

### Mr. Muzaffar Hisham Chief Executive Officer, Maybank Islamic Berhad



**Muzaffar Hisham** is the Group Head of Islamic Banking and Chief Executive Officer of Maybank Islamic Berhad since 30 March 2011. As the Head of Islamic Banking Group and CEO of Maybank Islamic, Muzaffar plays the leading role for managing and overseeing the overall Islamic banking franchise of Malayan Banking Berhad globally.

**Q:** What are the prospective markets in Asia where Malaysia's expertise in Islamic banking can help lead development of Islamic finance?

**A:** The Malaysian Islamic finance experience provides a case study for other Islamic finance developing countries on the practices that have worked well and otherwise. Some of the key success factors that have been crucial for the development of Islamic finance in Malaysia include the strong vision and support given from the government and central bank, conducive and clear Shariah framework, sound legal and regulatory framework and human capital development

**Q:** Can Malaysian banks help other markets develop money markets along the lines of Islamic Interbank Money Market (IIMM)?

**A:** As the Islamic financial hub, Islamic money market in Malaysia has undergone tremendous development and product innovation due to the changes in regulatory requirements and global demands. This in turn produces a wide range of money market products readily available on-the-shelf to cater towards the demand and requirements from different countries.

Maybank, through its global presence, has launched basic Islamic money market products in various jurisdictions such as London, Hong Kong, Singapore and Malaysia, leveraging on the head-quarter's product template and approval to adapt onto the international platform. We believe that the respective local markets will use these standard products and documentation as the benchmark to facilitate their Islamic treasury operations.

However, there are challenges that need to be acknowledged in this exercise mainly with regards to respective regulatory frameworks, Shariah, legal and tax infrastructure, talent and system infrastructure.

**Q:** Does the large intragroup liquidity position of a bank like Maybank provide it with more liquidity management flexibility in markets that lack a centralised money market like the IIMM?

**A:** Yes. Our balance sheet strength and regional presence allows us to manage liquidity intra-group to ensure competitive and more efficient pricing.

**Q:** What are the most crucial Islamic money market products? USD? Local Currency? Where does commodity murabahah rank in terms of the range of options for relatively less developed markets and would a high quality, local currency sukuk provide better options than CM with conventional banks?

**A:** Commodity Murabahah is still the main product in global Islamic interbank money market and the denomination is not only limited to USD but also the respective local currencies. This product will enable the bank to raise funding without having to be backed by any assets and this is crucial to less developed or non-Islamic countries that want to promote the Islamic financial system in their respective economies. In addition, the benefits to

the depositors is that the product is capital protected and with pre-determined target returns.

Sukuk is a different asset class and it serves different purposes. Commodity Murabahah deposit is mainly to facilitate liquidity management, whereas sukuk is more for investment and trading purposes with the expectation of potential capital gain and stream of income from the scheduled profit payments throughout its tenure, apart from being a fund raising tool to the issuer.

**Q:** What is the state of cross-border liquidity management and how do you think it should develop in the next couple of years?

**A:** Within the Bank, the development of both intra-group and inter-group liquidity management will help for efficient price discovery for funding of cross border deals in return for more efficient pricing/yield.

**Q:** To what degree do you expect the required reclassification of deposit accounts as principal guaranteed or investment accounts raise the funding costs from deposits?

**A:** We expect the reclassification of deposit accounts to investment account to increase the funding costs of liquidity as (i) investors will be expected to be compensated for the additional risks undertaken; and due to (ii) the additional disclosure requirement. This potential higher cost

however will be offset by lower capital charge and lower statutory reserve requirement which will allow the Bank to grow bigger and more profitably.

**Q:** Do you expect most of the depositors to stay in deposit products reclassified as investment accounts, even if they do not have deposit insurance?

**A:** Our role will be to educate and create awareness to customers on this reclassification with greater emphasis placed on product disclosure. Customers will then be able to better appreciate product offerings by the Bank and make informed decisions in respect of the choices of Islamic banking products.

**Q:** Are there conditions where you think the lack of deposit insurance on some retail deposits could create a systemic risk and how is Maybank Islamic expecting to manage having uninsured depositors?

**A:** We do not believe that the lack of insurance on Investment Accounts will create a systemic risk. Rather, we believe that the reclassification will allow the Islamic banking institutions to develop a wider range of products to meet the diverse needs of the customers with varying risk profiles. Furthermore, the strength of Maybank Islamic, a triple-A rated bank with sound risk management practice, will help to sustain the confidence of our customers.

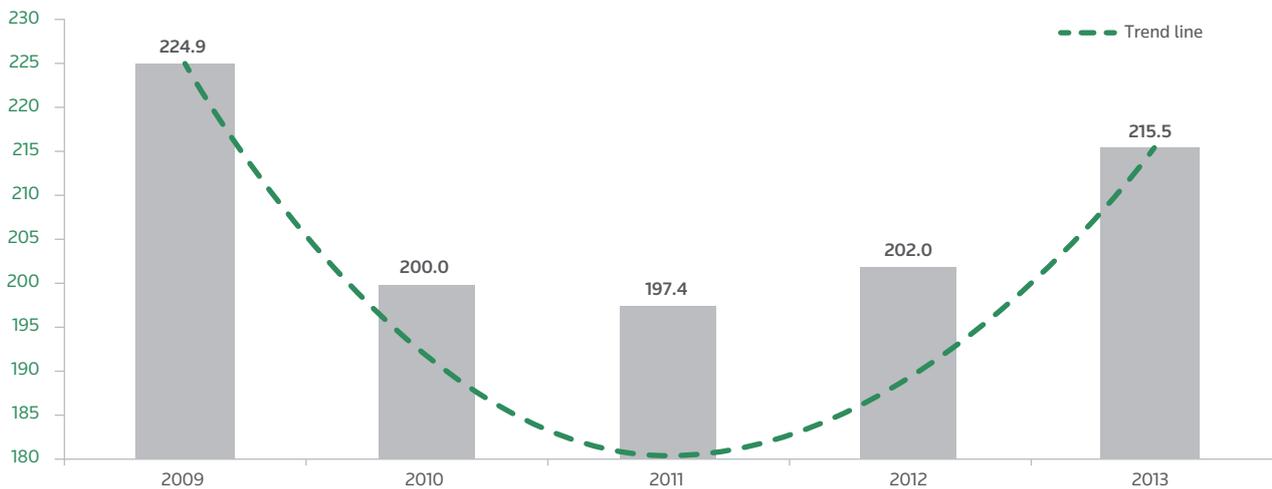
## Sector Size and Growth

**Conventional banking penetration rate is almost 3 times higher than that of Islamic banking.**

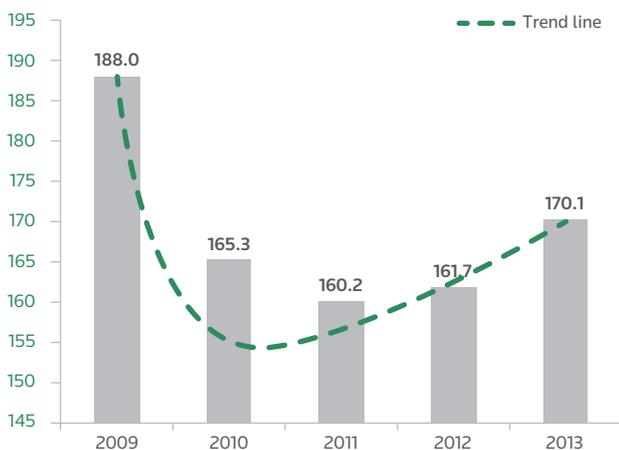
**Malaysia has a very high conventional banking penetration rate; it was 170% in 2013.** This is a 6.25% growth after recovery in 2011 post-global financial crisis. However, the Islamic banking sector lags conventional banking penetration rate by almost 3 times. Post-2008 global financial crisis, the introduction of foreign banking licenses in 2009 and initiatives

under the financial sector blueprint at the end of 2010 have attracted more investors and pushed up banking penetration but there is still a lot of room for growth for both the conventional and Islamic markets. For the Islamic banking sector the introduction of IFSA guidelines in 2013 that introduced stricter Shariah governance and increased consumer protection with new deposit accounts will transform the industry and drive the take-up rate for Islamic banking to a higher level.

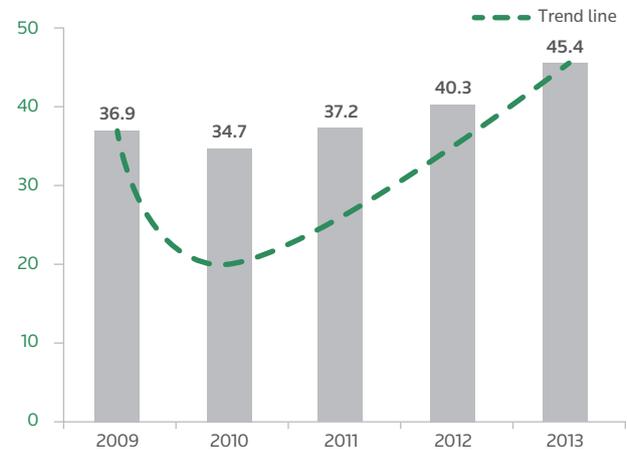
Overall Banking System Penetration in Malaysia (Total Banking assets as % of GDP)



Conventional Banking Penetration in 2013 (Total Banking assets as % of GDP)



Islamic Banking Penetration in 2013 (Total Banking assets as % of GDP)



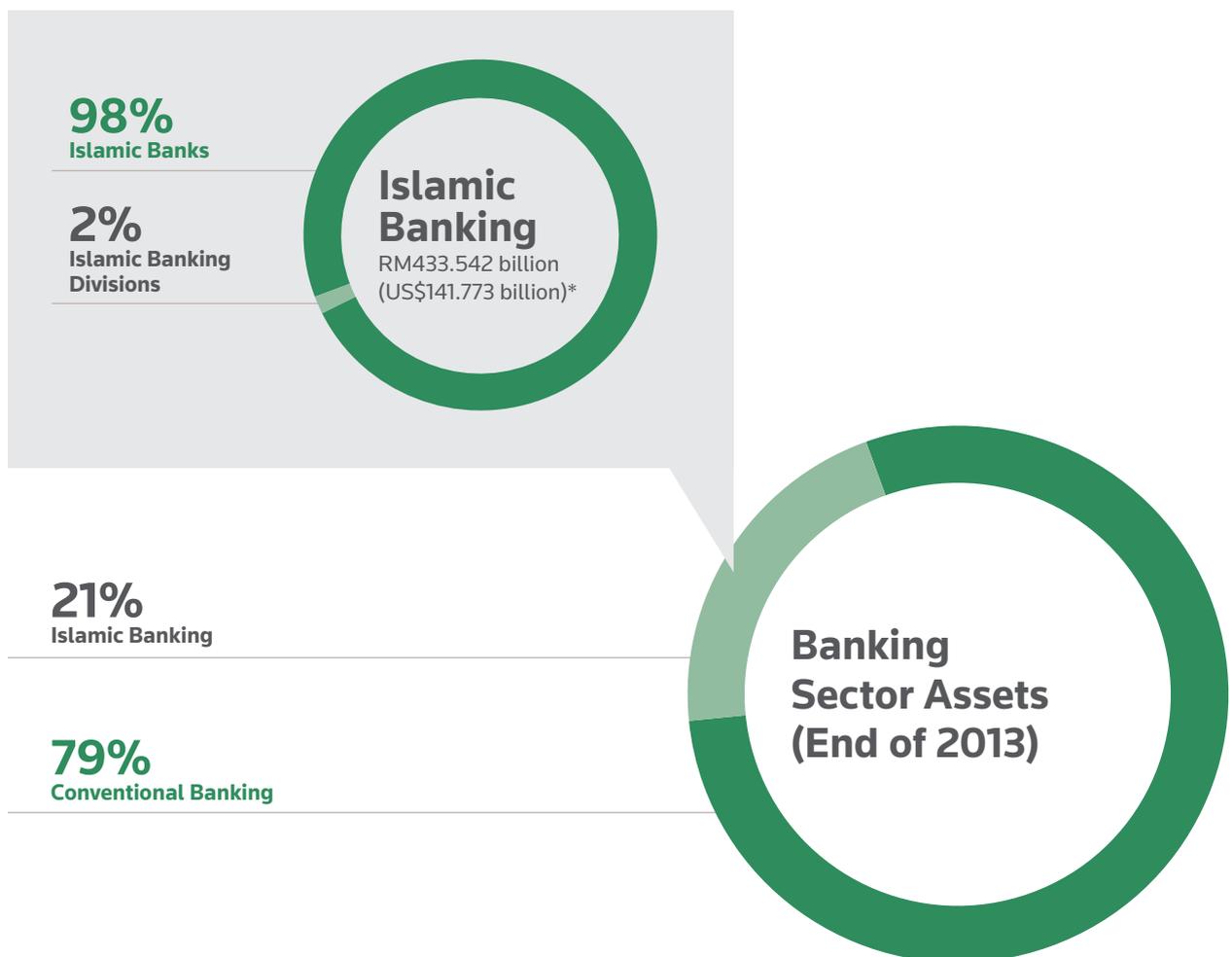
Data source: IMF World Economic Outlook Database (April 2014), BNM Database

**Islamic banking sector contributes 21% to total banking sector assets**

**Conventional banking assets make up 79% of total banking assets.** Of the 21% Shariah-compliant assets, 98% are held in Islamic banks with the remaining 2% from Islamic banking divisions (IBDs). The bigger Islamic banks in Malaysia are subsidiaries of conventional banking groups and not banking

divisions. The Islamic banking sector has seen steady growth in total assets between 2009 and 2014. The government has set the ambitious goal to make Malaysia a high-income country by 2020, and it has implemented a series of reforms to create a financial system that will be able to facilitate and support the transition. The banking system accounts for the lion's share of the activities of financial intermediation.

Banking Sector Assets (End of 2013)



\* Total Assets exclude Development Financial Institutions (DFIs)  
Data source: BNM Database

**Malaysia’s banking sector assets reached RM2.058 trillion (US\$673.074 billion) in 2013.**

Islamic banking assets comprised RM433 billion (US\$141.773 billion) of this total. Islamic banking assets growth YoY as well as CAGR ratios were better than conventional banking and the whole banking system on average.

Both conventional and Islamic banking assets surged from 2010 to 2011 by 30%; this growth could be attributed to the rise in statutory deposits with BNM as a result of increasing Statutory Reserve Requirements (SRR) from 1% which was

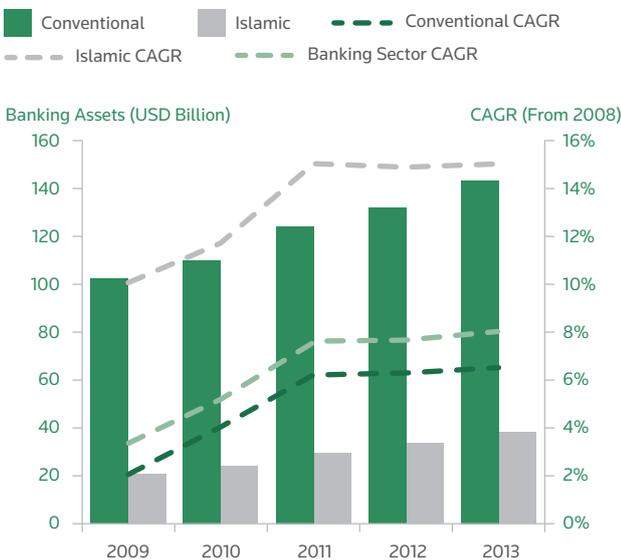
set in 2009 to 4% in 2011.<sup>1</sup> Growth stabilised from 2011 onwards.

Breaking down Shariah assets into Islamic banks and Islamic banking divisions (IBDs), we note that the share of IBDs’ assets relative to the Islamic market has been on the decline over the years despite the entrance of a new conventional bank into the Shariah-compliant banking business (BNP Paribas in 2011).

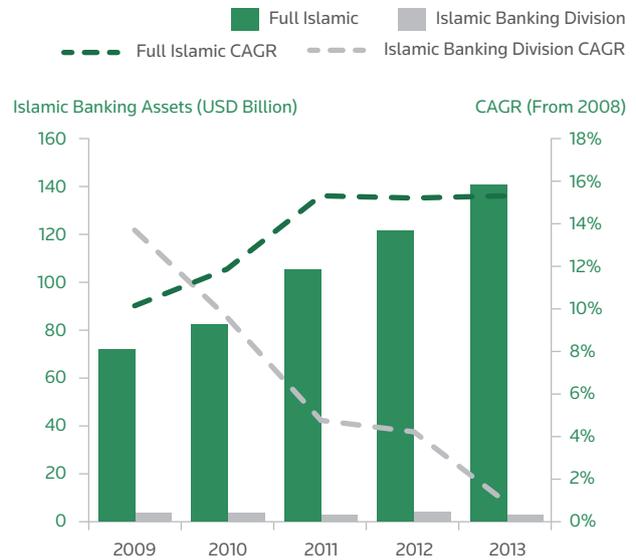
The decline of IBDs is inverse to CAGR of Islamic banks over the years. 2013 was the worst year for IBDs when YoY growth was 14% and CAGR was a very low 0.85%.

<sup>1</sup> Source: BNM guideines

**Islamic banking assets grew 2 times faster than average banking assets growth**



**Compared to Islamic banks; IBDs are facing continuous decline, showing an inverse correlation**



	2013	CONVENTIONAL BANKING	ISLAMIC BANKING
<b>Total Assets</b>		US\$531.301 billion (RM1.625 trillion)	US\$141.773 billion (RM433.542 billion)
<b>YoY</b>		8%	15%
<b>CAGR</b>		6%	15%

Data source: BNM Database

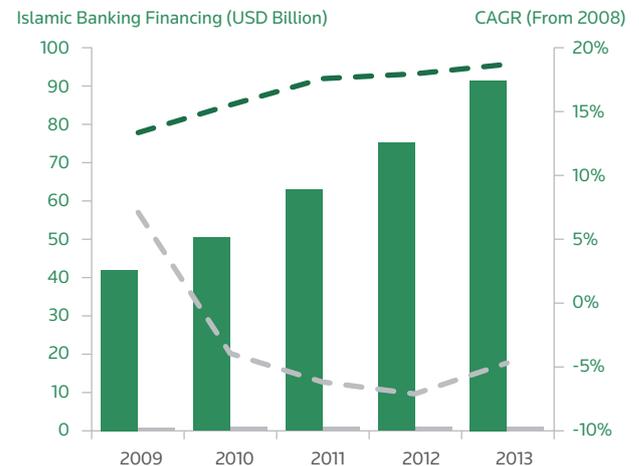
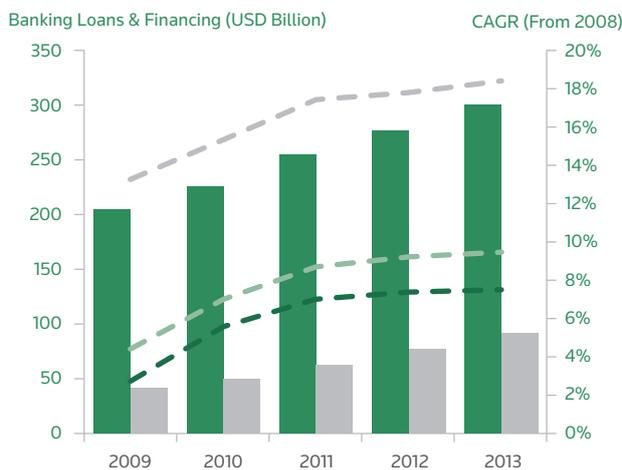
**Islamic modes of financing made up 23% of the banking sector's loans in 2013.** This amounted to RM277 billion (US\$90.873 billion) of total banking sector loans of RM1.194 trillion (US\$390.67 billion).

Growth of Islamic bank financing in 2013 was higher than growth of Islamic banking assets in the same year. The share of financing provided by Islamic banking divisions — approximately 0.2% of all Islamic banking financing in 2013 — is falling to almost negligible levels. Financing provided by IBDs dropped from 2009 to 2012 then saw a slight uptick from 2012 to 2013.

With the introduction of IFSA 2013, deposits will be reclassified into either Islamic deposits accounts (where the principal is guaranteed by Perbadanan Insurans Deposit Malaysia) using wadiah, qard and tawarruq, or non-guaranteed principal investment accounts using mudarabah, musharakah or wakalah. Customers will have to make informed decisions to choose the type of account suitable for their risk profiles. This differentiation of risk appetite affects the liabilities side of a bank's balance sheet and will impact their asset structure.

Islamic banking financing growth rate is higher than the growth of Islamic banking assets in 2013

Islamic banks' financing determine Islamic banking system financing CAGR, IBDs have negligible effect



	2013	CONVENTIONAL BANKING	ISLAMIC BANKING
<b>Total Assets</b>		RM916.839 billion (US\$299.816 billion)	RM277.890 billion (US\$90.873 billion)
<b>YoY</b>		8%	22%
<b>CAGR</b>		8%	18%

Data source: BNM Database

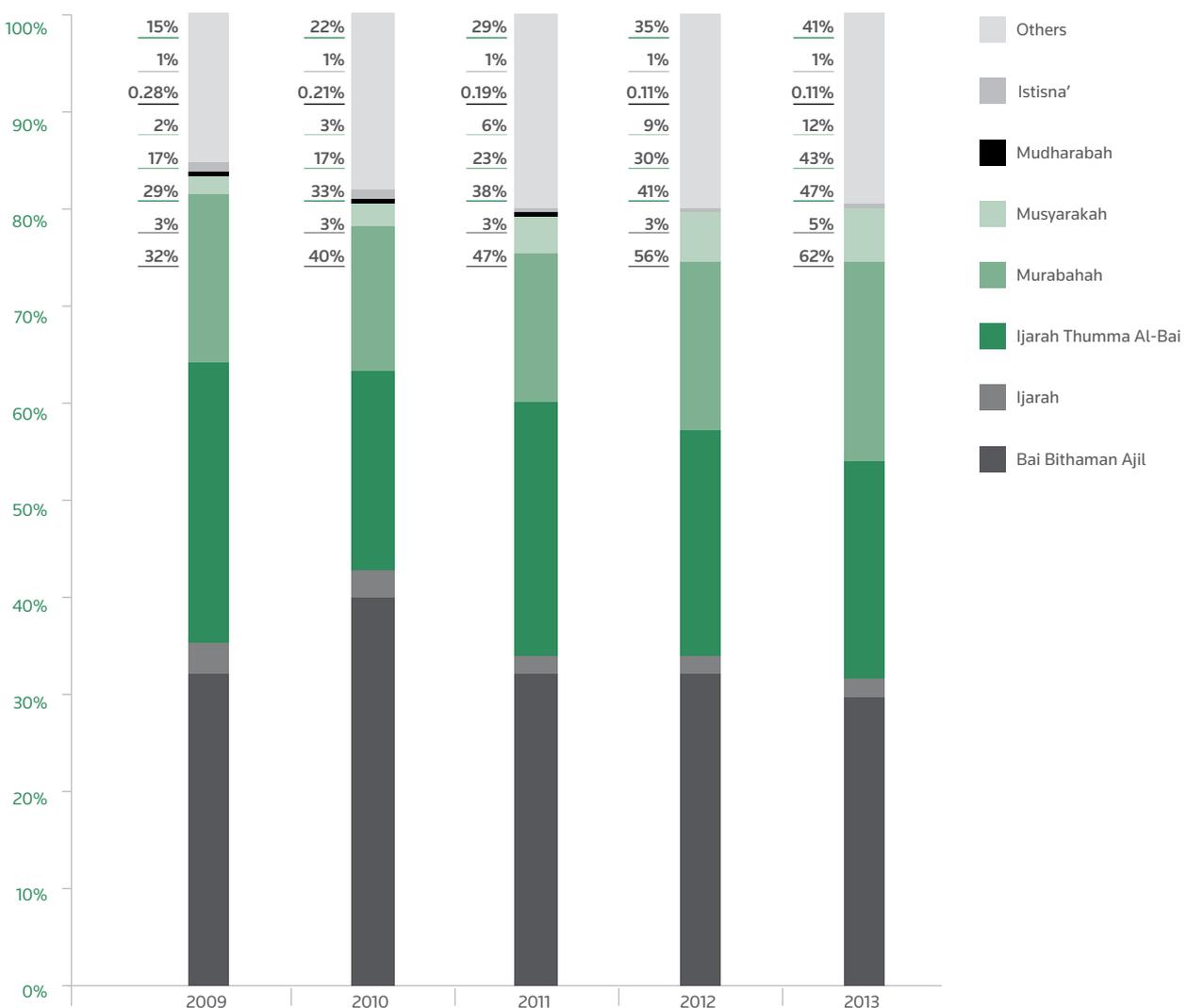
**The total financing provided by Islamic banks reached RM277.46 billion (US\$90.73 billion) in 2013 compared to RM428.2 million (US\$140 million) total financing from Islamic banking divisions (IBDs).** Financing from IBDs represented only 0.2% of total Islamic financing in Malaysia.

Deferred payment contract bai bithaman ajil and the fixed margin murabahah make up half of all financing. This is not peculiar to Malaysia’s Islamic banking sector; in general a sizeable proportion of Islamic banking and financing transactions

globally are based on debt and deferred payment products (although bai bithaman ajil is peculiar to Malaysia).

Breaking down Islamic financing into different contracts used in Islamic banks and IBDs, the numbers show that financing based on musharakah, which is equity-based, makes up a sizeable portion of financing from IBDs but it constitutes a smaller portion of financing from full Islamic banks. On the other hand, mudarabah contracts are the least popular for Islamic banks. Under the new IFSA 2013 guidelines,

Historical Trend of Financing by Type of Contract 2009 - 2013, %



Data source: BNM Database

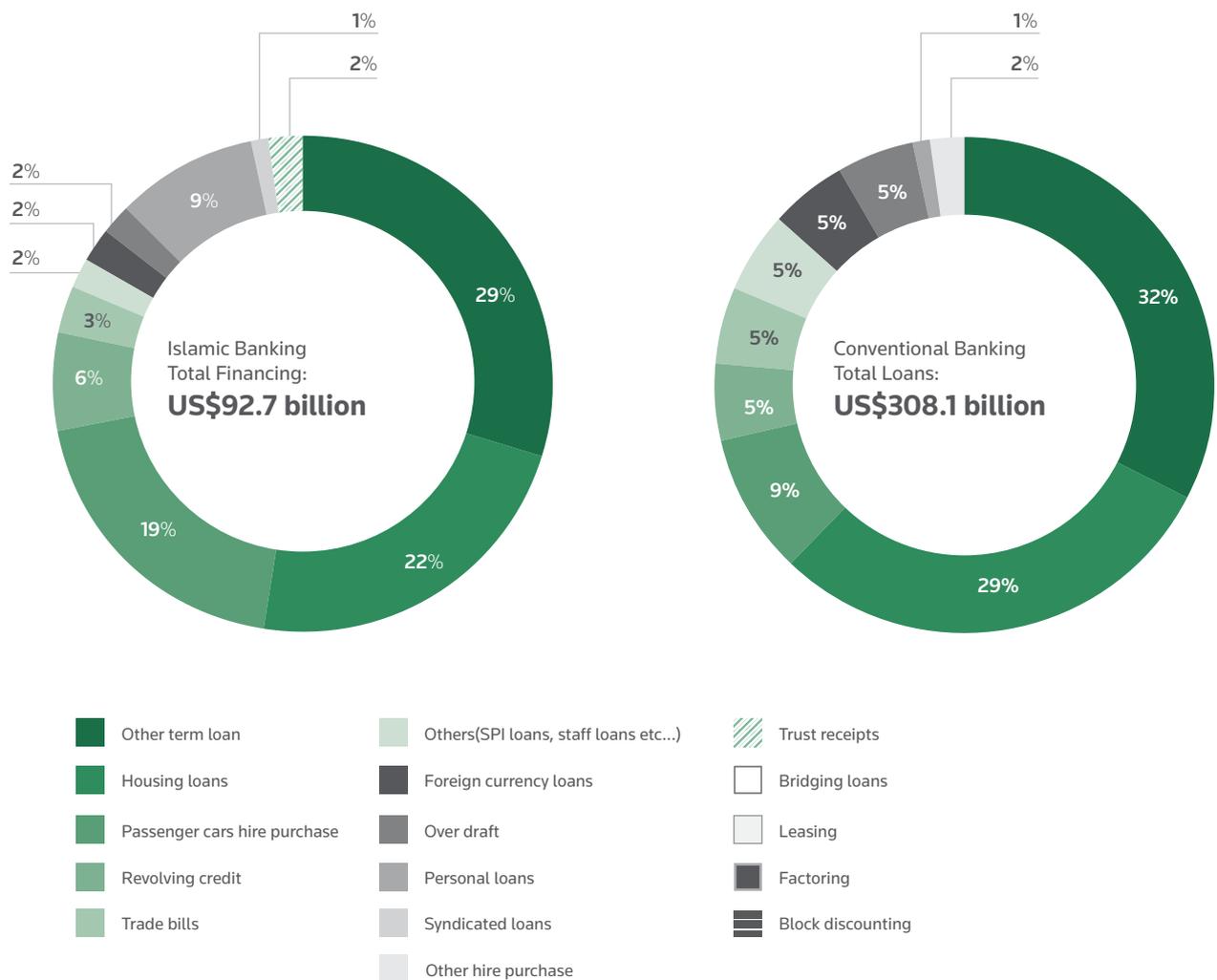
conversion of mudarabah deposits into investment accounts (which are not principal guaranteed) is most likely to make it less popular than the principal guaranteed alternatives.

Islamic divisions lacked ijarah and ijarah thumma al-bai despite it being the second most popular choice for the full Islamic banks.

**Housing loans, passenger cars hire purchase as well as other term loans were the top three types of financing for both conventional and Islamic banks.**

Personal loans are more popular for Islamic banking compared to conventional banking. Housing loans make up the second largest component of Islamic bank financing, which explains ijarah as the second most-used contract for Islamic financing.

### Banking System: Financing By Type



Data source: BNM Database

**Islamic banks in Malaysia have been enjoying a higher percentage growth of deposits compared to CAGR of the overall banking sector.** Growth trends are similar for the Islamic and conventional sectors. YoY and CAGR of Islamic bank financing are higher than Islamic bank deposits, which constitute 23% of the banking system’s deposits in 2013, up from 18% in 2009.

Islamic banking divisions have shown a constant decline over the years, reaching a negative CAGR of 7% in 2013. There was, however, a slight uptick from 2011 to 2012. Deposits into these IBDs made up 0.9% of all Islamic banking deposits in 2013, down from 3.7% in 2009.

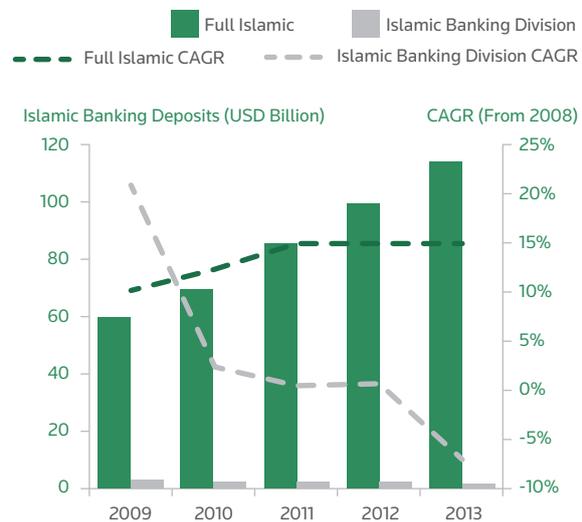
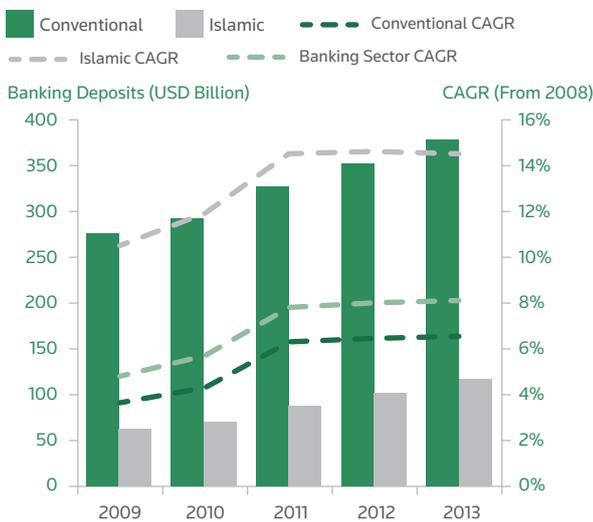
**What will attract more deposits?** The reclassification of deposits as a result of IFSA 2013 will

introduce greater investment avenues which in turn may attract investors and depositors to local Islamic banks. The distinction between deposits and investment accounts will also encourage banks to be innovative with their product offering, which may yield more liquid assets.

IFSA 2013’s emphasis on customer protection (which includes plans for a Financial Ombudsman to handle disputes and complaints), transparency, ethical practices and a higher level of professional conduct for the financial services is aimed at instilling greater public confidence in financial services, and make financial services more inclusive and accessible for all Malaysians. Developments in the next few years will shape Malaysia’s financial landscape for the long-term.

Islamic banking deposits have promising growth momentum

Up to 2013, the Islamic divisions deposits declined over the years, to reach a negative CAGR of 7%



	2013	CONVENTIONAL BANKING	ISLAMIC BANKING
<b>Total Deposits</b>		RM1.148 trillion (US\$375.554 billion)	RM348.947 billion (US\$114.109 billion)
<b>YoY</b>		7%	14%
<b>CAGR</b>		7%	15%

Data source: BNM Database



Malaysia's central bank governor Zeti Akhtar Aziz speaks during a news conference at their headquarters in Kuala Lumpur. REUTERS/Bazuki Muhammad

## Sector Performance

**Higher impaired provisions have driven down Islamic banking profitability**  
**From 2010, the Islamic banking system experienced lower average ROA compared to the whole banking system.** This could be attributed to a higher ratio of impairment provisions to net impaired financing for Islamic banks.

With the reclassification of Islamic banking deposits, Islamic banks are expected to face higher operating costs, at least in the near-term, as well as greater outlay to educate customers on the changes and new offerings. Net profit margins will be affected as the cost of funding will increase due to higher transaction costs as a result of the conversion.

**Basel III and the new capital adequacy requirements BNM has targeted a gradual phase-in of Basel III standards from the beginning of 2013 until 2019.** Higher capital requirements will be implemented gradually beginning 2013 through 2015 and the capital conservation buffer between 2016 and 2019. The reporting of Capital Adequacy Ratios (CAR) changed from Risk Weighted Capital Adequacy Ratio to Total,

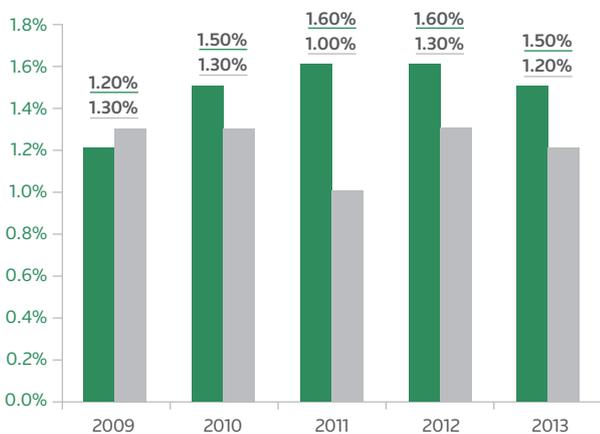
Tier 1 and Common Equity Tier 1 capital ratios from the beginning of 2013.

In Malaysia, conventional banks hold higher CAR than Islamic banks. The total capital ratio for Islamic banks in 2013 was 14.3% compared to a ratio of 14.9% for conventional banks. Most Islamic banks in Malaysia are subsidiaries of conventional banks, and enjoy capital management at the overall Group level. This leads to a lower capital ratio from the reporting subsidiary and higher capital commitment as reported by the parent Group. This framework provides stronger capital backing for the Islamic subsidiary, especially as the parent would not risk any financial or reputational threat to the whole banking group.

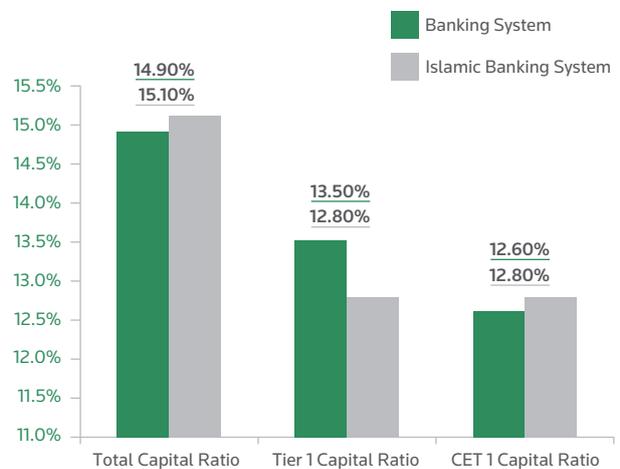
The average total capital ratio was 103.4% for Islamic banking divisions, which drove up the Islamic banking system's ratio.

IFSA's reclassification of deposit ruling affects capital adequacy ratios as it means that if the banks are funding from investment accounts, there will more capital buffer as the risk is transferred to the account holders.

### Return on Asset (ROA)



### Capital Adequacy Ratios for FYE 2013



Data source: BNM Database

Moreover, as a result of Basel III banking standards phasing out globally, many Malaysian Islamic banks are considering or have issued Basel III-compliant Tier 2 Sukuk. Such sukuk was first issued in Malaysia in February 2014 by AmlIslamic Bank in the form of Sukuk Murabahah which was structured to qualify as Basel III-compliant capital instrument under BNM's capital adequacy framework for Islamic banks.

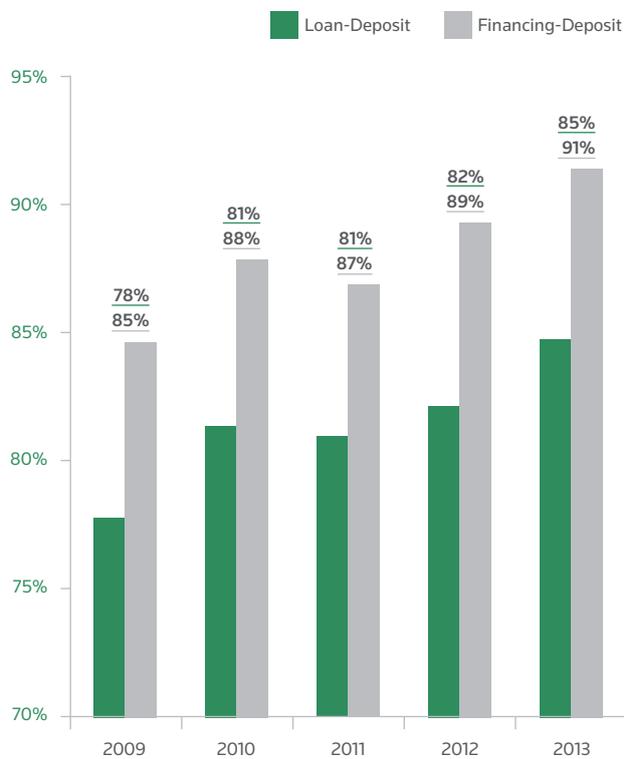
**Islamic banking liquidity situation remains an issue through the new transition policy**

**Over the years, the Islamic banking sector maintained higher financing-to-deposits ratio as compared with the loans-to-deposit ratio in the**

**banking system in general.** The financing-to-deposits ratio reached 91% in 2013. This could be a signal of greater competition in Islamic banking deposits, especially as the sector transitions under new IFSA 2013 rules.

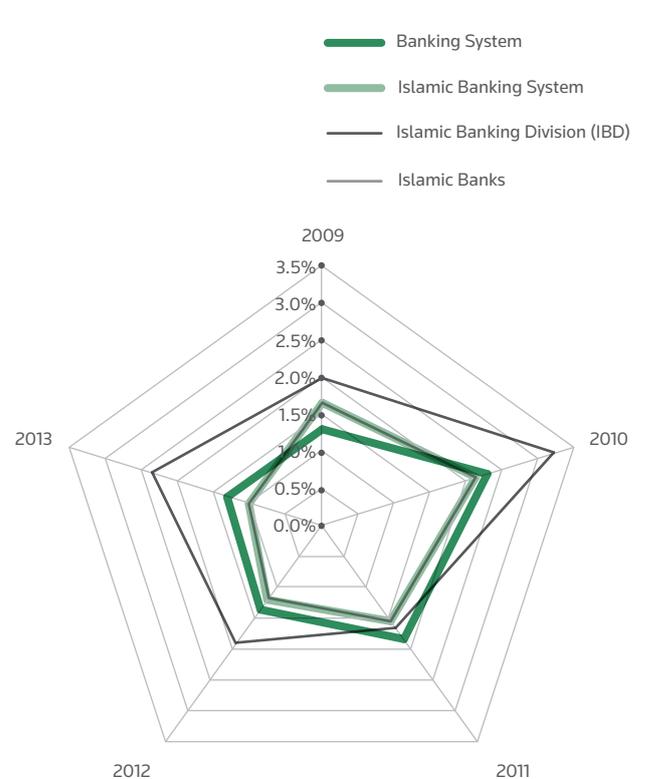
**During 2012 and 2013, the Islamic banking system exhibited lower impairment ratios than the general banking system (which has improved over years) indicating lower risk appetite after the global financial crisis.** Meanwhile, IBDs have higher ratios compared to the banking system and increased from 2011 to 2012. The Islamic divisions' ratios include commercial and investment IBDs.

Liquidity Situation



Data source: BNM Database

Net Impaired Loans/ Financing Ratio



Data source: BNM Database

# Regulations Development

## Achieving aspirations: Financial Sector Blueprint 2011 – 2020

The first Financial Sector Master Plan (FSMP) for the period 2001 – 2010 laid the foundation for the development of the financial industry, starting with the domestic financial infrastructure. The FSMP was followed by a second master plan, the Financial Sector Blueprint for the period 2011 – 2020. This blueprint builds on the objectives achieved under the FSMP to create a financial ecosystem to

support and contribute to the high value-added, high income-Malaysian economy by 2020 and help in meeting the growing financial needs of emerging Asia. The Financial Sector Blueprint 2011-2020 outlines plans to transform the Malaysian financial services sector through a focus on nine key areas that emphasise internationalisation. Some of the recommendations have already been implemented.



Malaysia's Prime Minister Najib Razak addresses the World Islamic Economic Forum in London. REUTERS/Luke MacGregor

## Banking focus areas under the Financial Sector Blueprint 2011-2020

---

### **FOCUS AREA (1) – EFFECTIVE INTERMEDIATION FOR A HIGH VALUE-ADDED, HIGH-INCOME ECONOMY**

#### **Introduce greater operational flexibility for financial institutions subject to appropriate safeguards**

- Gradually remove restrictions for locally-incorporated foreign banking institutions to establish non-branch delivery channels
- Accord greater flexibility for locally-incorporated foreign banking institutions to establish physical branches subject to meeting stipulated criteria
- Allow locally-incorporated foreign banking institutions to conduct hire purchase business

### **FOCUS AREA (2) – DEVELOPMENT OF DEEP AND DYNAMIC FINANCIAL MARKETS**

#### **Promote an efficient and competitive money market with greater depth and liquidity**

- Promote equity-based (including hybrid) instruments and establish a hedging mechanism/platform for Islamic banks

### **FOCUS AREA (3) – GREATER SHARED PROSPERITY THROUGH FINANCIAL INCLUSION**

#### **Adopt innovative channels to enhance the outreach of quality and affordable financial services in a more cost-efficient manner**

- Develop a comprehensive agent banking framework to enable outreach of financial services at lower costs
- Accelerate the roll-out of innovative delivery channels, including mobile banking

### **FOCUS AREA (5) – INTERNATIONALISATION OF ISLAMIC FINANCE**

#### **Increase the diversity of players in the domestic Islamic financial industry to support a wider range of financial products and services that serves the best interest of Malaysia**

- Issue new Islamic banking licences to institutions with specialised expertise
- Expand the business scope of qualified International Islamic Banks

#### **Continue to enhance financial linkages between different jurisdictions**

- Foster and enhance strategic alliances with other jurisdictions
- Encourage greater participation by Islamic banking institutions in offering trade finance facilities
- Encourage Islamic financial institutions to increase international correspondent banking arrangements
- Support and encourage a regional presence of strong Islamic financial institutions
- Leverage on Labuan business structures and institutions to raise funds in multi-currencies

### **FOCUS AREA (6) – SAFEGUARDING THE STABILITY OF THE FINANCIAL SYSTEM**

#### **Enact a comprehensive legislative framework for the conventional and Islamic financial systems respectively. The proposed legislation will reinforce a sound, transparent, and accountable system for effective regulation and supervision that is consolidated across the banking, insurance, takaful, financial intermediary and payment system services sectors**

#### **Implementing prudential standards, risk management and Shariah governance practices**

#### **Implement the Basel III reform package to strengthen the capital and liquidity buffers held by banking institutions**

#### **Strengthen supervisory oversight over financial holding companies**

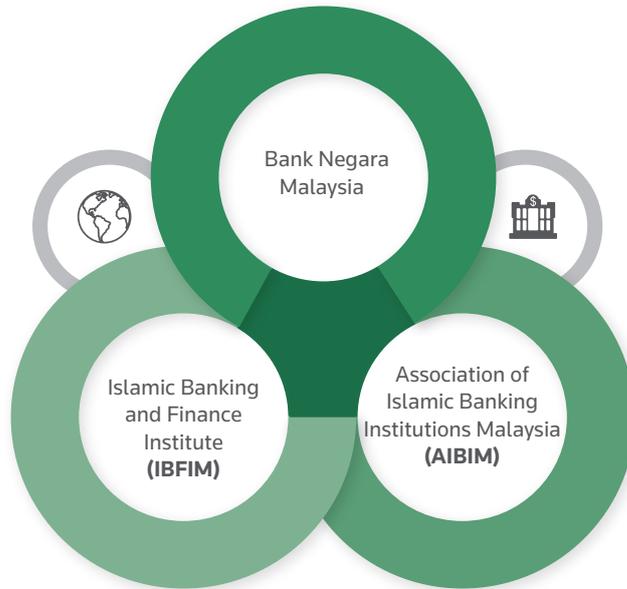
- Introduce formal authorisation of financial holding companies
- Enhance transparency of group structures with appropriate limits on the nature and scope of nonfinancial-related activities
- Strengthen requirements for financial groups to comply with prudential standards
- Enhance powers of the central bank to examine, request information and implement supervisory interventions for financial groups

#### **Strengthen the institutional structure of financial institutions to provide adequate safeguards against contagion risk and excessive leverage**

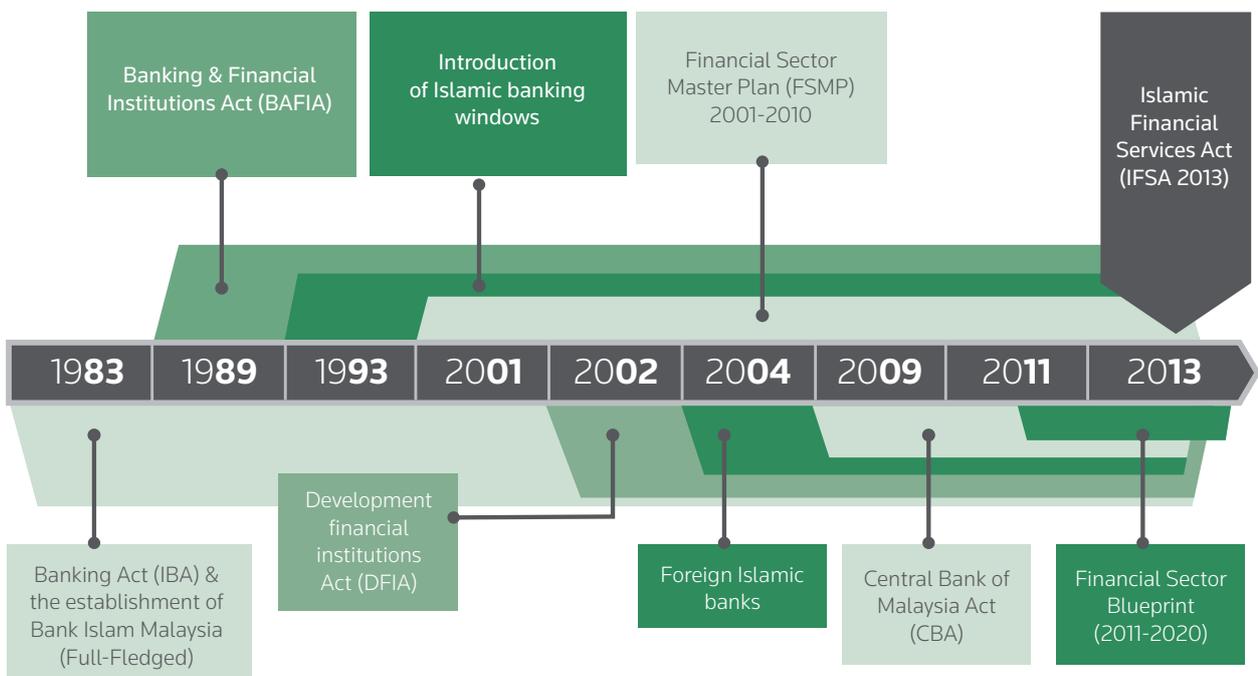
- Enhance safeguards for retail customers of banking institutions against risks associated with increasingly complex activities

**Regulatory framework aligned with omnibus of guidelines**

**(a) The shapers of the Islamic Banking Industry**



**(b) Gradual and pragmatic evolution of Islamic Banking Sector**

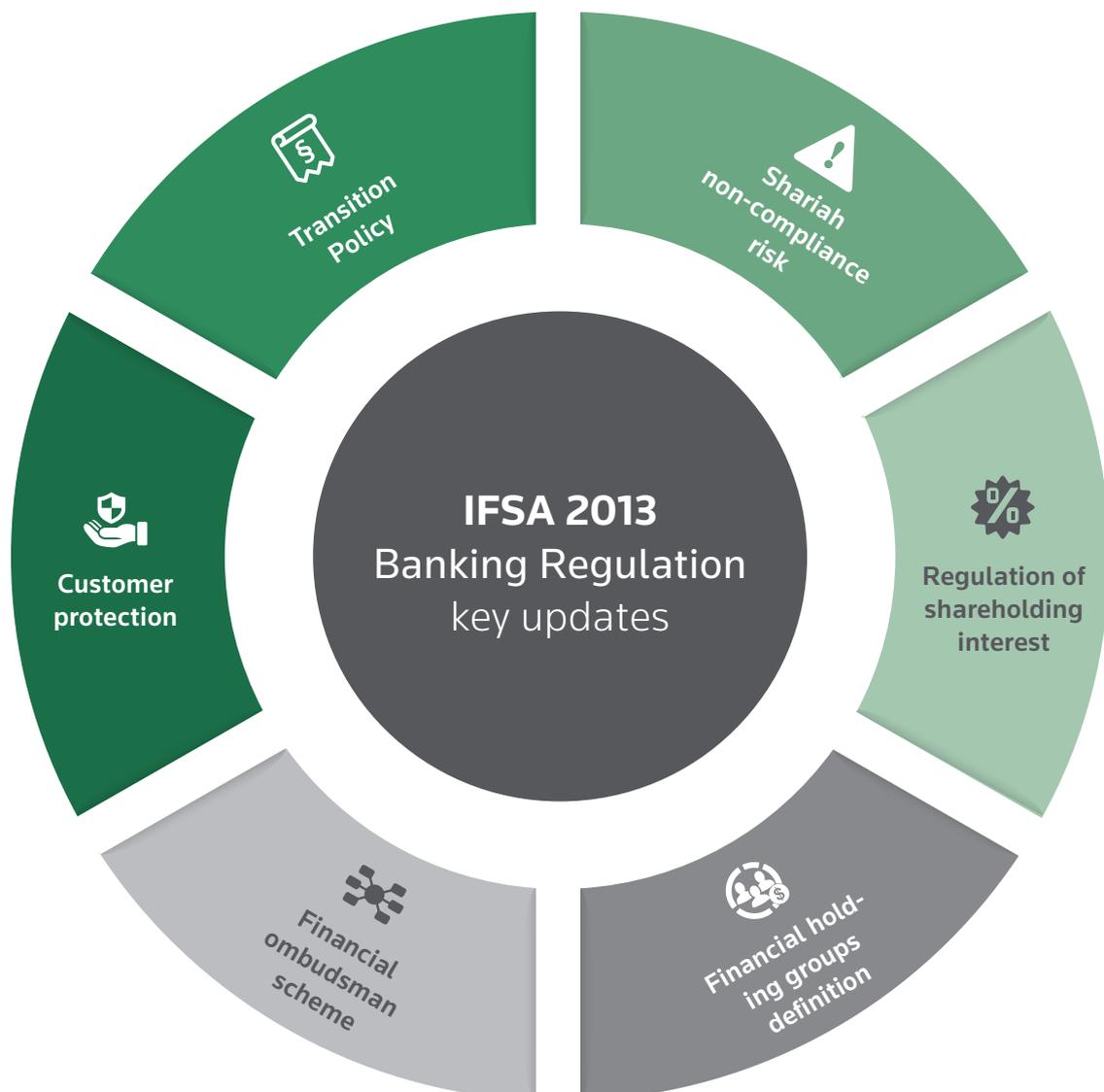


### (c) Legitimacy of Acts

The Islamic banking regulatory framework in Malaysia has undergone gradual changes since the Islamic Banking Act of 1983 led to the establishment of the country's first Islamic bank, Bank Islam. These changes have been designed to strengthen the sector in the face of changing domestic and international environment. Further, as evident in the most recent regulatory changes as embodied in the Islamic Financial Services Act 2013, the changes give the regulator Bank Negara Malaysia greater powers and move Islamic banking forward within a unified framework that will: 1) better serve

Malaysia's transformation into a high-income economy, 2) facilitate internationalisation and 3) develop a 'Shariah-based' practice more closely linked to the real economy. A closer study of the development of these changes and their impacts can be found in the articles contributed by ISRA and ZICO Law.

With Malaysia's changing needs and aspirations (which are detailed in the two financial sector plans 2001-2010 and 2011-2020), the Islamic Banking Act 1983 was repealed by the **Islamic Financial Services Act 2013**, which came into effect in July 2013.



**Guidelines to implementation process: the IFSA outlook**

Several guidelines were introduced in the IFSA 2013, including for Shariah governance and Shariah non-compliance, customer protection, reclassification of deposits and presentation of financial

statements. We look at the first three of these, which we believe have significant impact on Malaysia’s Islamic banking sector and which could influence regulations in other Islamic finance markets.

**POLICY DECISION**

**IMPACT ON THE MARKET**

**Strengthening Shariah governance and managing Shariah non-compliance**

More precise and stricter rules that define the roles and responsibilities of Shariah committee members to ensure stronger Shariah governance and Shariah compliance.

1. Extends power of Shariah committee members beyond Shariah governance to all company matters; these new responsibilities are not limited to only measuring and controlling internal Shariah governance but overseeing matters relating to corporate governance involving the board of directors. These changes are a strong signal of the greater emphasis on Shariah as the basis for the entire Islamic business, and a move towards a more ‘Shariah-based’ practice in Islamic banking in Malaysia, a point underpinning the way forward as mapped out in the Financial Sector Blueprint 2.
2. Widens the scope of governance by defining the fit-and-proper requirements for Shariah scholars and the compliance of the bank’s transactions to Shariah principles.
3. A significant new guideline is the one that makes Shariah committee members legally accountable for Islamic banking products and any breach in Islamic banking transactions. In the case of non-compliance a penalty clause demands imprisonment not exceeding eight years or a fine not exceeding RM25 million (\$7.5 million), or both.

**Paradigm shift:**

- Making legally accountable Shariah committee members who sign off on Islamic banking products and transactions will shift the market to a new level of confidence in the Islamic financial system. This is an unprecedented move and Islamic financial institutions and Shariah committee members would need more training and awareness to ensure adherence to this new regulation.
- Creating innovative market in terms of product development that is 100% authentic. This feeds into the movement away from simply copying conventional products towards innovating Shariah-based products and services.
- We foresee the global Shariah governance level to be influenced by these changes made in Malaysia. The conscientiousness of Shariah scholars and other Shariah committee members would be increased and the scholar who sits on Shariah committees of Malaysian institutions as well as those of IFIs abroad will diffuse their experience and different level of expertise globally.

**Impact on cost:**

- Higher operational cost by Islamic banks, as the new legislation will raise the standard of advice and level of services dispensed by Shariah experts.

**A more powerful central bank:**

- The enforcement of the penalty clause by Bank Negara Malaysia emphasises the power of the central bank as the seat of control in the financial sector, specifically over Islamic banks and takaful companies.

**Customer protection**

IFSA 2013 ushers in a new definition of the “financial consumer” in banking transactions in general to ensure that a financial service provider is fair, responsible and professional when dealing with financial consumers.

1. Plans for a financial ombudsman (for the overall financial system) have been formulated and as of this writing are being reviewed by financial industry stakeholders. The aim is to have the ombudsman up and running in the second half of 2015.

**Strengthening role of Islamic banks as financial intermediaries:**

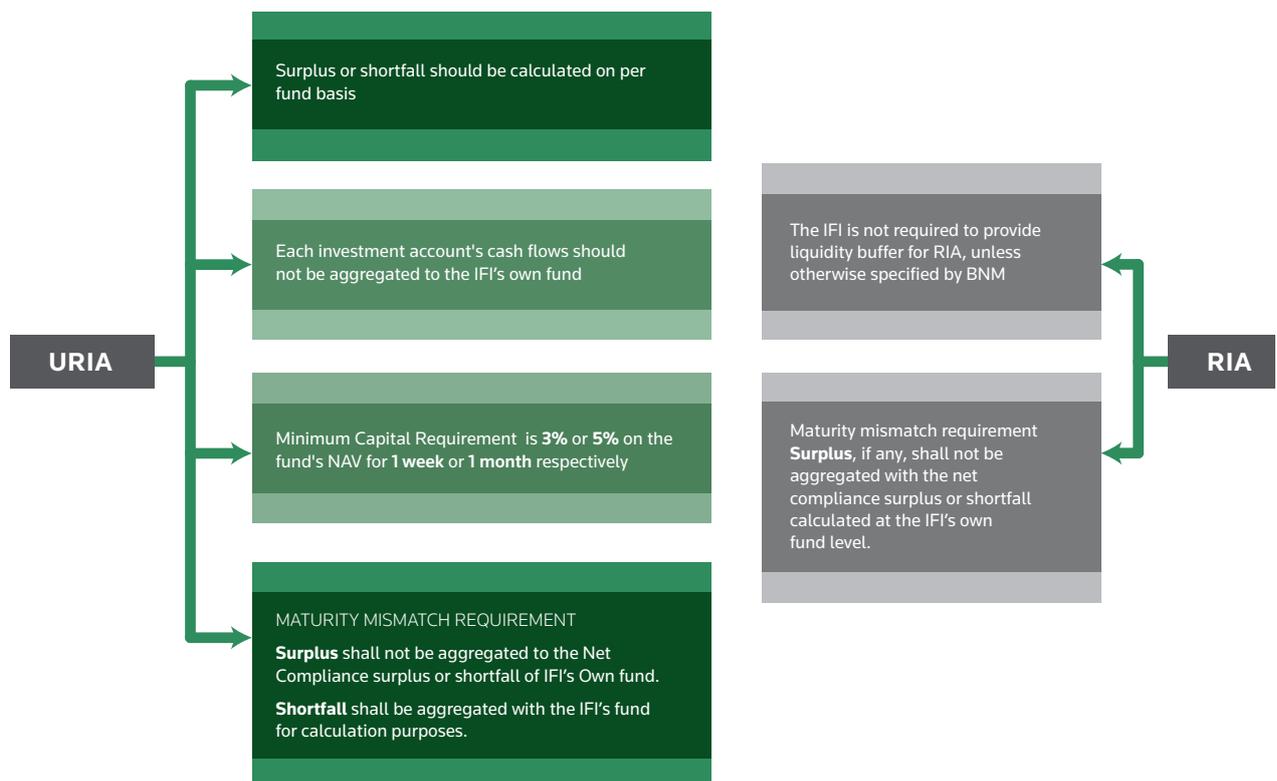
- These changes will prevent deceptive and aggressive practices by bank employees.
- Could help increase banking profitability generated by greater sales due to greater consumer confidence.

**More transparent system with clear rights and responsibilities for consumers and Islamic banks:**

- As it is mandatory by law under the power of the central bank, consumer rights are privileged and protected.
- Consumers will have easier access and recourse to a financial ombudsman that aims for an “effective and fair handling of complaints.”
- Healthier relationships between consumers and IFIs.

Transition policy of Islamic deposits	
<p>Under the IFSA 2013, Islamic banks are obliged to reclassify Islamic deposits — as defined in the IBA — as Islamic deposits and investment accounts within a term of two years (30 June 2013 – June 2015).</p> <ol style="list-style-type: none"> <li>1. Clarification of the differences between both products must be provided to consumers with the option of either retaining the Islamic deposit account or migrating to the investment account during the transition period until June 2015.</li> <li>2. All Islamic deposits (accepted under IBA) will continue to be covered by Perbadanan Insurans Deposit Malaysia during the transition period.</li> <li>3. After the transition, investment accounts will be evaluated by the performance of the underlying assets (via risk sharing products) that support them. Therefore, the accounts would neither be guaranteed nor protected by Perbadanan Insurans Deposit Malaysia.</li> </ol> <p><u>The investment accounts will opt into a liquidity framework as defined by BNM in investment account guidelines — section 30.</u></p>	<p><b>Paradigm shift, competition and differentiation from conventional banking:</b></p> <ul style="list-style-type: none"> <li>• The reclassification forces a paradigm shift in Islamic banking in Malaysia. Products that will be introduced as a result of the reclassification will be differentiated from conventional deposit products and further strengthen the Shariah base of banking. This could be the start of product innovation that will initiate a diversified environment with better rate of returns to both consumers and institutions.</li> <li>• New shape of balance sheet, as this law will allow Islamic banks to manage their future capital requirements to better comply with Basel III.</li> <li>• The reclassification will create a competitive market by offering consumers a wider range of products. This could work in favour of Islamic banks.</li> <li>• The new enhancement will attract more investment opportunities in the financial sector in Malaysia.</li> </ul> <p><b>Costs to Islamic banks:</b></p> <ul style="list-style-type: none"> <li>• As of this writing it is still too early to assess if there will be an outflow of deposit funds from Islamic banks to conventional banks if consumers choose not to take on the risks attached to investment accounts which will not be backed by deposit insurance.</li> <li>• The reclassification of deposit accounts as principal guaranteed or investment accounts could raise the funding costs from deposits.</li> </ul>

### The Liquidity Framework as mandated for the investment accounts by IFSA 2013





## Leadership Article



**By Madzlan Hussain, Partner and Head, Islamic Financial Services Practice, Zaid Ibrahim & Co.**

Madzlan Mohamad Hussain is a Partner and Head of the Islamic Financial Services Practice Group for Zaid Ibrahim & Co. Mr. Madzlan holds an MSc. in Islamic economics, banking and finance from Loughborough University, UK.

### Malaysia's IFSA: Gaps to be addressed by Islamic Financial Institutions

Compared to the repealed Islamic Banking Act 1983 and Takaful Act 1984 (collectively; the “**Repealed Laws**”) which have served the Islamic finance industry in Malaysia for the past three decades, the Islamic Financial Services Act 2013 (IFSA) which came into force in June 2013 has certainly raised the levels of compliance expected from Islamic financial institutions (IFIs) especially amongst Islamic banks and takaful operators.

Besides notably increasing the overall penalties for offences by multiple folds, the IFSA is also much more extensive than the Repealed Laws when it provides for, among others:

- control and oversight over financial holding companies (FHC);
- stricter requirements governing corporate governance, Shariah governance, business conduct and consumer protection, including detailing out the statutory duties of the FHC, the chairman of the board, the Shariah Committee and the CEO;
- enhanced powers of intervention of the central bank, Bank Negara Malaysia (BNM);
- applying the concept of ‘consumer takaful contracts’ which makes it more difficult for takaful operators to cancel takaful

---

*IFIs should acknowledge immediately that their compliance, internal audit and Shariah secretariat teams may naturally need additional enforcement in terms of human capital, as the compliance, audit and Shariah governance framework all need to be more robust under the IFSA.*

---

certificates notwithstanding misrepresentation by customers;

- imposing separation of general takaful and family takaful licences and businesses within the next five years (i.e. by 2018); and
- differentiating the regulatory treatment between Islamic deposits (which is principal guaranteed) and investment accounts (which are not principal guaranteed) — despite the two having been treated as “deposits” generally for regulatory purpose throughout the past three decades of Islamic banking in Malaysia.

In this respect, IFIs will need to invest more in terms of time, money and human capital development to ensure that their infrastructure (both in the forms of hardware and software) is adequate to meet the more rigorous governance and prudential requirements imposed under the IFSA. The writer notes that several IFIs have taken the right approach towards ensuring that they have properly identified and mapped out the gaps between their current compliance level (which presumably would have been adequate to comply with the requirements of the Repealed Laws) and the new compliance level (which are only imposed under the IFSA) by undertaking their own gaps analysis exercise along the lines of audit or due diligence exercise, whether internally or externally using the service of consultants. IFIs which have yet to undertake such gap analysis or review face the real risks of finding that their compliance level may be insufficient to comply with the IFSA, by which time it may be too late and they might already have committed an offence thereunder.

For illustration, it is submitted that a proper gap analysis exercise would be able to help IFIs, among others, to:

- test and confirm the readiness of their FHCs to comply with the IFSA, as previously the Repealed Laws did not govern the FHC as comprehensively as the IFSA does today. For instance, the fit-and-proper test for board members and CEO (which previously was only applicable to the IFIs) are now also applicable to the board members and CEO of the FHCs and failure to comply would be a serious offence;
- ensure full understanding of the statutory duties of the board, the Shariah Committee and the senior management in relation to Shariah governance, which have become more stringent as illustrated by the IFSA's requirements for IFIs to report to BNM within 30 days whenever a breach of Shariah compliance is identified. It is only through proper briefings of these IFSA requirements would the board member, for example, be able to fully understand that Shariah governance is also their duty and not just the Shariah Committee's. Such realisation would also help the IFIs to address, among others, acute talent gaps (for instance, in having competent and well-qualified Shariah auditors, Shariah reviewers and Shariah researchers, which previously may have been taken for granted as IFIs continue to rely heavily only on the Shariah Committees);
- mitigate and manage contractual gaps in 'consumer takaful contracts', whereby takaful operators must appreciate that since statutorily it would be more difficult to cancel takaful

certificates notwithstanding misrepresentation by customers; better fraud investigation capabilities may need to be developed and put in place;

- assess the takaful operators' capacity and ability to run general takaful and family takaful business via separate licences and separate legal entity;
- properly restructure Islamic deposits and investment accounts contracts and disclosure mechanisms, as the two have now become clearly distinguished. This would also bring about have wider implications to the IFIs' capital adequacy framework, fund mobilisation, leverage model, etc. BNM's new Policy Document on Investment Account which was issued in March 2014 introduces, among others, various disclosure requirements on investment account products which previously have never been a requirement during the first 30 years of Islamic banking in Malaysia.

IFIs should acknowledge immediately that their compliance, internal audit and Shariah secretariat teams may naturally need additional enforcement in terms of human capital, as the compliance, audit and Shariah governance framework all need to be more robust under the IFSA. The generally heavier statutory responsibilities and liabilities of the board of directors, Shariah Committee members, CEO and senior officers of IFIs may require their remuneration schemes to be revised to reflect the proper reward system. It cannot be ignored that the 'war for talents' may intensify as every IFI would want higher qualified and competent personnel to minimise risks of non-compliance.

The anticipated higher costs of compliance and operations may force some IFIs to seriously consider ways to rationalise their business model and structures, especially takaful operators which will need to separate their general takaful and family takaful business in the next five years.





Locals from Sabah wave Malaysian flags during the Malaysia Day celebrations marking Sabah's entry into Malaysia, in Kota Kinabalu. REUTERS/Bazuki Muhammad



## Basel III for Islamic banks in Malaysia

### Phase-in arrangements

	2012	2013	2014	2015	2016	2017	2018	2019
<b>Leverage Ratio</b>	Observation period reporting				Standard in force			
<b>Minimum common equity capital ratio</b>		3.5%	4%	4.5%	4.5%	4.5%	4.5%	4.5%
<b>Capital conservation buffer</b>					0.625%	1.25%	1.875%	2.5%
<b>Minimum common equity plus conservation buffer</b>		3.5%	4%	4.5%	5.125%	5.75%	6.375%	7%
<b>Minimum tier 1 capital</b>		4.5%	5.5%	6%	6%	6%	6%	6%
<b>Minimum tier 1 capital plus conservation buffer</b>		4.5%	5.5%	6%	6.625%	7.25%	7.875%	8.5%
<b>Minimum total capital</b>		8%	8%	8%	8%	8%	8%	8%
<b>Minimum total capital plus conservation buffer</b>		8%	8%	8%	8.625%	9.25%	9.875%	10.5%
<b>Capital instruments that no longer qualify as non-core tier 1 or tier capital</b>					Phased out over a 10-year horizon beginning 2013			
<b>Liquidity Coverage Ratio</b>	Observation period reporting				Standard in force			
<b>Net Stable Funding Ratio</b>	Observation period reporting				Standard in force			

### New Capital Requirements under Basel III against Basel II standard underpinning Capital Adequacy Framework for Islamic banks

	COMMON EQUITY TIER 1 CAPITAL RATIO	CORE CAPITAL RATIO (CCR)	RISK-WEIGHTED CAPITAL RATIO (RWCR)
<b>Basel III</b>			
<b>Minimum</b>	4.5%	6%	8%
<b>Conservation buffer</b>	+2.5%		
<b>Minimum plus conservation buffer</b>	7%	8.5%	10.5%
<b>Basel II</b>			
<b>Minimum</b>	2%	4%	8%

Source: Bank Negara Malaysia





## 05

# INSURANCE AND TAKAFUL SECTOR DEVELOPMENT AND RECENT ACTIVITY

---

## INSURANCE AND TAKAFUL SECTOR LANDSCAPE AND PROFILE

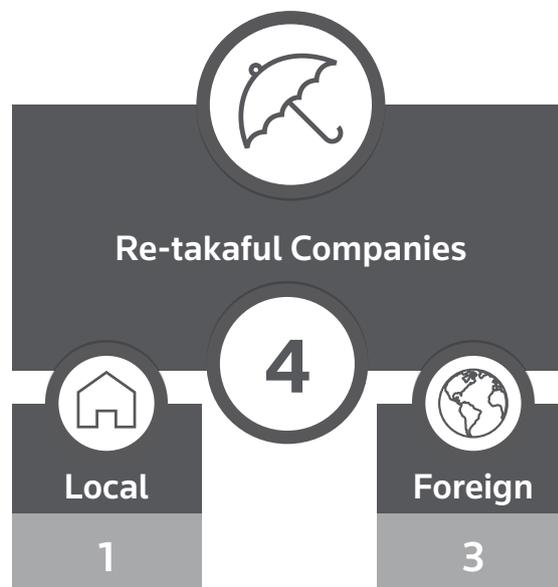
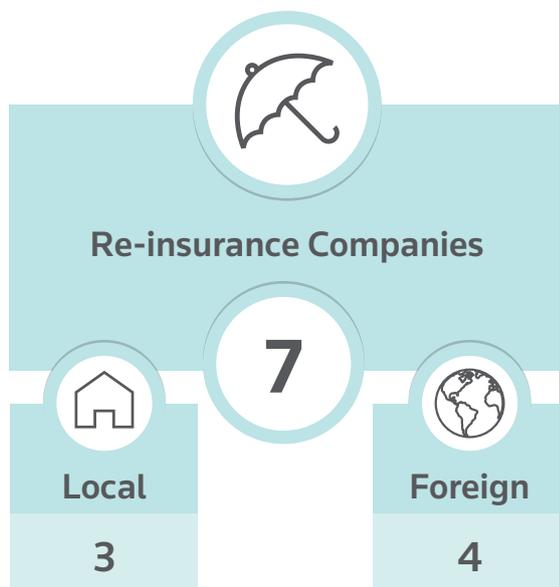
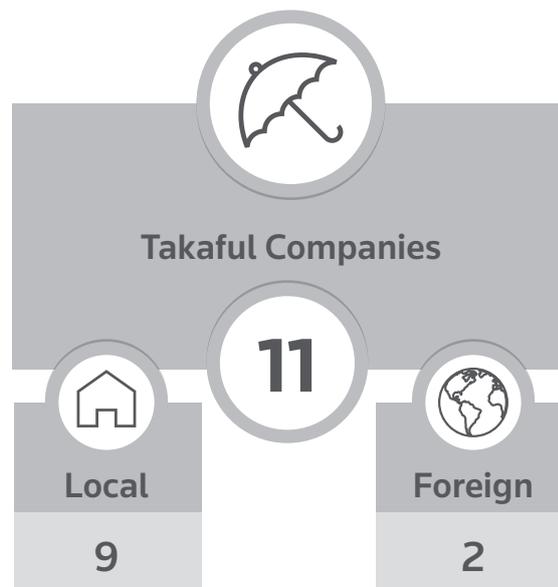
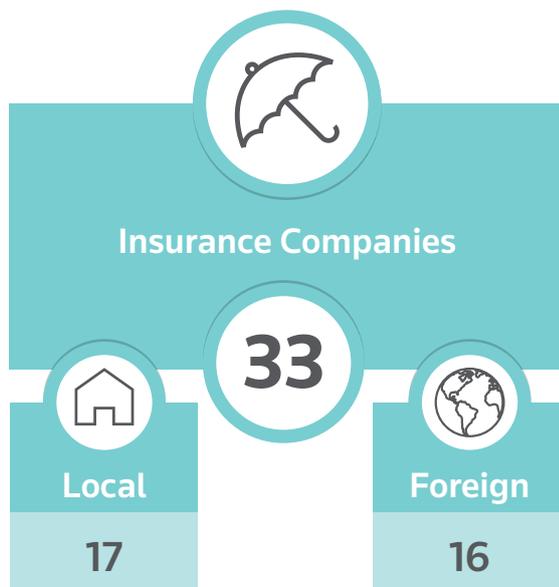
- 173 Top 5 sector players by assets (latest FYE)
- 175 Sector Size and Growth
- 183 Sector Performance
- 185 Future Outlook

## REGULATIONS DEVELOPMENT

- 186 The way ahead for the takaful industry
- 190 Regulatory framework aligned with omnibus of guidelines
- 191 2013 was a seminal year for takaful regulatory development

# Insurance And Takaful Sector Landscape And Profile

Insurance Institutions in Malaysia



Source: Bank Negara Malaysia, List of Registered Institutions

## Top 5 sector players by assets (For FYE 2013)

### Insurance Companies

 Great Eastern Life Assurance (Malaysia) Berhad	 RM63.465 billion (US\$20.753 billion)
<b>"Oldest and Largest Life Insurer in Malaysia"</b>	
<ul style="list-style-type: none"> <li>• Segment: Life insurer</li> <li>• Year of Establishment: 1908</li> <li>• Ownership Type: Foreign</li> <li>• Number of Branches: 21</li> </ul>	
 AIA Berhad	 RM42.361 billion (US\$13.852 billion)
<b>"Strong Asian roots provide AIA with the experience, in-depth understanding of local markets and trends as well as regional connections to serve customers' needs for the future"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 1948</li> <li>• Ownership Type: Foreign</li> <li>• Number of Branches: 41</li> </ul>	
 Prudential Assurance Malaysia Berhad	 RM20.785 billion (US\$6.797 billion)
<b>"Prudential has a long history in Asia, having maintained a presence in the region for over eighty years"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 1924</li> <li>• Ownership Type: Foreign</li> <li>• Number of Branches: 44</li> </ul>	
 Etiqa insurance Berhad	 RM16.279 billion (US\$5.323 billion)
<b>"Etiqa's rock solid financial standing puts it in good stead to become the No.1 insurer in Malaysia"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 2005</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 35</li> </ul>	
 Hong Leong Assurance Berhad	 RM10.144 billion (US\$3.317 billion)
<b>"Commitment to the customer is the key to HLA's success"</b>	
<ul style="list-style-type: none"> <li>• Segment: Life insurer</li> <li>• Year of Establishment: 1982</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 22</li> </ul>	

### Takaful

 Etiqa Takaful Berhad	 RM11.191 billion (US\$3.659 billion)
<b>"Etiqa is already in pole position for the Takaful businesses"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 2005</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 35</li> </ul>	
 Syarikat Takaful Malaysia Berhad	 RM6.924 billion (US\$2.264 billion)
<b>"Takaful Malaysia is proud to be the first Takaful operator in the local insurance industry"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 1984</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 29</li> </ul>	
 Takaful Ikhlas Sendirian Berhad	 RM2.580 billion (US\$843 million)
<b>"Takaful IKHLAS has established a strong presence in the provision of Islamic financial protection services based on the takaful system"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 2002</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 13 regional offices</li> </ul>	
 Prudential BSN Takaful Berhad	 RM1.418 billion (US\$464 million)
<b>"PruBSN is a leader in providing innovative and dynamic Takaful solutions within the Takaful industry in Malaysia"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 2006</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 8</li> </ul>	
 HSBC Amanah Takaful (Malaysia) Sendirian Berhad	 RM970 million (US\$317 million)
<b>"In developing and offering Takaful solutions to Malaysian consumers, we will leverage on the Group's international experience and expertise in Islamic Finance"</b>	
<ul style="list-style-type: none"> <li>• Segment: Composite insurer</li> <li>• Year of Establishment: 2006</li> <li>• Ownership Type: Local</li> <li>• Number of Branches: 26</li> </ul>	

The Malaysian Insurance and Takaful industry is going through important changes with the introduction of new regulations and interesting proposals being mooted by the Bank Negara Malaysia (BNM) with a view to boost the industry and lay the grounds for more competitive, transparent and diversified product offerings.

Just like the BNM did for the Islamic Banking sector, it is now looking to further enhance and develop the capabilities of the takaful sector to boost its growth rate and maintain Malaysia’s position as a global leader in takaful. In the ASEAN region, Malaysia commands over 70% of the share of takaful contributions. Within Malaysia, over 75% of the market share is that of family takaful with operators looking aggressively into general takaful segments.

### Takaful Industry Evolution

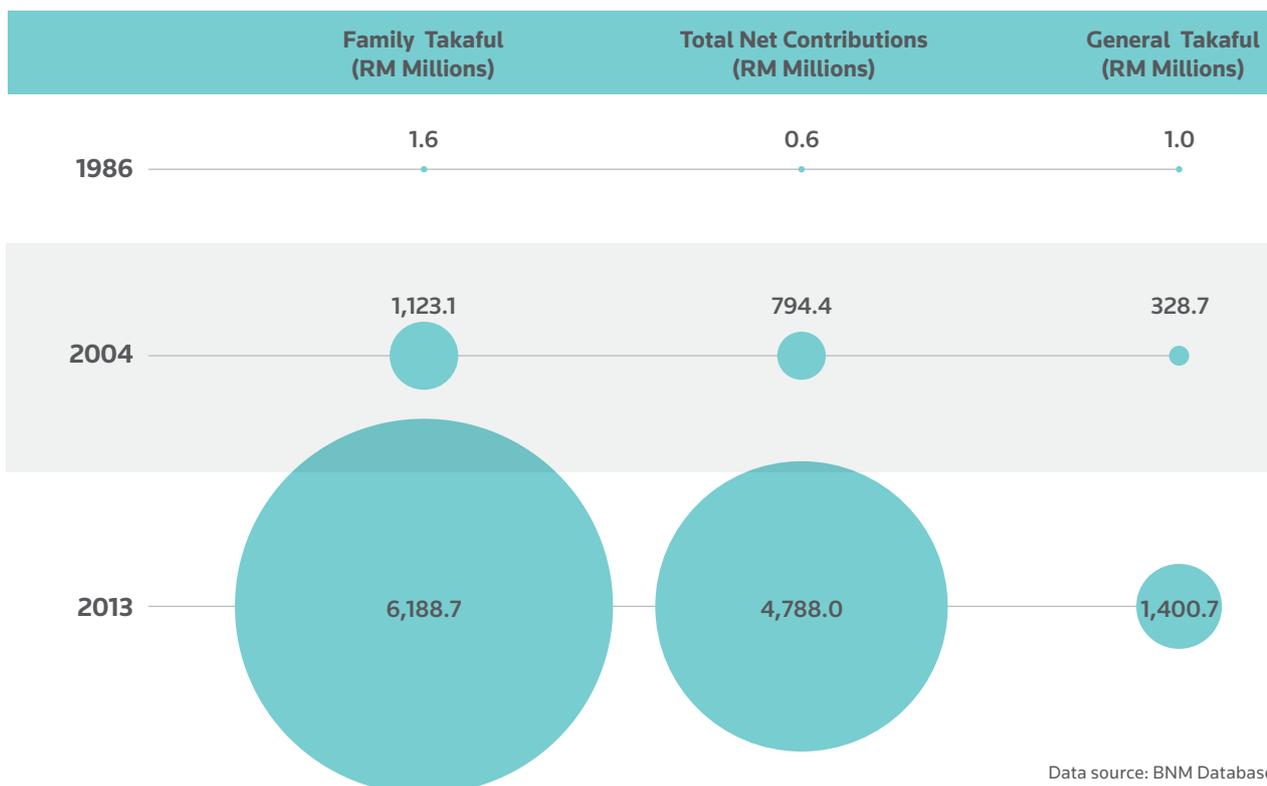
The evolution of the takaful industry in Malaysia has been progressive since its inception in 1984. Under the Takaful Act 1984, takaful operators were allowed to conduct both general and family takaful business under one entity. The Malaysian Takaful Industry has witnessed significant progress and development since. The evolution of the industry can be seen as follows:

	1986	2004	2013
<b>Number of Takaful Operators</b>	1	4	12
<b>Number of Offices</b>	-	133	215
<b>Number of Agents</b>	-	16,316	77,804

Data source: Bank Negara Malaysia

### Takaful Contributions Evolution

The evolution of the Takaful sector can best be depicted in the chart below. Total net contributions stood at RM 6.2 billion in 2013, compared to RM 1.1 billion in 2004 and RM 1.6 million at the end of its first year of operation in 1986.



Data source: BNM Database

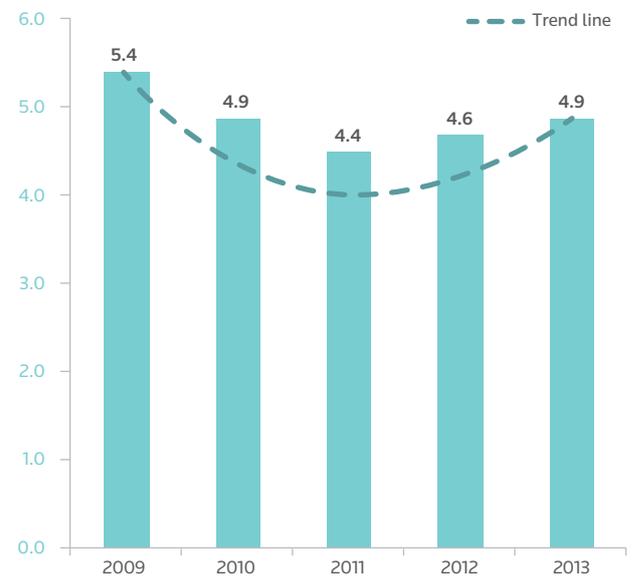
### Sector Size and Growth

#### Conventional insurance penetration rate is around 7 times higher than takaful penetration

**Malaysia has a very low insurance penetration rate.** In 2013 total conventional insurance premiums and takaful contributions as a percentage of GDP was 4.8% – 4.2% was conventional insurance and a much lower 0.6% for takaful. The takaful sector is growing at a faster pace (almost double) compared to the conventional insurance sector, although both were hit by slower growth in 2013. Takaful penetration rate has been on the rise since 2011. This growth coincides and is driven by new family operators that started operations between 2010 and 2012, leading to an increase in family takaful net contributions of 24% from 2011 to 2012. This is in alignment with the aims of the Financial Sector Blueprint but the percentage is still very low considering the maturity of Malaysia as an Islamic finance market. Given the demographic mix of the country – around 45% of the population are under the age of 25 in a majority-Muslim population – and the still relatively low penetration rate for insurance and takaful, the potential for growth in the takaful sector remains high. The Islamic Financial Services Act 2013 will

transform the sector’s composition as takaful operators are required to segregate their family and general businesses by June 30, 2018. The same rule applies to the life and general conventional insurance sectors under the Financial Services Act 2013.

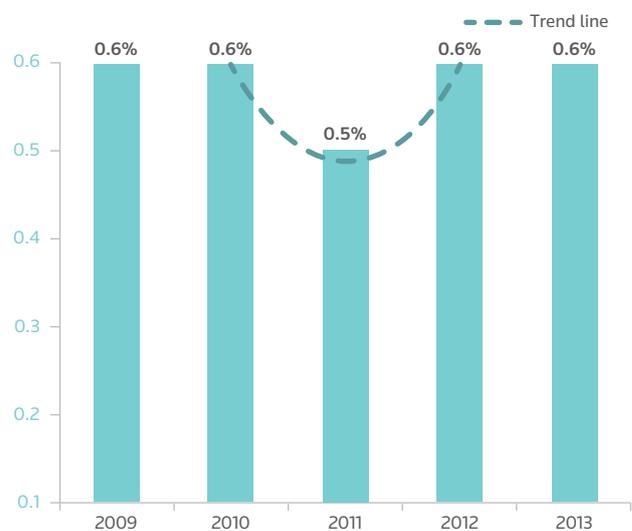
#### Overall Insurance and Takaful System Penetration in Malaysia (Premiums and Contributions as % of GDP)



#### Insurance Penetration (Premiums as % of GDP)



#### Takaful Penetration (Contributions as % of GDP)

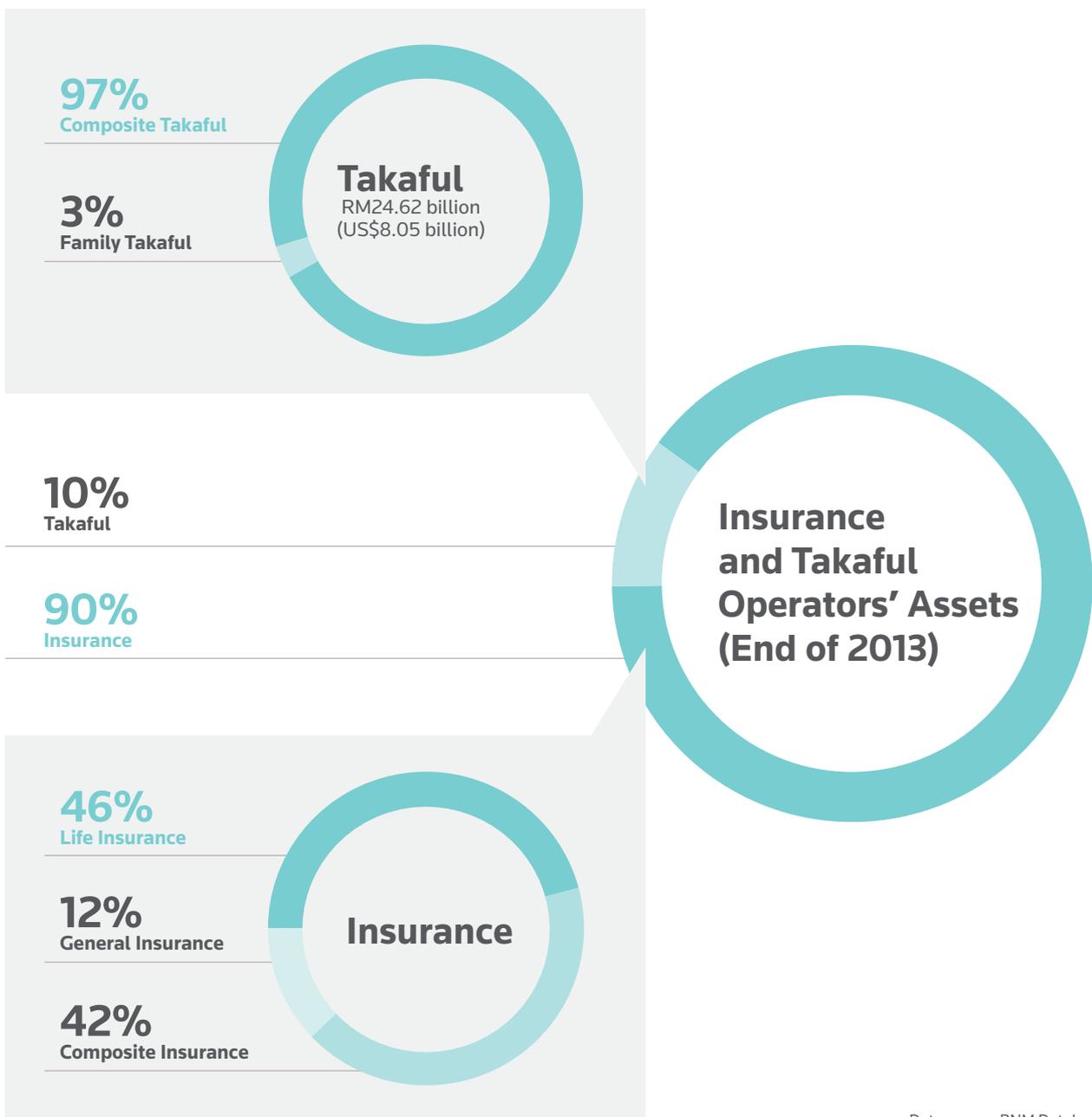


Data Source: IMF World Economic Outlook (April 2014), BNM Database

Malaysia’s overall insurance assets in 2013 comprised 90% conventional assets and 10% takaful assets. Of this 10%, 97% were in composite takaful compared to 3% family takaful. But family takaful held 86% of total funds assets, with operators aggressively looking into the general takaful segment.

The Islamic Financial Services Act 2013 will transform the sector’s composition as takaful operators are required to segregate their family and general businesses by June 30, 2018. The same rule applies to the life and general conventional insurance sectors under the Financial Services Act 2013.

**Malaysia is the second largest takaful market globally, but takaful market share in the country is small, accounting for only 10%**



Data source: BNM Database

**The retakaful sector is dominated by 4 operators, 3 of which are foreign.** The single local retakaful operator (MNRB Retakaful) was incorporated in 2006 as the first retakaful operator in Malaysia. Retakaful businesses cover family and general retakaful. Within the overall reinsurance sector, retakaful holds 16% of total operators' assets, based on our gathered data for the 2013 fiscal year.

Reinsurance Operators' Assets (End of 2013)

**84%**  
Reinsurance

**16%**  
Retakaful



Data compiled by Thomson Reuters through available sources



Malaysia's central bank governor Zeti Akhtar Aziz (L) and Chairman of the Financial Stability Institute, Bank of International Settlements, Josef Tosovsky, talk before the Islamic Financial Services Board Inaugural Public Lecture on Financial Policy and Stability in Kuala Lumpur. REUTERS/Bazuki Muhammad

**GENERAL TAKAFUL**

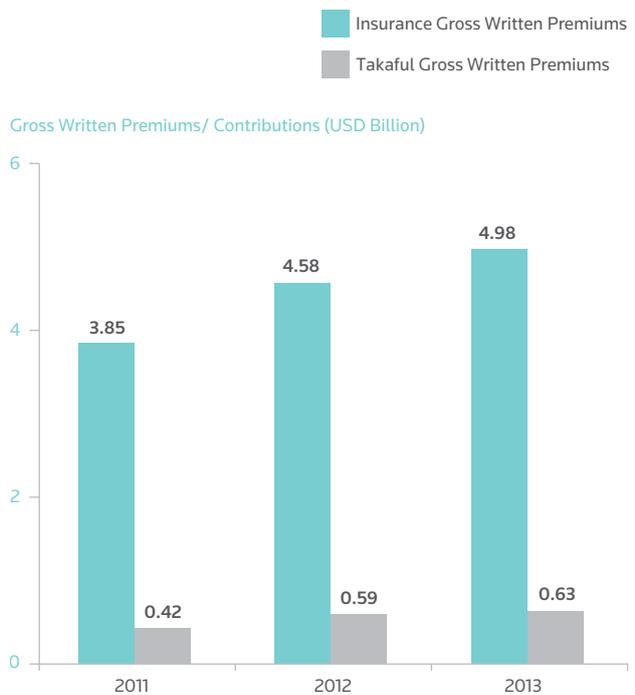
**Gross written contribution (GWC) CAGR for takaful outpaced conventional insurance operators' gross written premiums in 2013.** However, YoY growth for takaful is lower at 7% compared to 9% for conventional insurance. Takaful gross written contributions increased 7.3% to US\$632.7 million from US\$589.4 million in 2012. However, this growth is significantly lower than the previous period when there was a jump of 40% from 2011 to 2012. The main driver for the jump in GWC for 2012 was Etiqa Takaful, which had a 144% growth. Etiqa Insurance also had a successful year.

**There has been a general increase in premiums/contributions.** This could be attributed to the introduction of phased motor tariff adjustment in January 2012 that led to an increase in premiums and this is expected to continue in 2016.<sup>1</sup>

For medical and health insurance, a rise in premiums is expected to cover claims as a result of an anticipated increase in private medical fees approved by the government after it was requested by the Malaysian Medical Association (MMA).<sup>2</sup>

**Liability and disaster insurance premiums demands are also expected to increase as businesses and individuals buy risk management tools.** Cases of natural disasters (and other tragedies such as those which affected Malaysian Airlines flights in 2014) have affected customers' and AirAsia awareness of the need for insurance.<sup>3</sup> Finally, growth of disposable income and private consumption generally leads to higher premiums. Such growth should be met with appropriate distribution channels like agents and Bancassurance/Bancatakaful.

General takaful gross written contributions CAGR is higher than general insurance CAGR



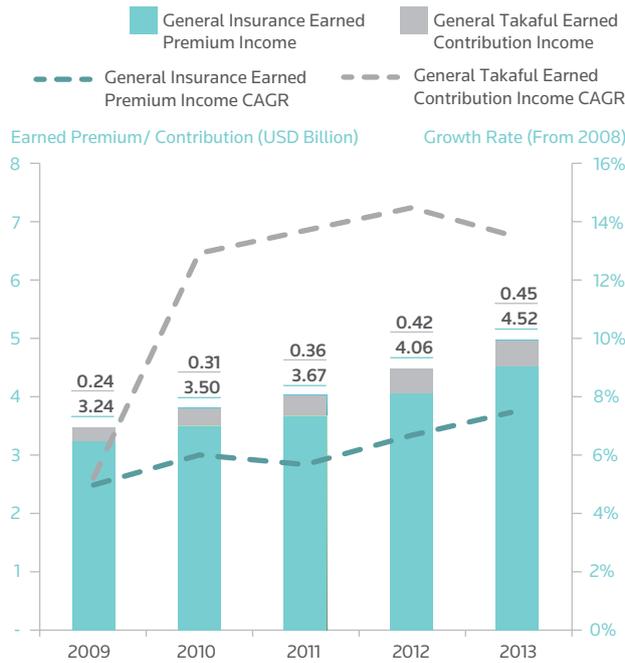
Data source: Data compiled by Thomson Reuters through available sources

2013	GENERAL INSURANCE	GENERAL TAKAFUL
<b>Gross Written Premium/Contribution</b>	RM15.225 billion (US\$4.978 billion)	RM1.935 billion (US\$632.7 million)
<b>YoY</b>	9%	7%
<b>CAGR (2011 – 2013)</b>	9%	14%

1 Motor Insurance: Asia's Growth Engine, Ernst & Young  
 2 Policyholders to pay more for coverage, The Star- April 20<sup>th</sup>, 2014  
 3 Insurance Premium expected to Increase in 2014, Renew Insurance- January 27<sup>th</sup>, 2014

Despite a 2013 growth dip for general takaful earned contribution income, takaful is still proving popular since 2008, reflected by a higher CAGR

Taking into account net premium/contribution made by Malaysian insurance operators as well as changes in premium/contribution liabilities during the year,<sup>4</sup> the earned premium income grew at 11%, while earned contribution income grew at 8%. However, CAGR figures favour takaful – general takaful outperformed the conventional market by 6%.



Data source: BNM Database

4 BNM Monthly Statistical Bulletin

2013	GENERAL INSURANCE	GENERAL TAKAFUL
<b>Earned Premium/ Contribution Income</b>	RM13.821 billion (US\$4.519 billion)	RM1.390 billion (US\$454.51 million)
<b>YoY</b>	11%	8%
<b>CAGR (2008 – 2013)</b>	7%	13%



A worker puts up decorations made of red lanterns at Thean Hou Temple in Kuala Lumpur. REUTERS/Zainal Abd Halim

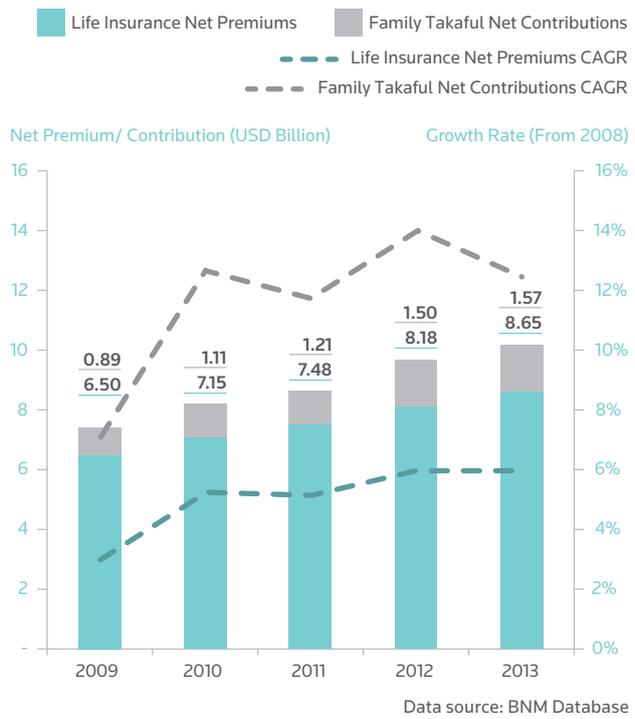
## FAMILY TAKAFUL

**Net premiums CAGR for insurance operators (6%) is lower compared to net contributions for takaful operators (12%).** Also, the CAGR for net premiums had a smoother growth post-2008 in contrast to net takaful contributions because of new family takaful operators since 2010.

### New diversified distribution channels for life insurance and family takaful are in the pipeline.

This will be introduced to ensure convenient access to the sector and healthy competition.<sup>5</sup> With these, growth of premiums/contributions is expected to increase. This is mentioned in detail as part of BNM’s Concept Paper for Life Insurance and Family Takaful Framework. In addition, product disclosures are enhanced to help consumers make informed decisions. Disclosures could be in the form of guaranteed and non-guaranteed benefits along with components and costs paid for premiums/contributions. In addition, BNM highlighted the need for availability of online facilities to ease access, and suggested the need for an online product aggregator. All of these are aimed at increasing the penetration of insured Malaysian residents to 75% by 2020.<sup>6</sup> Family takaful has a huge opportunity for growth given its low penetration in a Muslim-majority country.

New family takaful entrants and reforms have resulted in a continuous increase in net contributions



2013	LIFE INSURANCE	FAMILY TAKAFUL
<b>Net Premiums / Contributions</b>	RM26.459 billion (US\$8.652 billion)	RM4.788 billion (US\$1.565 billion)
<b>YoY</b>	6%	5%
<b>CAGR (2008 – 2013)</b>	6%	12%

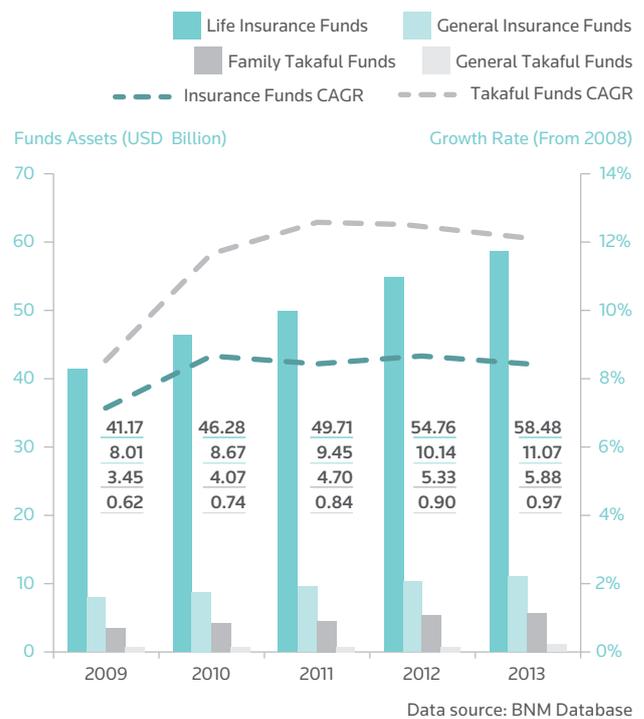
<sup>5</sup> BNM Life Insurance and Family Takaful Framework Concept Paper, 2013  
<sup>6</sup> Life: Riding on government initiatives, Asia Insurance Review – May 2014

### TAKAFUL FUND ASSETS EVOLUTION

**Takaful funds, especially family takaful funds, are growing at a faster pace (2013 CAGR 12%) compared to life insurance funds (2013 CAGR 9%).**

Faster growth pace of family takaful funds, with its long-term horizon, could explain the trend toward sukuk investments. Breaking down investments composition for life insurance in 2013, corporate debts and securities took 63% of funds assets of life insurance funds followed by government securities.<sup>7</sup> Islamic debt securities and equities accounted for 62% of assets of family takaful funds followed by government Islamic papers that accounted for 15%.<sup>8</sup> As for general insurance, corporate debts and government securities account for 22% and 20% of total funds assets, respectively.<sup>9</sup> For general takaful, Islamic debt securities and Islamic money market instruments account for 45% and 22% of total funds assets, respectively.<sup>10</sup>

As a potential investor, family takaful funds could spur increase in sukuk investments



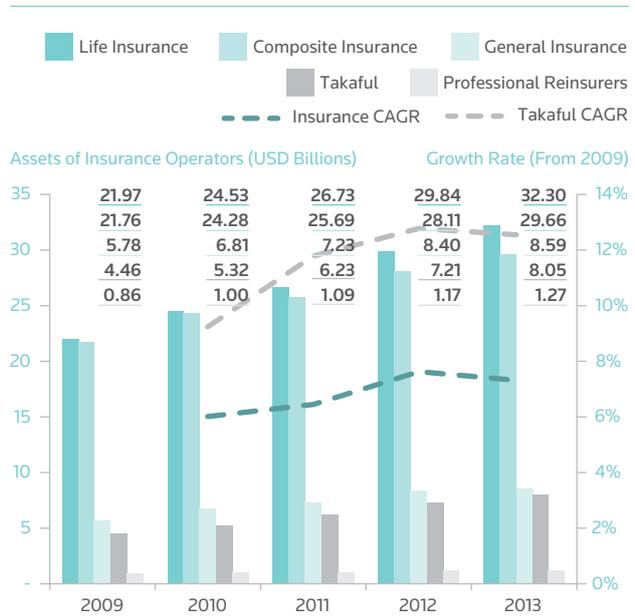
2013	CONVENTIONAL INSURANCE	TAKAFUL
<b>Funds Assets</b>	RM212.686 billion (US\$69.551 billion)	RM20.943 billion (US\$6.849 billion)
<b>YoY</b>	7%	9%
<b>CAGR (2008 – 2013)</b>	8%	12%

7 BNM Monthly Statistical Bulletin: Life Insurance: Assets of Life Insurance Funds  
 8 BNM Monthly Statistical Bulletin: Family Takaful: Assets of Family Takaful Funds  
 9 BNM Monthly Statistical Bulletin: General Insurance: Assets of General Insurance Funds  
 10 BNM Monthly Statistical Bulletin: General Takaful: Assets of General Takaful Funds

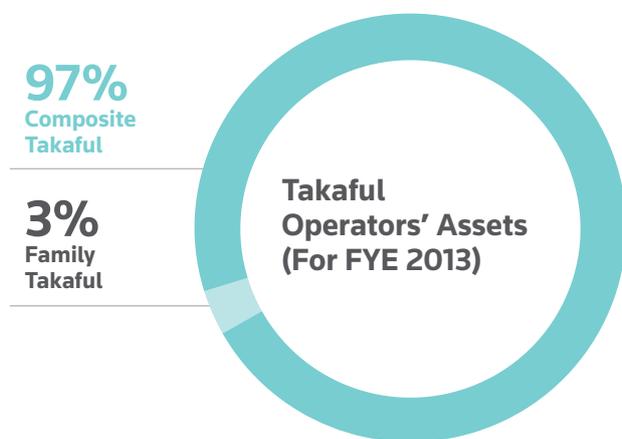
**Composite takaful operators’ assets (i.e. combined general and family takaful businesses) make up almost 97% of all takaful sector assets.** Assets from family takaful operators — there are four as of this writing — which started operations between 2010 and 2012, make up the remaining 3% in 2013. This is compared to conventional insurance that consists of 42% composite insurance 46% of life insurance while the remaining assets go to general insurance that makes up 12% of insurance operators’ assets in 2013. The new Financial Services Act (FSA) and Islamic Financial Services Act (IFSA), that require insurance and takaful operators to segregate composite licenses, will change significantly the assets structure of the insurance and takaful sector. The impact will be greater for the takaful sector as it has a higher proportion of composite licenses than the conventional sector.

**The CAGR for the reinsurance sector was 8%<sup>11</sup> in 2013.** Retakaful in Malaysia has 4 operators but despite this capacity, is not as competitive as the reinsurance market. This problem, as well as mismatched risk appetite by retakaful operators has resulted in a leakage into the conventional reinsurance market.<sup>12</sup> (There are 7 reinsurance operators in Malaysia. By ratio, there is 1 retakaful operator to 3 takaful operators and 1 reinsurance operator for every 4.7 insurance companies.)

Segregating composite licenses for both insurance and takaful will change operators’ assets structure



Takaful Operators’ Assets (For FYE 2013)



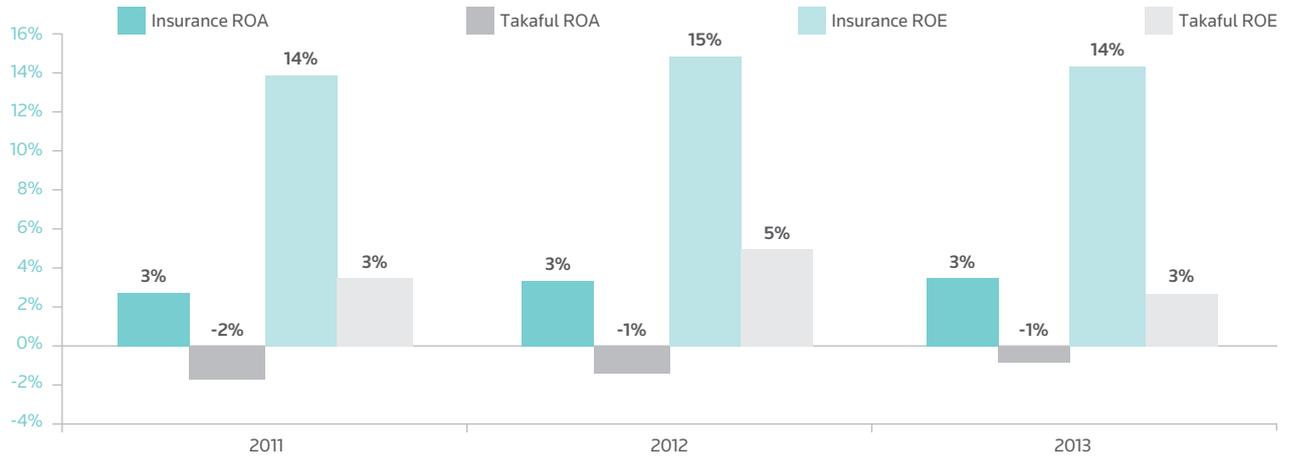
Data source: BNM Database

2013	CONVENTIONAL INSURANCE	TAKAFUL
<b>Operators Assets</b>	RM215.728 billion (US\$70.545 billion)	RM24.617 billion (US\$8.050 billion)
<b>YoY</b>	6%	12%
<b>CAGR (2009 – 2013)</b>	7%	13%
<b>No. of Registered Direct Operators</b>	33	12

11 BNM Monthly Statistical Bulletin: Insurance: Assets and Liabilities of Malaysian-Incorporated Insurers  
 12 Retakaful continues to prove its worth, Middle East Insurance Review-April 2013

**Sector Performance**

Insurance & Takaful Operators Performance (Excluding Reinsurance and ReTakaful)



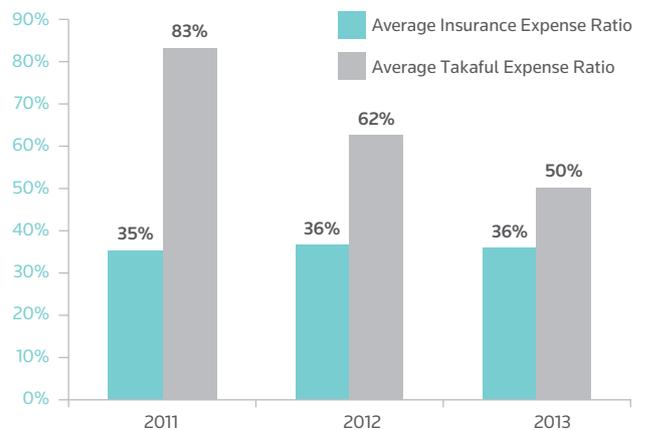
Data source: Data compiled by Thomson Reuters through available sources

**Performance measures for the takaful sector is let down by family takaful.** In 2013, the average ROA for the whole insurance industry stood at 2.2% while average ROE stood at 10.4%. When broken down into its sub-sectors of insurance, takaful, reinsurance and retakaful, we see different performance outcomes for each sub-sector. The reported ROA ratio for the takaful sector is negative while the ROE maintains a positive ratio. Still, it is much lower compared to the conventional sector.

**Further analysis reveals that life insurance companies outperformed family takaful businesses, which only came into the market from 2010.**

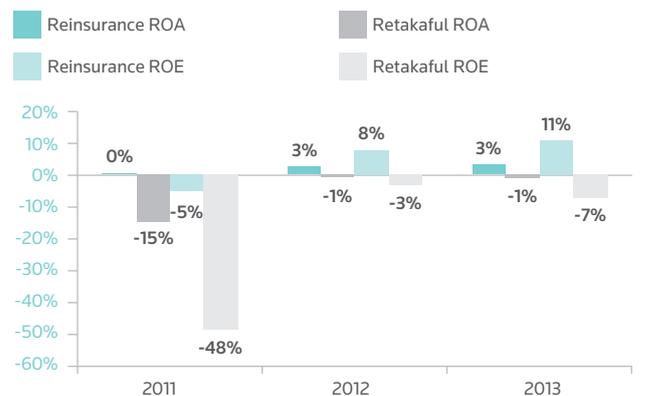
Central bank data shows there were no family takaful operators assets prior to 2010. However, the performance ratios for family takaful businesses are improving. This is also reflected in high expense ratio for family takaful that improved significantly in 2013. Insurance operators have had a steady performance on expense ratio. It is noted also that retakaful operators suffered from losses leading to negative ROA and ROE compared to the reinsurance sector.

Expense Ratio



Data source: Data compiled by Thomson Reuters through available sources

Reinsurance & Retakaful Operators Performance

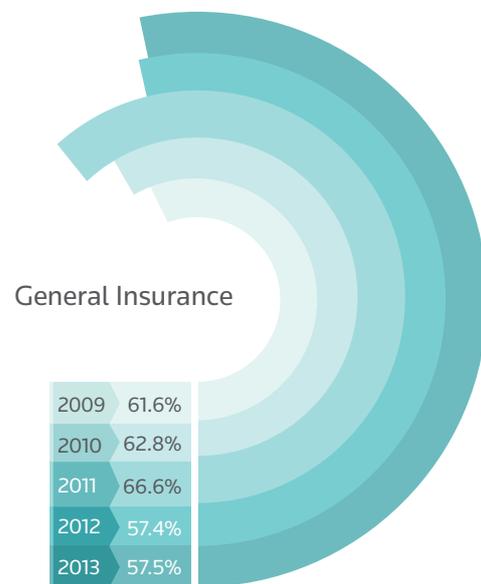
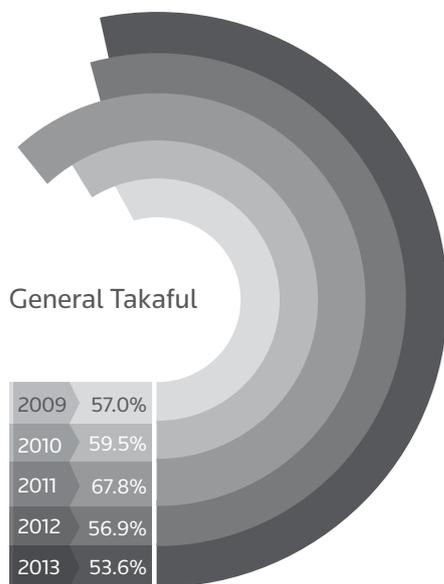


Data source: Data compiled by Thomson Reuters through available sources

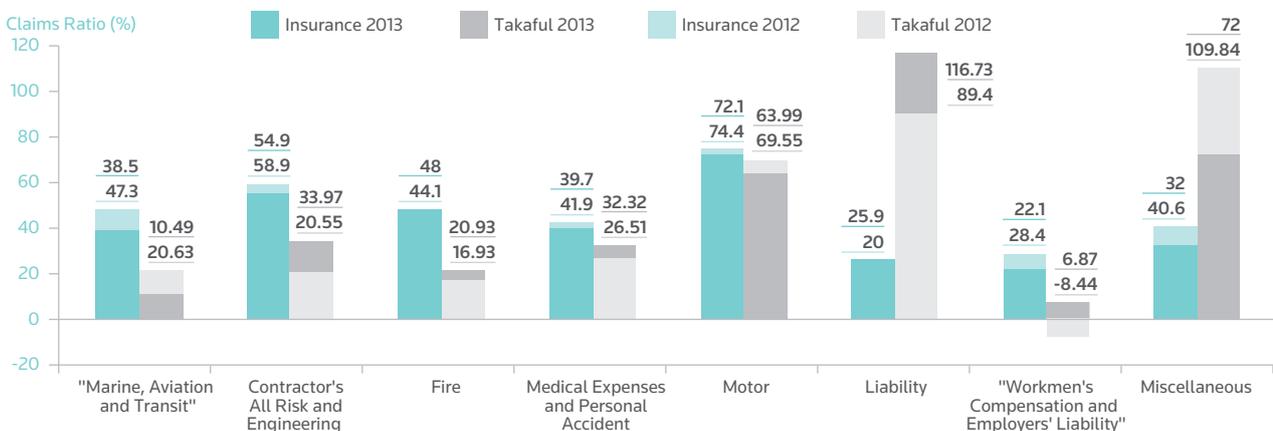
**General takaful claims ratio in 2013 was lower than general insurance claims ratio – 53.6% vs. 57.5%.** The claims ratio peaked in 2011 for both general insurance and general takaful. The peak is attributable mainly to the fire line of business with claims ratio of 78.2% followed by motor insurance at 76.7%. For takaful, motor claims recorded the second highest claims ratio of 80.3%. ‘Miscellaneous’ leads with 88% claims ratio. For many years, the motor insurance line of business

was suffering from high claims ratio. This needed a revised motor tariff rate that was introduced in January 2012 and which led to a gradual rise in motor premiums.

Breaking down 2013 data, motor insurance contributed to the highest claims ratio out of all lines of businesses for insurance. The liability line of business shows a huge gap between insurance and takaful in 2012 and 2013.



Claims Ratio by Line of Business at end of 2012/2013



Data source: BNM Database

## Future Outlook

The next few years hold a lot of promise in terms of industry restructuring with more mergers and acquisitions, growth of the takaful business and a possible rebalancing in the composition of contributions between family and general takaful.

It will also be interesting to see the potential effects of the reforms put in place by Bank Negara Malaysia concerning the distribution channels and their effectiveness as well as the impact on takaful and insurance agents. The takaful sector has lagged behind in terms of development as compared to the Islamic banking segment, but with the leveling of the playing field between insurance and takaful, industry players will have no choice but to review their strategies and go full throttle in order to remain competitive.

Takaful operators will have to bring more innovation to the market and offer better customer service as compared to their conventional counterparts. Bank Negara Malaysia is playing a prominent role in the development of the industry by providing a

conducive growth-enabling environment through appropriate legal, regulatory and Shariah frameworks although it could give a real boost to the industry if it could replicate the attention it gave into the Islamic banking industry.

In terms of global presence, we will likely see local takaful operators venturing in other continents, for example, Takaful Ikhlas has stated intentions to tap into the growing Muslim population in Europe. With the implementation of the IFSA and the creation of specialised entities in family and general takaful, there will also be a need for specialists and highly technical staff at the executive and management level within the industry. This will likely be quite a challenge given the lack of skilled human capital in Islamic finance and takaful.

Nevertheless, the future of takaful in Malaysia is one to watch and learn from, as the Malaysian Takaful Industry remains the uncontested leader in the takaful arena.



Indonesians work at a construction site in Cyberjaya outside Kuala Lumpur. REUTERS/Bazuki Muhammad

# Regulations Development

## The way ahead for the takaful industry

The two financial sector master plans that cover 2001-2020 are important elements to the development of the financial sector in Malaysia. The plans envision that Islamic banking and takaful would evolve in line with conventional banking and insurance. In the Financial Sector Blueprint covering 2011-2020, the insurance and takaful industry is slated for further development through a diversification of insurance/ takaful products, further

expansion of the takaful industry and more merger and acquisitions activities.

The blueprint outlines nine major focus areas in which recommendations/initiatives were introduced. An important part of this is the takaful industry that is envisioned to be a key driver for the growth of the financial system. Some of the recommendations for the takaful industry have already been implemented.

## (a) Takaful focus areas under the blueprint

### FOCUS AREA (1) – EFFECTIVE INTERMEDIATION FOR A HIGH VALUE-ADDED, HIGH-INCOME ECONOMY

**Promote a conducive environment for financial institutions to develop more products and enhance services for businesses to better manage business risks**

- Facilitate greater injection of foreign expertise in the insurance and takaful broking and loss adjusting industries to better support insurance and takaful business

**Enhance the capacity and capability of the insurance and takaful industry to provide higher value-added medical and health insurance**

- Encourage insurers and takaful operators to offer higher-end insurance products to complement the national health financing scheme
- Encourage strategic alliances between domestic and foreign financial institutions with specialised expertise in medical and health insurance

**Introduce greater operational flexibility for financial institutions subject to appropriate safeguards**

- Encourage insurers and takaful operators to enhance offering of insurance products through alternative delivery channels

### FOCUS AREA (2) – DEVELOPMENT OF DEEP AND DYNAMIC FINANCIAL MARKETS

### FOCUS AREA (3) – GREATER SHARED PROSPERITY THROUGH FINANCIAL INCLUSION

**Expand the range of products and services that will meet the distinct financial needs of all citizens, including the underserved**

- Facilitate the insurance/takaful industry to develop affordable microinsurance/microtakaful products for protection against unexpected adverse events

### FOCUS AREA (4) – STRENGTHENING REGIONAL AND INTERNATIONAL FINANCIAL INTEGRATION

**Enhance the position of the Labuan IBFC as a cost-effective and attractive regional operational hub for global corporations and investors to conduct their business in the region. This will involve:**

- Further develop the insurance industry in Labuan, including reinsurance and retakaful

### FOCUS AREA (5) – INTERNATIONALISATION OF ISLAMIC FINANCE

**Increase the diversity of players in the domestic Islamic financial industry to support a wider range of financial products and services that serves the best interest of Malaysia**

- Issue new takaful licenses to institutions with specialised expertise



Delegates take their seats before the opening of Global Islamic Finance Forum in Kuala Lumpur. REUTERS/Zainal Abd Halim

---

#### **Position Malaysia including Labuan IBFC as an international retakaful centre**

- Encourage international players to establish retakaful operations in Malaysia and brokers with international linkages to serve the takaful sector
- Encourage greater involvement of takaful brokers to broaden the range of takaful product offerings and outreach by extending MIFC incentives
- Promote the use of takaful as a risk management tool in Islamic financial transactions

---

#### **FOCUS AREA (6) – SAFEGUARDING THE STABILITY OF THE FINANCIAL SYSTEM**

**Enact a comprehensive legislative framework for the conventional and Islamic financial systems respectively. The proposed legislation will reinforce a sound, transparent, and accountable system for effective regulation and supervision that is consolidated across the banking, insurance, takaful, financial intermediary and payment system services sectors.**

---

#### **Strengthen the institutional structure of financial institutions to provide adequate safeguards against contagion risk and excessive leverage**

- Require life and general businesses of insurers, and family and general businesses of takaful operators to be carried out under separate entities

---

#### **Raise the standards of risk management and internal control functions across the financial sector**

- Require insurers and takaful operators to be served by independent and dedicated heads of risk

---

#### **FOCUS AREA (7) – ACHIEVING GREATER ECONOMIC EFFICIENCY THROUGH ELECTRONIC PAYMENTS**

---

#### **FOCUS AREA (8) – EMPOWER CONSUMERS**

---

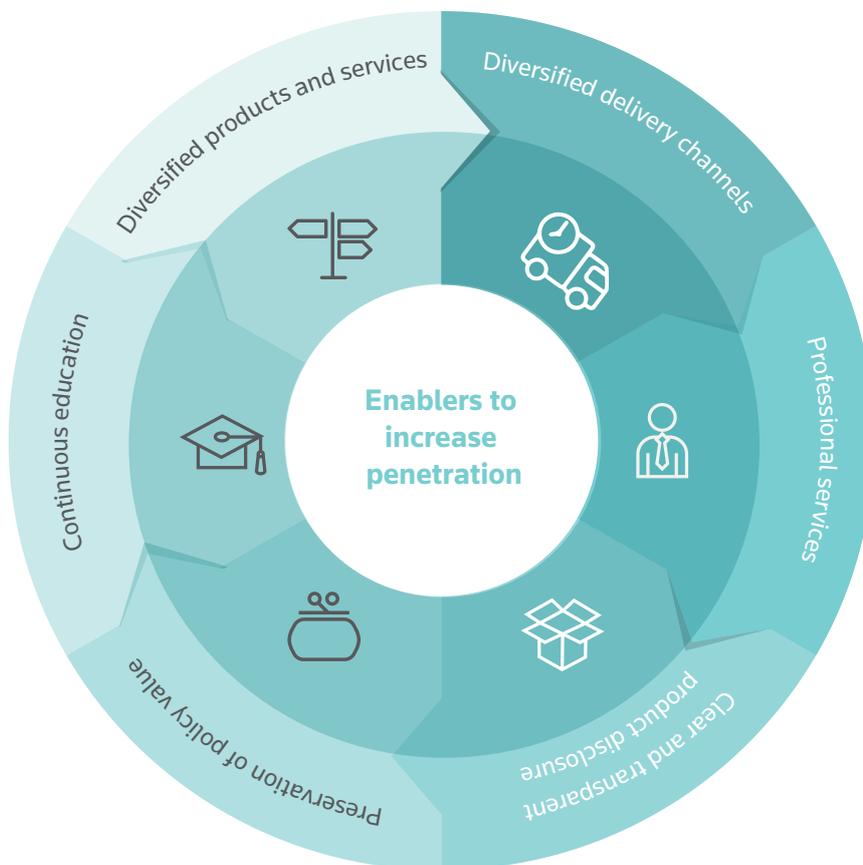
#### **FOCUS AREA (9) – TALENT DEVELOPMENT FOR THE FINANCIAL SECTOR**

**(b) Priorities for a more solid insurance and takaful market**

In order to ensure that the insurance and takaful sectors maintain their competitive positions, a number of areas should be tackled with the aim of ensuring robust growth for the industry in the coming years.



**(c) Desired Attributes of the Life Insurance and Family Takaful Industry Under The Future Landscape**



Source: The Financial Stability and Payment Systems Report 2013 – Bank Negara Malaysia

### (d) Reforms in the life insurance and family takaful industry

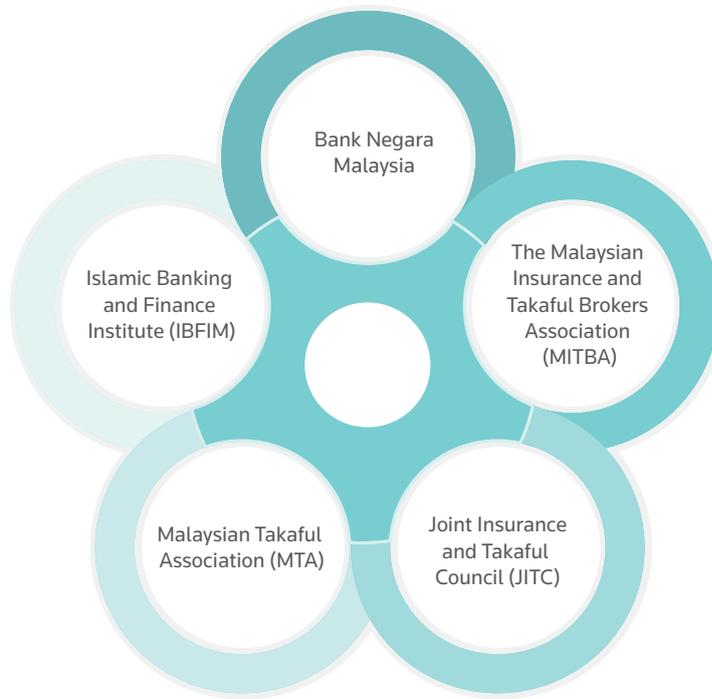
The Malaysian government and relevant authorities have made continuous efforts to promote greater product innovation and increase efficiency and effectiveness of delivery channels in the life insurance and family takaful industry.

In November 2013, Bank Negara Malaysia issued a concept paper with a set of proposals to improve the life insurance and family takaful industry.

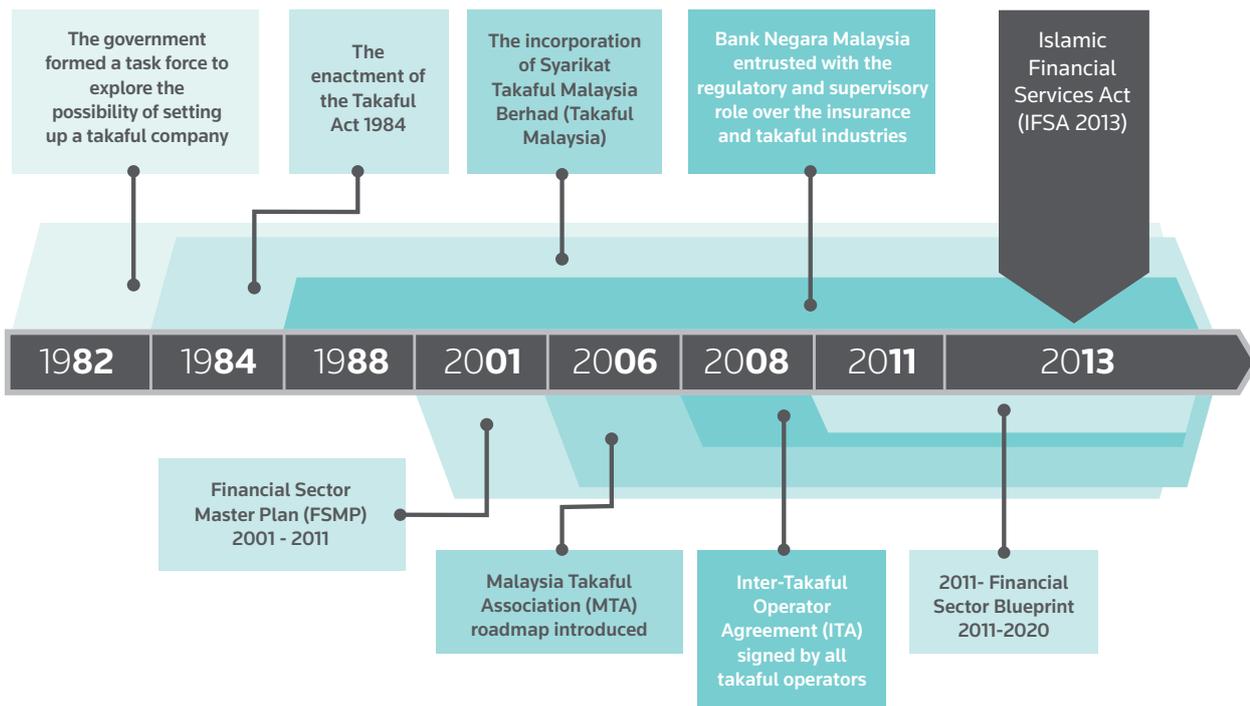
ACCORD GREATER OPERATIONAL	IMPROVE EFFECTIVENESS OF DELIVERY CHANNELS	EMPOWER CONSUMERS AND ELEVATE INTERMEDIARIES' PROFESSIONALISM
<ul style="list-style-type: none"> <li>Remove operating cost limits applicable to investment-linked products in the form of commission and agency related expenses</li> </ul>	<ul style="list-style-type: none"> <li>Align commission limits for bancassurance and corporate agents</li> </ul>	<ul style="list-style-type: none"> <li>Implement balanced scorecard for the remuneration of intermediaries</li> </ul>
<ul style="list-style-type: none"> <li>Remove commission limits for pure protection products (pure term, medical and health and critical illness) subject to insurers and takaful operators offering those products via direct distribution channels</li> </ul>	<ul style="list-style-type: none"> <li>Incentivise growth of financial advisers (FA)</li> </ul>	<ul style="list-style-type: none"> <li>Enhance disclosure standards to aid decision-making by consumers</li> <li>Introduce product aggregator to facilitate product comparison</li> <li>Introduce online insurance/ takaful account to provide information on policy status</li> <li>Remove limits on agency financing scheme</li> </ul>

**Regulatory framework aligned with omnibus of guidelines**

**(a) The shapers of the takaful industry**



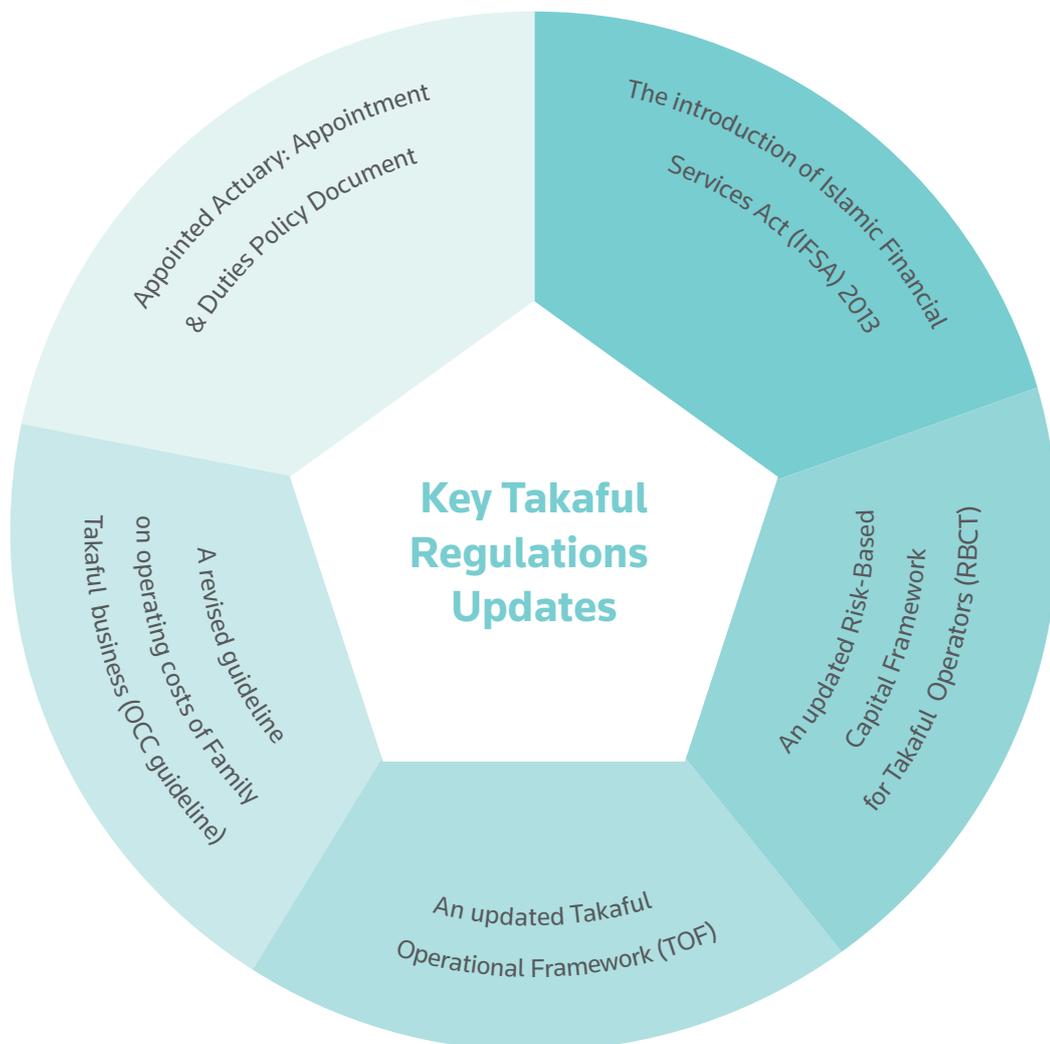
**(b) The evolution of the takaful regulatory environment**



### 2013 was a seminal year for takaful regulatory development

Malaysia's key to success in takaful has been a clear and robust regulatory framework that has evolved with market needs and which has created an enabling environment for the sector to thrive. Regulatory developments over the last couple of years have further bolstered support for takaful and laid a solid foundation for its sustainable growth. In 2013, the takaful sector came under significant regulatory changes that

aim to strengthen separate family and general takaful businesses to help them grow sustainably towards meeting Malaysians' changing socio-economic needs — e.g. a greying population that needs better health-care and retirement cover — as well as contribute to the overall growth of the Islamic finance industry that is reaching towards greater internationalisation and Shariah-based practices.



**(a) Islamic Financial Services Act (IFSA) 2013**

The IFSA 2013 covers both Islamic banking and takaful. The Takaful Act 1984 was repealed when the IFSA came into effect on June 30, 2013.

POLICY DECISION	IMPACT ON THE MARKET
<p>Separation of general and family takaful businesses</p>	
<p>Takaful operators are required to hold separate capital requirements for each business. They have been given until June 30, 2018 to comply with the new rule.</p>	<p><b>We will see mergers and acquisitions (M&amp;As) in the takaful industry over the next few years as a result of the increased cost of running two separate businesses.</b></p> <ul style="list-style-type: none"> <li>• The creation of a more specialised takaful market as each operator will focus either on family or general business. This is expected to improve the efficiency of takaful players in Malaysia.</li> <li>• This would possibly increase the growth in the general takaful business as the market is now more focused on family takaful.</li> <li>• Increase the operating cost of companies that will choose to retain both family and general takaful businesses.</li> <li>• Increase the need for more specialised human capital in the takaful industry</li> </ul>
<p>Shift in responsibility of the Appointed Actuary to the Board of Directors</p>	
<p>Under the IFSA, there is a shift in the duties and functions of the appointed actuary of a licensed takaful operator, where the Board of Directors will take on more responsibility.</p>	<ul style="list-style-type: none"> <li>• Change in Board of Directors structure and appointing directors with more experience in the takaful industry to absorb more responsibilities given to the Board.</li> </ul>
<p>Takaful operators required to set up financial holding company</p>	
<p>Takaful operators will have to submit an application to Bank Negara Malaysia to be approved as a financial holding company.</p>	<ul style="list-style-type: none"> <li>• In this case, takaful operators will be commercial ventures. Although this is not prohibited under Shariah, it is better for takaful operators to have the option to be co-operatives or mutuals, given the nature of mutual assistance in takaful.</li> </ul>
<p>Greater emphasis on Shariah governance</p>	
<p>The new Act has a more comprehensive coverage of Shariah aspects compared to the Takaful Act 1984.</p>	<ul style="list-style-type: none"> <li>• Ensuring increased level of compliance to Shariah principles in conducting takaful businesses.</li> <li>• This could result in a rise in operational costs by takaful operators in an effort to increase Shariah compliance.</li> </ul>

## Greater emphasis on consumer protection

The new Act focuses on ethical business conduct in a way that it hopes will result in greater consumer protection and public confidence in the takaful sector. Under the new Act, the central bank has the power to set and enforce standards on business conduct for financial services providers to ensure financial consumers are treated fairly.

- Increasing public confidence and trust, hence attracting and retaining more consumers.
- There is an emphasis on transparency, with guidelines for enhanced disclosure requirements that are expected to be accurate, clear, timely and not misleading.
- As of this writing, Bank Negara Malaysia is laying the groundwork for a financial ombudsman to ensure fair and effective handling of complaints and resolution of disputes.
- There is an element of financial inclusion embedded in the need to ensure consumer protection via ethical business conduct. For example, an insurer or takaful operator must pose specific questions to consumers for its underwriting purpose and operators must provide a wider choice of delivery channels – such as the Internet and mobile technology – for insurance and takaful.

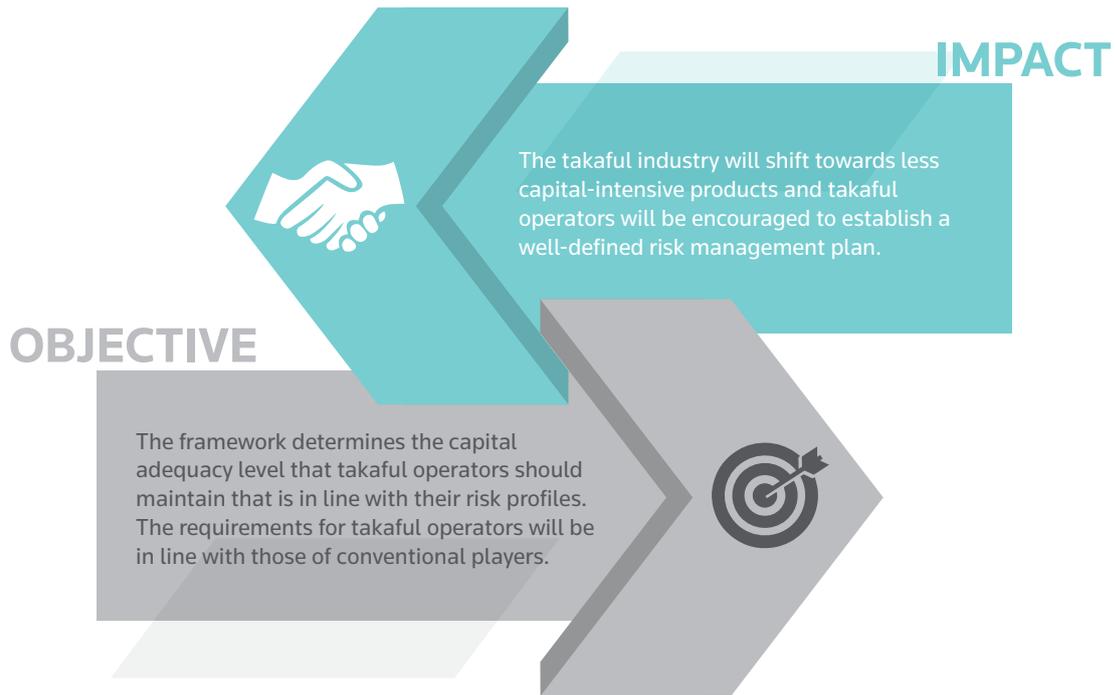
## Greater clarity on legal and prudential requirements

New prudential requirements have been added to the new Act regarding maintenance of various funds, assets and risk management, among others. In case of deficiency in the risk fund, the provision of Qard hasan (interest-free loan) is compulsory.

- This is expected to bring greater transparency and superior governance in the management of assets and funds.

**(b) Updated Risk-Based Capital Framework for Takaful Operators (RBCT)**

The Risk Based Capital Framework for Takaful Operators (RBCT) was initiated in 2013 and adopted in January 2014.



KEY CHANGES	EXPLANATION	IMPACT ON THE MARKET
<b>Restrictions on the payment of dividends</b>	A prior formal approval from Bank Negara Malaysia is required for all dividend payments. With the previous act, dividends payments were permitted without approval from BNM.	Stricter approach in ensuring that takaful operators have a sufficient level of capital adequacy that can absorb unexpected losses.

**(c) Updated Takaful Operational Framework (TOF)**

To further enhance the growth of the takaful sector, guidelines on Takaful Operational Framework were issued, with the aim of governing the operational processes of takaful operators.

KEY CHANGES	EXPLANATION	IMPACT ON THE MARKET
<b>Surplus distribution policy</b>	Surplus of the risk fund is permitted to be distributed to the takaful operator before the full settlement of any outstanding qard.	<ul style="list-style-type: none"> <li>Surplus can be distributed to takaful operators with more flexibility.</li> <li>Avoiding the potential cross-subsidy between profitable and unprofitable products. As in the previous TOF, surplus is being used to repay any qard that is caused by a particular product first and then distribute to other profitable products.</li> </ul>

**(d) New revised guidelines on operating costs of takaful businesses (OCC guideline)**

KEY CHANGES	EXPLANATION	IMPACT ON THE MARKET
<b>Scope of application</b>	<ul style="list-style-type: none"> <li>The guideline was applicable only to family takaful operators that are charging operating costs to the takaful funds. The revised guideline is now applicable to all takaful operators, whether the operating costs are being charged to the takaful fund or shareholders' fund.</li> <li>Takaful operators are required to comply with the specified limitations on management expenses and agency compensations in the guideline.</li> </ul>	<ul style="list-style-type: none"> <li>Placing a limit on the expense level could indirectly result in limiting the growth of newly-established operators.</li> <li>Constraints on expenses could result in agents preferring to sell conventional insurance products compared to takaful products.</li> </ul>

**(e) Appointed Actuary: Appointment and Duties Policy Document**

KEY CHANGES	EXPLANATION	IMPACT ON THE MARKET
<b>Appointment of Actuary</b>	The appointed actuary should be an employee (not an external consultant) of the takaful operator. As mentioned in the Appointed Actuary: Appointment & Duties policy document, in some exceptional cases, Bank Negara may accept that the actuary not be an employee of the takaful operator.	<ul style="list-style-type: none"> <li>An increase in the number of required actuaries in the market. There is a limited number of actuaries with solid takaful experience in Malaysia (and indeed globally).</li> <li>Greater impact will occur as a result of separating family and general takaful businesses by 2018. Operators which will run two businesses will need a separate actuary for each of the family and general takaful businesses.</li> <li>An increase in the operating cost of the takaful operator. The operator will have a fixed cost throughout the year, instead of appointing a consultancy firm on an ad-hoc basis.</li> </ul>



# ISLAMIC CAPITAL MARKETS DEVELOPMENT AND RECENT ACTIVITY

## ISLAMIC CAPITAL MARKETS AND DEVELOPMENT

- 199 Almost 60% of Malaysia's capital market is Shariah-compliant
- 199 Malaysia is the world's largest sukuk market
- 200 Capital Market Masterplan 2 forecasts the size of Malaysia's equity and debt capital market (Islamic and conventional) to more than double from RM2 trillion in 2010 to RM4.5 trillion in 2020

## MALAYSIAN SUKUK MARKET OVERVIEW AND DEVELOPMENT

- 218 Market Overview 2012- Q3 2014
- 219 The Malaysian sukuk market is made up of 96% local currency issues
- 220 The Malaysian government has been a critical driver of the sukuk market
- 221 Malaysia's sukuk market leans heavily towards the murabahah structure
- 222 Sukuk rating dilemma: local investors are more familiar with their local neighbourhood
- 224 Malaysia is eyeing greater cross-border issuance

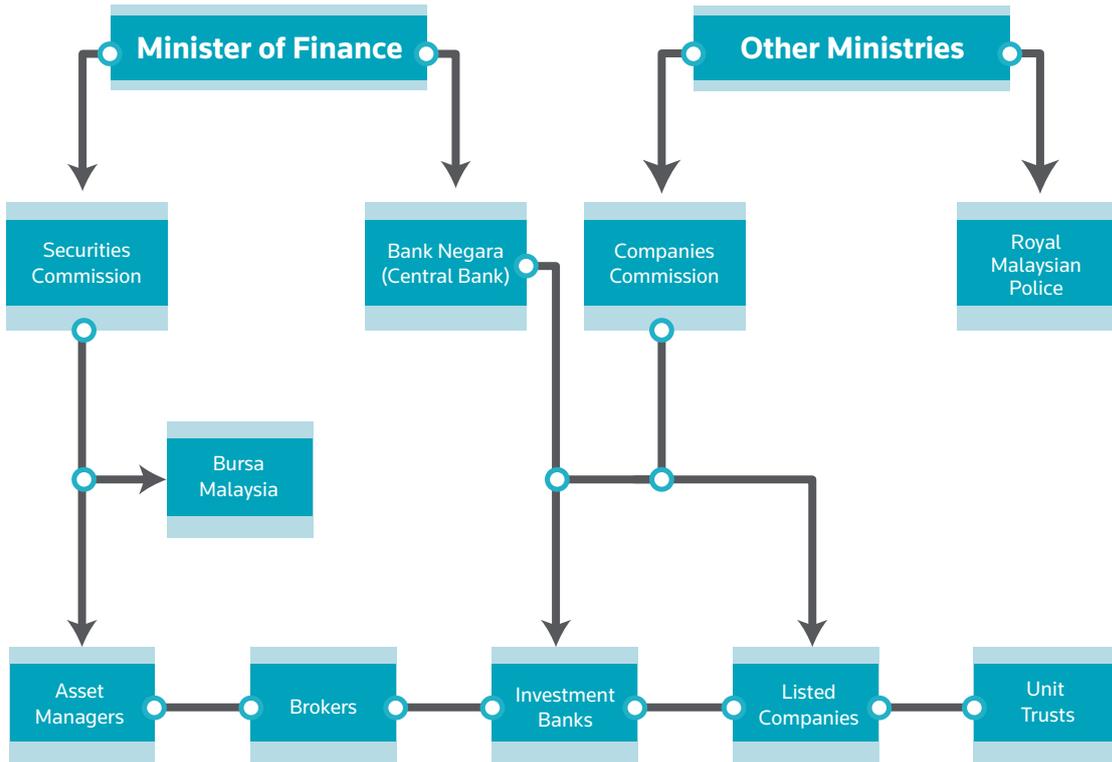
## MALAYSIAN ISLAMIC FUND MARKET OVERVIEW AND DEVELOPMENT

- 239 Asset management companies are eligible to invest in markets outside Malaysia
- 240 50% of funds invest in equities
- 241 Since 2010 Malaysian funds have been heavily focused on the domestic market
- 241 Procedures to offer ASEAN CIS Fund and their impacts
- 242 ASEAN Collective Investment Scheme (CIS) Framework for Malaysia, Singapore and Thailand
- 243 Wider geographical focus: Asia Region Funds Passport

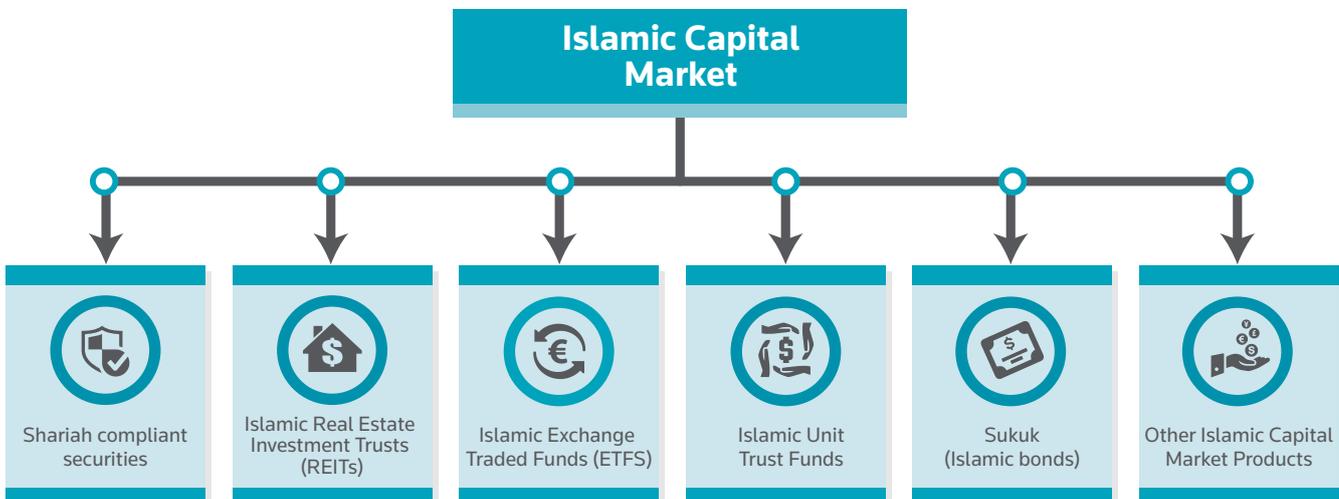
# Capital Markets Overview And Development

## Market Overview

Institutional structure of Malaysia's Capital Market



Components of Malaysia's Islamic Capital Market



Source: Securities Commission Malaysia

### **Almost 60% of Malaysia's capital market is Shariah-compliant.**

The overall size of Malaysia's capital market grew by 10.5% in 2013 to reach RM2.733 trillion (\$810 billion). 56.4% of this total, or RM1.542 trillion, is Shariah-compliant: RM1.029 trillion in the Islamic equity market and RM512.1 billion in the sukuk market. The Islamic capital market (ICM) grew 8.8% in 2013.

### **74% of listed companies are Islamic.**

The new screening methodology which came into effect in November, 2013 resulted in a drop of Shariah compliant listed companies from 800 in June, 2013 to 673 in November, 2014 as companies which did not meet the more stringent requirements were dropped. All FTSE Bursa Malaysia indices are based on the list of Shariah-compliant listed securities issued by the SC which is reviewed by its Shariah Advisory Council (SAC) twice a year. Tradable indices, such as the FTSE Bursa Malaysia Hijrah Shariah Index, are further filtered and reviewed quarterly by a licensed third party Shariah consultancy. The revised screening was designed to strengthen Malaysia's move to a more Shariah-based capital market and to be more in line with international Islamic screening methodologies. It streamlines business activity benchmarks from four (5%, 10%, 20%, 25%) to two (5% for activities such as conventional banking and insurance and non-halal F&B, and 20% for hotel and resort operations, share trading, stockbroking, rental from Shariah non-compliant activities, and other non-Shariah-compliant activities) and introduced a new 33% financial ratio benchmark covering interest bearing cash over total assets and debt over total assets.

### **Malaysia is the world's largest sukuk market.**

The total value of sukuk outstanding rose by 7.9% in 2013 to reach RM512.1 billion. (See following sukuk section for details.)

### **However, the Islamic funds sector is not as prominent.**

In June 2014, 16.7% (RM105.2 billion) of the country's total assets under management (AuM) in the funds industry was Shariah-compliant. Of this total, 19 full-fledged Islamic fund management companies accounted for a combined AuM of RM37.9 billion.

### **Overall capital market strategy is outlined in the Capital Market Masterplan 1 (CMP1) for the decade beginning 2001 and the CMP2 moving towards 2020.**

CMP1 was released after two years of consultations with domestic and foreign market participants, academics and capital market reform experts. It set out and implemented plans to make Malaysia's capital markets internationally competitive, efficient, and supported by a strong regulatory framework. CMP2 identifies structural weaknesses and outlines plans to develop efficiencies in critical linkages in the capital market to encourage more innovation and diversification, and strengthen governance frameworks. Specifically for the Islamic capital market, this means products and services will be more 'Shariah-based' instead of merely being 'Shariah-compliant'.



An investor covers his face as he monitors share market prices in Kuala Lumpur. REUTERS/Bazuki Muhammad

## Market Outlook

### **CMP2 forecasts the overall size of Malaysia's equity and debt capital market (Islamic and conventional) to more than double from RM2 trillion in 2010 to RM4.5 trillion in 2020.**

According to the CMP2, this baseline forecast is predicated on annual real GDP growth of 6.5% and historical market benchmarks, and is subject to prevailing economic and market conditions. Out of this forecasted RM4.5 trillion by 2020, debt securities are forecasted to exceed RM2 trillion, which would be three times its size in 2010 (RM758.6 billion). It has the historical growth record to back this 2020 forecast – the debt market grew 2.8 times from 2000 to 2010. In the equity market, total market capitalisation (Islamic and conventional) is forecasted to reach around RM2.4 trillion (\$800 billion) by 2020, based on real GDP growth of 6.5% and a historical average market capitalisation to GDP ratio of 139%. This growth is envisioned to come from the greater internationalisation of domestic listed companies and additional foreign listings.

### **CMP2 forecasts the size of the Islamic Capital Market (ICM) to almost triple from RM1.1 trillion in 2010 to RM2.9 trillion in 2020 (RM1.551 trillion equity, RM1.331.5 trillion sukuk).**

Malaysia hopes to achieve growth of 10.6% per annum for 2011-2020 compared to 13.6% per annum for 2000-2010 when the ICM tripled from RM293.7 billion to RM1.050 trillion. The market capitalisation of Shariah-compliant equities rose by 9.3% in 2013 to reach RM1.029 trillion (60.5% of total equity market

capitalization in 2013), which is 66% of 2020's RM1.551 trillion goal. Assets under management (AuM) in the Islamic funds industry is forecasted to grow from RM377.4 billion in 2010 to RM1.6 trillion in 2020. Malaysia's sukuk market is the largest in the world and its CAGR for 2000 to 2010 was 22.2%. It is expected to grow at a CAGR of 16.3% from 2010 to 2020.

### **But as Malaysia's stock market capitalisation is getting bigger, its growth is not matched by trading, relative to regional peers.**

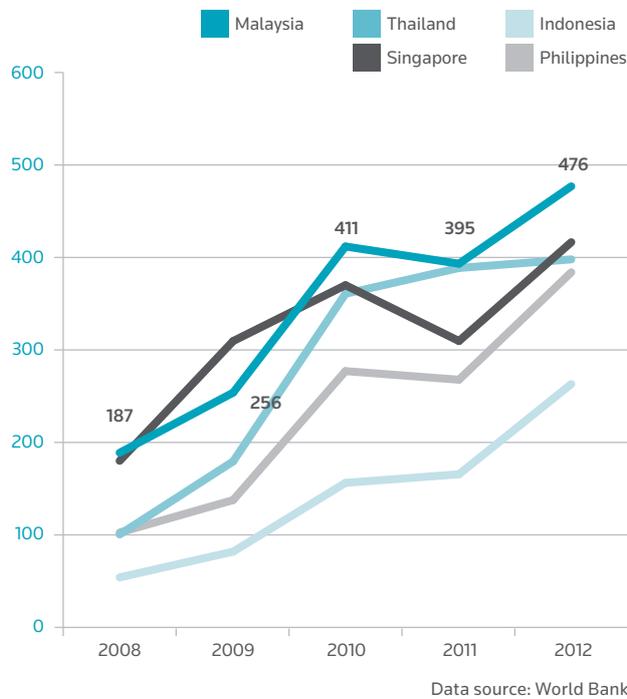
(This, considering market capitalisation against total value of stocks traded.)

As a whole, Malaysia's stock market is a lot less active than its peers in the region and in developed Western economies. Turnover ratio measures the level of share trading, and in the ASEAN region Malaysia's level of stock market activity is comparable to the Philippines. Malaysia's average for 2008-2012 was 30.77%. (Data from World Bank, as calculated by dividing total value of shares traded by average market cap.) In comparison, turnover ratios for regional averages for the same period were: 21.45% for the Philippines, 90.12% for Thailand, 52.63% for Indonesia and 81.07% for Singapore. For further comparison the U.S.'s was 250.79% and the UK's was 131.68%. The need to improve market liquidity, as measured by turnover ratio, is acknowledged in the national Economic Transformation Programme; the target is to increase the ratio to 60% in line with regional averages.

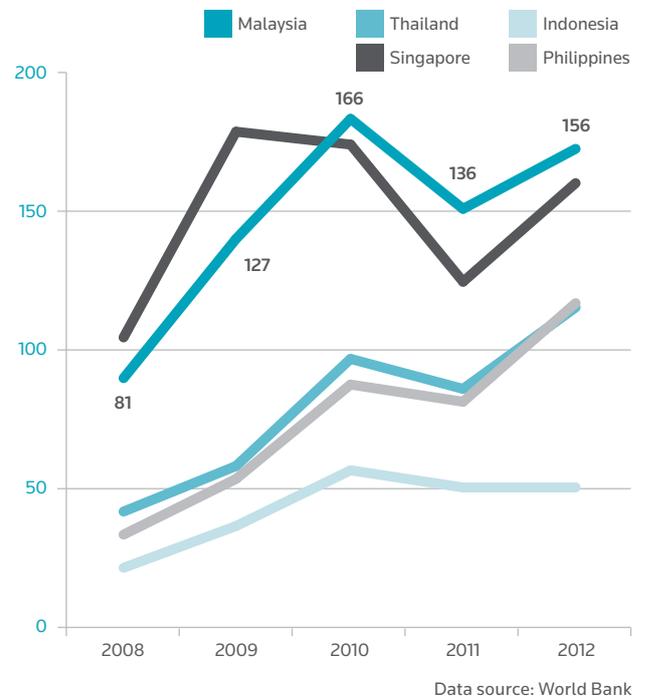
## Overview of CMP2 Strategies

GROWTH	GOVERNANCE
Promote capital formation	Enhance product regulation to manage risks
Expand intermediation efficiency and scope	Expand accountabilities as intermediation scope widens
Deepen liquidity and risk intermediation	Robust regulatory framework for a changing market landscape
Facilitate internationalisation	Effective oversight of risks
Build capacity and strengthen information infrastructure	Strengthen corporate governance
	Broaden participation in governance

Market capitalisation of listed companies, US\$ current prices billion



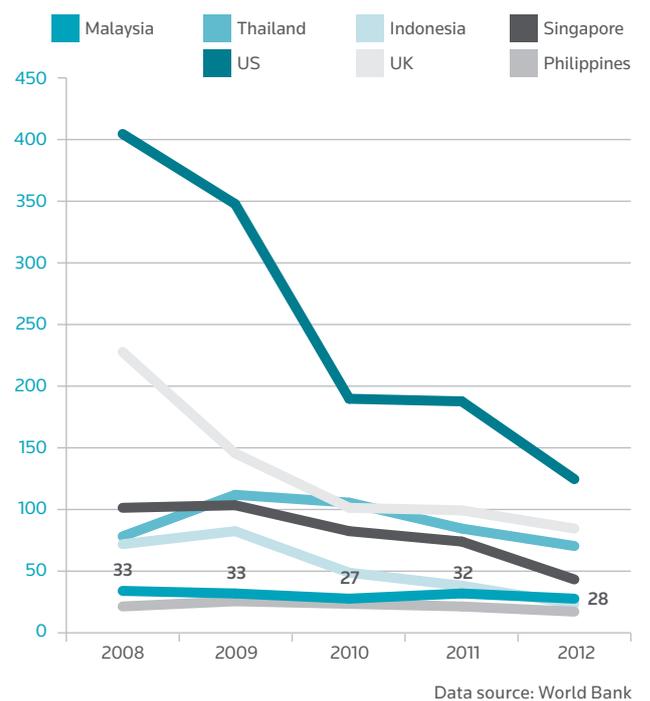
Market capitalisation of listed companies as % of GDP



Total value of stocks traded (% of GDP)



Stock market turnover ratio 2008-2012, %





## YOUR GATEWAY TO ISLAMIC MARKETS AND INVESTMENTS

**Zawya Islamic** makes Shariah-compliant investment, decision making and networking with the Islamic markets easier with access to:

- Fatawa, Standards, Regulations, and Product Structuring Guidance Notes intelligently connected with scholars and instruments
- Global Sukuk, Islamic Funds, and Shariah-compliant Equities
- Islamic Finance Research, News, Money Markets, Indices, & Benchmark Rates
- The Islamic Finance Development Indicator
- The Zawya Islamic Community and Islamic Finance Gateway Publications

For more information about Zawya Islamic and how it can support your business, please contact our membership services team or visit us online.

[membership.zawya@thomsonreuters.com](mailto:membership.zawya@thomsonreuters.com)

+971 4 4536768

#ZawyaIslamic @IFGateway

[zawya.com/islamic-finance](http://zawya.com/islamic-finance)

### Shariah-compliant securities

Shariah-compliant securities are the ordinary shares, warrants and transferable subscription rights issued by Shariah-compliant companies. The total number of Shariah-compliant securities listed on Bursa Malaysia (as designated by Securities Commission's Shariah Advisory Council) dropped to 673 in November, 2014 from 800 in June, 2013.

The total market capitalisation of Bursa Malaysia at the end of 2013 was RM1.67 trillion (69.58% of 2020's RM2.4 trillion goal), which is 167% above

Malaysia's gross domestic product (GDP) 2012 and 229% to 2013 gross national income (GNI). This perhaps points to the local stock exchange being overvalued and in need of a market correction. According to the World Bank, the average value of market capitalisation to GDP for Malaysia during 1988-2012 was 156.38% with a maximum of 328.88% in 1993 and a minimum of 66.06% in 1988. Total market capitalisation was RM1.77 trillion at the end of H1, 2014.

### KLCI & Shariah Index 1-Year Performance

From June 2013 to June 2014, all Islamic indices performed well registering positive cumulative change which indicates investors' confidence in the equity markets. Noticeably, the FBM Hijrah Shariah index which was designed to be used for Shariah-compliant investment products has performed better than its peers at 24.2% as of June, 2014. The DJIM Malaysia Titans 25 which measures the performance of 25 blue chip companies in Malaysia has shown 13.7% positive change from June 2013 to June 2014 attributed to the positive performance by most of its big-cap stocks. The FBM KLCI, which stands for FTSE Bursa Malaysia Kuala Lumpur Composite Index, is a capitalisation weighted stock market index of the largest 30 companies on the bourse. It also registered a substantial increase at 17.7% over the same period.

#### KLCI & Shariah Index 1-Year Performance

EQUITY MARKET INDICES	30-JUN-14	30-JUN-13	% CHANGE
FBM KLCI	1,882.71	1,599.15	17.7%
FBM EMAS Shariah	13,387.34	11,003.17	21.7%
FBM Hijrah Shariah	14,718.65	11,853.05	24.2%
DJIM Malaysia Titans 25	1,064.82	936.71	13.7%

Source: Securities Commission Malaysia

## Selected Indices Comparison

INDEX	OVERVIEW
<b>FTSE Bursa Malaysia EMAS Shariah Index (launched 2007)</b>  <b>FTSE Bursa Malaysia Small Cap Shariah Index (launched 2012)</b>	<ul style="list-style-type: none"> <li>• Benchmark Indices</li> <li>• Shariah-compliant constituents of the FTSE Bursa Malaysia EMAS Index/ FTSE Bursa Malaysia Small Cap Index that meet the screening requirements of the SC's SAC (sector and financial)</li> <li>• Tested for market capitalisation, free float and liquidity</li> <li>• Reviewed by FTSE in June and December after SC releases its list of Shariah-compliant companies on the last Friday of May and November. FTSE's review will then be approved or considered for any other action by the FTSE Bursa Malaysia Index Advisory Committee</li> </ul>
<b>FTSE Bursa Malaysia Hijrah Shariah Index (launched 2007)</b>	<ul style="list-style-type: none"> <li>• Tradable Index</li> <li>• 30 largest Shariah-compliant companies in FTSE Bursa EMAS Shariah Index (already meeting SC's SAC screening methodology) that are further filtered by FTSE's chosen Shariah consultancy, Yasaar Ltd</li> <li>• Yasaar screens quarterly</li> </ul> <p>1. Companies first screened by their business sector activity. Broadly, the following are not permitted:</p> <ul style="list-style-type: none"> <li>• Conventional finance</li> <li>• Alcohol</li> <li>• Pork-related products and non-halal food production, packaging and processing or any other activity related to pork and non-halal food</li> <li>• Entertainment (Casinos, Gambling, Cinema, Music, Pornography and Hotels)</li> <li>• Tobacco</li> <li>• Weapons, arms and defence manufacturing</li> </ul> <p>2. Companies are then screened by financial ratios. To be Shariah-compliant they must meet the following:</p> <ul style="list-style-type: none"> <li>• Debt less than 33.333% of total assets</li> <li>• Cash and interest-bearing items less than 33.333% of total assets</li> <li>• Accounts receivable and cash less than 50% of total assets</li> <li>• Total interest and non-compliant activities income should not exceed 5% of total revenue</li> </ul> <p>Companies that change financial compliance between two successive quarters will be monitored to check if their debt, and/or cash/interest bearing ratios fall within 33.333% +/- 5% (i.e. below 31.667% and 35% or above). If during the monitoring period any company remains above or below 33.333% +/- 5% for 2 consecutive quarters, the compliance of that company will change accordingly.</p> <p>Appropriate purification of dividends is at 5%. This ratio calculates the recommended purification amount to be paid by the investor. (Source: All information listed here from Bursa Malaysia)</p>

INDEX	OVERVIEW
<b>Dow Jones Islamic Market Malaysia Titans 25 Index</b>	<ul style="list-style-type: none"> <li>• Blue-Chip Indices</li> <li>• Includes 25 stocks which comprise of Malaysia-domiciled companies that are Shariah-compliant and trade on the Bursa Malaysia</li> <li>• Stocks are screened to exclude companies based on industry and financial ratios.</li> <li>• An independent Shariah supervisory board advises S&amp;P Dow Jones Indices in matters related to Shariah compliance.</li> <li>• Exclude any share that has more than 10 non-trading days over the past quarter</li> <li>• Exclude any share that Shariah Advisory Council (SAC) of the Securities Commission (SC) considers non Shariah-compliant</li> <li>• The index is weighted by float-adjusted market capitalisation. The weight of each individual constituent is capped at 20% of the index. Weights are reviewed quarterly.</li> </ul>
<b>Malaysia MSCI Islamic</b>	<ul style="list-style-type: none"> <li>• MSCI Islamic Index Series</li> <li>• An Islamic Index based on an MSCI Equity Index (or any combination of MSCI Equity Indexes), but excludes all the non-compliant securities in accordance with the MSCI Islamic Index Series Methodology</li> <li>• Business activity screening does not allow investment in companies with more than 5% of their revenue (cumulatively) from prohibited activities such as alcohol, tobacco, pork-related products, conventional Financial Services, defense / Weapons, gambling / casino, music, hotels, cinema, adult entertainment.</li> <li>• MSCI uses three financial ratios which should not exceed 33.33% to screen: total debt over total assets, sum of a company's cash and interest-bearing securities over total assets, and the sum of a company's accounts receivables and cash over total assets</li> <li>• In order to reduce index turnover resulting from financial screening, a lower threshold of 30% is used to determine new inclusions to the Index. A security that is currently not a constituent of the MSCI Islamic Indexes will be considered compliant with respect to financial screening only if all three financial ratios do not exceed 30%.</li> <li>• MSCI will apply a "dividend adjustment factor" to all reinvested dividends. The "dividend adjustment factor" is defined as: (total earnings – (income from prohibited activities + interest income)) / total earnings</li> </ul>

## Islamic Real Estate Investment Trusts (iREITs)

The issuance of iREITs guidelines by the Securities Commission in 2005 was a world first and introduced a new Shariah-compliant asset class. REITs are defined as funds or trusts with a combination of equities and bonds with a portion of real estate investment. They own and manage income-producing commercial real estate (shopping complexes, hospitals, plantations, industrial properties, hotels and office blocks). Islamic REITs are treated as collective investment schemes in real estate, in which the tenant(s) operate(s) permissible activities according to Shariah. Rental can be collected on non-permissible activities (which align with business activities under the SC's Shariah screening methodology for companies) but only up to 20% of total turnover of the iREIT. Further, iREITs are barred from owning real estate in which all the tenants operate non-permissible activities even if the percentage of rental from that property to the total turnover of the iREIT is still below the benchmark 20%. (These guidelines do not apply to real estate used for residential purposes.)

There are three types of REITs: Equity, Mortgage and Hybrid. Only equity is Shariah-compliant. The first Islamic REIT was the Al-Aqar KPJ Islamic

Healthcare REIT launched in 2006 with a fund size of RM180 million. The other iREITs are: AXIS (hybrid of properties), which was listed on Bursa Malaysia in 2005 as a conventional REIT and reclassified as Shariah-compliant in December 2008, KLCC REIT (shopping complexes, offices, meeting, conventions and exhibition facilities) and Al-Hadharah Boustead (plantations), which de-listed in February 2014. At the end of H1, 2014 there were three listed iREITs with a value of \$14.3 billion compared to the whole industry of \$34.1 billion (listed); on average, (listed) iREITs are bigger holdings than their conventional counterparts.

REAL ESTATE INVESTMENT TRUSTS (REIT)	JUNE 14	2013	2012
Listed Islamic REIT*	3	4	3
Total industry	16	17	16
Market Cap Islamic REIT (RM billion)	14.30	14.14	3.47
Market Cap Total industry (RM billion)	34.10	33.13	24.59
% iREITs to total industry	41.9%	42.68%	14.11%

Source: Securities Commission Malaysia



A labourer works on a residential construction site in Bukit Raja Klang, outside Kuala Lumpur. REUTERS/Samsul Said

### Islamic Exchange Traded Funds (iETFs)

Islamic Exchange Traded Funds (iETFs) track indices with Shariah-compliant equities. MyETF Dow Jones Islamic Market Malaysia Titans 25 (MyETF-DJIM25) was the first Islamic ETF launched in Asia in January 2008. (The world's first ever Islamic ETF was launched in 2007 by BNP Paribas.) The Exchange Traded Funds market is still niche and very small compared to other instruments. At the end of June 2014, there were only two Islamic ETFs: MyETF Dow Jones Islamic Market Malaysia Titans 25 and MyETF MSCI Malaysia Islamic Dividend. Diversification is one important benefit of investing in Malaysian ETFs due to a portfolio of 20 securities. Liquidity and low minimum investment are also key as ETFs are traded in board lots on Bursa Malaysia. In October 2014 the Securities Commission Malaysia issued parameters on Islamic ETFs based on gold and silver as a step to develop the ETF market.

EXCHANGE TRADED FUNDS (ETF)	JUNE 14	2013	2012
Islamic ETF	2	1	1
Total industry	6	5	5
Market Cap Islamic ETF (RM billion)	0.32	0.31	0.29
Market Cap Total industry (RM billion)	1.03	1.03	0.92
% iETFs to total industry	31.5%	30.10%	31.52%

Source: Securities Commission Malaysia



Malaysia's Second Finance Minister Ahmad Husni Hanadziah (2nd L) hits a traditional Malay gong as Chairman of Maxis Bhd Raja Arshad Raja Tun Uda (2nd R), Chief Executive Officer of Maxis Bhd Sandip Das (L) and Non-Executive Director of Maxis Bhd Ralph Marshall look on during the launch of Maxis Bhd's initial public offering (IPO) in Kuala Lumpur November. REUTERS/Bazuki Muhammad

## Venture Capital

VC growth is relatively slow considering the extent of support extended to the sector via funding and tax incentives from the Malaysian government since 2001 when tax incentives and guidelines for VC companies were first introduced (amended in 2014). The Securities Commission released specific guidelines and best practices for Islamic VC in 2008. Incentives include 10-year income tax exemption (subject to minimum % threshold of invested funds) and tax deduction for both individuals and companies for an amount equivalent to the value of the investment made in a venture company.

To move the industry forward the Malaysian Venture Capital Development Council (MVCDC) was formed in 1998 (chaired by the Securities Commission). Financial and funds institutions such as banks and insurance companies are the most risk-averse to VC investments and the major domestic VC funds active in Malaysia – such as the biggest VC company Malaysia Venture Capital Management Berhad (MAVCAP) that was established in 2001 – are linked to the government, either directly or through affiliates set up by the Minister of Finance. Indeed, the government is the main funder of the VC industry. Most recent available full-year data reveals that 61.36% of total committed funds in 2013 – equivalent to RM3.56 billion – came from the government. (SC data)

The majority of funds are injected at the Expansion/Growth and Early stages followed by the Mezzanine/Pre-IPO stage. Seed and Start-Up VC investment lags far behind.

The most popular industries for VC investment in Malaysia are: ICT, consumer services, manufacturing, and Life Sciences. The government is pushing for more VC investment in pharmaceutical and biotechnology companies and the focus of these within the global Islamic Economy have, in recent years, given the sectors more exposure to Shariah-compliant investors although progress is still slow. To boost VC investments in the two sectors there are the Malaysian Life Science Capital Fund and collaboration programmes between Malaysian and American scientists.

Despite government efforts to strengthen the VC business in Malaysia, private sector involvement has been very limited partly due to the higher stakes involved in VC investment and also because of the lack of legal structures for pooling investments covered by corporate law reform to facilitate wider asset classes for intermediation. In addition, VC needs to be encouraged more internationally through attracting foreign investment or domestically through universities that need to set up the right base infrastructure of education and R&D to cover business knowledge.

## Key statistics for VC development in Malaysia 2009-2013

	2009	2010	2011	2012	2013
<b>No. of registered VC funds/corporates</b>	59	58	56	59	61
<b>No. of registered VC Management Operations (VCMCs)</b>	55	55	52	53	58
<b>No. of investee companies</b>	445	389	409	466	356
<b>No. of VC professionals</b>	313	160	131	124	103
<b>SHAREHOLDING STRUCTURE</b>					
<b>Local ownership</b>	104	102	98	100	99
<b>JVs</b>	9	9	8	10	15
<b>Foreign Ownership</b>	1	2	2	2	5
<b>INVESTMENT FUNDS (RM MILLION)</b>					
<b>Total committed funds under management as at end of period</b>	5,347	5,959	5,460	5,698	5,796
<b>Total investment as at end of period</b>	2,586	3,389	3,586	2,757	3,433
<b>Investments in investee companies during period</b>	597	453	253	230	264
<b>Divestments during period</b>	43	89	146	235	287
<b>SOURCE OF FUNDS</b>					
<b>Government</b>	52.92%	51.4%	54.1%	54.07%	61.36%
<b>Local companies</b>	23.52%	29.44%	25%	23.27%	18.73%
<b>Foreign companies &amp; Individuals</b>	11.01%	9.73%	10.64%	10.64%	11.49%
<b>Banks</b>	7.31%	4.93%	5.15%	6.98%	3.64%
<b>Insurance</b>	0.63%	0.55%	0.61%	0.58%	0.54%
<b>Pension &amp; Provident Funds</b>	2.1%	2.09%	2.27%	2.12%	1.64%
<b>Local Individuals</b>	2.51%	1.86%	2.23%	2.34%	2.6%

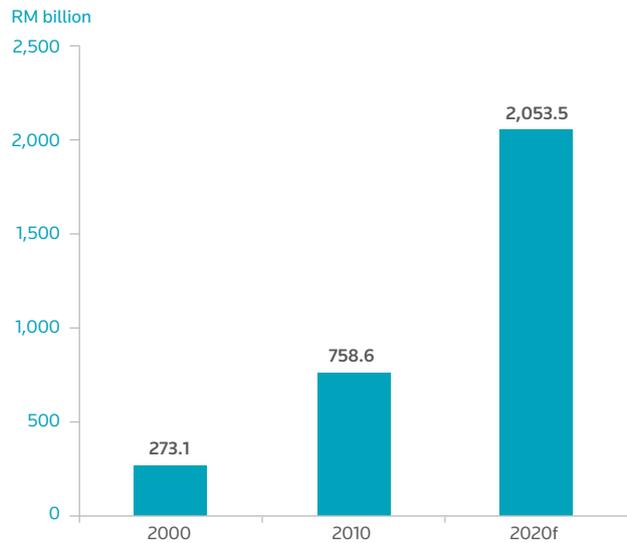
Source: Securities Commission Malaysia

## Sukuk

Sukuk is a key Islamic instrument in Malaysia’s ICM and it will be discussed further down this chapter in detail. One recent capital market inclusion is the launch of the Malaysian retail bonds and sukuk framework in 2012 as a way to broaden the investor and liquidity base and allow retail investors easier access to tap the growing capital market. Retail bonds and sukuk can be traded either on the exchange (Bursa Malaysia) or over-the-counter (OTC) via appointed banks.

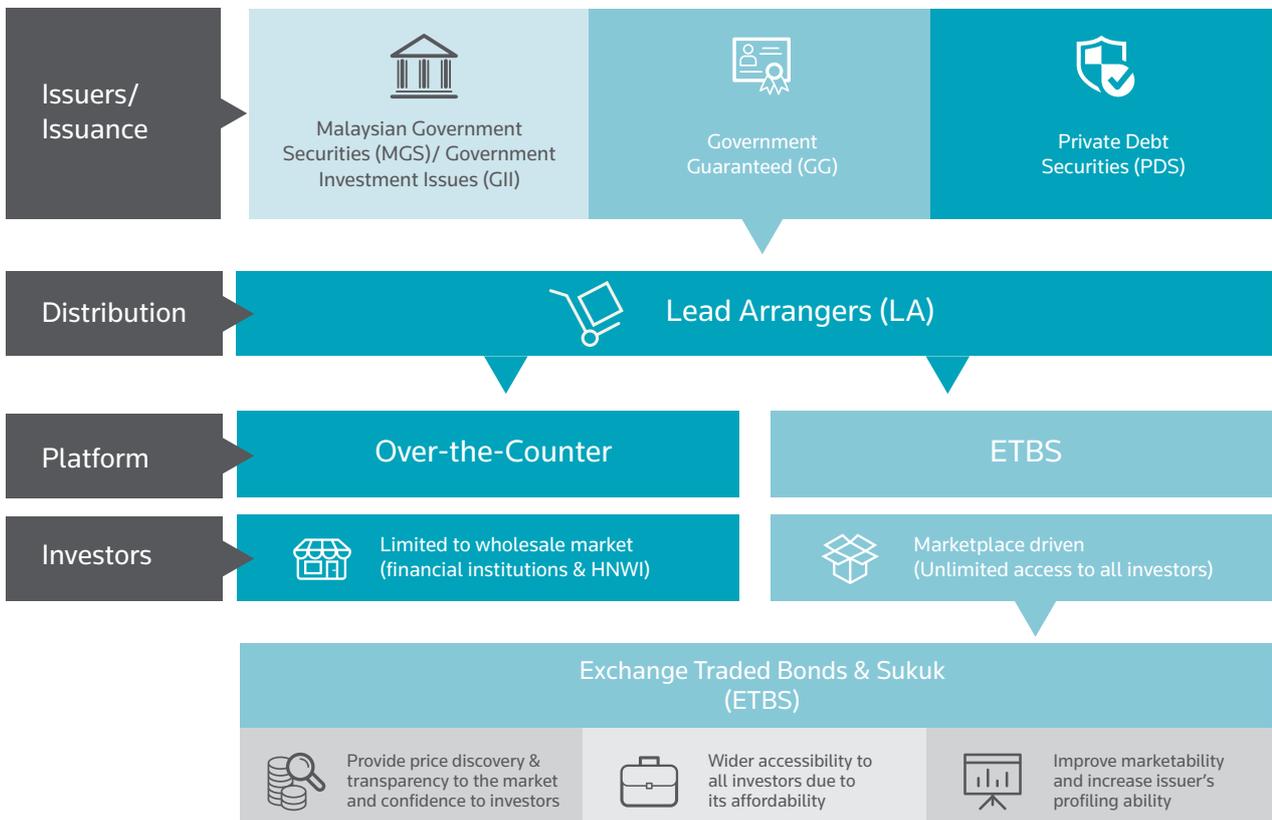
Most retail bonds and sukuk are investment grade instruments aimed at investors with conservative risk profiles. Investors enjoy non-taxable coupon payments via ETBS. The first issuance was a RM300 million sukuk from state-owned SPV Danalnfra Nasional Berhad for the Mass Rapid Transit (MRT) project.

### Debt securities (conventional + Islamic) to exceed RM2 trillion in 2020



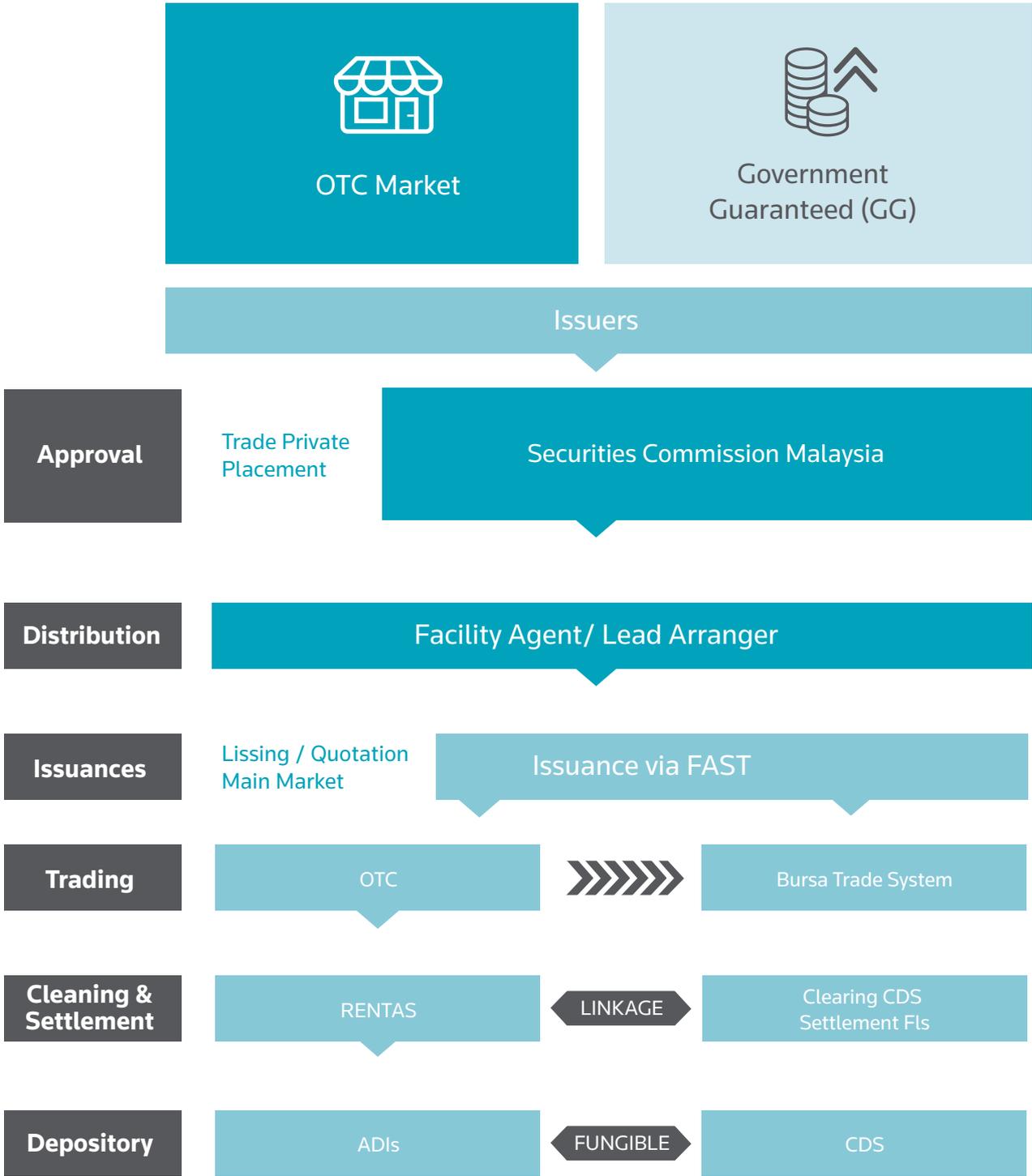
Source: Securities Commission Malaysia

### Retail Bonds and Sukuk Framework



Source: Bursa Malaysia

ETBS Framework





## Islamic Derivatives

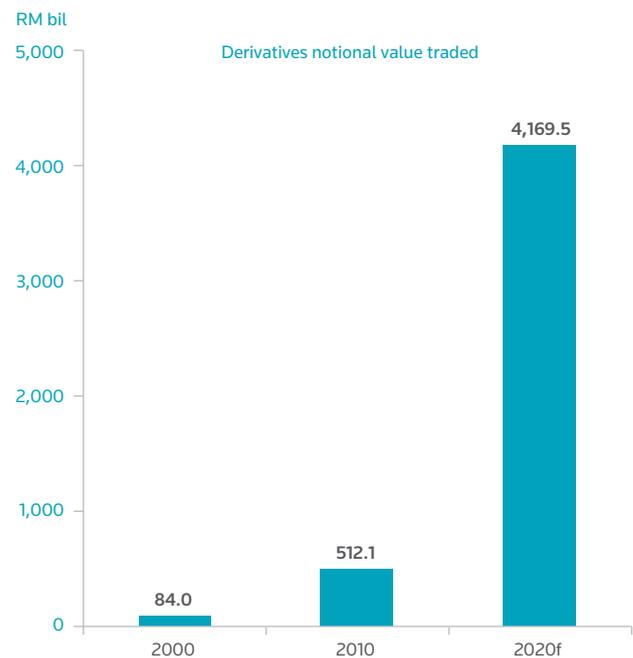
The Shariah-compliant derivatives market is still very limited given the reservations of many Shariah scholars on the permissibility of derivative instruments. The development of Islamic derivatives started in 2006 when Bank Islam and Bank Muamalat launched a pro-forma master agreement for documentation of Islamic derivative transactions. In 2007, CIMB Islamic introduced the world's first Islamic Profit Rate Swap (IPRS). In 2010, the Bahrain-based International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association Inc. (ISDA) released the Tahawwut Master Agreement Hedging (MA). Following that, on 28 March 2012, IIFM and ISDA published a standard contract template to supplement the MA.

The most basic Islamic derivative is IPRS which is structured to have a similar function to conventional interest rate swaps (IRS) while complying with Shariah. IPRS allows two parties to exchange floating-profit payments for fixed-profit payments in the same currency over a fixed period of time through execution of a series of underlying Shariah contracts. Most of the banks in Malaysia construct IPRS with a combination of a hybrid of contracts such as wa'ad, murabahah and musawamah. IPRS has also been used by fixed income fund managers to protect against profit rate exposure.

The second hedging product is foreign currency swaps. Cross currency is the application of both IPRS and Forex Swaps, for contracts exceeding 1 year. The Islamic cross currency swap (ICCS),

includes completing two murabahah transactions concurrently to produce cash flows that is similar to the conventional currency swap. ICCS involves real transaction of Shariah-compliant assets and it allows fund managers to effectively convert an asset from a currency to another at a pre-agreed exchange rate. Further, the profit rate of the resulting swap can be either floating or fixed. ICCS combines the benefits of managing currency risks and profit rate within Shariah principles. Subsequent to the growth of USD Sukuk in Malaysia, ICCS has witnessed growth by local fund managers to hedge against foreign currency risk.

### Projected growth in derivatives market





## Leadership Article:



**By Datuk Ranjit Ajit Singh,  
Chairman, Securities  
Commission Malaysia**

Datuk Ranjit Ajit Singh has played a key role in international securities regulatory policy work. He is Vice Chairman of the Board of the International Organisation of Securities Commissions, and Chairman of IOSCO's Growth and Emerging Markets Committee that covers 86 jurisdictions. He currently chairs the Securities Industry Development Corporation, the Malaysian Venture Capital Development Council and the Capital Market Development Fund. He is also Vice-Chairman of the Asian Institute of Finance and board member of the Labuan Financial Services Authority and the Financial Reporting Foundation. Datuk Ranjit received his Doctor of Laws honoris causa from Monash University Melbourne and is a fellow of CPA Australia.

## Shariah-compliant securities as catalyst to the development of the Islamic Capital Market

Malaysia's Islamic Capital Market has developed considerably since the mid-1990s. In this article, the country's Securities Commission describes the milestones that have made Malaysia's ICM what it is today.

The Islamic Capital Market (ICM) has become a viable alternative avenue for investment and fund raising in Malaysia. It is now a key component of the Malaysian capital market, accounting for more than half of the total capital market. The size of the ICM more than tripled during the ten-year period of the first Capital Market Masterplan, growing from RM293.7 billion in 2000 to RM1,050.1 billion in 2010, with a compounded annual growth rate of 13.6%. Growth momentum has been sustained with the size of the Malaysian ICM reaching RM1,541.7 billion at the end of 2013, representing 56.4% of the Malaysian capital market.

In the equity market, 71% of securities listed on Bursa Malaysia were Shariah-compliant (Editor's note: This number increased to 74% as at Nov, 28 2014, which was when the most recent list of Shariah-compliant securities were released by the Securities Commission.) with their market capitalisation representing 60.5% of the total market capitalisation as at the end of 2013. In the sukuk market, the total value of outstanding sukuk stood at RM512.1 billion as at the end of 2013. Malaysia remains the leading jurisdiction in the sukuk market accounting for 58.8% of outstanding sukuk and 69% of sukuk issuances globally as at the end of 2013.

Malaysia is also a significant player in the Islamic fund management industry, accounting for approximately 22% of global Islamic assets under management (AUM) as at December 2013. On the domestic front, Islamic AUM accounted for 16.6% of the industry's total AUM.

### **Building a comprehensive ICM**

The availability of a wide range of intermediation capabilities is a key element contributing to the comprehensiveness of the ICM in Malaysia. The Malaysian ICM is home to local and foreign fund management companies that offer Islamic fund management services either solely or alongside their conventional business. In addition, there are a number of investment banks, legal firms and Shariah advisers that are highly capable and experienced in originating, arranging, advising, distributing and marketing ICM products and services for both domestic and international markets.

In developing the ICM, the focus for the Securities Commission (SC) is on facilitating the availability of ICM products and services that meet the needs of the stakeholders within a framework that ensures the protection of investors, as well as efficiency in intermediation. Today, there is a comprehensive range of ICM products available in the market catering to the different groups of investors with different risk appetite. These products include Shariah-compliant securities, sukuk, Islamic unit trust funds, Islamic wholesale funds, Islamic real estate investment trust funds, Islamic exchange traded funds and Islamic structured products. Islamic private equity and venture capital funds, while still a niche segment, are fast becoming alternative sources of funding for startup entities engaged in Shariah-compliant businesses with growth potential.

All these ICM products are being offered within a regulatory framework that also applies to conventional capital market products, with additional specific guidelines or provisions to address relevant Shariah issues and requirements. This approach ensures that all capital market products in Malaysia, whether conventional or Islamic, are governed under

the same enabling regulatory framework for issuers while according investors the same degree of clarity, consistency and protection when participating in the Malaysian capital market.

### **Screening methodology since 1995**

Shariah-compliant securities were among the earliest ICM products available in Malaysia and were introduced initially to meet the demand by domestic institutional and retail investors for Shariah-compliant investments. The Shariah Advisory Council of the SC (SAC), which has evolved to become the apex authority for the ascertainment of Shariah matters for the ICM, had in 1995 developed a methodology for screening the Shariah status of securities listed on the stock exchange. The screening process for Shariah compliance, which leads to the issuance of the "List of Shariah-Compliant Securities" in May and November each year, provides certainty and clarity as to the status of securities listed on the stock exchange and has encouraged greater investor participation in the Islamic equity market.

The Shariah screening methodology developed by the SAC provides for quantitative and qualitative assessments to determine the Shariah status of listed securities. When the screening methodology was introduced in 1995, quantitative assessment focused on the business activities carried out by companies. Companies were therefore classified as Shariah non-compliant if they were involved in activities which were clearly prohibited by Islamic law and principles. For companies with business activities comprising both Shariah-permissible and Shariah non-permissible activities, the SAC had established specific benchmarks to determine the tolerable level of mixed contributions from permissible and non-permissible activities. Companies must not breach any of the established benchmarks in order to be classified as Shariah-compliant. The qualitative assessment, on the other hand, focused on public perception or image of the companies as well as *maslahah* (benefit in general) to the Muslim community and the country.

### Screening at pre-IPO stage

As an agenda to further develop and promote the Islamic equity market, the SC had in 2004 extended the screening of securities to include those at the pre-initial public offering (IPO) stage. The initiative was introduced following high demand from the industry for information on the Shariah status of securities at the pre-IPO stage. This assessment is carried out by the SAC upon application by the prospective issuer and the Shariah status of the issuer is then disclosed in the prospectus. The introduction of Shariah screening at the pre-IPO stage enables both institutional and retail investors to participate in Shariah-compliant securities at an early stage, and at the same time provides an opportunity for potential issuers to market their securities to a broader investor base. Since then, there have been many companies, including those with large market capitalisation, applying for the sharia status at the pre-IPO stage.

As an extension of the Shariah-compliant securities segment, the then Kuala Lumpur Stock Exchange (KLSE, renamed Bursa Malaysia in 2004) introduced the KLSE Shariah Index in 1999, which served as the benchmark for Shariah-compliant equities on the exchange to support and capitalise on growing investor interest in Shariah-compliant investments. In January 2007, this index was replaced by the FTSE-Bursa Malaysia EMAS Shariah Index that takes the constituents of the FTSE-Bursa Malaysia EMAS Index – which have been screened and tested for market capitalisation, free-float and liquidity – and applies the SAC's screening methodology to derive a transparent Shariah-compliant index. Subsequently, the FTSE-Bursa Malaysia Hijrah Shariah Index, a tradable index, was introduced in May 2007. These two indices enable investors and the public at large to track the performance of fund managers or of their own equity investments, as well as facilitate the potential creation of index-tracking funds, exchange-traded funds and structured products that would add variety and diversity to the Malaysian ICM.

### November 2013 screening revisions

In view of the development and growing sophistication of the Islamic finance industry in Malaysia, the

SAC endorsed a revised Shariah screening methodology effective November 2013 by adopting a two-tier approach to the quantitative assessment which applies the business activity benchmarks and the newly-introduced financial ratio benchmarks while at the same time maintaining the qualitative assessment. The rationale behind this revision is to bolster the competitiveness of the Islamic equity market and fund management industry at both domestic and international levels, in line with the SC's initiatives to further build scale in the Shariah-compliant equity and investment management segments as well as expand the ICM's international reach, as outlined in the *Capital Market Masterplan 2* which covers the 10-year period starting 2011. The revision to the Shariah screening methodology for listed securities is also aimed at attracting greater international inflows into the Malaysian capital market.

### Setting the foundation for Islamic fund management industry

The introduction of the Shariah screening methodology and the classification of Shariah-compliant securities by the SAC have, to a certain extent, set the foundation for the development of the Islamic fund management industry in Malaysia. Today, the country is a significant player in this industry with a track record spanning over 20 years. Since 1993 when only two Islamic funds were established, the country has been driving the Islamic fund management industry's innovation with notable milestones including the launching of the world's first Islamic real estate investment trust in 2006 and Asia's first Islamic exchange traded fund in 2008. Malaysia had 178 Islamic unit trust funds and 52 Islamic wholesale funds as at December 2013. The healthy growth of the Islamic funds segment in Malaysia has enhanced access to Shariah-compliant investments particularly for retail investors.

The conducive ecosystem for the Islamic fund management industry in Malaysia, which includes liberalisation of foreign ownership and tax incentives, has spurred the development of the industry. Fund managers managing Islamic funds and Shariah-compliant private mandates (mainly

---

*The broadening of access to financial investments and capital through the stock market has been the main thrust of the SC in developing the Malaysian ICM.*

---

for institutions) are accorded tax exemption on management fees received from these portfolios. The various measures and incentives, as well as Malaysia's global position in Islamic finance, have also attracted leading international fund management companies to set up operations in the country. Malaysia is the first and presently the only jurisdiction that issues specific licences to companies undertaking solely Islamic fund management activities (Islamic fund management companies or IFMCs). This licensing regime ensures that the IFMCs demonstrate full commitment to the principles of Shariah in their business conduct thus gaining the confidence of investing clients. In terms of flexibility of funds operation, IFMCs are allowed to offer funds in both local and foreign currencies, and invest 100% of the funds abroad.

To-date, there are 19 licensed IFMCs including global entities such as Aberdeen, Amundi, BNP Paribas, Franklin Templeton, Nomura and the Principal Group. Through their worldwide networks, these entities are potentially able to attract and mobilise global liquidity into and through Malaysia, and help spur further development of the country's Islamic fund and wealth management industry.

#### **Developing international links**

As part of the SC's initiatives to broaden the Islamic fund management industry and develop international linkages through multilateral and bilateral arrangements, the SC signed a mutual recognition agreement (MRA) with the Dubai Financial Services Authority in March 2007 for cross-border marketing and distribution of Islamic funds between Malaysia and the Dubai International Financial Centre. The SC followed up on this initiative with another MRA with the Securities and Futures Commission of Hong Kong in November 2009. These agreements help

to widen the industry's distribution network and promote an exchange of ideas to enhance product offerings, especially for funds meant for regional distribution. This was evidenced by the recent launching of two Malaysia-based Islamic funds in Hong Kong, showcasing Malaysia's capability to offer its investment products internationally.

#### **New growth areas: Business trusts and Private Retirement Scheme**

Two recent developments in the Malaysian capital market — business trusts and the Private Retirement Scheme (PRS) — have provided new growth areas and opportunities for the Islamic fund management industry. At the same time, these developments enable both companies and individuals to tap into such offerings, create liquidity and a sustainable marketplace for wealth creation and extend the reach of the capital market.

The broadening of access to financial investments and capital through the stock market has been the main thrust of the SC in developing the Malaysian ICM. In fact, widening access to the ICM is critical to the development of a successful and inclusive Islamic finance industry in general. In supporting this goal, the SC together with other stakeholders continues to explore innovative and inclusive financial solutions that serve the various segments of the investing public. A market with breadth and depth provides its participants with more choice, builds liquidity and promotes greater efficiency and innovation for a sustainable and orderly development of the ICM.

# Malaysian Sukuk Market Overview And Development

## Market Overview 2012 -2014

The global sukuk market has grown tremendously in the past decade mostly driven by Shariah-compliant institutions and OIC governments. Most sukuk issued — both domestic and international sales — have been from Malaysia and the GCC. Malaysia is the world's biggest sukuk market.

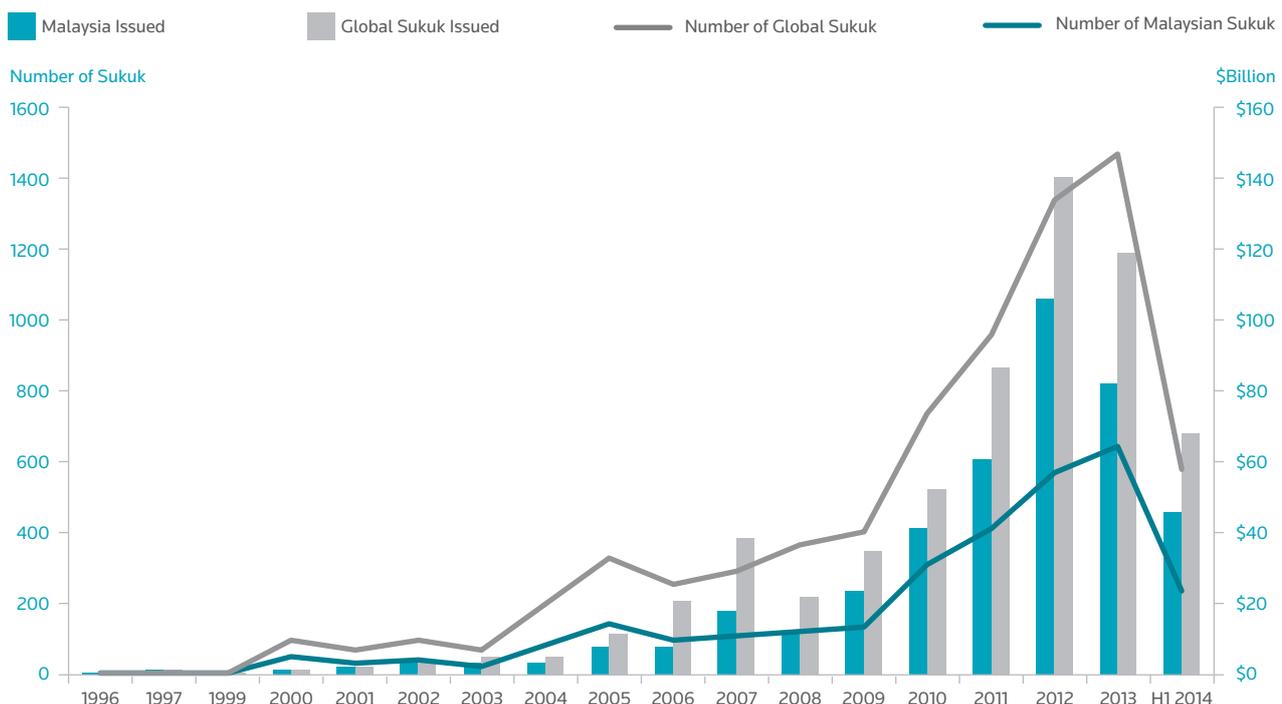
- **2012 high:** 2012 was an exceptional year due to big sovereign and quasi-sovereign issuances. Sukuk issuance reached an all-time high of \$137 billion.
- **2013 drop:** Due to prospects of the US Federal Reserve reducing significantly its bond purchase volume, markets became anxious about the fixed income space in 2013. This also affected the global sukuk market; as a result issuance dropped to US\$119.47 billion.
- **Several milestones in 2014 but total issuance value dropped again:** Total sukuk issued in 2014 was US\$114.08 billion covering longer term and

bigger sizes compared to 2013. In 2014, the sukuk market witnessed new countries making their debut in the market such as the United Kingdom, Hong Kong, and South Africa. However, the overall issuance level still fell short of 2013's despite initial positive outlook.

**Malaysia holds 67% of global outstanding sukuk:** The Malaysian sukuk market jumped from US\$11.86 billion in 2008 to reach US\$82.39 billion in 2013. Total Malaysia sukuk issued in 2014 was US\$77 billion. This represents a fall of 6.5% of the total value of sukuk issued in Malaysia in 2013, largely due to the drop in the value of the Ringgit. In Ringgit terms, Malaysian sukuk increased by 1.6% to RM260.87 billion in 2014 compared to RM256.63 billion in 2013.

- **Total Malaysian sukuk issuance since 1996 stands at US\$451.02 billion** representing almost 67.% of global sukuk issuance.

## Global vs Malaysia Sukuk Historical Trend (1996 – H1 2014)



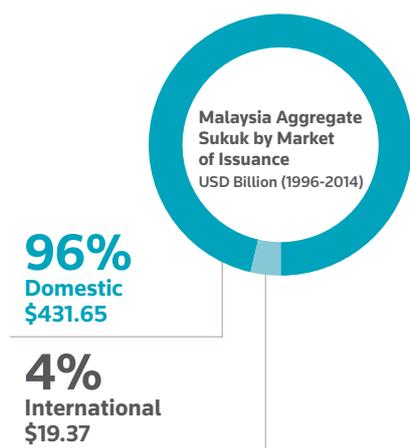
Source: Thomson Reuters Zawya

**The Malaysian sukuk market is made up of 96% local currency issues.**

These are mainly from sovereign and quasi-sovereign local currency issues, which serve issuers' local funding requirements and the country's wide local investor base. From 1996 to 2014, total local currency sukuk accounted for 96% of total local issuance – the volume reached US\$431.65 billion compared to only US\$19.37 billion international sukuk. This surge was mostly driven by highly liquid available investment

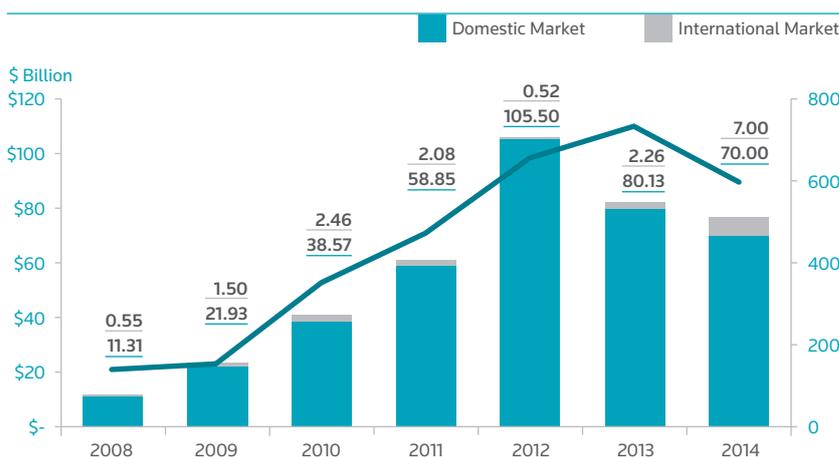
funds mostly from local Shariah-compliant financial institutions, corporates, retailers and large institutional investors with Shariah-compliant mandates or plans to expand their Shariah-compliant portfolios. This overwhelming local currency sukuk market has led to criticisms levelled at Malaysia's Islamic finance industry as being too closed a market. However, the country's wide and deep pool of liquidity and investors (plus attractive pricing) has attracted many foreign issuers to consider issuing in Malaysia.

Malaysia Aggregate Sukuk by Market of Issuance  
USD Billion (1996-2014)



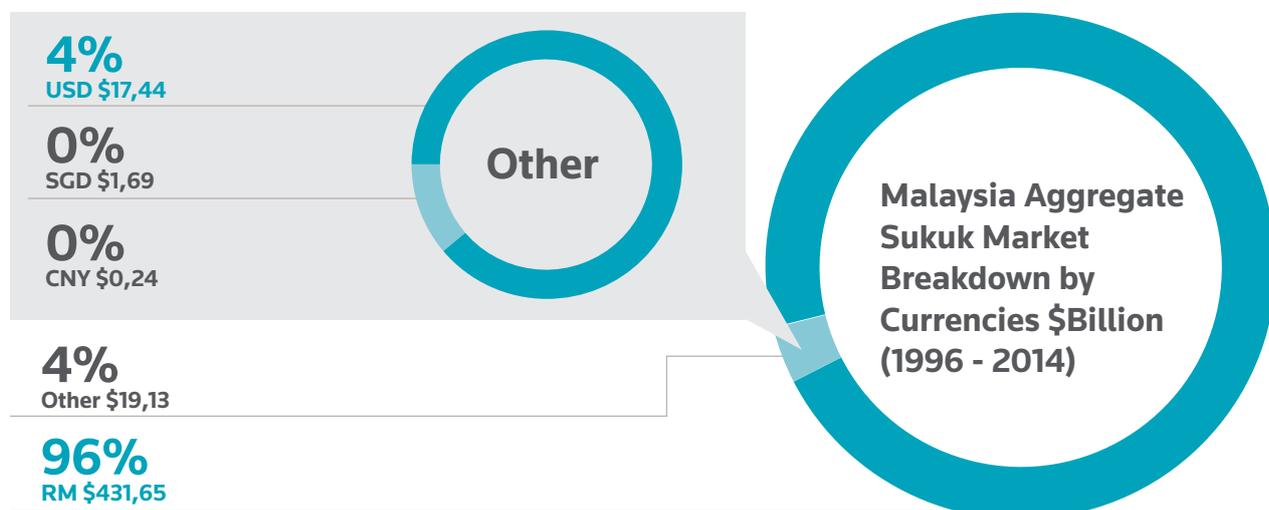
Source: Thomson Reuters Zawya

Malaysian Sukuk breakdown by market of Issuance (2008 – H1 2014)



Source: Thomson Reuters Zawya

Malaysia Aggregate Sukuk Market Breakdown by Currencies \$Billion (1996 – 2014)



Source: Thomson Reuters Zawya

**The Malaysian government has been a critical driver of the sukuk market.**

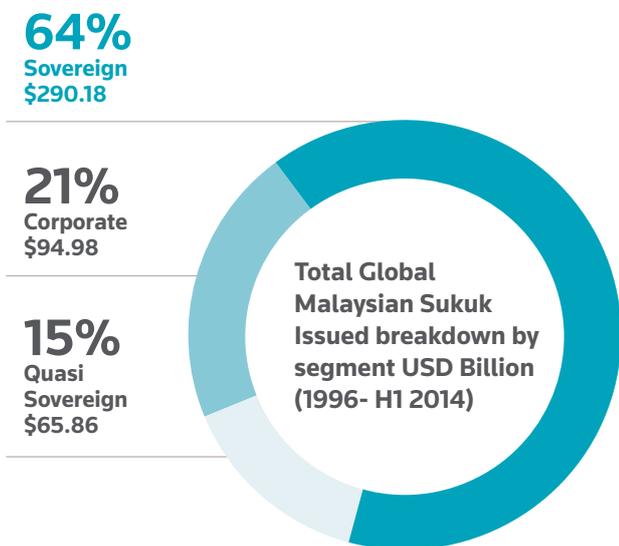
Total aggregate Malaysia sovereign sukuk issued since 1996 until 2014 reached US\$290.18 billion; this is 64% of total issuance. This number jumps to 79% if quasi-sovereign issues are included. Corporate sukuk only makes up 21% of issuance, or US\$94.98 billion, of total Malaysia sukuk issued.

Most of the sovereign sukuk issued are short-term papers with less than one-year tenors; these are primarily instruments to help manage and control liquidity in the Shariah-compliant market. However, corporate issuances have started to grow gradually in the past couple of years mostly led by financial services, particularly banks. Unlike other jurisdictions, Malaysia’s corporate sukuk issuances are well-diversified; they include utilities, transportation (both mainly serving to build and/or maintain infrastructure) and services, as well as less frequent issues from sectors such as education, healthcare and consumer goods.

Malaysia Aggregate Sukuk Breakdown by Sector (1996 – 2014)

SECTOR	NUMBER OF SUKUK	SUKUK AMOUNT (\$BILLION)
Governmental Institutions	787	287.02
Financial Services	446	51.71
Power and Utilities	441	30.08
Transport	352	28.06
Construction	489	17.68
Telecommunications	108	9.43
Real Estate	163	6.18
Conglomerates	41	3.94
Agriculture	99	3.67
Oil and Gas	88	3.62
Services	56	3.26
Health Care	74	1.55
Industrial Manufacturing	53	1.34
Education	11	1.03
Food and Beverages	23	0.78
Consumer Goods	31	0.72
Leisure and Tourism	2	0.32
Mining and Metals	8	0.24
Information Technology	20	0.22
Retail	18	0.18
<b>Grand Total</b>	<b>3310</b>	<b>451.02</b>

Total Global Aggregate Sukuk Issued breakdown by sector USD Billion (1996- 2014)



Source: Thomson Reuters Zawya

Malaysian Sukuk breakdown by sectors (2008 – 2014)



Source: Thomson Reuters Zawya

### Malaysia's sukuk market leans heavily towards the murabahah structure.

There may be a divergence of market acceptance towards trading murabahah sukuk but the numbers obviously show that this is not an issue for the domestic local currency Malaysian market.

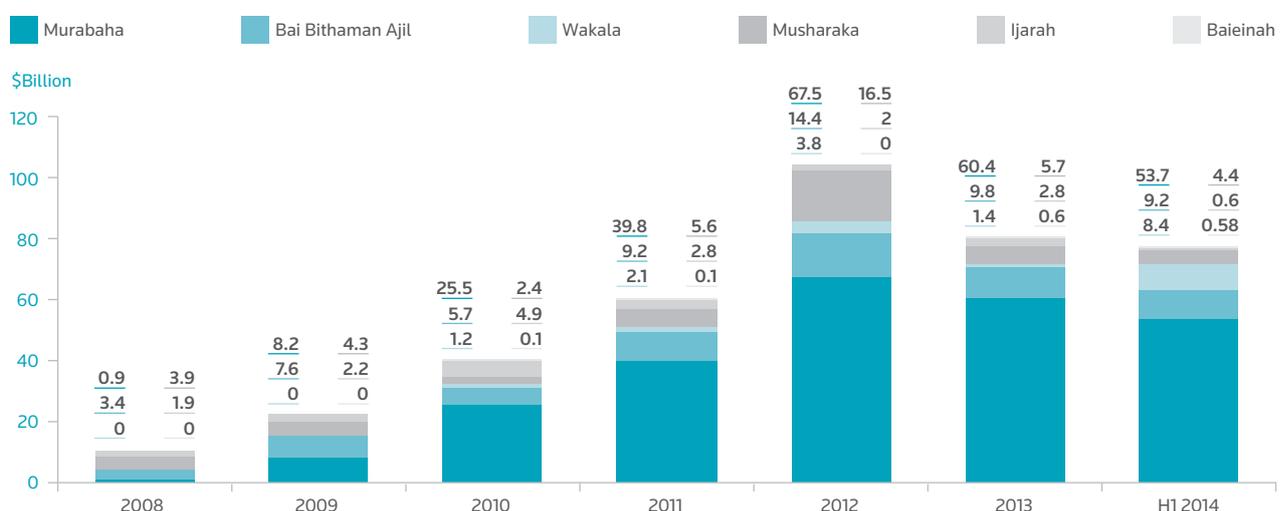
Other debt-based structures such as bai bithaman ajil, and to a lesser extent bai inah and bai dayn, also gained popularity within the local markets; these structures are not accepted outside Malaysia. However, the types of sukuk structures used have shifted towards the more globally-accepted murabahah, musharakah, ijarah and wakalah in the last five years as Malaysia moves towards the international markets and a globalisation of its Islamic finance industry.

As at the end of 2014, murabahah sukuk totalled \$53.67 billion of the country's total sukuk issuance followed by bai bithaman ajil, then wakalah with US\$9.24 billion and US\$8.48 billion, respectively. Next to these regular issuances, the hybrid sukuk started to penetrate the market with a mix of two or more structures within one paper. In addition, more innovative structures are evolving such as convertible, retail and structured covered sukuk (discussed further down this section).

### Malaysia Aggregate Sukuk breakdown by Structure (1996 – 2014)

SUKUK STRUCTURE	NUMBER OF SUKUK	SUKUK AMOUNT (\$BILLION)
Murabahah	1,539	261.86
Bai Bithaman Ajil	352	74.02
Musharakah	644	57.61
Ijarah	334	22.54
Wakalah	74	16.93
Istisnaa	33	5.30
Ijarah-Mudarah-Musharakah-Murabahah-Istisnaa	10	2.55
Mudarabah	73	2.05
Bai Inah	44	1.71
Ijarah-Musharakah	4	1.35
Al-Wakalah Bil-Istithmar	11	1.32
Murabahah-Musharakah	10	0.87
Al-Istithmar	3	0.79
Ijarah-Istisnaa	42	0.62
Ijarah-Wakalah	39	0.51
ALIm	1	0.31
Bai Dayn	51	0.28
Mudarabah-Murabahah	27	0.22
Ijarah-Murabahah	5	0.11
Murabahah-Istisnaa	12	0.03
Istisnaa-Mudarabah	2	0.02
<b>Total</b>	<b>3,310</b>	<b>451.02</b>

### Malaysia Sukuk Historical Trend (2008 – 2014) Top 5 Sukuk Structure



Source: Thomson Reuters Zawya

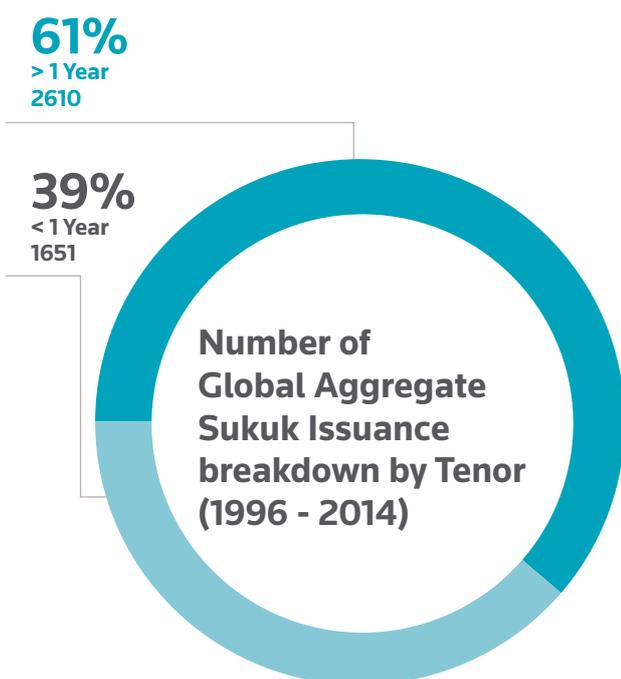
**There are still very few long-term sukuk.**

Most Malaysia sukuk carry tenors of between five and 10 years. However, there is a gradual transition towards the two ends of the maturity curve. Short-term papers started to gain recognition as a liquidity management solution led by the central banks of Bahrain and Malaysia, and the International Islamic Liquidity Management Corporation (IILM). The Malaysian government issues the majority of the short-term sukuk in the local market. On the other hand, Basel III requirements are forcing longer tenors and we've already seen three GCC banks issue Basel III-compliant Tier 1 sukuk. Malaysian financials have issued Basel III-compliant Tier II sukuk only. However, according to Thomson Reuters Sukuk Perceptions & Forecast 2015 report, investors and traders still prefer medium-term papers with maturity of five to 10 years, over longer-term papers. In the past couple of years, the number of short-term sukuk <1 year amounted to more than half of total sukuk issued in Malaysia's domestic market.

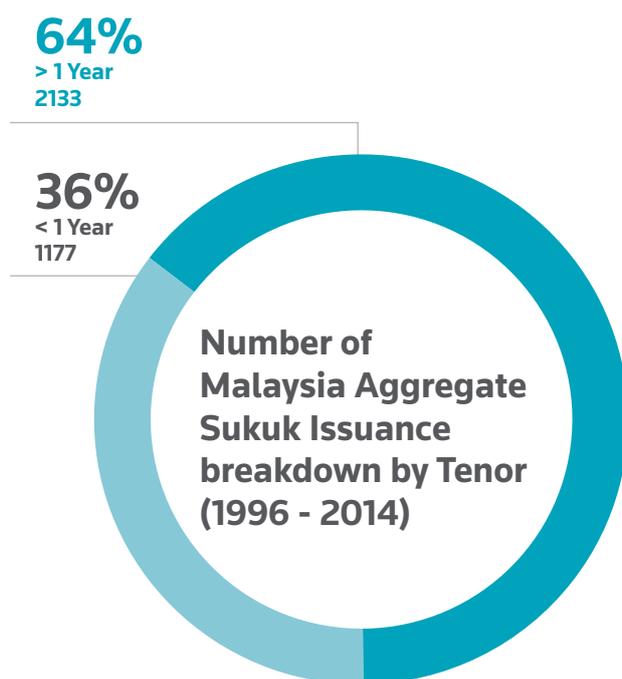
**Sukuk rating: local investors are more familiar with their local neighbourhood.**

Most Malaysian sukuk are issued in the local currency in domestic markets where issuers are comfortable with capital market conditions and investors are familiar with the different credit risks. Malaysia has released plans to remove credit rating requirements from 2017 to lower transaction costs and attract more issuers. (The UAE also released new sukuk and bond rules in September 2014, including exempting corporate bonds and sukuk from ratings, in a bid to lower costs and encourage more issuance.) Market analysts estimate that issuers can be charged about 0.06% of a total sukuk size by rating agencies and the annual review can be an additional 0.05%. However, for unrated sukuk to gain buyers, investors will need to relax their mandates to allow them into the portfolios. Investors would also need to do credit analysis homework either through fund houses or their own investment/credit departments which may require longer approval periods.

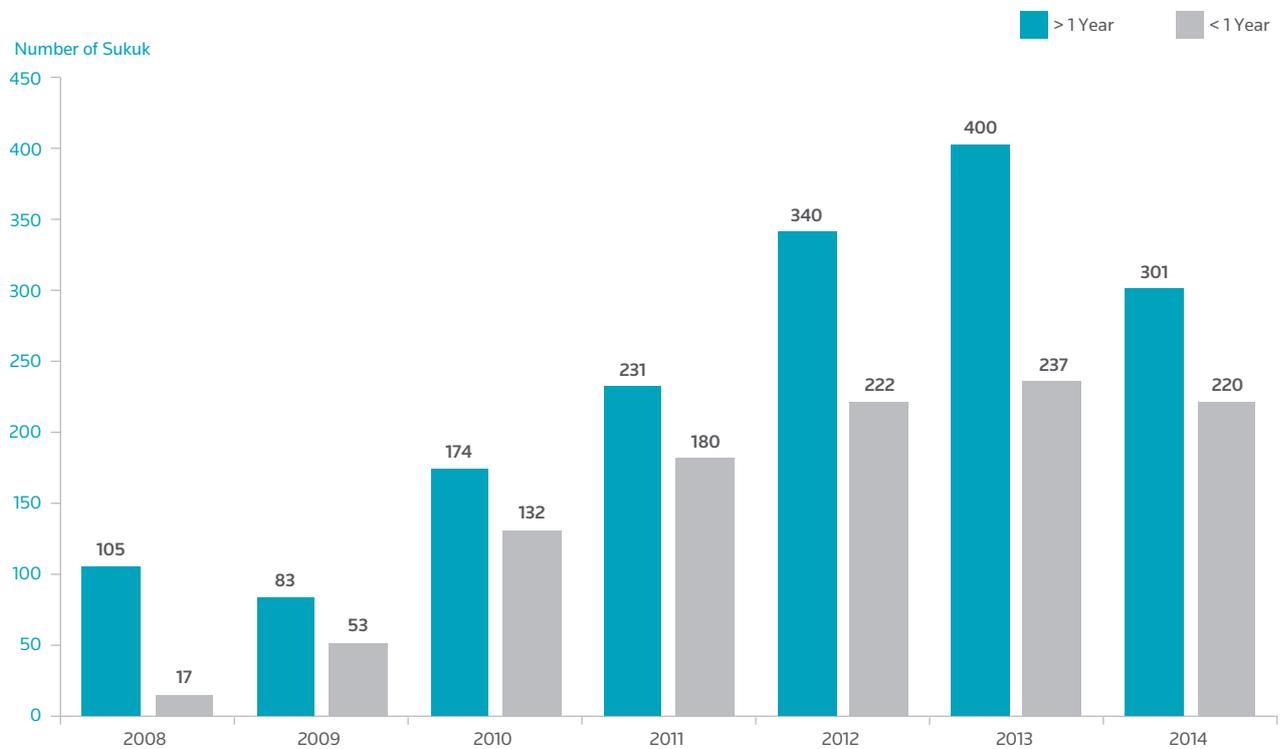
Number of Global Aggregate Sukuk Issuance breakdown by Tenor ( 1996 – H1, 2014)



Number of Malaysia Aggregate Sukuk Issuance breakdown by Tenor ( 1996 – H1, 2014)

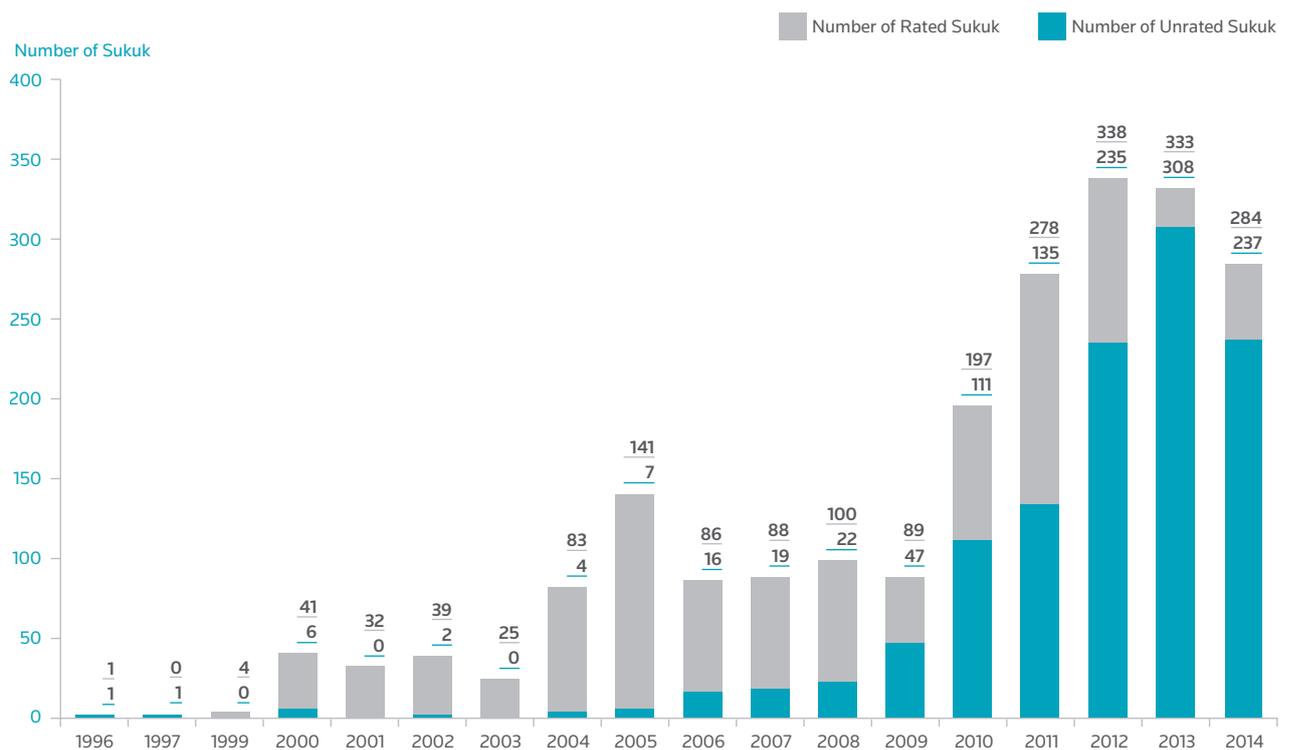


### Malaysian Sukuk Issuance breakdown by Tenor ( 2008 – 2014)



Source: Thomson Reuters Zawya

### Malaysia Sukuk Historical Trend Rated vs. Unrated (1996 – 2014)



Source: Thomson Reuters Zawya

**As Malaysian sukuk gain more recognition in the global market, more issuers are keen to tap the country's high liquidity.**

As it stands, most of the sukuk outstanding in the Malaysian market are sovereigns with maturity profiles up to 10 years, and there are more corporate and quasi-government papers outstanding towards the longer end of the curve. The total outstanding Malaysian sukuk amounts to US\$159.01 billion as at the end of December 2014, which is more than half of the global total.

**Malaysia is eyeing greater cross-border issuance.**

Malaysia is known for being the most liquid market for sukuk and any issuer will not hesitate to tap a liquid market. Between the two sukuk powerhouses — Southeast Asia and the GCC — the trend for cross-border sukuk issuances has been one-way — Middle Eastern issuers selling in Malaysia. Investor and currency diversification will also encourage issuers to tap other markets other than their home base to reduce the concentration of both investors and currencies. In 2014, the Malaysian capital market continued to attract potential investors with its solid performance — issuances reached about US\$42 billion in Malaysian Ringgit sukuk and US\$3 billion issued in US dollars.

**Additionally, there is the attraction of the availability of a variety of structures that are used in Malaysia but not as favoured elsewhere.**

Abu Dhabi National Energy Company's (TAQA) sukuk programme (first issue February 2012) in Malaysia is a prime example of an issuer seeking financing and geographical diversification. The sukuk is based on the commodity murabahah (via tawarruq arrangement) structure that is not as favoured by the GCC countries.

**More cross-border issuances have acclimatised Malaysian investors to GCC sukuk issuers.**

The returns on GCC sukuk are attractive to Asian investors mainly because of the political risk which adds a premium to yields. Most GCC sovereigns also have higher ratings than Malaysia's. Diversification also applies to investors, as they will be able to

reduce concentration risk by distributing their eggs in different baskets.

In 2013, Malaysia had only four cross-border sukuk issued totalling US\$385 million from three different companies from China, Saudi Arabia and Singapore, compared to 11 issuances (US\$1.6 billion) in 2012 from Bahrain, China, Indonesia, Kazakhstan, Kuwait, Singapore and UAE. In a slight increase in the first six months of 2014, two countries issued cross-border sukuk in Malaysia — Turkey and Singapore, for a total volume of US\$409.7 million.

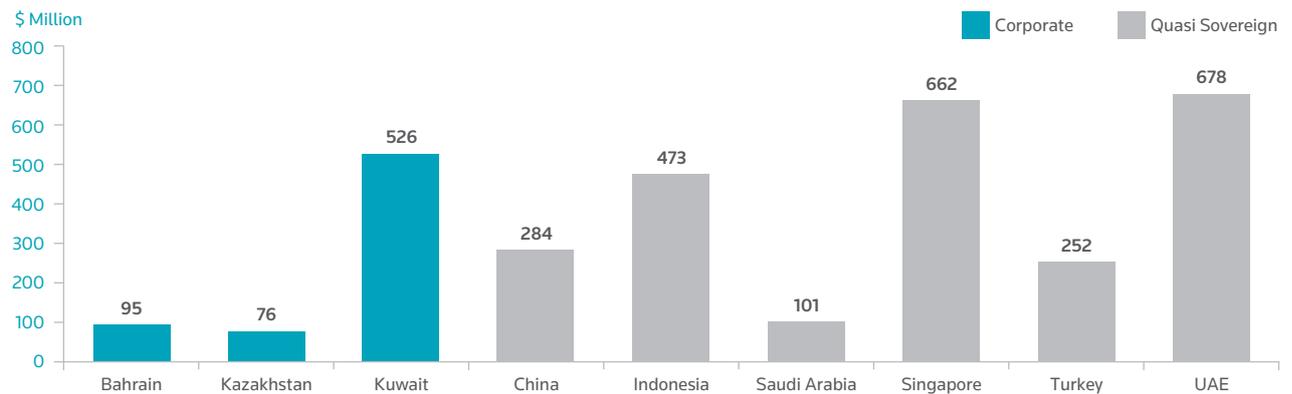
The latest cross-border sukuk was issued by Turkish participation bank Türkiye Finans selling in Ringgit and fellow participation bank Kuveyt Türk announced in November 2014 its intention to issue up to RM2 billion in Malaysia. Türkiye Finans is the first Turkish financial to tap the Malaysian market with its RM800 million sale (out of its inaugural RM3 billion sukuk murabahah programme). The deal is considered the largest single tranche issuance from the European and Middle Eastern region in the Malaysian capital market. The largest deal belongs to the Indonesian lender Golden Assets International Finance raising RM1.5 billion in 2012.

Since 2010, cross-border issuers have been mainly corporates and some quasi-sovereigns. Zawya Islamic Sukuk Monitor shows that 78% of the issuances were from corporates and 22% from quasi-sovereigns. The numbers make sense; it is normally the corporates which look for different options and markets for issuing sukuk. Pricing and tradeability are the two main factors that an issuer would consider before deciding on a market and Malaysia is known for sukuk tradeability which would put the issuer in a better pricing position.

### Outstanding Malaysian Sukuk Maturity Profile Breakdown by Type of Issuer As End of December 31, 2014



### Foreign issuers Total MYR Cross Border Sukuk in Malaysia Domestic Market (2010-2014)



### Malaysian Ringgit Cross Border Issuance (\$ Million)

COUNTRY	2010	2011	2012	2013	2014	TOTAL CROSS BORDER ISSUANCE
Bahrain			\$94.548			\$94.548
China			\$189.095	\$94.548		\$283.643
Indonesia			\$472.739			\$472.739
Kazakhstan			\$75.638			\$75.638
Kuwait		\$425.465	\$100.851			\$526.316
Saudi Arabia				\$100.851		\$100.851
Singapore			\$315.159	\$189.095	\$157.580	\$661.834
Turkey					\$252.127	\$252.127
UAE	\$315.159		\$362.433			\$677.592
<b>Total Cross-Border Issuance</b>	<b>\$315.159</b>	<b>\$425.465</b>	<b>\$1,610.463</b>	<b>\$384.494</b>	<b>\$409.707</b>	<b>\$3,145.288</b>

Source: Thomson Reuters Zawya



## Leadership Article:



Professor Datuk Rifaat Ahmed Abdel Karim, CEO, IILM

Professor Datuk Rifaat Ahmed Abdel Karim is the CEO of the International Islamic Liquidity Management Corporation (IILM). He was the inaugural Secretary-General at both the Accounting and Auditing Organisation for Islamic Financial Institutions and the Islamic Financial Services Board. During his time at AAOIFI and IFSB, Professor Rifaat played a key role in the conception and development of standards and guidelines which have been a key catalyst in the establishment and integration of the Islamic finance industry within mainstream global financial services. He became CEO of the International Islamic Liquidity Management Corporation in October 2012.

### Malaysia's Potential Role in Developing a Global Sukūk Market

The Islamic capital market (ICM) is an essential part of the Islamic financial system that permits the flow of investment capital into Shari'ah-compliant economic activities.

Within the ICM, the development of Shari'ah-compliant financial instruments is integral to the Islamic financial system in order to fund capital requirements, provide liquidity and grow wealth. Since the early 2000s, the ICM has grown across many jurisdictions, with numerous entities across all business sectors. Amongst ICM products, apart from Shari'ah-compliant equities, Sukūk are clearly the forerunners of this progress and are the second fastest growing segment of Islamic finance after Islamic banking.<sup>1</sup> Even taking into account the ill effects of the global financial crisis, from 2005 until 2012, the Sukūk market has grown at an average annual rate of 41.6%, with annual Sukūk issuances in 2013 being recorded at \$119.7 billion.<sup>2</sup> Malaysia, which was the domicile of the first corporate and sovereign Sukūk, has long been at the forefront of the development of ICM products and has perennially been the leading domicile for Sukūk issuances. In 2013, Malaysia again dominated the market with a 68.3% share of the global issuance of Sukūk (by value), followed by Saudi Arabia and the United Arab Emirates, with 12.9% and 6%, respectively.<sup>3</sup>

However, despite the popularity and global growth of Sukūk, the sector has been hampered by an illiquid and small international secondary market. A traditional buy-and-hold mentality by investors and institutions offering Islamic financial services (IIFS), coupled with a number

1 "Islamic Financial Services Industry Stability Report 2014", Islamic Financial Services Board, p.21.  
 2 *Kuwait Finance House Research*  
 3 Islamic Financial Services Industry Stability Report 2014, p. 23.

of serious systemic obstacles to active international trading, has diminished the potential of the Sukūk market. This is not a simple matter of fiscal limitations in OIC countries either. Despite the fact that 10 of the world's top 20 sovereign wealth funds are from Muslim countries, stock exchanges in these jurisdictions are still very small relative to more mature conventional markets and do not contain platforms on which Sukūk can be traded.

The entire MENA region, for example, represented only 2.2% of the global equity market wealth in 2007 and an estimated 2% in 2012.<sup>4</sup> Given the Sukūk market's strategic importance not only for IIFS, but for the economic development of OIC member countries, the weakness of international secondary markets needs to be addressed.

In order to deepen secondary markets in Sukūk on a global basis, proponents of Islamic finance need to emulate the focus of Malaysia's authorities over the last decade on advancing liquidity by addressing a variety of systemic obstacles. In a similar spirit, the International Islamic Liquidity Management Corporation (IILM) has fashioned its Sukūk to focus on liquidity so as to overcome some of these same obstacles. In either case, on the national or product level, the emphasis must be on developing secondary markets and a liquidity infrastructure, and on standardizing the legal and regulatory environment to encourage IIFS to actively trade Sukūk.

On a regional level, most large Islamic financial markets appear to be prone to economic vulnerabilities that characterize emerging markets. Similarly, the Sukūk sector, being a sub-set of the broader global capital market, is exposed to underlying risks resulting from developments in major economies. For example, the 13% decrease in Sukūk issuance in 2013 versus 2012 is understood to have been caused by extraneous macroeconomic factors, most importantly, as a reaction to anticipated policy changes by

the United States' Federal Reserve. Still, weaknesses in the global Sukūk secondary market are largely the result of definable and persistent problems within the Islamic financial system.

As we discuss these crucial obstacles in this article, we will also note how Malaysia and the IILM Sukūk, as a country and Sukūk product, respectively, have countered these problems.

### **Absence of inter-bank money market**

One of the crucial impediments to developing a liquid Sukūk secondary-market globally is the absence of an inter-bank money market and related money-market instruments for IIFS. In a 2012 IMF paper entitled, "Islamic bond issuance — what sovereign debt managers need to know", the IMF noted that:

"Given the current short-term nature of bank liabilities, the creation of money-market instruments, and asset securitization with shorter maturities should help to encourage a secondary market for Sukūk. Although Islamic banks are currently one of the largest buyers of Shari'ah-compliant products (with long maturities), they would benefit most from issues at shorter tenors. Short-term Sukūk could serve as money market instruments for liquidity management purposes."<sup>5</sup>

The interbank money market allows interest-based banks not only to keep statutorily required levels of liquidity on-hand and to meet short-term liquidity needs, but to sell, collateralize and borrow funds to buy targeted investments from time to time. As most of the facilities used in the conventional inter-bank money market are interest-bearing or otherwise impermissible and somewhat difficult to reproduce in a Shari'ah-compliant manner, an analogous interbank money market for IIFS has remained relatively small. Furthermore, the use of Sukūk as money-market instruments (akin to bonds in the conventional space)

4 Nasser Saidi, Nasser Saidi and Associates (2013), "Asia: Coming Financial Transformation", presentation at Asian Finance Forum, Seoul, 27 May 2013.

5 *Secondary Market Stalemate?* by Nazneen Halim, Islamic Finance News, November 2012.

---

*One of the crucial impediments to developing a liquid Sukūk secondary-market globally is the absence of an inter-bank money market and related money-market instruments for IIFS.*

---

is hampered by the reality that most Sukūk tenors are long, connected directly to the long-term nature of the underlying assets, which form the basis of the Sukūk. Some countries have addressed this issue by having their central banks establish their own interbank money markets or other liquidity facilities for local IIFS.

Malaysia began this effort early and established its Islamic Interbank Money Market (IIMM) in 1994.<sup>6</sup> Since then, the IIMM has grown significantly, with a total traded volume increase of 100% between 2007 and 2011 and a compound annual growth rate of 19% during the same period.<sup>7</sup> The vitality of this market is crucial to the ability of Malaysian IIFS to access liquidity in the short term and to sell Sukūk held on their books.

The IILM addressed the weakness of international interbank money markets and related instruments for IIFS by specifically designing the IILM Sukūk to be short-term (i.e. with maturities of less than one year). The IILM further customized its Sukūk as a money market instrument by structuring it to be Basel III compliant as a 'High Quality Liquid Asset' (HQLA).

Proponents of the ICM must continue to foster an interbank money market. This will encourage not only the increased trading of Sukūk, but the development of short-term Sukūk products that will become increasingly needed as a result of the advent of Basel III.

### **Different legal frameworks pose added risks and obstacles**

Another crucial obstacle to deep and liquid international Sukūk secondary markets is the incongruity between the legal and regulatory environments in the various countries from where Sukūk are issued. Although the majority of countries involved in Islamic finance have some specific legislation for Islamic banks,<sup>8</sup> Sukūk products involve a diffuse variety of legal arenas, including property, bankruptcy and tax. Differences between the legal treatments of Sukūk in common law versus civil law jurisdictions, the processes for registering title, the enforceability of claims in bankruptcy courts, all contribute to the perception amongst some investors that there are inherent risks to actively buy new and exotic Sukūk in the secondary market.

A twin aspect of this obstacle is the incongruity, or perceived incongruity, of Shari`ah rulings and opinions on various Sukūk structures from jurisdiction to jurisdiction, from deal to deal. Sukūk investors are understandably disinclined to purchase Sukūk whose Shari`ah-compliance is tenuous or requires special deliberation. This concern is not simply handwringing by investors, as was demonstrated by the controversy which began in 2007 where some prominent Shari`ah scholars became critical of certain Sukūk structures that had previously been in favour throughout the sector.

Lack of certainty with Sukūk law, both sacred and secular, has been a persistent assumed risk but must become a negligible factor in order to deepen the

<sup>6</sup> Islamic Financial Services Industry Development: Ten-Year Framework and Strategies: A Mid-Term Review, p. 87.

<sup>7</sup> *Ibid*

<sup>8</sup> *Ibid*, p. 38.

international secondary market. Again, Malaysia was ahead of the curve with respect to enacting laws and regulations that specifically catered for Islamic banks and ICM products.<sup>9</sup>

Malaysian Sukūk investors enjoy tax neutrality in holding Sukūk versus conventional fixed income investments, and Malaysia has even offered tax incentives to Islamic financial sectors in the past.<sup>10</sup>

On the Shari`ah front, Malaysia established its Shariah Advisory Council of Bank Negara Malaysia (SAC) in 1997. The SAC has authority to ascertain the Shari`ah stance for Malaysian authorities with respect to Islamic finance, and has even clearly delineated approved Sukūk structures for the Malaysian market.<sup>11</sup>

For its part, the IILM could do little to affect the legal and regulatory environments of its member nations, but made extensive efforts with regard to reducing Shari`ah concerns. The IILM's own Shari`ah Committee represents a diverse group of scholars from different jurisdictions who consider various Shari`ah schools of thought and international Shari`ah standards in their review of the IILM Sukūk. Furthermore, the IILM engaged in extensive discussions with the Shari`ah boards of its various initial institutional investors and secured their approval of the IILM Sukūk as well. All of these painstaking steps were taken to diminish any perception of impermissibility or confusion by the broadest swathe of potential IILM Sukūkholders. There can only be a highly-active Sukūk secondary market globally when investors are confident of their rights, remedies and legal position, in the courts of men and their Creator.

### **Lack of a developed secondary market infrastructure**

Another crucial shortcoming hampering the development of a deep global secondary market in Sukūk is the lack of a developed secondary market infrastructure. Such an infrastructure includes ICM exchanges upon which Sukūk are traded as well as associated enablers to make trading Sukūk across borders simple. This is not to say that there are no stock exchanges for ICM. The London Stock Exchange, NASDAQ Dubai and even Dublin Stock Exchange, are known destinations for ICM products. The London Stock Exchange and Dow Jones even have their own Islamic indices. However, such arrangements mainly concern Shari`ah-compliant equities, and across the globe, most Sukūk are still traded over the counter through discrete brokerages.

Through the third quarter of 2013, only 32 out of 520 Sukūk issued globally were listed on an exchange, a proportion that was nearly unchanged from 2012.<sup>12</sup> Hedging instruments, which are essential parts of any cross-border, fixed-income market, continue their arduous transition into the mainstream of Islamic finance. These hedging instruments are sometimes important for IIFS to access reserve or even foreign currencies when buying cross-border Sukūk and essential for managing profit rate exposure to the plethora of variable rate Sukūk in the market.

Lastly, with respect to other shortcomings in the Sukūk secondary market infrastructure, the absence of any mark-to-market valuation of global Sukūk makes it more difficult for traders to act swiftly and confidently in the market.

For its part, Malaysia has been as astute in supporting its Sukūk secondary market infrastructure as it has been in passing foundational laws and regulations. In addition to the Malaysian IIMM mentioned above, its main stock exchange, Bursa Malaysia, has had the shares of almost 90% of

9 The Islamic Banking Act of Malaysia was passed in 1983. Various laws and regulations related to the ICM in Malaysia were promulgated in the 1990s.

10 See, "The Evolution Of The Malaysian Islamic Capital Market: Towards A Global Hub", p. 10-12. <http://uaelaws.files.wordpress.com/2012/09/the-evolution-of-the-islamic-capital-market-towards-a-global-hub.pdf>

11 Bank Negara Malaysia, Shariah Advisory Council of Bank Negara Malaysia. [http://www.bnm.gov.my/microsites/financial/pdf/resolutions/04\\_sac.pdf](http://www.bnm.gov.my/microsites/financial/pdf/resolutions/04_sac.pdf)

12 "Global sukuk supply/demand gap to peak in 2014 —study", Reuters, November 20, 2013.

---



---

*In the upcoming years, we can expect to see more short-term Sukūk products that not only aim to reduce legal and Shari`ah incongruence, but also set out to comply with impending Basel III requirements.*

---



---

Malaysia's qualified Shari`ah-compliant companies listed on the exchange since 2009.<sup>13</sup>

Furthermore, reliable infrastructure platforms, specifically the Electronic Trading Platform and the Real-time Electronic Transfer of Funds and Securities System enable efficient trading and settlement of ICM products in Malaysia. On the hedging front, Malaysian markets were some of the first to develop and use Shari`ah-compliant profit rate and currency hedging contracts. The Malaysian central bank, Bank Negara Malaysia, has even developed its own hedging facilities to assist Malaysia IIFS in managing their risks when transacting in the ICM. The wide availability of pricing information in the Malaysian secondary market makes valuation of Sukūk much simpler than in other jurisdictions that host IIFS. For its part, the IILM Sukūk developed its own secondary market infrastructure by creating a real-time, virtual trading interface via Bloomberg and requiring its initial institutional investors to post active two-way pricing on the electronic system.

### **Need for collective effort**

The growth of the global Sukūk secondary market requires a collective effort from all stakeholders in the Islamic finance industry. Small international Sukūk markets are less liquid, and with illiquidity comes increased volatility. The higher volatility is a reflection both of shallowness and a lack of integration with global markets. The net cost of all this is higher required risk premiums and, consequently, a higher implied cost of funds to firms. The higher cost of capital reduces the competitiveness of firms.

Although there are many obstacles to a vibrant global Sukūk secondary market, some of which are complex and difficult to overcome, stakeholders have an excellent blueprint in tackling some of the aforementioned issues. For their part, regulators and legislators from other nations interested in sparking ICM in their own countries have an excellent example in Malaysia's past efforts.

This year's much-publicized meetings and cooperative initiative between the Malaysian securities commission and Hong Kong regulators demonstrates that many new entrants to the Islamic financial markets are not ignorant of this point. With respect to developing Sukūk that facilitate secondary market trading, the IILM Sukūk is also a trailblazing product. In the upcoming years, we can expect to see more short-term Sukūk products that not only aim to reduce legal and Shari`ah incongruence, but also set out to comply with impending Basel III requirements.

---

<sup>13</sup> "The Evolution Of The Malaysian Islamic Capital Market: Towards A Global Hub", p. 6-7.



CIMB BANK

## Sukuk Regulations Development

Malaysia is the backbone of the global sukuk market holding approximately 67% market share. This dominance is a result of decades of efforts exerted by the Malaysian government and Securities Commission (SC).

The Islamic Capital Market (ICM) is advised by the Shariah Advisory Council (SAC) of the Securities Commission, a key body in the development of the ICM in the country in providing guidance, innovation and creating a robust Shariah governance framework. The SAC of the Securities Commission was established in 1996, a year before the establishment of the SAC at the BNM which overlooks Islamic banking and takaful.

SC's SAC advises the SC on issues related to the ICM to ensure adherence to Islamic principles. The Council is an important authority of ICM innovation as it is responsible for ascertaining the application of Shariah principles which can be used in ICM products and services. The SAC is also responsible for analysing issues related to the operation of the ICM to provide guidance and advice to investors, the government and industry.

What is also noteworthy is that both of Malaysia's SACs include female Shariah scholars; there are no female Shariah committee members in the Islamic financial services industry in any other country, according to Thomson Reuters Zawya databases.

### Guidelines for issuing sukuk for onshore and offshore ICMs

The process of issuing sukuk falls under a number of legislations including rules, guidelines, and practice notes released by a number of authorities, mainly the SC for onshore ICM and the Labuan Financial Services Authority (LFSA) for the offshore ICM.

The key legislation regulating the onshore ICM is the Capital Markets and Services Act (CMSA), which guides and regulates activities pertaining to markets

and intermediaries in the capital markets. To issue an onshore sukuk, the issuer must be corporations, being bodies corporate formed or incorporated or existing within Malaysia or outside Malaysia, including foreign companies but excluding certain entities such as any government corporate body which is not incorporated for commercial purposes, any society registered under law relating to co-operative societies, or any trade union registered under any law as a trade union.

The provisions of the Offshore Companies Act 1990 are relevant where the issuer of sukuk is an offshore company. Under the OCA guidelines, if a company decides to issue sukuk it has to comply with a checklist issued by LOFSA which sets out the documentation requirement for an application including, but not limited to, an application letter setting out the approvals sought, the prospectus (if available), details of the parties involved in the transaction such as issuer, guarantor, promoter, trustee etc.

### Internationalising Malaysia's sukuk market

As part of plans to make Malaysia an international market for sukuk, a framework was introduced in March 2007 to support the issuance of foreign currency-denominated sukuk by qualified issuers. If the issuer of the sukuk is listed on the country's stock exchange, Bursa Malaysia, the provisions of the listing requirements of Bursa should be met. However, as our sukuk overview has shown, sukuk issued in Malaysia remains overwhelmingly in Ringgit.

### Tax Incentives

Malaysia provides incentives for investors to enjoy a tax-free environment when investing in the country and the authorities offer tax exemptions to promote the Islamic finance markets. Exemptions include the following:

1. The income of any person not resident in Malaysia in respect of interest derived from Malaysia and paid or credited by carrying on the business of banking or finance licensed under the Banking and Financial Institutions Act 1989 or the Islamic

- Banking Act 1983 (now repealed and replaced with the Islamic Financial Services Act 2013);
2. Profit/interest or discount paid or credited to any individual, unit trust and listed closed-end: a) in respect of securities (conventional and Islamic) or bonds (including sukuk) issued by the Government; or in respect of bonds (including sukuk), other than convertible loan stock, issued by public companies listed on Bursa Malaysia; in respect of bonds, other than convertible loan stock, issued by a company rated by Rating Agency Malaysia (RAM) or Malaysian Rating Corporation Berhad; in respect of Bon Simpanan Malaysia issued by the Central Bank of Malaysia.
  3. Income of a unit trust in respect of profit/interest derived from Malaysia and paid or credited by any bank or financial institution licensed under the Banking and Financial Institutions Act 1989 or the Islamic Banking Act 1983 (now repealed and replaced with the Islamic Financial Services Act 2013)

There are also tax incentives for issuing sukuk: when such costs are relevant to the issuance of sukuk, a tax deduction up to year of assessment (YA) 2015, on expenses incurred by either the issuer or an originator (if the issuer is an SPV) for the issuance of Islamic securities based on the principles of *murabahah*, *musharakah*, *ijarah* or *istisna* or any other Shariah principles as approved by the SC.

Finally, SPVs are also tax exempted. SPVs are generally set up merely to facilitate funds and issuance. As a result they are not subject to income tax and are not required to comply with the administrative requirements under the Income Tax Act (ITA). In addition, any income of the SPV will then be reflected by the company that has launched the SPV for the purpose of issuing the sukuk.

### Recent Revisions and Developments: Opening the door to retail and SRI sukuk

In October 2014 Prime Minister Najib Razak announced adjustments in the tax structure to favour *ijarah* and *wakalah* sukuk until 2018. No such favours were extended for *murabahah* sukuk per se but there is an incentive given if the sukuk is

using *murabahah* or *bai bithaman ajil* based on the concept of *tawarruq*. This is another telling sign of Malaysia shifting its position to attract more foreign issuers and narrow differences with the Gulf. There have also been a number of revisions with regards to the ICM since 2012 with new SC guidelines introduced to encourage market and product innovation.

Under new guidelines other products such as Islamic securities, unit trust schemes, derivatives, private retirement schemes (PRS), any product which is based on securities or derivatives would fall under the category of ICM products.

### Retail sukuk

Likewise in 2012, the SC released revised guidelines on sukuk to allow eligible issuers as set out under the Guidelines on Sukuk to issue sukuk to retail investors.

Phase 1 — Retail investors were allowed to invest in sukuk issued and/or guaranteed by the Malaysian government.

Phase 2 - Investors were given more access to sukuk including issuances by banks licensed under the Banking and Financial Institutions Act 1989 (now known as Financial Services Act 2013) or the Islamic Banking Act 1983 (now known as the Islamic Financial Services Act 2013) and also by public listed companies. Following the launch of the framework, the first retail sukuk, a RM300 million sale, was issued by Danalinfra Nasional Berhad for the national Mass Rapid Transit (MRT) project.

### SRI Sukuk

In August 2014, the SC released the framework for Sustainable and Responsible Investment (SRI) sukuk that facilitates the financing of SRI initiatives. There are solid reasons supporting the SRI initiative in the Malaysian market: a) Malaysia needs to keep up with the growth of SRI in different parts of the world and position itself as the Islamic platform for the financing of SRI initiatives, b) to satisfy the need for increasing demand for halal funds in Malaysia, and c) SRI initiatives (and hence a need for their financing) are grounded as part of the Shariah-based mandate.

Beyond welcoming a 'new' type of sukuk, this new framework is a signal from Malaysia that SRI is on the national agenda for continued economy building based on diversification and socio-economic development. SC's new framework specifies that eligible SRI projects refer to those that aim to:

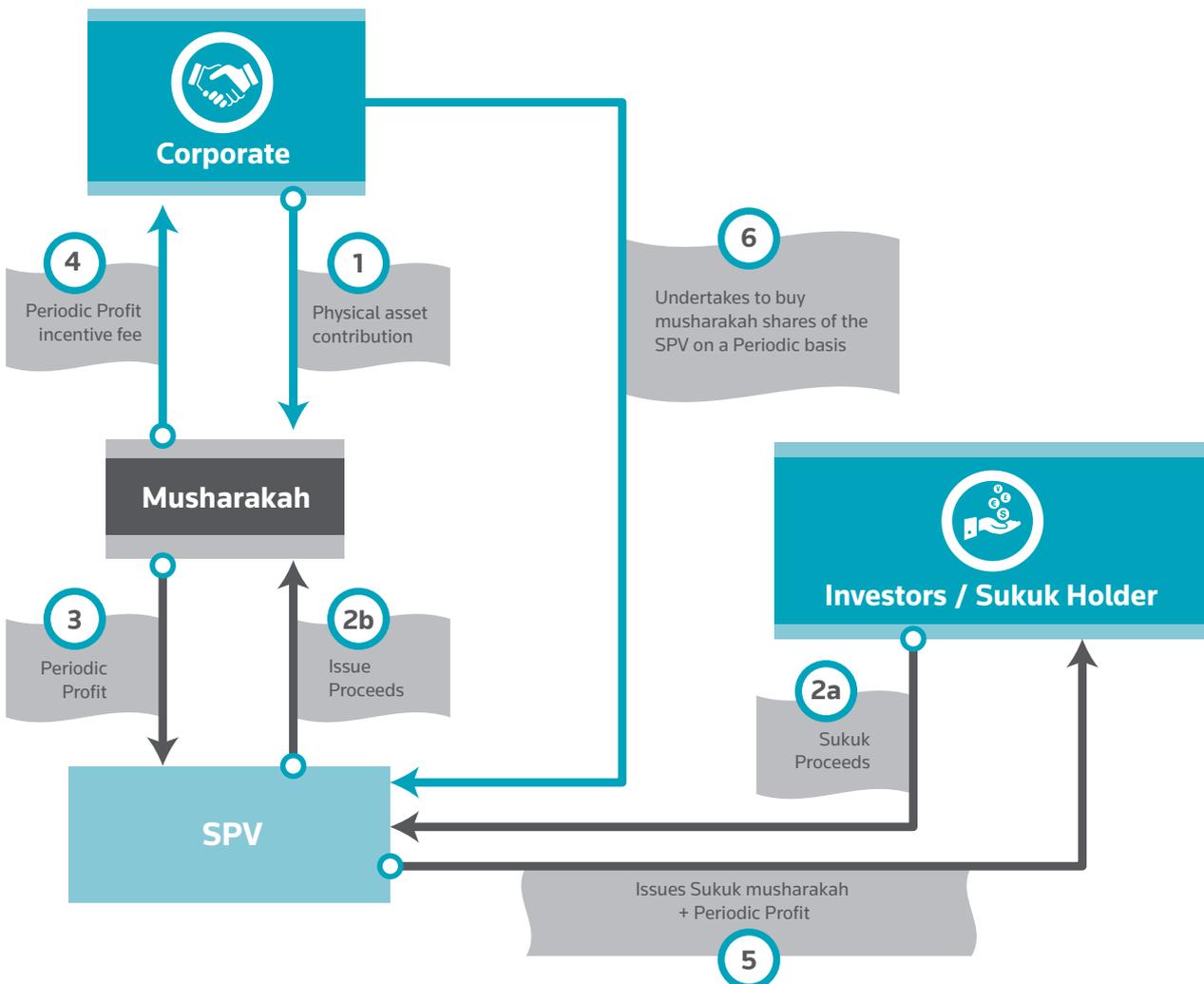
- a) preserve and protect the environment and natural resources
- b) conserve the use of energy
- c) promote the use of renewable energy
- d) reduce greenhouse gas emissions
- e) improve the quality of life for the society

Projects relating to four sectors are eligible:

- a) natural resources
- b) renewable energy and energy efficiency
- c) community and economic development
- d) waqf properties/assets

Apart from the significance of furthering the socio-economic Shariah-based mandate, the inclusion of waqf as one of the sectors eligible for SRI sukuk is a significant development for the waqf sector that is in the process of transformation under professional Islamic finance management.

### SRI Sukuk Framework



### Revision of Shariah screening methodology

Other developments include the SC revising the Shariah screening methodology in November 2013. The new methodology adopts a two-tier quantitative approach which takes into account the business activity benchmarks and the newly-introduced financial ratio benchmarks while maintaining the qualitative assessment. The revision is a result of rapid growth and development of the Islamic finance sector in the country since the early 1990s.

### Innovation: Malaysia Building Society Bhd (MBSB) issues region's first structured covered sukuk

The region's first covered sukuk was issued by Malaysia Building Society Bhd (MBSB) in its first tranche of RM95 million (approx US\$154 million) under its RM3 billion programme in December 2013. The transaction bears similar features to covered bonds as the sukukholders have dual recourse, first to the issuer and then to a pool of securitised assets in the event of issuer's default. A covered bond is a structure suitable for investors that are seeking liquid and safe investments.

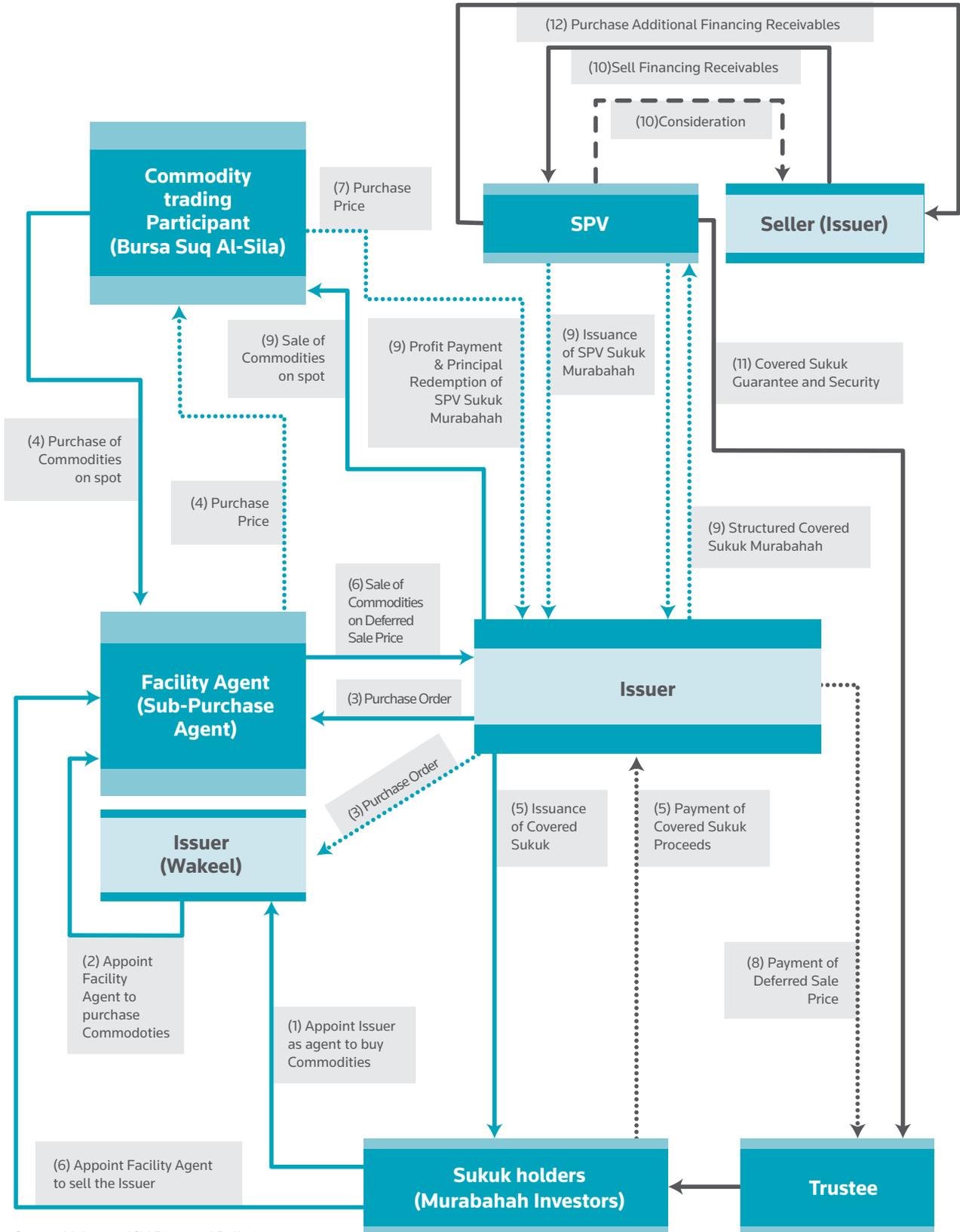
The new structure offers an additional layer of security to the investors through a structure similar to conventional covered bonds. The first sukuk to use this structure was London-based Gatehouse Bank, a subsidiary of Kuwaiti firm Securities House, through a private placement in December 2012. Normally, plain vanilla ijarah structures are asset-based as there isn't a full transfer of the underlying assets to the investors; however, by adding an additional layer of security, the Gatehouse sukuk effectively became asset-backed.

Covered sukuk share many similarities with Asset-Backed Securities (ABS) but the key difference comes down to the banks that package the securities. The banks that turn them into covered sukuk must show these securities on their balance sheets. This means when a company with securities assets on its balance sheets issues a covered sukuk, the company's balance sheet increases, which would not be the case if the company issued an ABS, although it may still guarantee the securities cash flows.

Malaysia is yet to pass legislation on covered sukuk, but the issuance by MBSB mimics a structure that has provided stable, low-cost funding for financial institutions elsewhere, possibly creating a template for other lenders to follow. Details of MBSB sukuk show that the company will set aside a portfolio of loans Shariah compliant personal financing receivables as underlying assets. The assets will be put under a special vehicle (SPV), Jana Kapital, which will provide a guarantee to the issue. Should the issuer default, sukukholders will have recourse to both issuer (MBSB) and the pool of Shariah compliant personal financing receivables.

Credit ratings agency RAM rated the covered sukuk AA1, generously above MSBS's own rating of A2. The rating has helped the company cut down cost of funding, and more importantly widens the investor base, as a number of funds in the country can only invest in sukuk rated A and above. However, despite the mechanism of the structure, some risks are still inherent in the MBSB sukuk. RAM pointed out that there was no dedicated regulation on covered sukuk, with only contractual mechanisms to ensure the sukuk was serviced in the case of issuer's default. In addition, liquidity is another risk as there isn't market to liquidate the assets in the cover pool.

Structured Covered Sukuk



Source: Malaysian ICM Bi-annual Bulletin

# Malaysian Islamic Fund Market Overview And Development

## Market Overview 2014

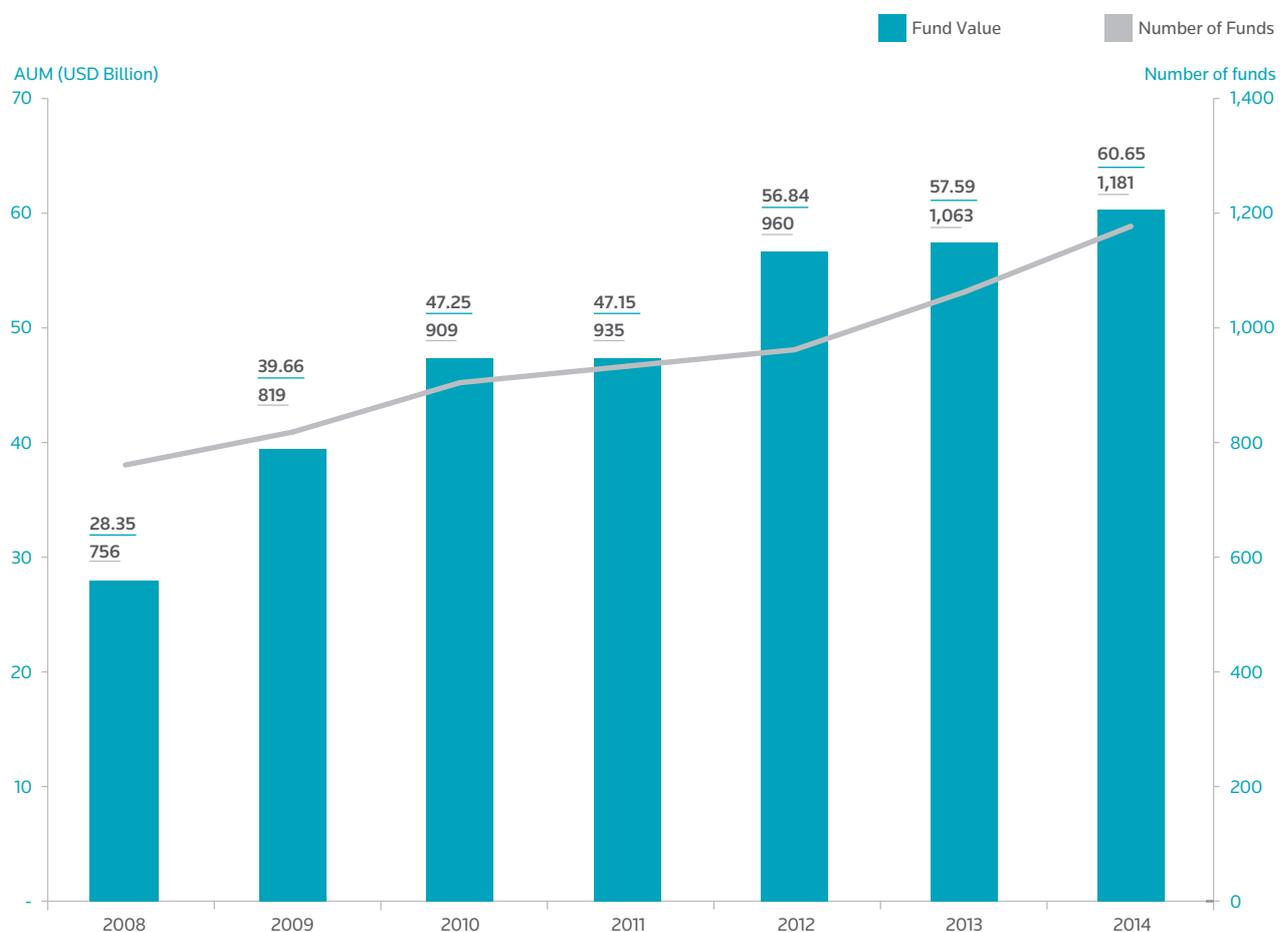
The Islamic mutual fund market proved to be more resilient in 2013 than in previous years and growth continued into 2014. As of the end of 2014 the highest number of Islamic mutual funds was launched and their number grew by approximately 55% since 2008. The sector has developed considerably in the past decade although it still remains a fraction of the global Islamic finance industry. There were 1,181 active Islamic funds as of 2014, a significant growth from 756 in 2008. However, assets under management (AuM) have not grown simultaneously with number of funds; since 2008 AuM increased 14%.

- Malaysia held the highest number of Islamic mutual funds – 230 – and assets under management

(AuM) of US\$17.5 billion, representing 32.9% of the total assets of Islamic mutual funds worldwide.

- The three leading hubs for Islamic funds were Malaysia, Saudi Arabia and Luxembourg; the three represented more than 70% of the size of the global industry.
- With a sizeable domestic market and new growth opportunities in Southeast Asia especially with the new ASEAN CIS passporting framework involving Malaysia, Singapore and Thailand, expansion and growth of the country's Islamic funds market is expected to continue.

## Global Islamic Funds (2008 – 2014)



Source: Lipper

**Out of the 390 Islamic funds launched since 2012, 115 came out of Luxembourg, followed by Malaysia and Indonesia with 105 and 43 funds, respectively.**

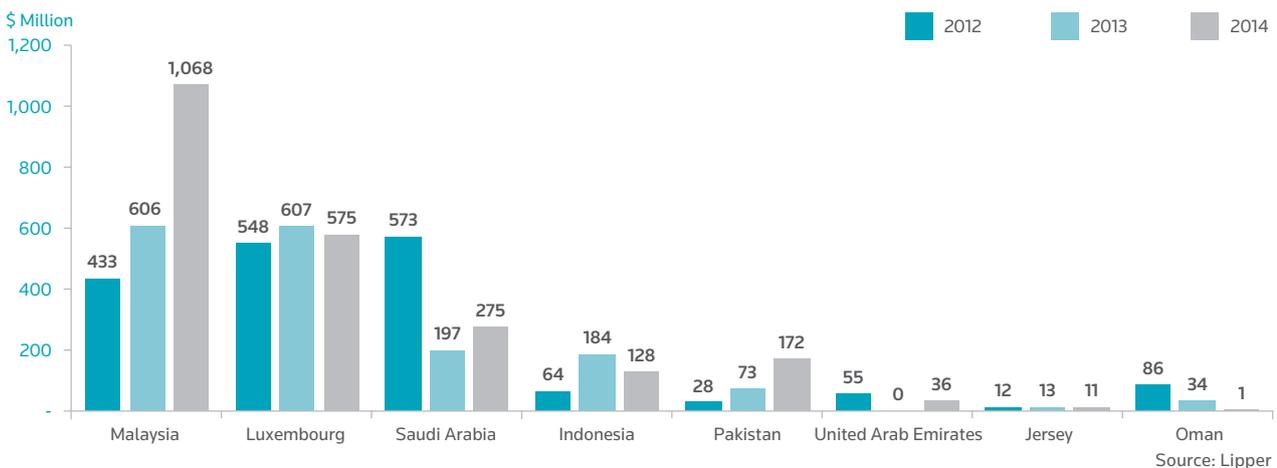
However, the highest fund flows happened in the GCC due to excess liquidity in the region. Since 2010 Malaysia has lost slight market share on the number of funds launched in terms of geographical focus, from 22% to 21%. This is a result of asset managers regaining confidence in markets that were previously seen as problematic or volatile. However, the focus of funds remains with global mandates. Indonesia witnessed some growth from 4% in 2010 to 6% in 2014 driven by new infrastructure, sukuk, and pilgrim funds. We forecast more Indonesian funds

going forward given the planned increase in government expenditures.

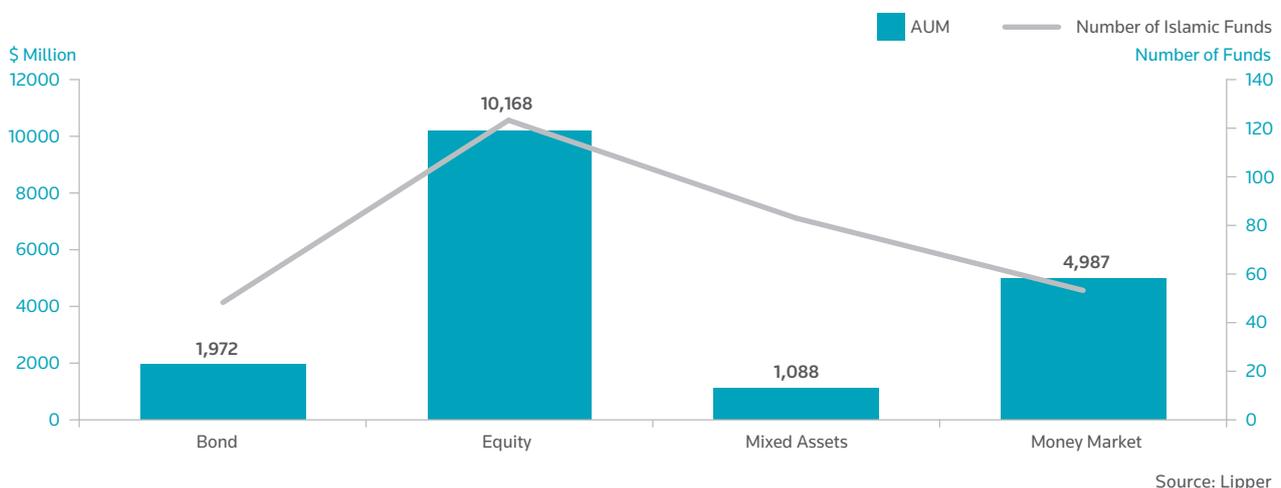
**The asset management industry in Malaysia is divided into seven different schemes under the Collective Investment Schemes (CIS) regulated by the SC as illustrated the next page.**

The guidelines for these schemes are issued by the SC under section 377 of the Capital Markets and Services Act 2007 (CMSA). Any financial management company should be incorporated in Malaysia to be eligible to start operations. Currently, there are 96 fund managers licensed with SC as of July 31, 2014.

### Global Islamic Funds Launched Breakdown by Country (2012 – 2014)



### Malaysia Outstanding Islamic Funds (2014) Breakdown by Asset Type



**Asset management companies are eligible to invest in markets outside Malaysia.**

There are different rules put in place by SC for each investment scheme; however, there are also general rules for foreign investments which are applicable to all. To name a few, foreign markets become eligible if they have satisfactory provisions relating to a) regulation of the foreign market, b) adequacy of market information, c) corporate governance.

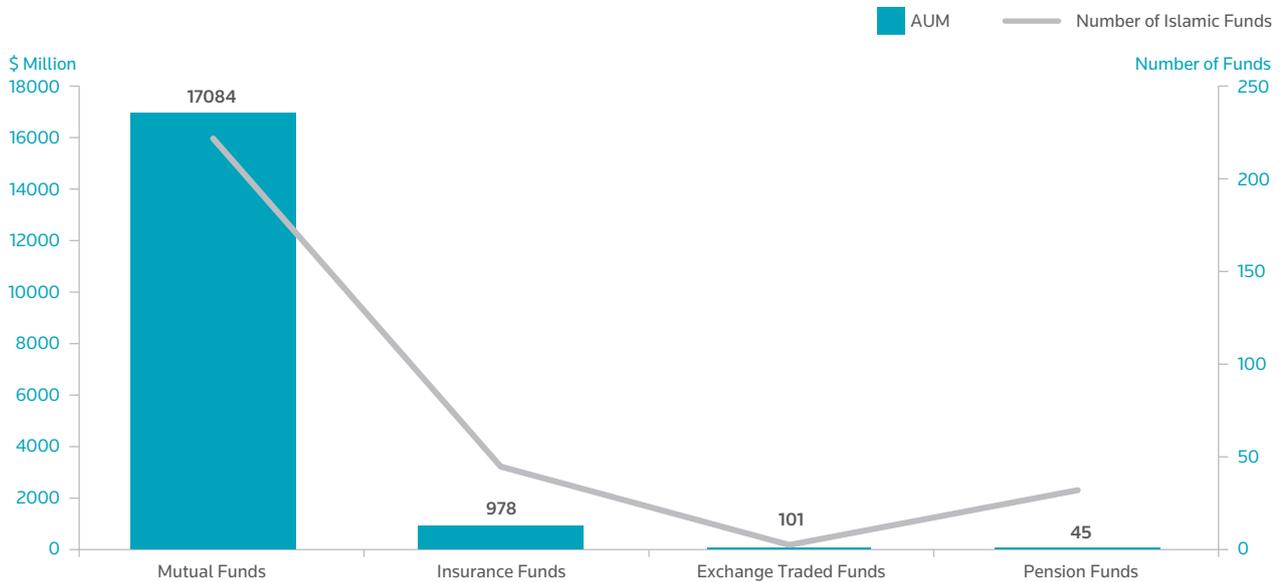
**The guidelines for Unit Trusts state that a company, aside from being incorporated in Malaysia, should maintain minimum shareholders' funds of RM10 million at all times.**

The same guideline is applicable for Exchange Traded Funds (ETFs); however, in addition, an ETF company should have minimum of 30% Bumiputera equity (Bumiputera refers to Malaysians who are ethnically Malay or indigenous people of Sabah and Sarawak) and should not exceed 49% foreign equity. For a REIT company, it should have a minimum 30% local equity and minimum shareholders' funds of RM1 million at all times.



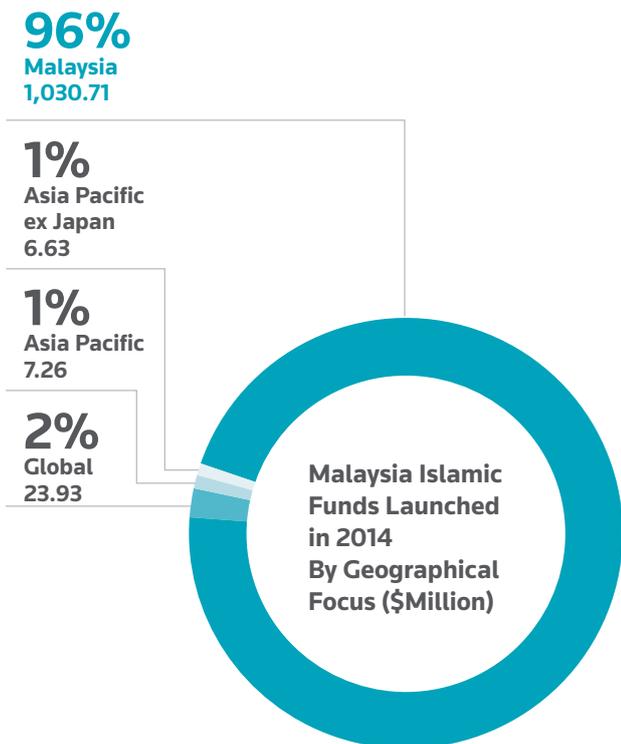
Source: The Securities Commission

### Malaysia Outstanding Islamic Funds (H1 2014) breakdown by Asset Universe



Source: Lipper

### Malaysia Islamic Funds Launched in H1 2014 By Geographical Focus (\$Million)



Source: Lipper

### 50% of funds invest in equities

There are 79 fund management companies, out of which 19 are Islamic, that are currently active with total AuM of RM628.38 billion, according to the latest available data from the SC, i.e. as of June 2014. AuM of Islamic funds make up 17%, or RM105.2 billion. The Malaysian fund market consists mainly of mutual funds with a high concentration in equities. Equity funds continued to lead the number of all asset types by the end of 2014, registering 123 funds followed by mixed assets with 83 funds. Sukuk funds are the fewest in the country but given the continued demand for sukuk more sukuk-specific funds are expected in the short- to mid-term. The likelihood of more sukuk funds is linked to demand for the underlying assets as well as to supply in the secondary market. However, there has been a shift in fund flows from sukuk funds to equities as investor risk appetite increases.

### Since 2010 Malaysian funds have been heavily focused on the domestic market.

About 95% of funds are focused on Malaysia and very few are focused on the Asia Pacific. This could change over time as funds passporting under the ASEAN CIS Framework picks up speed. (See the Funds Passporting section.)

### Sustainable growth

Over the course of eight quarters from September 2012 to June 2014, Islamic funds grew from RM79.56 billion to RM105.15 billion, registering a compound annual growth rate (CAGR) of 17.3%. While the growth is insignificant compared to its conventional peers in actual numbers, the Islamic funds market is moving in the right direction. The market has the potential to grow faster once ASEAN passporting takes off.

#### ISLAMIC ASSETS UNDER MANAGEMENT (AUM) IN RM BILLION

	JUNE 2014	JUNE 2013
Islamic AuM	105.2	82.23
Total industry	628.4	555.32
% Islamic AuM of FMCs to total industry	16.70%	14.80%

Source: Securities Commission

### The idea of Islamic funds mobility across borders has been gaining traction in recent years.

Models such as the EU's Undertakings for the Collective Investment of Transferable Securities (UCITS) have been studied and in Southeast Asia the movement towards an ASEAN Economic Community (AEC), which started with the AEC Blueprint in 2007, has facilitated serious discussions and planning for mobility to become reality. An 'Integrated Capital Market' is one of the objectives of the AEC Blueprint. (See our ASEAN section for details) Malaysia stands to profit as a leading Islamic funds market.

### ASEAN Collective Investment Scheme Framework for Malaysia, Singapore and Thailand

The ASEAN Capital Markets Forum (ACMF) Collective Investment Scheme (CIS) Framework was announced on August 25, 2014 allowing investors in Malaysia, Singapore and Thailand to start buying and selling mutual funds issued in any of the three countries, provided they meet the set of common standards. Unlike the EU's UCITS that immediately qualifies funds for passporting throughout all EU member states on the basis of a single authorisation from one member state, the ASEAN CIS Framework cannot as yet depend on standardised or harmonised ASEAN-wide rules to support such a model. Hence, there is a two-step qualification process whereby prospective CIS Operators must gain approval first from their Home Regulators and then the intended Host Regulator.

ASSET CLASSES (IN RM BILLION) AS OF 30 JUNE, 2014	OVERALL (INCLUDING ISLAMIC)			ISLAMIC			% ISLAMIC
	INSIDE MALAYSIA	OUTSIDE MALAYSIA	TOTAL	INSIDE MALAYSIA	OUTSIDE MALAYSIA	TOTAL	
Equities	256.26	61.52	317.78	32	17.4	49.4	16%
Fixed income securities	99.05	22.31	121.36	16.7	8.65	25.35	21%
Money market placements	144.89	1.11	146	26.55	0.16	26.71	18%
Unit trust funds	9.94	6.61	16.55	0.5	0.36	0.86	5%
Private equities/Unquoted stocks	4.58	4.85	9.43	0.01	0.19	0.2	2%
Others*	10.46	6.8	17.26	0.75	1.88	2.63	15%
<b>Total</b>	<b>525.18</b>	<b>103.2</b>	<b>628.38</b>	<b>76.51</b>	<b>28.64</b>	<b>105.15</b>	<b>17%</b>

Source: Securities Commissions Malaysia

\*Others consist of other asset classes such as wholesale funds, REITs, ETFs, closed-end funds, derivatives, business trust, payables, receivables, accruals and uninvested cash.

## Procedures to offer ASEAN CIS Fund and their impacts:

PROCEDURE	IMPACT
1. CIS Operator must obtain approval from home regulator	This will not impact the CIS operator significantly as the majority of asset management companies already have operations in their home country; therefore, the process should be somewhat smooth. However, the CIS operator should be familiar with the foreign market to avoid delays in approval. The CIS operator should provide an application letter, any supporting documents required by home regulator, prospectus and application fee.
2. CIS Operator must then obtain approval from host regulator	This will have a greater impact as many of these asset management companies would have to familiarise themselves with foreign regulations before applying, in order to comply with the host's requirements. The applicant would need to provide the approval letter from its home regulator, in addition to ASEAN CIS application form, prospectus prepared in accordance with host requirements and application fees. In the event an application is declined by the host regulator, the CIS operator will have to repeat the process, which will incur additional costs and impede time to market.
3. The host regulator will assess the application and the offering document/prospectus for compliance with the host jurisdiction's disclosure requirements; the host regulator retains the right to decline an application.	
4. The offering of ASEAN CIS to the public in the host jurisdiction must be done through local licensed distributors/intermediaries.	For potential CIS operators which don't already have local subsidiaries or distributors, costs of setting up local operations or partnering with local intermediaries would need to be balanced with the company's long-term plans. These should include long-term ASEAN potential beyond just the three original participating countries. The rest of ASEAN (and investors and companies beyond ASEAN) will be keeping their eyes locked on this scheme as its progress will have an impact on future funds passporting throughout ASEAN.
5. The ASEAN CIS is subject to the ongoing reporting requirements in the host jurisdictions at all times.	This impacts CIS Operators and the professional services within the (Islamic) financial ecosystem — specifically lawyers, accountants, auditors and tax advisors will have to familiarise themselves with the applicable laws and regulations of the host jurisdiction.
6. An Annual Compliance Audit is mandatory; an annual audit must be performed in the home jurisdiction by an independent auditor regulated or registered in the home regulator.	

### Tax environment for ASEAN CIS

Unlike the tax complexity for the Asia Region Funds Passport (AFRP, see below), the ASEAN CIS tax framework has been tackled with greater commitment by member states as part of the larger ASEAN dialogue and cooperation. Considering the tax incentives for the three markets, Malaysian rules are completely relaxed as local and foreign investors are tax exempt when investing in foreign and local funds. However, in Singapore the law states that any foreign-sourced income is subject to tax if it is received or deemed received in Singapore from a

foreign country. Further, Singapore makes a distinction between profits made from 'trading gain' and 'capital gain' where the latter is not subject to tax. Thailand also requires its local investors, whether retail or corporates, to pay tax on dividend incomes as well as any capital gains received from an investment in ASEAN CIS.

However, Malaysia's foreign exchange controls apply for ASEAN CIS. Specifically, according to the ASEAN CIS Handbook, all Malaysian Ringgit (RM) settlement and management of RM exposure arising from the

issuance of CIS shall be undertaken with an onshore bank; and where proceeds from the RM CIS will be invested abroad, such proceeds shall be converted to foreign currency with an onshore bank before remittance abroad.

### **Wider geographical focus: Asia Region Funds Passport**

The idea for the Asia Region Funds Passport (ARFP) was mooted by Australia in 2008 and was further pursued under the auspices of the Asia-Pacific Economic Cooperation (APEC) in October 2010. The initiative aims to be implemented in January 2016. The most recent update for the ARFP is the Consultation Paper that was released in April 2014 which closed in July. Malaysia was neither a member of the working group that drafted the Consultation Paper nor a signatory to the Statement of Intent signed in 2013 by Australia, New Zealand, Korea and Singapore to move forward with ARFP. Malaysia has, however, participated since 2010 on the APEC meetings exploring the ARFP. The next scheduled step from the Consultation Paper is the February 2015 document which is to be signed by countries that wish to become members of the ARFP when it is launched. Between February and December 2015 a pilot group of markets are scheduled to implement legislation and measures to move the ARFP into full implementation by January 2016.

### **Different jurisdictions slowing ARFP progress**

The ARFP is yet to take root as there are a number of barriers for the idea to grow. These include: a) diverse taxation framework, as it would play a big role in attracting investors to invest in foreign funds, b) lack of a common currency which would activate the currency risk especially for the currencies that are not pegged to US dollar or any other hard currencies, and c) the size and development of some of the markets and investors.

### **Advantages to exploit for ARFP and CIS Framework**

Diversification: Despite the challenges, there are merits in creating the ARFP and a wider ASEAN CIS Framework beyond Malaysia, Singapore and

Thailand. Diversification will help both issuers and investors as many funds in the region are domestic. Liquidity management and funding growth are also key advantages for the countries in this scheme. In addition, cross-border capital flows among the countries will open doors for many investors in markets and expertise which previously were inaccessible. As a result, the funds market will grow at a faster pace once the ARFP and a potential future ASEAN-wide CIS Framework are implemented.

### **ASEAN free flow of labour**

Funds passporting under the CIS Framework will also result in job creation for the funds management sector as well as professional expertise in the region. The free flow of labour is one aim under the ASEAN Economic Community Blueprint. The current snapshot reflects a largely unbalanced ASEAN professional financial community concentrated in the bigger and more developed financial centres Singapore and Malaysia, with the latter being the Islamic finance hotspot.

The long-term vision is for expertise to be balanced out throughout ASEAN but it is generally accepted that in the short- to mid-term professional skills and expertise will still flock to and remain where wages are higher while the process of education, diffusing and disseminating knowledge and skills takes place outward to the rest of the ASEAN member states. One initiative working towards facilitating the free flow of labour is the ASEAN Qualifications Reference Framework (AQR) which will function as a device to enable comparisons of qualifications across ASEAN Member States while at the same time support and enhance each country's national qualifications framework or qualifications systems that are currently at varying levels of development, scope and implementation.



## Leadership Article



**By Badlisyah Abdul Ghani,  
CEO, CIMB Islamic**

Badlisyah Abdul Ghani is the Head of the Group Islamic Banking at CIMB Group, where he also serves as Executive Director and Chief Executive Director of CIMB Islamic Bank Malaysia and Country Head, Middle East and Brunei.

### Should Islamic Banks do Private Equity in Malaysia?

Less time has been spent discussing the development of Islamic private equity in comparison to time dedicated to Islamic banking, capital markets, asset management and other components of Islamic finance. But recently there has been a lot of discussion on whether Islamic private equity should be done within Islamic banking itself. Should an Islamic bank, licensed as a bank to do banking activities, do private equity? If an Islamic bank is asked to do private equity, and decides to do it, how should it undertake the business?

Historically, many Islamic banks in the Middle East operated for the most part like private equity institutions. When the 2008 global financial crisis hit many were stuck with a lot of equity exposure, in the form of real estate or actual business ownership. Banks had to scramble to liquidate their assets to meet regulatory requirements when the liquidity crunch hit. Now although economies and business prospects are recovering, two big challenges in the form of Basel III and International Financial Reporting Standards (IFRS) have emerged for banks to do the business.

#### **Effect of global developments and accounting standards**

On 13 December 2013, the Basel Committee approved an amendment to Basel II to increase risk-weights for fund investments. The new Basel

standard, if adopted by national banking supervisors, will apply to an internationally active bank.

Banking organisations need to meet prescribed risk-weighted minimum capital requirements. The higher the asset risk-weight, the more capital a banking organisation must maintain to meet capital adequacy requirements. From Jan 1, 2017, this new capital standard will require banking organisations in home countries adopting the Basel standard to have at least one dollar of regulatory capital for each dollar invested in a fund, unless a risk-weighting of the fund's actual investments or those permissible under the fund's mandate is possible and produces a lower risk-weighting. However risk weighting of a fund's assets must include a charge for the fund's leverage that will result in the same dollar-for-dollar capital requirement for investments. The requirement of one dollar of required capital for each dollar of fund investment requires a 1,250 percent risk weighting of fund investments, which is tantamount to a 100 percent capital requirement.<sup>14</sup>

International Financial Reporting Standards (IFRS) now require private equity fund managers to measure and present the fair value of their investment assets as opposed to valuing their portfolio company investments at cost.

The natural tendency is for shareholders of the bank to shy away from this exposure because the capital charge is too onerous. In light of these challenges what do you do if you are a nation or regulator that wants to develop Islamic private equity within a banking ecosystem?

It is foolhardy to go against the international norms of Basel III and accounting standards so the bank's shareholders need to decide on the amount that the bank will set aside for this activity and then proceed with raising additional funds from other investors. As a result, the bank can act as a catalyst but not as an active participant in this environment. European

banks, especially the investment banks that were involved in private equity funds, either via a fund-of-funds approach or equity participation, are all exiting due to this Basel III issue.

These international prudential and accounting standards are implemented and being looked at by regulators globally to ensure the safety of depositors. The by-product of this is that it will not allow Islamic banks to participate in the Islamic private equity space in any manner, as it is going to be hard to convince the bank's risk management to do Islamic private equity looking at the capital requirement ratios and the amount needed to fund the business.

It is interesting to note that the Middle East and Europe is moving away from doing private equity activities within a banking environment, while in Malaysia there is a lot of discussion involved at how Islamic banks can look at participating in these activities directly instead of simply being an intermediary.

Therefore, within the Islamic finance market, what really should be done? Should it continue to be done by a firm totally separated from the banking institution or it should be done by a bank?

### **A world of difference between banking and Private Equity**

The realms of private equity and banking are two different worlds. The infrastructure required is very different as private equity is not credit-driven. In many jurisdictions, regulations do not allow for banks to do private equity. In order to do Islamic private equity within a banking environment, a new set of laws and regulations will need to be put in place.

In addition to the business side, many Islamic financial institutions do not currently have the in-house talents or infrastructure and capability to undertake private equity activity and will need to build it from scratch. There are also legal implications and legal risks involved in Islamic private equity that many financial institutions are unfamiliar with. These are key issues for Islamic financial institutions licensed as banks to consider before undertaking such activities.

<sup>14</sup> Source: <http://www.lexology.com/library/detail.aspx?g=85775f89-bd7b-4f62-b8fd-46457f927>

---



---

*It is interesting to note that the Middle East and Europe is moving away from doing private equity activities within a banking environment, while in Malaysia there is a lot of discussion involved at how Islamic banks can look at participating in these activities directly instead of simply being an intermediary.*

---



---

In terms of having to alter or rearrange mindsets and resources to facilitate Islamic private equity, a proper governance structure and Shariah-compliance structure will need to be put in place. It is also necessary to keep Islamic private equity operations separate from the banking operations as the regulations and the risk management tools that you employ from the banking environment will not fit into the private equity environment.

Islamic banking institutions are comfortable with having hard assets like property as security or shares, but are likely to be less comfortable with treating intellectual property as collateral and conducting the valuation of such an asset.

#### **Undertaking Islamic Private Equity separately and independently**

There is also the possibility of creating a separate non-banking financial institution subsidiary to engage in private equity which is part of a larger financial group, outside the realm of the bank itself. The issue that emerges is whether the ratios and requirements imposed on Islamic banks will also be imposed on the parent company.

Even if a regulator accommodates the Islamic private equity industry and enables the relaxation of requirements for higher capital charges, it does not resolve the issue of accounting standards. A parent and its subsidiaries are collectively referred to as a group and are accounted for using consolidated statements, which will treat the net assets and activities of the subsidiaries held by the parent as if they were part of the parent's own net assets and activities. Control is presumed to exist when the

parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless it can be clearly demonstrated that such ownership does not constitute control.<sup>15</sup> The issue of control becomes paramount, with the new accounting standards. Who manages the money? Who is on the investment committee? Who controls the investment committee? The issue of fair value will rear its head again and it cannot be avoided.

Therefore the only serious and substantial way forward is for Islamic private equity activity to be done by a non-bank financial institution which is not part of a larger financial group.

#### **Islamic Private Equity participation by Islamic banks**

What are an Islamic bank's chances of success if it acts only as an intermediary to facilitate customer and client participation in Islamic private equity?

Banking customers and depositors are similar everywhere. For the most part, they do not look for a higher risk exposure vis-à-vis their conventional counterparts, and their appetite for the private equity asset class is limited.

It would not be right for the industry to approach customers who are reliant on their monthly salaries, i.e. the "man-in-the-street". Institutions like pension funds and insurance companies are likely to pursue Islamic private equity directly rather than go through

<sup>15</sup> Source: Müller, Kay; Achleitner, Ann-Kristin, Investing in Private Equity Partnerships: The Role of Monitoring and Reporting, (Wiesbaden: Springer Science & Business Media, 2008), p.163.

a bank as an intermediary as they will likely want to manage their own money directly.

This leaves high net worth individuals (HNWIs), which have a higher level of discretionary wealth which they can deploy into a diverse selection of investments, including Islamic private equity. Islamic private equity can play a part of the bank's wealth management value proposition to this customer segment. The opportunity is to see if these individuals would want to part with their money and give it to a bank to manage for private equity investment. The bank's role is to give higher confidence to HNWIs, and facilitate their participation in this asset class.

However, it has been the industry's experience that the bank's wealth management account managers will need to expend additional resources and time to manage the expectations of these customers, who are relatively inexperienced with Islamic private equity. As a result, private equity fund managers then have to spend more resources managing the bank's wealth management team to address investors' concerns on seeing returns. These HNWIs will be unfamiliar with waiting a long time, for example four to seven years, before seeing any kind of return. Liquidity becomes an issue for them, and then for the wealth managers, even if it is a HNWI unless he or she is very sophisticated. HNWIs need to be very clear that they are investing via the bank to participate in a private equity fund.

That said, if the only substantial opportunity is the HNWI customer segment, this leaves little room for an Islamic bank, licensed as a bank, to undertake Islamic private equity activities.

### **Role of pension funds and insurance companies in growing Islamic Private Equity**

In light of this, how do we then fill the gap and grow Islamic private equity? There is an opportunity for large pension funds, sovereign wealth funds and insurance companies to fund this growth and participate in this nascent asset class.

Institutions like pension funds and insurance companies usually do not have any investment time horizon issues of wanting to exit prematurely given their mandates. It is more a matter of making a decision to put in place an asset allocation for Islamic private equity, and it can participate in this asset class via a fund-of-funds approach or via direct investment. In this way a portion of this institutional money can be activated for the real economy, because by and large, these kinds of institutions are largely invested in securities. There is an opportunity to diversify and place some of the available funds directly in companies, into real business, and spur the development of this portion of Islamic finance.



## THE ROLE OF ISLAMIC FINANCE IN SOCIAL DEVELOPMENT

---

### OVERVIEW AND DEVELOPMENT OF SME

- 250 The value of SMEs as Malaysia's economic engines
- 251 SMEs employ more workers than large firms
- 252 Access to financing

### OVERVIEW AND DEVELOPMENT OF ZAKAT AND AWQAF

- 260 Governance of Islamic affairs
- 260 Zakat Overview
- 268 Waqf Overview
- 274 Cooperative Institutions Overview

# Overview and Development of SMEs

## The value of SMEs as Malaysia's economic engines

Malaysia has recognised the role of manufacturing, agriculture, and the services sectors to its economy. It is important to examine the sustainability of the economy in terms of source of economic growth, per capita income, economic activities and the role of small and medium enterprises (SMEs).

SMEs constitute about 97.3% of total business establishments in Malaysia, according to the Department of Statistics Economic Census 2011. They are considered engines of economic growth and also play a major role in effecting import substitution by providing alternatives to foreign products and services.

The SME is defined as: a company with sales turnover not exceeding RM50 million or full-time employees not exceeding 200 for companies in the manufacturing sector; and sales turnover not exceeding RM20 million or full-time employees not exceeding 75 for services and other sectors.

## SMEs contribution to GDP growth has consistently exceeded the growth of the overall economy.

For the period 2006-2012, the average annual growth rate (or compounded annual growth rate, CAGR) of SMEs was 6.3%, higher than the average growth of the overall economy of 4.7%. As a result, SME contribution to GDP increased from 29.4% in 2005 to 32.7% in 2012.

## The services and construction sectors led contribution to GDP growth for 2006-2012

The services sector expanded at an average annual rate of 8.1% and the construction sectors at a rate of 7.3% during 2006-2012. Overall, contribution to GDP growth by SMEs in all economic sectors increased during the same 7-year period.

## Malaysian SMEs contribution to GDP still lags behind the advanced and other high middle income countries.

The contribution to GDP in most of these countries is greater than 40% of total GDP whereas SMEs in Malaysia contributed only 32.7% to GDP (2012).

Table 1: Yearly GDP Growth and SMEs GDP Growth, 2006-2012 (Constant 2005 Prices)

	2006	2007	2008	2009	2010	2011	2012	CAGR
Overall GDP	5.6	6.3	4.8	-1.5	7.4	5.1	5.6	4.7
SMEs GDP	6.4	10.0	6.5	0.2	8.3	7.0	6.0	6.3

Sources: Department of Statistics and SME Annual Report

Table 2: GDP of SMEs and Large Firms in Percentage Share to GDP at Constant 2005 Prices

	2006	2007	2008	2009	2010	2011	2012
Large Firm	70.4	69.3	68.8	68.3	68.0	67.5	67.3
SMEs	29.6	30.7	31.2	31.7	32.0	32.5	32.7

Sources: Department of Statistics and SME Annual Report

**SMEs employ more workers than large firms.**

SMEs absorbed about 4.1 million workers or 59.4% of total employment in 2009, declining to 57.4% in 2012 (although it was a higher 4.8 million workers in absolute numbers, see Table 4). The total employment absorbed by both SMEs and large firms increased during 2009-2012 but the growth for large firm employment was higher. As shown in Diagram 1, the growth for SMEs employment in 2010 was lower than for large firm employment growth but SMEs employment growth rate picked up pace in 2011 and 2012, ahead of large firms. As a result, the percentage share of SMEs employment to total employment increased from 57.3% to 57.4%.

**The productivity of SMEs – as measured by real GDP per worker – is relatively low compared to large firms.**

However, the productivity of SMEs improved gradually from 2010 to 2012. In 2010, the labour productivity was 2.84 times lower than for the large firms, declining to 2.78 times in 2012. The growth rate of labour productivity for both large firms and SMEs declined in 2012 (see Diagram 3). This is due mainly to the increase in employment versus GDP growth. The growth rate of total employment increased to 6.2% in 2012 from 3.1% in 2011.

**Local SMEs are also central to Malaysia's Islamic Economy development.**

The Halal Park as an

Table 3: SME GDP share by Key Economic Activity at Constant 2005 Prices

SME CONTRIBUTION TO GDP	2005 (% SHARE)	2012 (% SHARE)	CAGR 2006-2012
Overall	29.4	32.7	6.3
Services	17.0	20.2	7.3
Manufacturing	8.1	7.9	4.3
Agriculture	3.4	3.3	4.1
Construction	0.7	0.9	8.1
Mining and Quarrying	0.1	0.1	6.3

Source: Department of Statistics, Malaysia

Table 4: Employment in SMEs and Large Firms (million)

	2009	2010	2011	2012
Employment in SME	4.1	4.4	4.6	4.8
Employment in Large Firm	2.8	3.3	3.4	3.6
Total Employment	6.9	7.7	8.0	8.5

Source: Department of Statistics, Malaysia

established brand has a plan to involve SMEs. Its future plans to bring local SMEs on board will also be made easier with incubation facilities provided at Halal Parks. These incubators will help SMEs overcome one of the primary challenges they face – obtaining halal certification. Once SMEs acquire certification and are able to get their products on board, the Halal brand will then be able to act as a key selling point.

**Access to financing**

SMEs in Malaysia find it difficult to obtain funding or financing due to a variety of factors, chief of which are: weak credit rating, lack of collateral, and lax financial record-keeping or lack of documentation that are required by most formal financial institutions. In addressing these challenges, the Malaysian government, through various ministries and agencies, has prioritised access to financing through

private sector funding with government funds, schemes and guarantees especially for businesses in early stage of their growth cycle, addressing information asymmetry, and enhancing financial inclusion to cover the rural and excluded segment. This is done through the linkages between financial institutions and SMEs, as shown in Diagram 4.

Financial assistance for SMEs is designed with the main source of financing coming from financial institutions, comprising banks and development financial institutions (including cooperative institutions). Other sources of financing include venture capital and private equity; leasing and factoring; the special funds and schemes by the government and Bank Negara Malaysia as well as the Ar Rahnū scheme, and zakat and waqf-based Islamic microfinance institutions and kutu. (See Islamic social finance instruments further down this chapter.)

Diagram 1: Employment Growth, % (2010-2012)

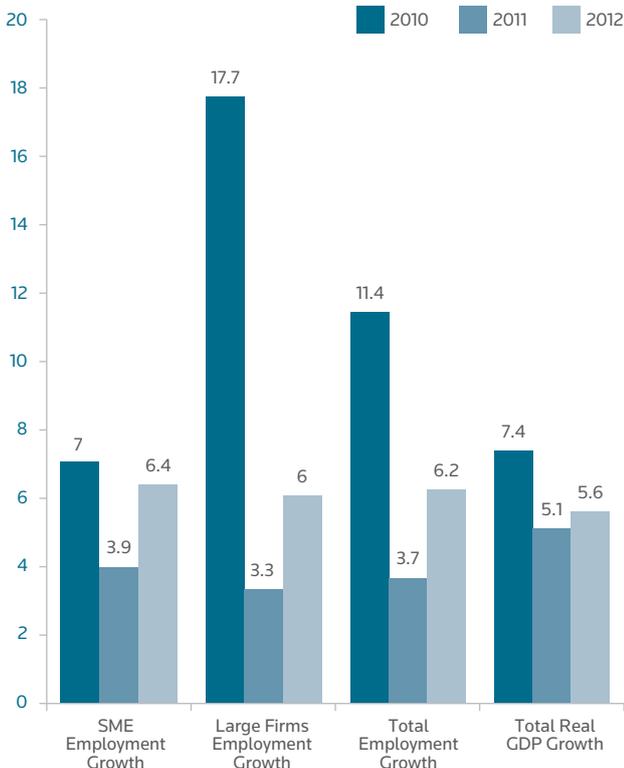
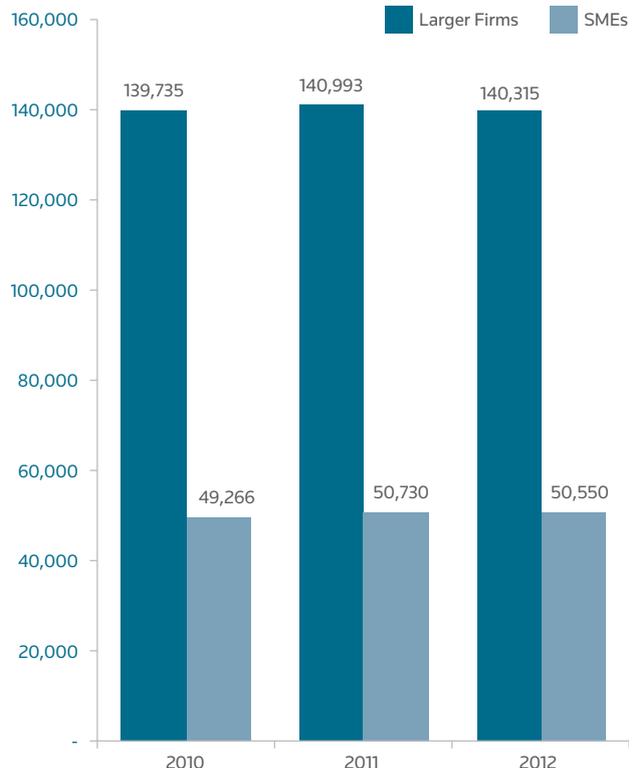


Diagram 2: SMEs and Large Firm Productivity Levels, RM millions



Sources: Source: Department of Statistics, Malaysia

Diagram 3: SMEs and Large Firm Productivity Growth, % (2010-2012)

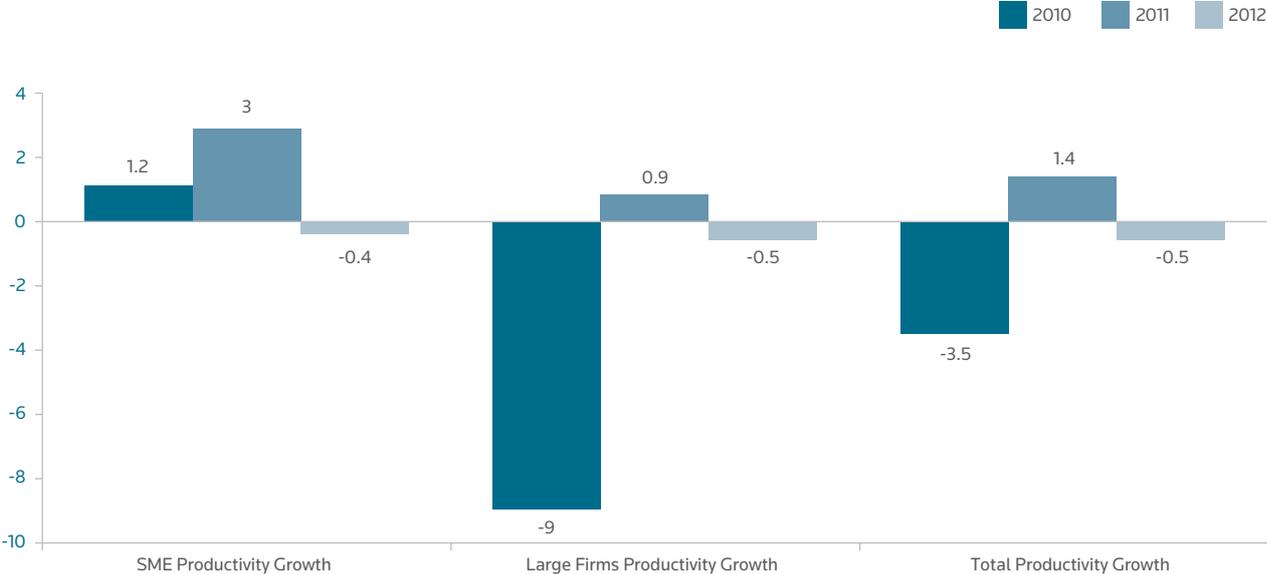
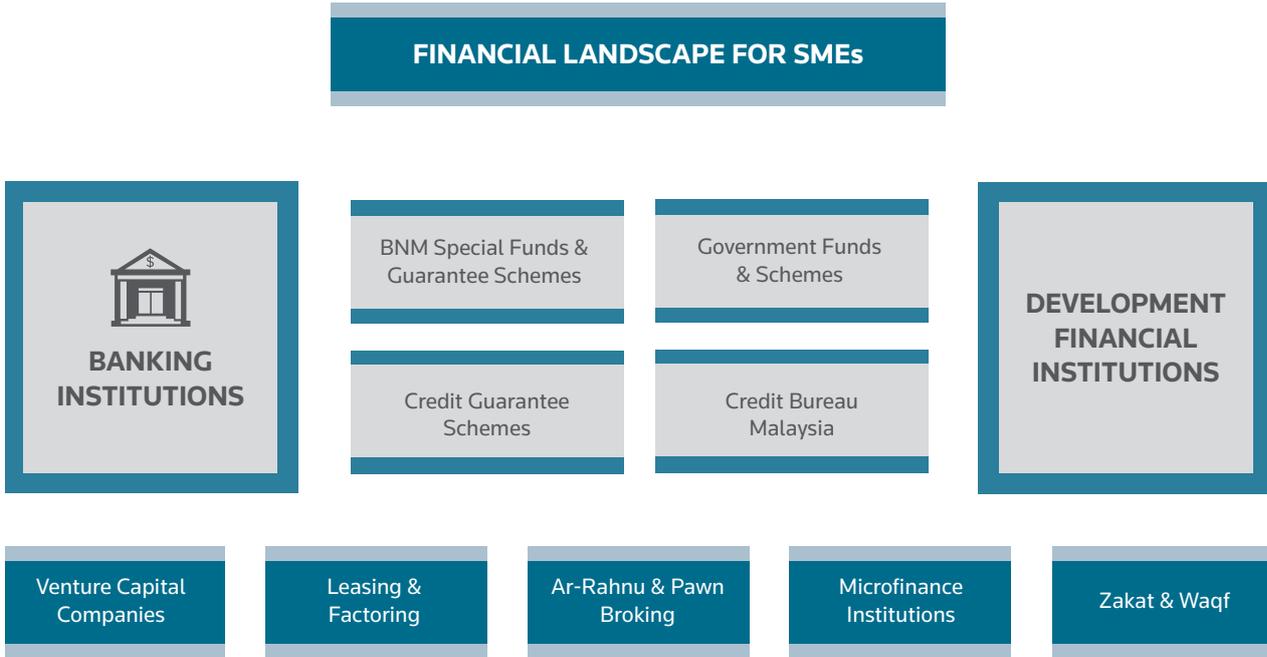


Diagram 4: Linkages between Financial Institutions and SMEs





## Leadership Article



**By Dr. Mohammed  
Obaidullah, IRTI**

Mohammed Obaidullah is a Senior Economist at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IsDB). Prior to joining IRTI in November 2006, he served the Islamic Economics Research Center, King Abdulaziz University, Jeddah, Saudi Arabia and taught at the International Islamic University Malaysia as an Associate Professor.

### Islamic Microfinance: Case Study of Amanah Ikhtiar Malaysia

Poverty alleviation initiatives in Malaysia owe their origin to the New Economic Policy (NEP) of the government of Malaysia. Unlike in many economies faced with staggering levels of acute poverty, such initiatives in Malaysia have been targeted primarily at reducing disparities of income and wealth among different strata in the society. Between 1970 and 1990, the Malaysian government introduced the New Economic Policy (NEP) that undertook large-scale social and economic development in the country with a view to alleviating poverty, restructuring the society and removing racial imbalances in the economic sector.

Microfinance was introduced in Malaysia in 1987, inspired by the microcredit initiatives in Bangladesh. The first microfinance institution in Malaysia was Amanah Ikhtiar Malaysia (AIM). AIM has been providing microfinance services throughout Malaysia (Peninsular, Sabah and Sarawak). In 1987, the state of Sabah also established its own microfinance institution called Yayasan Usaha Maju (YUM), with a focus on providing microcredit loans to the poor people of the state. Both AIM and YUM were replications of the Grameen Bank model. The third microfinance institution in Malaysia is The Economic

Fund for National Entrepreneurs Group (TEKUN), established in 1998. TEKUN provides microcredit services throughout Malaysia. All three microfinance institutions receive full financial support from the government in terms of grants and soft loans since their inception till date.

The Amanah Ikhtiar Malaysia (AIM) is rightly cited as the pioneer — the oldest and one of the largest replications of the Grameen model of microfinance in Asia<sup>1</sup> — that also sought to introduce Shariah-compliant products in conformity with the belief systems of its beneficiaries. Conceived in 1986-87 as Projek Ikhtiar — an action research project by Universiti Sains Malaysia (USM) in the Northwest Selangor Area, the pilot was financed by the state of Selangor, Asia Pacific Development Center, and Malaysian Islamic Economic Foundation (YPEIM). This research was led by Professor David S. Gibbons and Professor Sukor Kasim. The institutionalization of the action research materialized in the later part of 1987 when AIM was formally established as a Registered Private Trust Corporation. Using a modified Grameen Bank model, the Amanah Ikhtiar Malaysia or AIM aimed to become a progressive, dynamic and world-class micro-credit institution that would alleviate poverty and uplift society's well-being in a Shariah compliant manner. The stated objective of AIM was to reduce poverty among very poor households in Malaysia by extending benevolent loans (qard al-hasan) for the purpose of financing additional income generating activities. (Instrument of Trust of AIM, 1987).

1 John D Conroy (2002) Microfinance in Malaysia: Time to Rebuild

The evolution and growth of AIM may be seen to have occurred in two phases:

**Phase 1 (1988-1995)** witnessed the expansion of AIM in peninsular Malaysia, funded by loan funds from YPEIM, banks and the Credit Guarantee Corporation; the administrative costs and charge on loans (called service charge) were absorbed by grants from the State and Federal Government.

**Phase 2 (1996- present)** witnessed the expansion of AIM into Sabah and Sarawak, financed by loan funds in the form of soft loans from the Federal Government, while administrative costs were fully absorbed by administrative charge on loans (called service charge).

The table below throws light on the status of AIM at present.

#### Current Status of AIM

##### BASIC INFORMATION

Number of Members	286,105
Number of Groups	58,154
Number of Centers	6,779
Number of Branches	114
Number of Staff	2,040

##### BASIC INFORMATION

Total Loan Disbursed	US\$ 2,109,829,557.7
Loan Outstanding	US\$ 404,810,142.6
Quality Portfolio	99.6%

*Between 1970 and 1990, the Malaysian government introduced the New Economic Policy (NEP) that undertook large-scale social and economic development in the country with a view to alleviating poverty, restructuring the society and removing racial imbalances in the economic sector.*

## Financial Products

AIM has been offering several loan products since its inception. Its flagship product – Skim Pembiayaan Ikhthiar – sought to provide loans to poor households in a phased manner, increasing the loan size to borrowers who graduated in income and had a good repayment record for the previous loan(s). These schemes continue in a modified framework (see table 2). AIM discontinued with some products, such as the Single Mother Loan Scheme and Fisherman Loan Scheme, that were primarily responsible for its poor performance during the Nineties.

AIM's loan portfolio has experienced a steady growth over the last five years. This may be observed from Figure 1 and Table 3.

The number of AIM clients or sahabat (that translates into companions) increased from 200,000 in the year 2008 to about 286,000 in 2012, which translates into an average annual growth of 9.3 percent over the last four years. The growth in its loan portfolio during the same period has been much higher at about 32.11 percent. This is perhaps attributable to a shift in policy favoring larger sized loans in recent years.

Figure 1: Time-Series Growth in AIM's Loan Portfolio

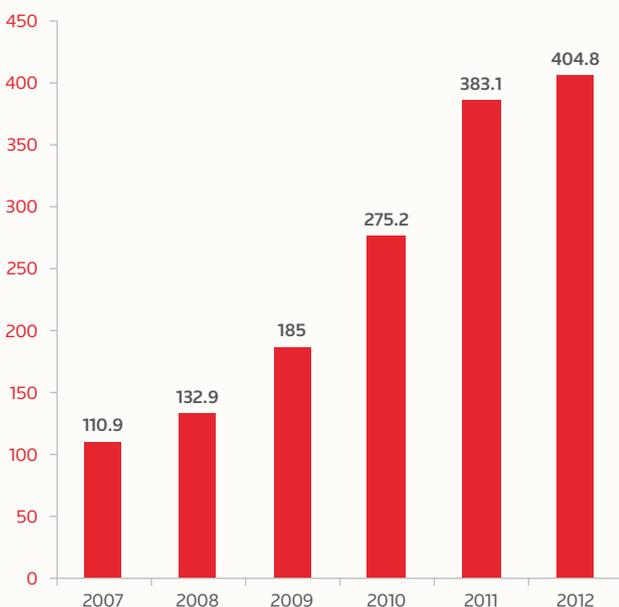


Table 2: Financing Products at AIM

FINANCING SCHEME	SIZE (RM)	PAYBACK PERIOD (WEEKLY)
<b>ECONOMY</b>		
i-Mesra	1,000 to 2,000	12, 25, 35, 50
	3,000 to 10,000 (max)	12, 25, 35, 50, 75, 100
i-Srikandi	12,000 to 20,000 (max)	12, 25, 35, 50, 75, 100, 125, 150
i-Wibawa	5,000 (max)	12, 25 weeks or every month for 6 months or a lump sum
<b>OTHER</b>		
i-Sejahtera	1,000 to 2,000	12, 25, 35, 50
	3,000 to 10,000 (max)	12, 25, 35, 50, 75, 100
i-Bestari	1,000 to 2,000	12, 25, 35, 50
	3,000 to 5,000 (max)	12, 25, 35, 50, 75, 100
i-Panyayang	1,000 to 2,000	12, 25, 35, 50
	3,000 to 5,000 (max)	12, 25, 35, 50, 75, 100
i-Emas	2,000 (max)	12, 25, 35, 50

Table 3: Time-Series Growth in AIM's Loan Portfolio

YEAR	IN USD MILLION
2007	110.9
2008	132.9
2009	185
2010	275.2
2011	383.1
2012	404.8

*A major challenge confronting the global microfinance sector arises out of the need to balance the conflicting requirements of operational and financial sustainability of the institutional providers on one hand, while seeking to expand outreach and providing microfinance services to increasing numbers of the poor and the destitute on the other.*

### **Non-Financial Services**

Provision of non-financial services constitutes an important part of the intervention by AIM to alleviate poverty. Training programs organized by AIM have increasingly assumed significance and are handled by two units: Entrepreneurship Development Unit (EDU) and Training Center. The EDU organizes courses specifically for its micro-enterprise clients in the fields of basic accounting; entrepreneurship; product promotion; financial management and business communication. The Training Center offers general courses on self-development of members.

### **Pricing**

AIM's establishment was aligned with the New Economic Policy of the government to help the poor. The government agencies not only provided soft loans to AIM for onward lending, but also helped absorb a large part of the cost of funds as well as the administrative costs through grants and enabled AIM to extend loans at below-market rates. The cost of finance was levied as a service charge, since the loan product was structured as a qard al-hasan. However, the ad-hoc nature of pricing was partly responsible for gross financial indiscipline and poor quality of the loan portfolio. This led to a major restructuring of AIM management in the mid-1990s. The new management philosophy emphasised on full-cost recovery as a means to ensure long-term sustainability.

Presently, AIM charges zero percent as cost of finance (loan is still viewed as qard al-hasan) plus ten percent as cost of provision of non-financial services (ujrat) involving (i) intensive supervision and

business development (ii) skills training (iii) human capital development and (iv) consultation.<sup>2</sup>

### **AIM as a model of poverty alleviation: Impacts and limitations**

The performance of AIM as a model of poverty alleviation has been subjected to several evaluation and impact studies, both internal and external. Among other things, these studies sought to measure the increase in income of the client-households because of AIM intervention. The findings are briefly presented in table 4 and figure 2. The studies concluded that the impact on household was quite significant and positive and the magnitude of the impact is greater in recent years than in the past.

Some interesting highlights from these studies are presented below.<sup>3</sup> Many of these reinforced the various Grameen hypotheses regarding microfinance.

- Not only is micro-credit an important element in poverty reduction, its effectiveness is greater in households headed by women. Further, women make far better clients than men with much better repayment rates.
- The percentage contribution of micro-credit to the total household income increases with the movement away from the lowest economic status to better-off positions.

<sup>2</sup> The Role of Microfinance in Poverty Alleviation: AIM's Experience, Presentation by Datuk H Zabida Ismail, World Islamic Economics Forum, held in Johor Baru, Malaysia in April 2012

<sup>3</sup> This section draws heavily on *Impact Study and Plan of Action for AIM Expansion in Malaysia* (2009)

- A comparison of average income to the number of economic loans undertaken reveals that, it is the “three-time borrowers” who demonstrate significant increases in income compared to the “two-times borrowers” and the “single loan borrowers”.
- Most active borrowers also managed to increase the quality of their lives through a variety of non-monetary benefits over time compared to the non-participating poor, such as access to drinking water, electricity and toilet facilities, improved physical housing conditions, means of transportation etc.

**Limited outreach**

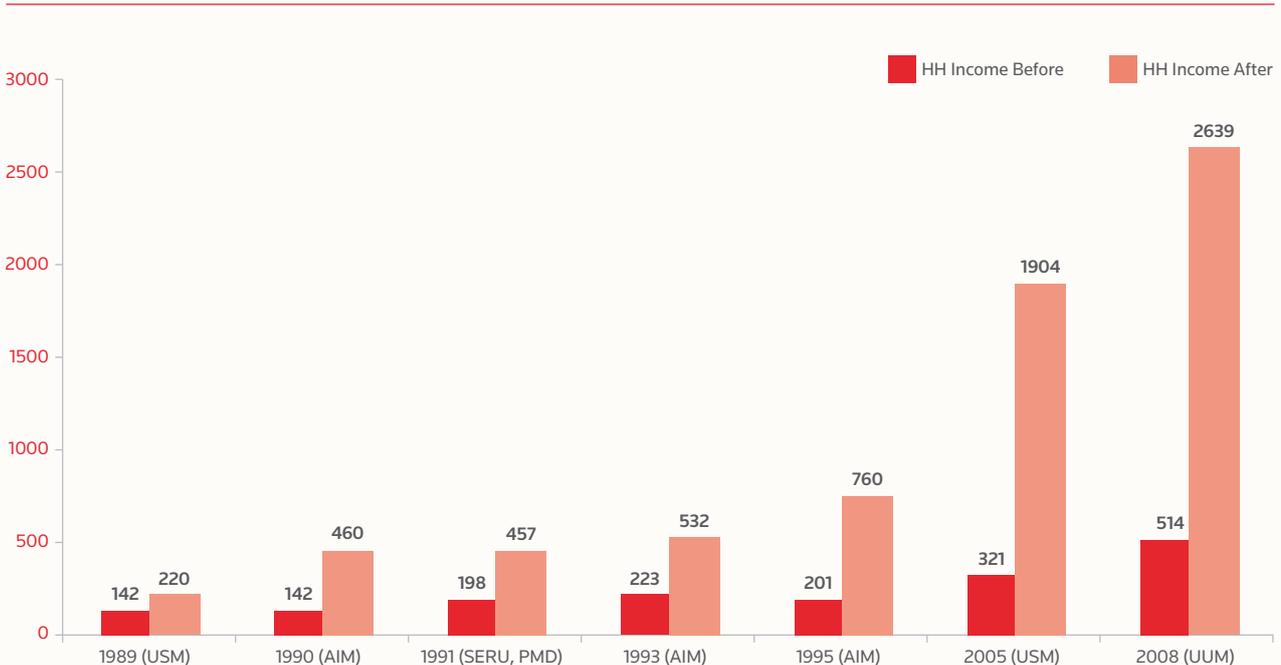
However, interestingly, the studies also noted that AIM’s overall outreach was very limited. It was only around 30 percent after many years of reaching out to the poorest of the poor. The studies also advocated continuous government support in the form of on-lending funds or subsidizing operating costs for a reasonable period in the future.

The key success factors for the poor to get out of poverty were identified as: access to micro-credit; continuous utilization of credit; management of microenterprise by the borrowers themselves; and the ability to obtain substantially bigger amount of loan for fast-movers and high-jumpers.

Table 4: Impact of AIM Microfinance on Household Income

YEAR (EVALUATING AGENCY)*	1989 (USM)	1990 (AIM)	1991 (SERU, PMD)	1993 (AIM)	1995 (AIM)	2005 (USM)	2008 (UUM)
HH Income Before	142	142	198	223	201	321	514
HH Income After	220	460	457	532	760	1904	2639

Figure 2: Impact of AIM Microfinance on Household Income



\*Evaluating Agencies: USM: Universiti Sains Malaysia; SERU, PMD: Socio-Economic Research Unit, Prime Minister’s Department; UUM: Universiti Utara Malaysia

### High repayment rates

A major criticism of subsidised microfinance systems is their high default rates. While this continues to be true for finance providers like TEKUN and YUM,<sup>4</sup> AIM reported a major turnaround and its recent performance in this regard has been very satisfactory with repayment rates at as high as 98.98 percent.

### Positive impact of provision of non-financial services

Some studies have also highlighted the importance of providing non-financial services such as training and human development as key success factors. A study at IIU Malaysia<sup>5</sup> found that AIM training has considerably helped members in financial management and self-development and recommends that AIM intensifies its human development intervention. Another study<sup>6</sup> surveys various economic activities and income obtained from these activities. It identifies specific economic activities in the trading sector that are lucrative and result in higher average income than activities in production and service sectors. The study suggests that AIM should provide training to its members to impart skills and knowledge necessary to take up high income generating microenterprises. AIM management should encourage borrowers to venture into these activities and discourage them from undertaking activities that result in low income.

A major challenge confronting the global microfinance sector arises out of the need to balance the conflicting requirements of operational and financial sustainability of the institutional providers on one hand, while seeking to expand outreach and providing microfinance services to increasing numbers of the poor and the destitute on the other. The challenge is more severe for the Islamic microfinance

sector that must act with the additional constraint of complying with the Shariah in letter and spirit. The model of intervention at AIM has undergone major changes as it has moved along the learning curve. Finally, it seems to have found a winning combination of government support, market discipline through simplified loan products and hand-holding non-financial support. While the model can be replicated elsewhere, it also strengthens the case for similar but alternative models. A model where charity and philanthropy funds replace government funds may be one such model that needs to be tried out.

4 See Suraya Hanim Mokhtar, Gilbert Nartea and Christopher Gan (2012) "Determinants of Microcredit Loans Repayment Problem among Microfinance Borrowers in Malaysia", *International Journal of Business and Social Research*, Vol.2, No.7

5 Norma Md Saad (2010), "Achieving Human Development Objectives through Microfinance Institution: The Case of Amanah Ikhtiar Malaysia", *Journal of Islamic Economics, Banking and Finance*, Vol.6 No.2

6 Norma Md Saad (2011), "Selecting High-income Generating Activities for Micro-entrepreneurs: The Case Study of Amanah Ikhtiar Malaysia", *International Journal of Humanities and Social Science* Vol.1 No. 5

# Overview And Development Of Zakat And Awqaf

## Governance of Islamic affairs

Malaysia recognises Islam as its official religion.<sup>1</sup> It is not the central or Federal Government, but each of the states in the Federation that governs Islamic affairs (including zakat and waqf) in its domain.<sup>2</sup>

The Sultan as head of the state acts in his discretion to appoint state religious officials, and to determine the direction of religious affairs in the particular state. The Sultan has a significant role and the ultimate responsibility in the issue of fatwa or rulings on Islamic law in its full compliance and implementation. The institutional responsibility for implementing Islamic law in each state is entrusted to the State Islamic Religious Councils. However, since each state in Malaysia has the prerogative to enact laws and regulations regarding Islamic matters, there is a great diversity in the macro regulatory environment governing the zakat and waqf sectors. This has also resulted in diversity across states in the institutional infrastructure that supports the zakat and waqf sectors.

The Federal Government has no direct jurisdiction over Islamic law. However, for the purpose of coordinating and increasing the efficiency of Islamic religious activities in all states across the nation, the Federal Government through the Conference of Rules and the National Fatwa Committee may take certain initiatives. In relation to zakat, the federal government has established a task force or department to study the administration, collection and distribution of zakat, bait-ul-mal and waqf. In 2005 the Federal Government established the Department of Wakaf, Zakat and Hajj (JAWHAR). Prior to this, the supervision of zakat administration fell under the Department of Islamic Religious Development (JAKIM). Through this department, the federal government takes initiatives to ensure the efficiency and effectiveness of zakat collection and distribution throughout the country.

1 Article 3 (1) of the federal constitution asserts that while Islam is the official religion, other religions may be practised in peace and harmony in any part of the federation.

2 Provided in Item 1 of List II (State List) of Schedule 9 of the federal constitution

## ZAKAT

Institutional management of zakat has been in existence in Malaysia for a long time. However, from viewing zakat as a personal ibadah and religious obligation, Malaysian society has moved on to broadening its scope and mission as a social institution. As a social institution, the states recognise zakat as an economic tool to alleviate poverty among the Muslim Ummah.

### Regulatory and Institutional Infrastructure

In Malaysia, the 13 provinces and capital territory have respective legislations pertaining to zakat. The states of Pahang, Malacca, Sarawak and Kedah have additional regulations/ rules. A comprehensive list of these laws and regulations is provided below.

1. Syariah Criminal Offences (Federal Territories) Act 1997
2. Majlis Ugama Islam (State of Sabah) Enactment 2004 & Zakat And Fitrah Enactment 1993
3. Majlis Islam Sarawak Ordinance 2001, Zakat and Fitrah Regulations 1966 (Sarawak)
4. Syariah Civil Enactment (State of Melaka), 1991 and Regulations of zakat and fitrah and wakaf 1982, Melaka
5. Council of the Religion of Islam and Malay custom (State of Kelantan) Enactment 1994
6. Administration of the Religion of Islam (State of Johor), Enactment 2003 & Syariah Criminal Offences Enactment 1997
7. Administration of the Religion of Islam (State of Selangor), Enactment 2003 & Syariah Criminal Offences Enactment 1995
8. Administration of the Islamic Affairs (State of Terengganu), Enactment 2001 & Syariah Criminal Offences Enactment 2001
9. Administration of the Islamic Law Enactment (State of Pahang), 1991, Administration of the Religion of Islam and the Malay Custom (State of Pahang), 1982
10. Administration of the Religion of Islam (State of Perlis) Enactment 2006
11. Administration of the Religion of Islam (State of Penang), Enactment 2004 & Syariah Criminal Offences Enactment 1996

12. Administration of the Religion of Islam (Perak) Enactment 2004 & Syariah Criminal Offences Enactment 1992
13. Administration of the Religion of Islam (State of Negeri Sembilan), Enactment 2004 & Syariah Criminal Offences Enactment 1996
14. Zakat Regulations Kedah 1982

### Professional Zakat Centres

A major step in the institutionalisation of zakat management in Malaysia has been the establishment of Zakat Centres as organised and professional bodies in several states as subsidiaries of their respective state Islamic Religious Councils. The establishment of the Zakat Collection Centre Wilayah Persekutuan Kuala Lumpur (PPZ-MAIWP) in 1991, followed by the Selangor Zakat Centre (PZS-MAIS) in 1992, the Pulau Pinang Zakat Management Centre (PUZ-PP) in 1994, the Pahang Zakat Centre (PZ-MAIP) and the Melaka Zakat Centre (PZM) in 1996 and the Negeri Sembilan Zakat Centre (PZ-MAINS) in 1998 have been major milestones for the professionalisation of the zakat sector in Malaysia.

However, not all states have embraced the idea of establishing Zakat Collection and Distribution Centres as organised and professional bodies. Six states – Kedah, Perlis, Kelantan, Terengganu, Perak and Johor – still maintain the conventional approach of managing zakat. For example in the State of Kedah, zakat management is controlled by a Department of Zakat which is directly under the supervision of the Sultan. In other States, zakat management of the particular states are directly controlled by the Baitul-mal of the State Islamic Religious Council.

Further the corporatised Zakat Centres are entrusted with varying roles in zakat collection and distribution in different states. For example, in Selangor and Pulau Pinang, the Zakat Centres are entrusted with both zakat collection and distribution. However, in Wilayah Persekutuan, Negeri Sembilan, Pahang and Melaka the Zakat Centres are entrusted with zakat collection only while zakat distribution is directly undertaken by the respective state Islamic Religious Councils. The following table presents the institutional infrastructure that exists in various states to undertake zakat collection and distribution.

Table 1: Institutional Infrastructure for Zakat Collection and Distribution in States

STATES	ZAKAT COLLECTION	ZAKAT DISTRIBUTION
Johor, Terengganu, Kelantan, Perak and Sabah	State Islamic Religious Council	
Kedah	Kedah State Zakat Committee	
Sarawak	Sarawak Baitulmal Fund	
Pulau Pinang	Subsidiary of State Islamic Religious Council	
Perlis	State Islamic Religious Council	State Islamic Religious Council and appointed agents acting as trustee
Selangor	Lembaga Zakat Selangor (MAIS)	State Islamic Religious Council and Lembaga Zakat Selangor (MAIS)
Wilayah Persekutuan, Negeri Sembilan, Pahang & Melaka	Subsidiary of State Islamic Religious Council	State Islamic Religious Council

\* Source: National Audit Department Zakat Management Report 2013

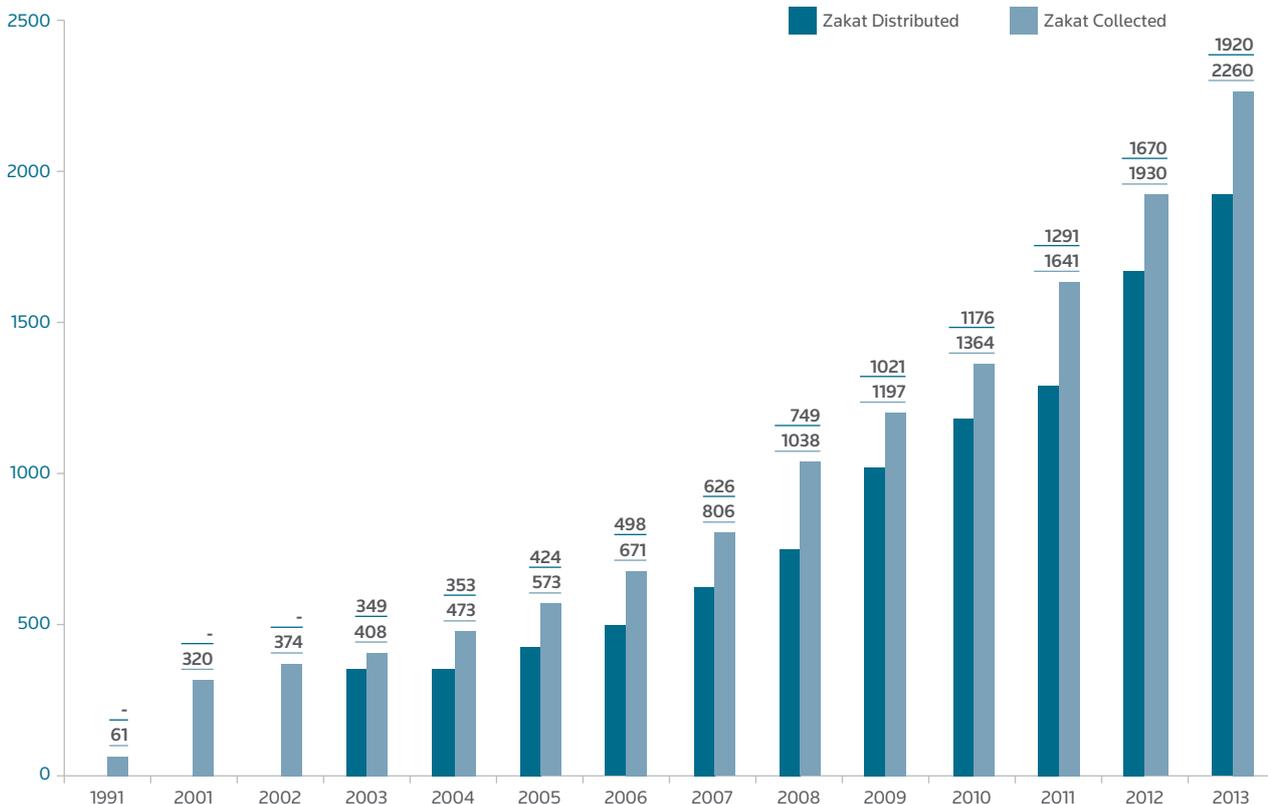
### Zakat Mobilisation

Zakat collections in Malaysia have shown a steadily rising trend over the years, multiplying by about 37 times over the last 22 years.

From the zakat collection data it is clear that Malaysia undertook a major push of its zakat collection strategy over the last two decades and the positive results may be easily seen in terms of the exponential growth in zakat collection. The last two years have also witnessed a steady annual growth of about 17%. This is largely attributed to the following factors:

Table 2: Time Series of Zakat Collected & Distributed in Malaysia (RM million)

YEAR	TOTAL ZAKAT COLLECTION (RM MILLION)	TOTAL ZAKAT DISTRIBUTION (RM MILLION)	DISTRIBUTION AS % OF COLLECTION
1991	61	–	–
2001	320.3	–	–
2002	373.9	–	–
2003	408.4	349.5	85.6
2004	473.3	353.1	74.6
2005	573.1	424.2	74.0
2006	670.7	498	74.3
2007	806.3	626	77.6
2008	1038.1	749.4	72.2
2009	1196.9	1020.8	85.3
2010	1363.8	1176.5	86.3
2011	1641.1	1291.5	78.7
2012	1930	1670	86.5
2013	2260	1920	85



### Compulsory Nature of Zakat

In Malaysia it is compulsory to pay zakat. Law provides for stringent punishment for non-payment of zakat when it is due. For example, the Syariah Criminal Offences (Federal Territories) Act 1997 provides for stringent penalty for non-payment of zakat. As Sec.16 of the Act states: “any person who, being liable to pay zakat or fitrah— (a) refuses or wilfully fails to pay the zakat or fitrah; or (b) refuses or wilfully fails to pay the zakat or fitrah through an amil appointed, or any other person authorised, by the Majlis to collect zakat or fitrah, shall be guilty of an offence and shall on conviction be liable to a fine not exceeding one thousand ringgit or to imprisonment for a term not exceeding six months or to both.”

The law also prescribes stringent penalty for any person who in any manner prevents another person from paying zakat in the form of a fine not exceeding RM2,000 or imprisonment for a term not exceeding one year or both. (Sec.17-2)

Further, zakat can be collected only by amil appointed and authorised by the Majlis. Section 33 prescribes a financial penalty not exceeding RM3,000 or imprisonment for a term not exceeding two years or both to unauthorised zakat collectors. Law also requires confiscation of any such collection that would be paid into the Baitul Maal established under section 60 of the Act.

Further, it is not only the unauthorised collection, but the payment of zakat to an unauthorised collector is also punishable. Such a zakat payer faces the prospect of a financial penalty not exceeding RM1,000 or imprisonment for a term not exceeding six months or both.(Sec.34)

The compulsory nature of zakat payment is, however, accompanied by weak enforcement by the zakat officials. Major reasons for this include, inter alia, absence of muzakki database, unwillingness of zakat officer to list down those who fail to pay zakat, shortage of staff and inadequate authority to zakat officer to investigate any failure.

### Zakat on Business

The diversity in law as well as in the infrastructure across the states in Malaysia has led to divergent zakat practices, especially in the matter of determination of business zakat. Researchers have documented several methods of business zakat estimation being practised in various states and institutions in Malaysia, e.g. the net assets (or working capital), net equity (growth model), net profit after tax, combined methods, and dividend methods.

There have been various pronouncements and standards released so far with respect to accounting for business zakat. One of this relates to zakat accounting for Islamic financial institutions called the “Financial Reporting Standard: Presentation of Financial Statements of Islamic Financial Institutions” (FRS i-1) released by the Malaysian Accounting Standard Board (MASB). It focuses on presenting an IFI’s financial statements that pays zakat. Merely includes definition of zakat, the provision of zakat as part of other liabilities and highlights the need for IFIs to disclose their zakat obligations.

The other standard relates to zakat accounting for businesses and companies in general. The Technical Release (TR) i-1 by MASB provides comprehensive guidance on the accounting treatment for zakat on business. According to MASB, the state has jurisdiction on matters pertaining to Shariah, and that issues regarding the zakat rate on business shall be referred to and determined by the relevant zakat authorities.

### Calculating Business Zakat

The TRi-1 mentions two methods of determining zakat base recommended by the Malaysian Islamic Development Department (JAKIM) in Panduan Zakat di Malaysia, 2001: (a) Adjusted Working Capital method; or (b) Adjusted Growth method. The adjusted working capital method calculates zakat base as net current assets, adjusted for items that do not meet the conditions for zakat assets and liabilities.

Zakat base = Current Asset - Liabilities + /  
- Adjustments

The adjusted growth method calculates zakat base as owners' equity and long-term liabilities, deducted for property, plant and equipment and non-current assets, and adjusted for items that do not meet the conditions for zakat assets and liabilities as determined by the relevant zakat authorities.

Zakat base = Equity + Long Term Equity - Fixed Asset - Non Current Asset + / Adjustments

The method used for the determination of zakat base would be applied consistently from one period to another. Both methods would result in the same amount of zakat base. Although the Board propagated these two methods, an entity was advised to refer to its relevant zakat authorities on the method of determining zakat base applicable in its jurisdiction.

### Tax Benefits with Zakat

Tax benefits in the form of tax deductibility as well as tax rebates have been variously used by different countries to incentivise zakat payment. Some countries, such as Indonesia, Pakistan and Sudan, treat zakat at par with charity contributions made to voluntary organisations and provide tax relief in the form of allowing the same as a deduction to taxable income. The amount of zakat paid is adjusted against the taxable income and not against the tax payable. Others like Kuwait and Saudi Arabia provide for tax rebate, which means a reduction in the income tax liability by the full amount of zakat paid. Malaysia provides for tax rebate on zakat payment by individuals but tax deduction on zakat payment by businesses.

The difference between the two is explained below with a simple example. If  $I$  is the taxable income of an entity,  $t$  is the relevant income tax rate, and an entity pays zakat, the quantum of zakat being  $Z$ , then:

- (1) in case of tax rebate, tax payable is reduced by the amount  $Z$ , is now equal to  $(I \cdot t - Z)$ ; and the after-tax income is equal to  $\{I - (I \cdot t - Z)\}$  or  $\{I \cdot (1-t) + Z\}$
- (2) in case of tax deductibility, taxable income is reduced by  $Z$ ; taxable income is equal to  $(I - Z)$ ;

tax payable is equal to  $(I - Z) \cdot t$ ; after-tax income is equal to  $\{I - (I - Z) \cdot t\}$  or  $\{I \cdot (1-t) + Z \cdot t\}$

Thus, the income tax payable by the zakat payer is reduced by  $Z$  in the case of the former, while it is reduced by  $Z$  times the tax rate in the latter case. The tax factor thus constitutes a powerful incentive for zakat collection.

Taxation in Malaysia is managed by the Internal Revenue Board, an agency under the Ministry of Finance of the Federal Government. A wall of separation is carefully erected between zakat and income tax conceptually and for all practical purposes. A Muslim in Malaysia has to make two compulsory payments on the same source of income every year, namely income tax and zakat. Zakat is obligation to the Creator while tax is obligation to the Federal government. Failure to pay zakat as well as tax should invite punishment for the defaulter, even though the enforcement of the same is extremely weak in case of zakat-related default.

- For individual zakat and tax payers, zakat payment attracts full tax rebate under Section 6A(3) of the Income Tax Act, 1967; which means for every one ringgit of zakat given to the SIRC, the tax payable by the zakat payer is reduced by one ringgit during the same assessment year. Rebate is a deduction from tax payable. If zakat paid is less than tax payable then the balance must be paid to IRB. However, if zakat paid is more than tax payable then the difference cannot be claimed from IRB — Sec 6A(4)
- Offshore companies also enjoy the benefit of tax rebate. Zakat on business income paid by the Labuan offshore companies is given a rebate equivalent to the amount of business zakat paid to the religious authority. It is subject to a maximum of 3% of net profit or RM20,000.
- For onshore companies however, there is no rebate admissible. They however, enjoy the benefit of treating zakat paid as a tax-deductible expense. The tax-deduction allowed is subject to a maximum of 2.5% of the aggregate income — Sec 44(11A)

- In order to accord equal tax treatment between companies and trust bodies, zakat settled by cooperatives, trust bodies and societies is also allowed as a tax deduction up to 2.5% of the Aggregate Income.
- Zakat paid by Limited Liability Partnership (LLP) is also treated as tax deduction up to 2.5 % of the Aggregate Income.

Thus, zakat paid to the SIRC's are treated favourably by the IRB. The total tax payable is reduced when there is zakat paid during the year of assessment. However, the zakat must be paid to an appropriate religious authority established under any written law or any person authorised by such religious authority. (Sec 44-11A)

### Corporatisation & Use of Technology

As mentioned earlier, the zakat system in Malaysia was corporatised in several states in the 1990s. This step was intended to improve the collection of zakat funds and to develop the ways zakat payers can easily transfer their financial obligations.

Studies report that this move brought in a general increasing trend in collection in the majority of states. Additionally, zakat institutions have developed other instruments for handling zakat funds.

Apart from the corporatisation and collection by workers or "amilis" assigned by the zakat offices, there are several other supporting bodies, which are given the authority to collect funds from the payers and transfer to the accounts of zakat institutions. Such collection bodies include the Income Tax department (through deductions from salaries), Baitul-mal subsidiaries, higher learning institutions (such as universities), collection counters in the banks, post office, and shopping centres, where all play an important role to facilitate collection procedures. Additionally, the collection process has been simplified, made safer and less time-consuming for the payers through computerised collection systems, proactive marketing approaches, and payments via commercial banks and e-banking systems.

### Contribution pools — salary deduction largest

The largest contribution to the pool of zakat in Malaysia comes from the monthly salary deductions. The second largest source is the corporate sector comprising of companies and enterprises giving zakat on their business income. Next in importance are the appointed agents acting on behalf of the designated zakat collection administrator. Zakat counters at strategic locations in all states rank fourth in terms of quantum of contribution.

To sum up, zakat collection and distribution have grown consistently over the years. Observers attribute such consistent growth to increase of da'wa and promotional activities, visibility of distribution activities, tax rebate to individual and tax allowable deduction to corporate payers, right given to zakat giver to distribute zakat to their preferred asnaf in collaboration with Zakat Institutions and the multiplicity of zakat payment channels including internet banking and mobile phones.

### Zakat Utilisation

While the quantum of zakat mobilised has steadily grown over the years, the quantum of zakat distributed has also kept pace with the distribution ratio hovering around 80% over the past. Table 5 shows the quantum of zakat distributed among asnaf by Sates during 2013. Zakat has been distributed in accordance with the norms set by Shariah among the asnaf as follows:

**Maintaining surplus:** Distribution of zakat as a percentage of collection is 80% on average over time. This has however improved to around 85% over the last five years. Though there has been greater "holding" of zakat funds in the past, zakat management must steadily improve over time.

**Defining and prioritising asnaf:** The average figures for distribution of zakat among asnaf for Malaysia as a whole presents a stable scenario where around 40% of total zakat is channelled to the poor and the needy. Another 35-40% is channelled to fi-sabilillah activities. However, these ratios vary widely across states.

Table 3. Multiple channels for zakat mobilisation in Malaysia<sup>1</sup>

NO. STATES	OFFICE / COUNTER BRANCH	AMIL		SALARY DEDUCT	KIOSK	CREDIT CARD	POST OFFICE	AGENT					SMS	
		CORP	CORP					BANK				MATA		
								COUNTER	INTERNET	ATM	PHONE BANK			
1	Johor	12	✓	✓			✓	✓	✓		✓			
2	Kedah	1	✓	✓		✓	✓	✓						
3	Kelantan	6	✓	✓		✓	✓	✓						
4	Melaka	7	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	
5	NS	9	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	
6	Pahang	10	✓	✓	✓	✓	✓	✓	✓		✓			
7	Perak	16		✓			✓	✓	✓					
8	Perlis	1		✓			✓	✓	✓					
9	P Pinang	7	✓	✓	✓	✓	✓	✓	✓					
10	Sabah	3		✓	✓		✓	✓	✓					
11	Sarawak	11		✓		✓	✓	✓						
12	Selangor	22	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
13	Terengganu	8		✓		✓	✓	✓	✓					
14	WP	6	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
	<b>TOTAL</b>	<b>119</b>	<b>6</b>	<b>14</b>	<b>14</b>	<b>2</b>	<b>10</b>	<b>14</b>	<b>14</b>	<b>13</b>	<b>4</b>	<b>6</b>	<b>2</b>	<b>4</b>

<sup>1</sup> Based on data collected from Jabatan Wakaf Zakat dan Haji (JAWHAR) by Dr Syed Ghazali Wafa; see Islamic Social Finance Report 2014, IRTI

## BOX 1: ASNAF CATEGORY AND TYPE OF ASSISTANCE OFFERED

- Poor & Needy: Eid-al-fitr, monthly food supply, monthly financial, medical, education, business capital and emergency
- Muallaf: Eid-al-fitr, monthly food, monthly financial, medical, education, celebration of conversion, business capital and emergency
- Fisabilillah: appliances for mosque, education grant, da'wa and propagation of islamic activities, religious teachers allowances
- Gharim: debt because of essential needs, debt for being a guarantor and debt for the ummah
- Ibnu sabil: transportation costs to place of study, stranded travellers
- Riqab: liberation of workers from oppressive employers, liberation from social ills and vice activities

\* Source: National Audit Department Zakat Management Report 2013

Table 5: Zakat Utilisation by States during 2013

STATE	POOR & NEEDY (RM MILLION)	AMIL (RM MILLION)	MUALLAF (RM MILLION)	FISABILILLAH (RM MILLION)	GHARIMIN (RM MILLION)	IBNU SABIL (RM MILLION)	RIQAB (RM MILLION)
Johor	80.17	16.73	10.61	51.15	0.63	0.26	0.00
Kedah	43.41	9.30	1.40	45.78	0.04	0.15	0.00
Kelantan	80.68	25.90	1.27	24.16	0.04	0.00	0.00
Melaka	17.89	7.16	3.28	14.10	7.10	0.06	0.60
N. Sembilan	25.43	7.70	6.48	21.82	1.76	0.54	14.16
Pahang	19.78	16.69	4.35	53.58	0.03	0.37	0.01
Perak	51.37	12.94	4.66	22.56	0.75	0.62	0.00
Perlis	24.56	8.56	2.98	53.91	2.51	2.51	6.13
Pulau Pinang	32.29	8.90	4.25	26.09	1.33	0.25	0.00
Sabah	30.89	4.51	4.50	8.24	0.00	0.07	0.00
Sarawak	9.53	5.30	2.50	17.22	0.00	0.00	0.00
Selangor	174.95	64.66	38.86	123.73	46.14	1.87	13.25
Terengganu	34.46	11.90	1.62	18.39	0.09	0.01	0.39
W. Persekutuan	151.59	55.69	13.53	197.75	4.58	0.41	0.00
<b>Total (RM million)</b>	<b>777.00</b>	<b>255.94</b>	<b>100.29</b>	<b>678.48</b>	<b>65.01</b>	<b>7.13</b>	<b>34.54</b>
<b>Percent to Grand Total</b>	<b>40.5</b>	<b>13.3</b>	<b>5.2</b>	<b>35.4</b>	<b>3.4</b>	<b>0.4</b>	<b>1.8</b>

\* Source: National Audit Department Zakat Management Report 2013

As many as eight states do not distribute zakat to riqab. This is perhaps due to adherence to the literal definition of riqab as slaves. Others prefer a broader definition of riqab as “freeing a Muslim from physical and mental oppression and humiliation by certain individuals”. Further, priority of asnaf also varies across states. While some states allocated more than half of the zakat funds to the hardcore poor and poor, others distributed more funds to the fi-sabilillah category.

**Controlling admin costs:** The percentage of zakat funds used in covering the admin and operational expenses of zakat administration under the Amil category is a critical factor governing the credibility of the zakat institutions. Traditionally in Malaysia, a cap or upper limit of one-eighth or 12.5% is tolerated by scholars. From the data, the ratio for all states together during 2013 stands at 13.3%. While this may be acceptable, the ratio for some states (e.g. Kelantan at 19.6%) may be a cause for concern.

## WAQF

Waqf, or wakaf as it is known in Malaysia, by definition, creates a sustainable entity, governed by the fundamental principles of perpetuity, inalienability, and irrevocability. It is now widely recognised that by creating community assets the institution of waqf has the potential to create robust not-for-profit entities that may address the education, healthcare and other social needs in Muslim societies. However, the potential of waqf remains largely untapped.

## Waqf Portfolio

There are currently no comprehensive figures available for valuation of waqf assets. According to the Department of Awqaf, Zakat and Hajj (JAWHAR) of the government of Malaysia, the 11,091 hectares of land under awqaf are valued at RM1.2 billion (US\$384 million).<sup>3</sup> As at 2012, the Malaysian waqf portfolio comprised of the following number of pieces of property:

<sup>3</sup> Malaysia reviews operations of Islamic endowments, The Star, March 27, 2013

STATE	NO. OF PIECES OF PROPERTY	NUMBER OF UNITS OF WAQF BUILDINGS	BY USE OF PROPERTY	
Johor	1,843	14	Cemeteries	2,446
Perak	1,749	50	Masjids	1,760
			Suraus	900
Kedah	1,472	NA*	Undefined use	367
			Paddy fields	314
Melaka	601	43	Religious schools	219
			Buildings	125
Selangor	285	NA*	Village lands	87
			Coconut plantations	46
Terengganu	236	3	Rubber plantations	42
			Orchards	38
Pulau Pinang	138	160	Empty lots	37
			House dwellings	15
Kelantan	52	3	Gardening	8
			Strata title ownership	2
Federal Territory Kuala Lumpur	30	4		
<b>TOTAL</b>	<b>6,406</b>	<b>277</b>		<b>5.5</b>

\* Not Available

### Waqf Laws

Historically, waqf thrived in all Muslim communities, including Malaysia. However, for a variety of reasons waqf in Malaysia has acquired some distinct characteristics. As cited earlier, the institutional responsibility for implementing Islamic law in each state is entrusted to the State Islamic Religious Councils. And since each state in Malaysia has the prerogative to enact laws and regulations regarding Islamic matters, there is a great diversity in the macro regulatory environment governing the zakat and waqf sectors.

Similar to zakat, the institution of waqf in Malaysia is governed by enactments by the respective states. In Selangor and Malacca, the provisions of law on waqf are provided under the Enactment of Wakaf (State of Selangor) 1999 and the Enactment of Wakaf (state of Malacca) 2005 and the other states that do not have such enactment are governed by the states' administration of Islamic law.

To elaborate on the key provisions relating to waqf that are common to various waqf-related laws of Malaysia, the example of the specific provisions of the Administration of the Religion of Islam (Federal Territories) Act 1993 relating to waqf as contained in Part VI of the Act are presented below.

Malaysian laws recognise two types of waqf. The law defines "Wakaf Am" as a dedication in perpetuity of the capital and income of property for religious or charitable purposes recognised by Islamic Law, and the property so dedicated. "Wakaf Khas" means a dedication in perpetuity or for a limited period of the capital of property for religious or charitable purposes recognised by Islamic Law, and the property so dedicated, the income of the property being paid to persons or for purposes prescribed in the waqf.<sup>4</sup>

### Creation of New Waqf

Malaysian laws place severe restrictions on the creation of waqf. Even while fiqhi rules permit an

individual to make waqf beyond one-third of his assets unless he is on his deathbed, the same is not permitted by Malaysian law.

As the law<sup>5</sup> states, whether or not made by way of will or deathbed gift, no waqf involving more than one-third of the property of the person making the same shall be valid in respect of the excess beyond such one-third.

Further, according to Malaysian law, waqf khas, which means a dedication for a finite period and/or for restricted purpose, cannot be created without explicit permission of the Sultan. (Sec.63-2)

Malaysian law is silent about the identity of the wākif and focuses on the purpose of dedication, which must be for religious or charitable purposes recognised by Islamic Law.

### Ownership and Management of Waqf Assets

As previously stated, waqf matters in each state are governed by a state-specific Majlis. Law requires that every waqf shall be registered in the name of the Islamic Religious Council as proprietor (Section 6 of the Enactment). Further, a Bayt al-māl is created to include all financial flows from waqf assets.

The income of a waqf khas or special-purpose waqf, if received by the Majlis, shall be applied by it in accordance with the lawful provisions of such waqf khas. (Art 64-1) The income of every waqf or nazar am or general-purpose waqf shall be paid to and form part of the Bayt al-māl. (Art.64-2) Not only the waqf property is vested in the Majlis, the income of every general waqf is to be paid to and form part of the Bayt al-māl, administered by the Majlis.

The law effectively eliminates the institution of nazir. As it asserts "the Islamic Religious Council or the Majlis shall be the sole trustee of all waqf (Art.61). Notwithstanding any provision to the contrary

<sup>4</sup> Administration of Islamic Laws (Federal Territories) Act Section 2 of Malaysia

<sup>5</sup> Refers to the Administration of the Religion of Islam (Federal Territories) Act 1993, Part VI of Malaysia, unless otherwise stated

contained in any instrument or declaration creating, governing or affecting it, the Islamic Religious Council shall be the sole trustee of all waqf, whether waqf am or waqf khas (Sec. 32). Of course, the Majlis will “establish Wakaf Management Committee to administer all matters pertaining to wakaf. The committee has authority to frame any policy, to supervise, to administer, to manage, to develop and to improve any matters related with waqf administration”. (Sec.21)

### Development of Waqf Assets

Malaysian law also prohibits a waqf that has come into effect from being sold or transferred by the waqif or inherited by any person. (Sec. 4.2) The law entrusts the entire responsibility of waqf development to the Majlis or Islamic Religious Councils.

Section 2 of the Enactment allows “istibdal as a substitution of waqf property with another property or cash either through substitution, purchase, sale or any other way approved by Shariah principles. Substitution can be divided into two forms i.e. substitution of one waqf with a similar and the substitution of land with its cash value.” Section 20 of the Enactment provides that the Islamic Religious Council may substitute any waqf property, when it is no longer beneficial as intended by the dedicator and in the event that the usage of waqf property does not meet the actual purpose of waqf.

### Corporate Waqf

The Malaysian waqf sector is known for an innovation – corporate waqf, which is an innovative adaptation of the classical waqf. A corporate waqf is established through voluntary and pious acts of endowment of corporate stocks and securities owned by the waqif for the benefit of intended beneficiaries.

While corporate waqf may be seen as a variant of cash waqf, there are important points of difference. Corporate waqf goes beyond the waqf entity being just a passive institutional owner of a corpus of financial assets, e.g. cash and stocks, and using the earnings or dividend payouts from these stocks for the good of the intended beneficiaries. The corporate waqf involves an institutional entity, a

“waqf corporation” by giving it the status of nazir or management-trustee that is fully empowered to exercise all the powers that come with ownership. A corporate waqf may also be established by the Government transferring its corporate interests into a corporate waqf body established for that purpose.

The operationalisation of the concept of corporate waqf was first attempted in the form of Waqaf An-Nur Corporation Berhad (WANCorp), a limited company established to guarantee proper management of Johor Corporation and its Group of Companies’ stocks and assets under endowment. JCorp’s Corporate Waqf took off in 2006 with the transfer to Waqaf An-Nur Corporation Bhd (WANCorp) RM200 million worth (on net asset value basis) of public listed shares owned by JCorp. WANCorp’s main income is derived from the annual dividend payout by the PLCs, a part of whose equity is now endowed and transferred to its ownership. These payouts are allocated for re-investment, as well as to fund Islamic CSR programs. WANCorp as a corporate waqf, thus, institutionalised the link between a corporate entity such as JCorp and its wealth creation and value adding business function, with a structured mechanism to address the needs of the poor and marginalised sections of the society on a sustainable basis. It has sought to ensure an efficient, transparent and professional management of waqf assets, coupled with the effective disbursement of waqf benefits.

The official status of WANCorp is that of ‘mauquf alaihi’ or beneficiary and not that of nazir/ mutawalli or trustee-manager even while it effectively performs the latter role. This is warranted by Malaysian law that permits the Islamic Religious Council of the state or Majlis alone to be the nazir/ mutawalli. WANCorp under an agreement with the Majlis is entitled to receive a major part of the benefits for onward transfer of the same to the ultimate beneficiaries.

### Sale-and-Waqf-Back

Sale-and-waqf-back is an innovative example of using plantation assets to create waqf with the ultimate aim of setting up a university in Malaysia.

The innovative aspect of the project may be traced to the novel method of raising funds that was initiated a decade ago in the east coast state of Terengganu. Peyatim (Persatuan Anak-Anak Yatim Malaysia), the organisation for the welfare of orphans, divided a large tract of land (that was originally funded by sadaqa or free donations) - 347.8 hectares of palm oil plantations in Kemaman (a district in Terengganu) - owned by the organisation into small lots of 10 square metres, each having a palm tree and sold to prospective waq contributors in Malaysia. The funds mobilised were used to build and develop residential hostels for the orphans. (Currently, the organisation has 54 hostels within the country to support the orphans in their educational pursuits in mainstream schools in the vicinity.) At the same time the organisation continues to benefit from the plantation, which is now a waqf.

This idea of the sale-and-waqf-back model to develop waqf funds is being expanded further for University College Bestari (UCB), which is owned by Peyatim and two other welfare organisations – Perkaya and Yakin. UCB was originally established as the Kolej Teknologi Bestari during the late 1990s. It was upgraded to become a University College in 2012, initially to offer degree programmes in economics, management, information technology, and counselling, as well as diploma programmes in various fields including nursing. Owned by non-governmental organisations, UCB has no recourse to government funding. Therefore, the only way such an expansion could be funded was through internally generated revenues in the form of tuition fees and accommodation fees. Since UCB believes that education could not and should not be priced at market rates, waqf endowment funds provided the answer.

### How sale-and-waqf-back works

According to Malaysian laws, the nazir of all awqaf is the respective State Islamic Religious Council. However, it may appoint an organisation to administer a given waqf on its behalf. For UCB the nazir is the state agency, the Majlis Adat Istiadat Melayu dan Agama Islam Terengganu or MAIDAM and will

appoint Peyatim as the administrator on its behalf subsequent to the acts of waqf. The asset that is to be used for the development of the waq fund is a piece of land that currently belongs to Peyatim and that presently houses the UCB. This land is 320 acres big located in Putera Jaya, Setiu, Terengganu. The said piece of land is then divided into small lots of one square foot each to be sold to potential donors (waqif) at a price of RM30.00 per lot. Those lots that are purchased would then be endowed back with Peyatim as the beneficiary. All waqifs would be awarded with certificates to show that they have a plot of land that has been given to waq for the university. The money collected through sale would become a fund for the development of the university.

The land prior to the commencement of the process is not a waqf land but owned by Peyatim. The funds that are collected are also not waqf. When the new owners make the act of waqf after the sale, they turn into waqif and the land becomes waqf land. In addition to being the beneficiary, Peyatim is also the administrator of the waqf. Though the collected funds are not waqf, Peyatim has the additional responsibility to ensure that these are managed efficiently and in an Islamically acceptable manner.

The ultimate beneficiaries of the waqf are UCB and its student community. UCB would get funds for its physical development as well as academic and research programmes, while the students would be able to finance their education through scholarships and possibly interest-free loans to cover their tuition fees. Physical development of the campus has so far been supported by the funds collected. It is envisaged that in the not too distant future, UCB would be able to develop into a full-fledged university, funded by waqf, and affordable for the student community.

### Waqf and Capital Market

It is interesting to note here that in countries such as Malaysia (and Singapore with a similar legal framework), where waqf laws have seen little reform with a dominant role for the state, and where the responsibility of waqf development and management vests almost entirely with the Majlis, one finds the most

interesting cases of waqf development involving private financing.

There is of course, a move to reform the law in Malaysia to mainstream the concept of corporate waqf and also to bring in large-scale waqf development by transforming the Malaysian Waqf Foundation – a trust under the central government – into a corporate entity and involving Islamic financial institutions as financiers in the development process.

### Sukuk for waqf development

The Securities Commission (SC) of Malaysia is now proactively promoting the idea of using a variety of sukuk to raise funds from the capital market for waqf development. It has identified a range of sukuk structures that may be used for waqf development – e.g. *ijarah*, *wakalah bi al-istithmar*, *murabahah*, *mudarabah*, and *musharakah* – similar to those used in Singapore and Saudi Arabia.

The Securities Commission has also set several criteria for retention of a licensed or supervised intermediary to professionally manage waqf assets. Such an intermediary must (i) adopt international best practices and standards, (ii) have technical knowledge and resources, (iii) must be subject to strong governance providing adequate level of investor protection and (iv) must have an established technology infrastructure.

The SC has also come up with a range of Principles (that encapsulate broad concepts underpinning good corporate governance and that the waqf institutions should apply) and Recommendations to be implemented by the waqf institutions.

#### Principle 1. Strengthening the Oversight of Waqf Institutions

Recommendation 1.1. The waqf trustee should establish clear roles and responsibilities reserved for them and those delegated to the waqf institutions,

Recommendation 1.2. The waqf trustee should ensure that the waqf institutions are governed by a satisfactory code of conduct.

Recommendation 1.3. The waqf trustee should

oversee and monitor the business operations and conduct of the waqf institutions.

Recommendation 1.4. The waqf trustee should be given access to information and advice.

#### Principle 2. Strengthening the Effectiveness of Waqf Institutions

Recommendation 2.1. The waqf institutions should have the necessary expertise to manage waqf assets.

Recommendation 2.2. The waqf institutions should have a clear strategy in managing waqf assets.

Recommendation 2.3. The waqf institutions should have in place adequate internal controls including risk management and internal audit.

Recommendation 2.4. The waqf institutions should produce an annual report which is made public.

#### Principle 3. Strengthening the Engagement with Stakeholders

Recommendation 3.1. The Waqf Institution should continuously engage its stakeholders.

Recommendation 3.2. The Waqf Institution should establish a clear and effective communication policy to manage relationships with its stakeholders.

### Ar Rahn

The term “*rahn*” refers to the property that is pledged to acquire an amount of money. In general, *ar-rahn* or Islamic pawnbroking is a service offered by an institution. This institution allows the property’s owner to pledge gold in return for money.

*Ar-rahn* has been established in Malaysia since 1992 and has shown a rapid growth. The first *ar-rahn* institution, *Mu’assasah Gadaian Islam Terengganu (MGIT)*, was set up by the *Majlis Agama Islam dan Adat Istiadat Terengganu* in January 1992. This was followed by *Kedai Al-Rahn (KAR)*, a subsidiary of *Permodalan Kelantan Berhad (PKB)*, which started its operations in March 1992. On August 21st 1993, the Minister of Finance announced the introduction of a scheme, known as *Skim Al-Rahn (SAR)* through the collaboration of three institutions – *Bank Negara Malaysia*, *Yayasan Pembangunan Ekonomi Islam Malaysia (YaPEIM)* and *Bank Rakyat Malaysia Berhad*.

The development of Ar-Rahnu provides an alternative pawn broking service for customers in accordance with Shariah principles.

- Qardhul Hassan — the owner pays only the amount borrowed
- Ar-Rahnu and Al-Wadiah — the owner places a valuable asset as collateral to get an amount of money and to guarantee repayment
- Al-Ujrah — the ar rahnu institution charges a fee for custody of the property items

### How Ar Rahnu works

Ar Rrahnu offers quick and easy loans to customers with a very low storage fee ranging from RM0.30 to RM0.60 per month for every RM100 pledged assets value. The amount of loan can fall within the range of RM100 to RM20,000. Ar Rahnu is hence categorised as microfinancing.

Only gold can be pledged. Both residents and non-residents are eligible to apply. It is also open to both Muslims and non-Muslims. Maturity of loans can range from 1-6 months. Customers can choose the payment method - either to repay lump sum or via monthly installments. The margin of financing can be as low as RM100 and up to 60-70% of the value of the gold.

In the case that the owner cannot repay the loan, the operator can provide an extension of up to 3

months. If the owner is still unable to repay the loan, the pledged gold will be sold and any surplus less outstanding loan and charges would be returned to the owner.

Ar Rahnu is free from any interest and gharar elements. Customers only need pay the principal plus a safekeeping fee as agreed in the agreement during the maturity date.

### Where to get Ar Rahnu facilities

There are two types of agents that offer ar Rahnu facilities

### Types of agents that offer ar Rahnu facilities

BANK/DEVELOPMENT FINANCING INSTITUTIONS	NON-BANK
RHB	Pos Malaysia
CIMB	Pos Malaysia
Bank Rakyat	YBU-YaPEIM
Bank Islam	Public Gold
Agrobank	Ar-Rahnu X'change
Bank Muamalat	Cooperative Institutions



People walk past an old building in Maungdaw town in northern Rakhine State, Myanmar. REUTERS/Minzayar

## Cooperative Institutions

### Overview

In Malaysia, the cooperative started in 1922, when the Co-operative Societies Enactment was introduced. This enactment was adopted from the British-established Indian Co-operative Societies Act of 1912 and remained unchanged up to 1948.

Cooperatives were introduced to solve the problem of rural indebtedness and deficit spending among wage earners. Initially, they were concentrated in the developed states and later moved to less developed ones such as Kedah, Perlis, Terengganu, and Kelantan. Cooperatives were later established in Sabah and Sarawak in 1958 and 1959, respectively.

After independence from the British in 1957, the cooperative institutions evolved. In the first half of the 1960s, consolidation and rationalisation efforts took place. This was proven by the establishment of Bank Rakyat (currently the largest Shariah-based cooperative). During this period, the government was concerned for speedier agricultural development and the Farmers Associations were also encouraged to undertake mainly agricultural extension activities. As a result, many agricultural-based cooperative institutions were established. This was followed by the setup of the Fisheries Department Authority (FDA) in 1975 and many fisheries-based cooperatives were established thereafter.

In the 1980s, several initiatives were undertaken to stimulate, rationalise and prepare the cooperatives for more vibrant and operative roles in the economic development of the country and poverty alleviation programmes. These initiatives had brought about new types of cooperatives, such as the district development cooperatives, the cottage industry cooperatives, the village development cooperatives, the school cooperatives and the workers investment cooperatives.

The consolidation period was recorded in the 1990s. Structurally, the cooperative institutions could be segmented into urban-based cooperatives which were financially strong and the rural-based

cooperatives which were many, that are, agro-based cooperatives, fishermen's cooperatives and cooperatives under the government agencies.

To make sure that the cooperatives operated in an orderly fashion, the National Cooperative Policy (2002-2010) was launched in 2002. It was also introduced to encourage cooperatives to play a bigger role and to participate actively in economic growth. The second version of the National Cooperative Policy (2011-2020) took place in 2011. These policies are expected to produce a cooperative institution which is active, strong and self-reliant. These policies also allow the Malaysia Co-Operative Societies Commission as the sole regulator.

### Shariah-compliant Cooperatives

The Cooperative Act of 1993 governs the incorporation and operations of cooperatives. From the Shariah perspective, the cooperative is similar to the form of *syirkah al-inan* whereby the members, who are owners of resources, give their mandate to a group among them, the Board of Cooperatives, to manage the organisation on everyone's behalf. Any profits or losses are shared among members. *Syirkah al-inan* is unanimously agreed upon by all Islamic scholars. Some specific details of *syirkah al-inan* are discussed.

**Firstly:** Capital accumulated from shares or subscriptions are used in the business of the cooperative with the approval of members. As a new member joins the cooperative, he is provided with information on the objectives and business of the cooperative. Thus he will abide willingly with the aims of the cooperative and no element of compulsion exists. This aspect complies with Shariah.

**Secondly:** Consent by each member to delegate and appoint among themselves in the Annual General Meeting, a Board of Cooperatives to carry out the daily affairs of the cooperative.

**Thirdly:** Profit distribution and the liability of losses are based on the amount of shareholdings in the

cooperative. Under the present Cooperative Act 1993, the members understand that the distribution of profits is limited to not more than 10%. Since the cooperative is not highly profit motivated, benefits in many forms are introduced to provide services to members. These may take the form of rebates on transactions, welfare schemes, specially priced financial schemes, benevolent funds, educational funds, and in the end, any profit balances may be given out in the form of dividends. In fact when a member withdraws from the cooperative, he or she will only be entitled to the face value of the capital provided in the cooperative. Any benefits would have been distributed during his tenure as a member of the cooperative. These "rules" are special to the cooperative organisation and consented to by existing and new members.

### Operations of the Cooperative

The operations of the cooperative will depend largely on the objectives of respective cooperatives. Overall, cooperatives are involved in beneficial activities. While in the first place fulfilling basic economic needs seems to be the prime mover of a cooperative, compliance with Shariah involves several factors.

**Firstly:** Motivation to avoid the practices of riba. Credit facilities in the cooperative sector have been in existence since their inception in the early 1920s. Thrift and loans were the main objectives of cooperative societies then. The loans were offered to members with interest charges. As interest on loans is forbidden in Shariah members of cooperatives had to adopt new mechanisms and procedures on financial matters.

Table 1: Contribution of Cooperative Institutions

NO	FUNCTION	UNIT		MEMBERSHIP		SHARES (MILLION RM)		ASSETS (RM MILLION)		REVENUE (RM MILLION)	
		2013	2009	2013	2009	2013	2009	2013	2009	2013	2009
1	Banking	2	2	1,009,647	838,932	3,349.46	2,289.50	84,060.01	51,251.54	6,263.80	4,338.06
2	Credit	589	575	1,653,139	1,963,054	5,342.69	4,170.09	10,820.40	7,180.09	1,853.52	1,367.61
3	Agriculture	2,324	1,362	542,563	289,484	516.96	244.32	2,143.46	1,256.09	799.62	613.88
4	Housing	180	107	170,846	89,182	206.46	133.36	982.31	406.62	304.30	36.44
5	Industry	225	117	18,399	17,634	10.03	5.24	76.75	56.62	40.39	33.13
6	Consumers - Adult	2,406	1,681	606,070	670,908	288.17	279.48	1,262.08	1,127.48	848.18	791.90
	Consumer-School	2,267	2,115	2,162,816	2,106,130	22.45	17.26	269.59	177.67	311.01	195.12
7	Construction	173	117	506,314	62,171	43.90	14.36	360.12	56.78	83.86	64.19
8	Transportation	447	346	148,874	148,196	64.59	58.65	299.58	250.16	661.69	512.21
9	Services	2,301	793	790,536	598,084	2,967.23	1,753.25	7,624.58	3,236.21	21,806.04	966.47
	<b>Total</b>	<b>10,914</b>	<b>7,215</b>	<b>7,609,204</b>	<b>6,783,775</b>	<b>12,811.94</b>	<b>8,965.52</b>	<b>107,898.88</b>	<b>64,999.27</b>	<b>32,972.43</b>	<b>8,919.01</b>

Note: Adult consumer co-operatives are co-operatives that operate stores in cities and companies. Their members are local citizens and company employees. School cooperatives run stores in secondary schools. Their members are students and employees of the school.  
Source: Annual Report, Malaysia Co-Operative Societies Commission

These new mechanisms served as viable alternatives to fulfilling the financial needs of members but did not change the cooperative's objectives. Bank accounts were switched from conventional to Islamic banking; investments were scrutinised so as to be in compliance with guidelines on investments issued by the Shariah Supervisory Council of Securities Commission Malaysia, and various takaful insurance coverage replaced conventional insurance.

**Secondly:** With the existence of new financial procedures, members were more inclined to practise Islamic transactions, or muamalat.

**Thirdly:** As business organisations aimed at providing welfare services to its members, Obligatory Zakat contributions and welfare benefits became common features of cooperatives.

### Contribution of Cooperative Institutions

All cooperatives are classified into nine different functions based on their business activities: banking, credit/finance, plantation, housing, industry, consumer, construction, transport, and services. The contribution of cooperative institutions by functions is shown in column two of Table 1. As at the end of 2013, 42.8% are consumer-based cooperatives, 21.3% are involved in agriculture, 21.1% provides services, 5.4% are involved with credit, and 4.1% in transportation, 1.6% in construction, 1.6% in housing and 2.1% are in industry. The cooperative institutions have two cooperative banks — Bank Rakyat and Bank Persatuan.

The cooperative institutions showed only a slight increase in growth from 2009-2013. Assets grew at 66.2%, revenue at 269.7%, capital at 43.8%, memberships at 11.8% and number of cooperatives at 51.4%. However, the following findings can be observed: first, the amount of assets per unit of cooperative only increased from RM9 million in 2009 to RM9.9 million in 2013. Second, each member contributed about RM1, 318.4 shares in 2009 compared to RM1, 175.3 shares in 2013. Third, membership increased from 23.9% in 2009 to 26.2% in 2013.

### Kutu: Rotating Savings

Rotating savings can be found all over the world. They are known by different names in different regions and countries. In Malaysia, they go by different names: *Kutu, Kootu, Kongsi, Tontine, Hui, Main, Kut*.<sup>6</sup>

### Mechanics of Rotating Savings

*Kutu* is among the oldest and most established informal savings institutions found in Malaysia. It plays an important role in savings mobilisation and helps the consumption needs of the people. *Kutu* is organised in groups. Participants hold regular meetings and at these meetings each participant contributes funds that are given in turn to one or more of the members (see diagram for illustration). For example, in the first meeting, each participant contributes RM1,000 a month and the collected funds will be given to Ali. In the next round, the collected funds will be given to Sharkawi and so forth. Once every participant has received funds, *kutu* can be terminated, or another round can be initiated.

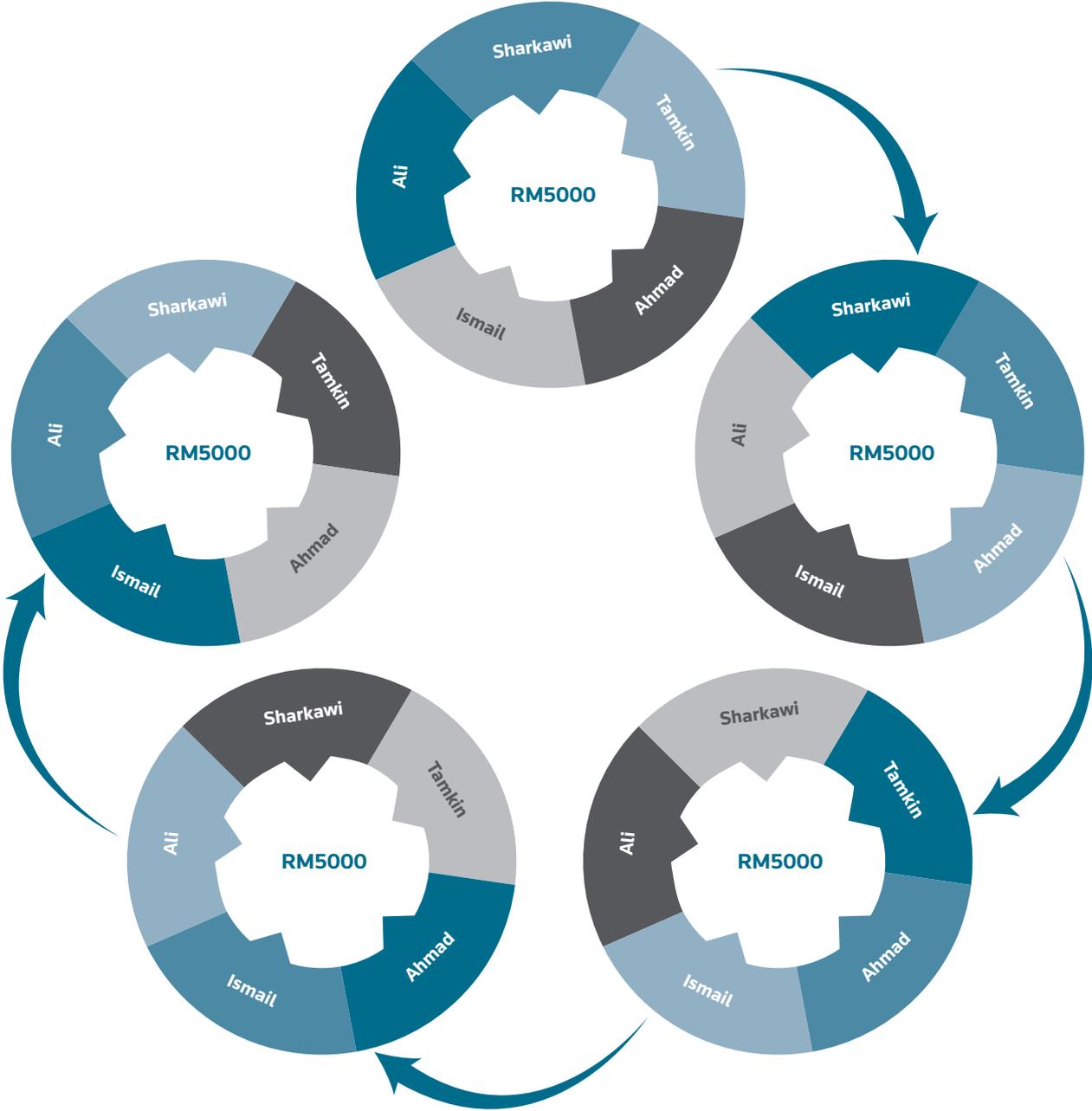
In assembling a *kutu*, a participant agrees on the payment based on the pre-agreed schedule. They also agree on a lump sum installment at a future date. Here, participants often pay no interest on the fund borrowed.

### Economics of Kutu

Participants join *kutu* mainly to finance the purchase of consumer durable goods (e.g. motorcycle, down payment for buying a house), as a response to avoid the interest charged by the conventional financial institutions. This requires self-discipline from participants, and a collective decision from the group in the absence of formal regulation. This simple method can serve as a commitment device in avoiding *riba*. However, the popularity of *kutu* has been on the decline as access to formal financial institutions increased for the purposes of saving and obtaining financing.

6 Adopted from Abdul Ghafar Ismail, Nur Azura Sanusi and Nafisah Mohammed (2004) "Will The Rotate Savings, Loan Sharks, and Rural Credit Disappear?" in Asan Ali Golam Hassan, Mohd Faisol Md. Salleh and Maria Abd Rahman (eds.) *Kedah: Towards a Developed State*. Sintok: Penerbit Universiti Utara Malaysia.

Diagram 1: Kutu Group





(L - R) The Sultan of Brunei Hassanal Bolkiah, Indonesia President Susilo Bambang Yudhoyono, Laos Prime Minister Thongsing Thammavong and Malaysia Prime Minister Najib Razak hold hands during the opening ceremony of the 21st ASEAN (Association of Southeast Asian Nations) and East Asia summits in Phnom Penh. REUTERS/Samrang Pring

# THE RACE TO BE THE WORLD'S ISLAMIC FINANCE HUB

## MALAYSIA'S GLOBAL POSITION

- 280 Foundations and building blocks from which Malaysia hopes to rise as a global Islamic finance hub
- 281 The role of the Malaysia International Islamic Financial Centre
- 285 Where does Malaysia stand in world Islamic finance development rankings?
- 290 Malaysia versus UK, UAE and the world's top Islamic finance countries

## MALAYSIA'S REGIONAL POSITION

- 298 Comparing Islamic finance strengths: SEA versus GCC
- 299 Southeast Asia's Islamic finance leader
- 304 Comparative analysis between Malaysia and active Islamic finance players in Southeast Asia
- 305 ASEAN Focus

# Malaysia's Global Position

Malaysia's government has made its intentions clear – the country wants to be the “indisputable global hub for Islamic finance.” The media has played up the ‘three-way fight’ between Kuala Lumpur, London and Dubai to be the global hub of Islamic finance. Malaysia outperforms London/UK and Dubai/UAE in many Islamic finance areas but will the country's strategies keep it ahead of its competitors? Are there other countries in the race? The focus on Malaysia to be the world's Islamic finance hub ultimately involves a comparison with its closest competitors leading to an assessment

and the near- to mid-term outlook of the biggest Islamic finance centres.

## Where do the big Islamic finance centres stand?

The current snapshot of macroeconomic and Islamic finance development favours Malaysia as the world's Islamic finance hub. Moving forward, the pace of development favours Malaysia and the UAE. However, it is prudent to also consider the other top ranking Islamic finance countries such as Bahrain, Qatar and Saudi Arabia which lie on the periphery of the race to be a global hub for Islamic finance.

## Foundations and building blocks from which Malaysia hopes to rise as a global Islamic finance hub

<b>Sound regulations, governance framework &amp; government strategies</b>	<ul style="list-style-type: none"> <li>• Islamic Financial Services Act 2013</li> <li>• Financial Reporting for Islamic Institutions guidelines 2013</li> <li>• Centralised Shari'ah Advisory Councils established in 1996 (SC) and 1997 (BNM)</li> <li>• Guidelines on sukuk</li> <li>• Guidelines on takaful</li> <li>• Rules of Bursa Malaysia Islamic Services Sdn Bhd</li> <li>• Financial Sector Blueprint 2011 - 2020</li> <li>• Attractive tax incentives for Islamic financial institutions</li> </ul>
<b>Product Innovation</b>	<ul style="list-style-type: none"> <li>• Global sukuk leader; issued first global sovereign and corporate sukuk</li> <li>• The world's first mudarabah and musharakah sukuk were launched in Malaysia</li> <li>• The first issuer of retail sukuk and exchangeable sukuk</li> <li>• Islamic Real Estate Investment Trusts (IREITs)</li> <li>• Broad range of products offered given the acceptance of all four schools of Islamic jurisprudence</li> </ul>
<b>Established Islamic banking &amp; Finance industry</b>	<ul style="list-style-type: none"> <li>• The country is a home to 16 Islamic banks</li> <li>• An increasingly liberalised market with 6 foreign Islamic banks</li> <li>• 11 takaful operators are currently in the market including 2 foreign operators</li> <li>• The world's largest sukuk market and Shariah-compliant capital market</li> <li>• The second largest takaful market in the world</li> <li>• Has the largest pool of Islamic mutual funds</li> </ul>
<b>Human Resource Development</b>	<ul style="list-style-type: none"> <li>• The market is a hub of Islamic finance education providers (e.g INCEIF, IIUM, IBFIM etc)</li> <li>• Various Islamic finance programmes are offered including full-fledged programmes or specialised modules</li> <li>• Tax relief up to RM5,000 annually for Islamic finance courses provided by higher learning local education institutions upon the approval of Bank Negara or the Securities Commission</li> </ul>
<b>Strategic Location &amp; Economic Centre</b>	<ul style="list-style-type: none"> <li>• Muslim- majority population, sharing similar religious beliefs with Middle Eastern countries</li> <li>• Malaysia is one of the most advanced countries in Asia in terms of infrastructure (including airports, network of highways, ports, etc)</li> <li>• Rapid economic growth and stability</li> </ul>
<b>Market Liberalisation</b>	<ul style="list-style-type: none"> <li>• Enabling cross-border environment for financial activities</li> <li>• 20% of the banking sector is dominated by foreign players, represented by 27 banks from 14 countries</li> <li>• 67% of the insurance and takaful sector is dominated by international players</li> <li>• Malaysia's financial sector blueprint champions greater liberalisation</li> <li>• Liberalised foreign exchange administration rules</li> </ul>

## The role of the Malaysia International Islamic Financial Centre

The Malaysia International Islamic Financial Centre (MIFC) is the country's 'shopfront' for Islamic finance. MIFC is supported by the Islamic finance ecosystem - from government ministries to regulators and private sector market players - that is at once the collective driver of national agenda and strategy for Islamic finance and the actual Islamic finance industry and ecosystem itself. It is meant to be the unified force of public and private sector driving Malaysia's Islamic finance industry

on the world stage. The MIFC plays a key intermediation role for the country as an Islamic finance centre.

The MIFC Initiative also aims towards strengthening the connectivity between Malaysia and other global financial centres through facilitating a collaborative domain between various stakeholders including financial regulators and industry players in different jurisdictions.

### MALAYSIA INTERNATIONAL ISLAMIC FINANCE CENTRE (MIFC)

Launched in 2006 as a governmental initiative dedicated to be a centralised marketing channel to develop Malaysia as an Islamic financial market through the involvement of regulators and private sector industry players.

#### MIFC is an initiative by

1. Bank Negara Malaysia
2. Securities Commission Malaysia
3. Labuan Financial Services Authority (LOFSA)
4. Bursa Malaysia and
5. Government ministries and agencies together with industry participation from the banking, takaful, re-takaful, capital market institutions, human capital development institutions and professional ancillary services companies

#### MIFC Governance Structure

1. Executive Committee
2. Secretariat

### Policies and initiatives from regulators already channelled through the MIFC:

#### (1) Building the base

1. The issuance of International Islamic Bank (IIB) and International Takaful operator (ITO) licenses to liberalise the market by allowing transacting in international currencies. (Completed)
2. 49% in existing Islamic banks/ takaful operators is allowed to be acquired by a foreign equity. (Completed) – This was followed by an amendment that allows foreigners to take up to 70% stake in Islamic banks and takaful operators, up from 49%.
3. Malaysian Islamic banks and takaful operators can offer Islamic financial services in foreign currencies through setting up International Currency Business Unit (ICBU). (Completed)
4. Labuan offshore Islamic banks, Islamic banks' offshore divisions and offshore takaful operators can operate in any area in Malaysia. (Completed)

#### (2) Increasing the scale:

1. Support the global human development in Islamic finance through setting up the International Center for Education in Islamic Finance (INCEIF). (Completed)
2. Harmonization of Shariah practices through the establishment of Shariah Endowment Fund to develop talents in Shariah researches and dialogues. (Completed)
3. Five years tax exemption on profits and remittances was given for Malaysian banks branches operating overseas to encourage Malaysian-owned banks to expand their operations abroad. (Completed)
4. Liberalising the foreign exchange administration rules. (Completed)

## MALAYSIA'S RELATIVE POSITION IN GLOBAL ISLAMIC FINANCE LANDSCAPE

Malaysia held 25%, or US\$423.29 billion, of global Islamic finance assets in 2013. Most of these are locked up in Islamic banks and outstanding sukuk.

### TOP 20 IFDI SCORES

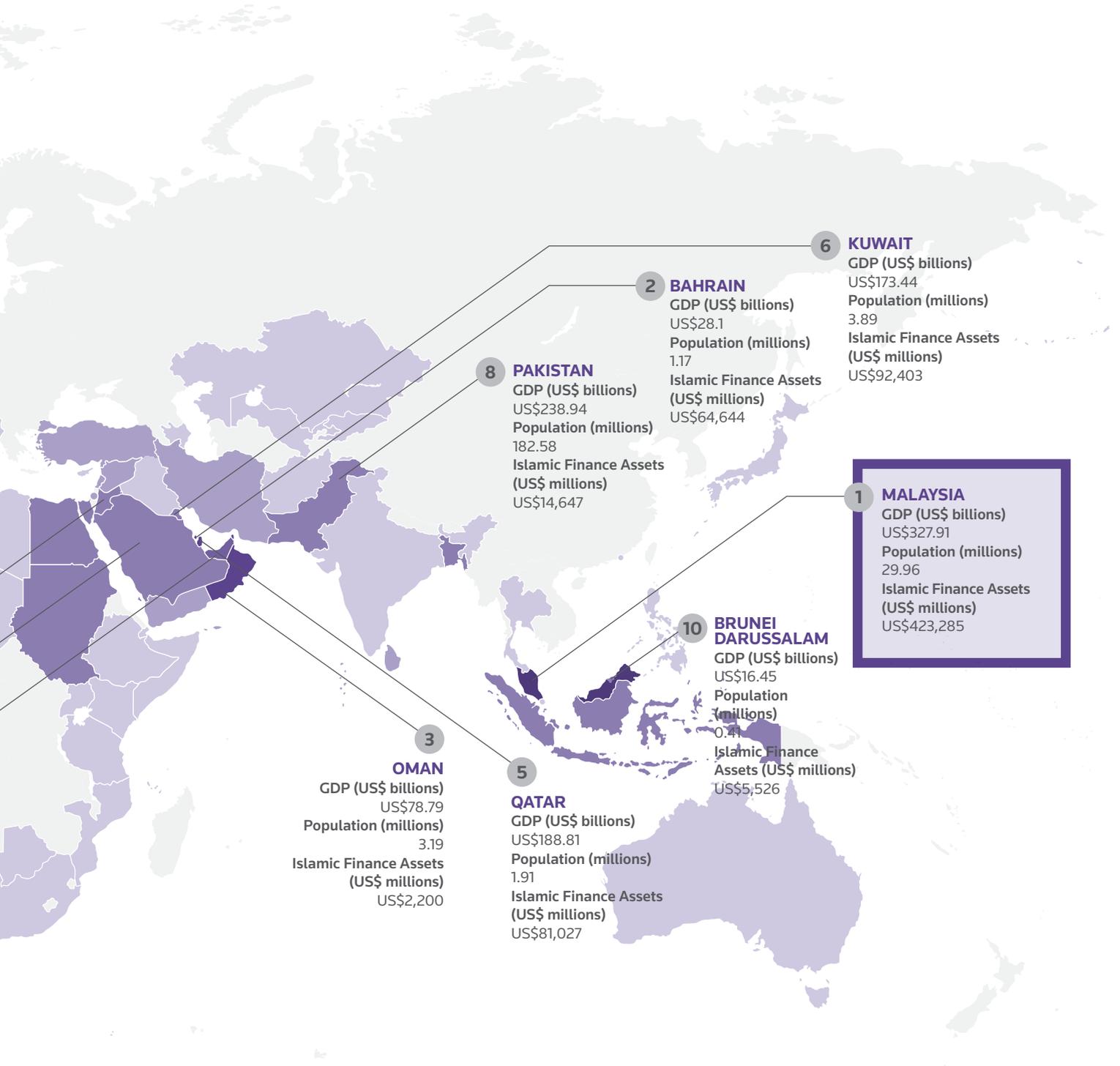
1	MALAYSIA	93
2	BAHRAIN	76
3	OMAN	64
4	UAE	57
5	QATAR	40
6	KUWAIT	38
7	JORDAN	36
8	PAKISTAN	34
9	SAUDI ARABIA	31
10	BRUNEI DARUSSALAM	29
11	SUDAN	28
12	INDONESIA	28
13	BANGLADESH	25
14	EGYPT	20
15	SRI LANKA	19
16	SYRIA	18
17	LEBANON	17
18	IRAN	17
19	PALESTINIAN TERRITORIES	16
20	UNITED KINGDOM	16

**JORDAN** 7  
 GDP (US\$ billions)  
 US\$34.08  
 Population (millions)  
 6.54  
 Islamic Finance Assets  
 (US\$ millions)  
 US\$7,430

**SAUDI ARABIA** 9  
 GDP (US\$ billions)  
 US\$745.62  
 Population (millions)  
 29.63  
 Islamic Finance Assets  
 (US\$ millions)  
 US\$338,106

**UAE** 4  
 GDP (US\$ billions)  
 US\$369.36  
 Population (millions)  
 5.70  
 Islamic Finance Assets  
 (US\$ millions)  
 US\$140,289





Source: Islamic finance assets: ICD – Thomson Reuters Islamic finance Development Indicator 2014  
 (Quantitative Development Indicator) GDP & Population: IMF - World Economic Outlook Database, April 2014

## MIFC MALAYSIA INTERNATIONAL ISLAMIC FINANCIAL CENTRE



Delegates talk at the Islamic Financial Centre booth during Malaysia's Central Bank - High Level Conference 2009 in Kuala Lumpur February 10, 2009. REUTERS/ Zainal Abd Halim (MALAYSIA)

## Where does Malaysia stand in world Islamic finance development rankings?

- Malaysia performed consistently well across all 5 indicators and emerged as the world's most developed Islamic finance country in 2013.
- The country is Number 1 for Knowledge – where it is the runaway leader for research output - and Quantitative Development.
- It is first runner-up for Awareness and Governance, where it was held back by its lower sharia governance score.
- Its Achilles heel is CSR where it ranks a woeful eighth. This was due to late disclosure by its IFIs for CSR activities, and relative lower funds disbursed (especially compared to GCC).

 <b>IFDI INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	<b>Malaysia</b>	<b>93</b>
2	Bahrain	76
3	Oman	64
4	UAE	57
5	Qatar	40

 <b>QUANTITATIVE DEVELOPMENT INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	<b>Malaysia</b>	<b>75</b>
2	Saudi Arabia	45
3	UAE	37
4	Qatar	36
5	Kuwait	35

 <b>KNOWLEDGE INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	<b>Malaysia</b>	<b>140</b>
2	Bahrain	62
3	Jordan	53
4	Pakistan	49
5	UAE	38

 <b>GOVERNANCE INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	Bahrain	90
2	<b>Malaysia</b>	<b>82</b>
3	Pakistan	67
4	Kuwait	65
5	Sudan	59

 <b>CORPORATE SOCIAL RESPONSIBILITY INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	Oman	85
2	Bahrain	76
3	Jordan	73
4	UAE	57
5	Indonesia	48
6	Bangladesh	47
7	Brunei Darussalam	43
8	<b>Malaysia</b>	<b>40</b>

 <b>AWARENESS INDICATOR</b>		
	COUNTRY	INDICATOR VALUE
1	Oman	156
2	<b>Malaysia</b>	<b>130</b>
3	Bahrain	127
4	UAE	103
5	Qatar	71



## Leadership Article



**By Badlisyah Abdul Ghani,  
CEO, CIMB Islamic**

Badlisyah Abdul Ghani is the Head of the Group Islamic Banking at CIMB Group, where he also serves as Executive Director and Chief Executive Director of CIMB Islamic Bank Malaysia and Country Head, Middle East and Brunei.

### What's the best model to go global?

There has been a lot of debate about the best business model for an Islamic bank to adopt in order to grow and expand overseas with integrity and commitment.

Proponents end up advocating for a standalone Islamic bank, an Islamic window, or a leverage model where the Islamic bank is part of a larger conventional financial group.

At the end of the day, the question of which makes the better model goes back to the question of how best to fulfill stakeholders' expectations in the undertaking of Islamic finance. It goes back to what your shareholders, regulators, customers, and employees want. Banks need to figure out what the best model is based on all these different basic expectations. The best model will then be the one that delivers value and nothing less.

There is no point talking about coming up with a standalone Islamic bank if you fail to deliver the value that your stakeholders expect. There is no point talking about an Islamic window if it also fails to deliver value. The right model must be very dynamic.

No one model is superior. Having worked in a standalone indigenous Islamic bank with no parent company (an "orphan", if you will) and having also worked in a conventional financial group using various operating models to undertake Islamic finance, I find all business models can be effective in delivering value depending on the expectations they need to fulfill.

With the closure or retreat of larger international financial groups in the arena of Islamic finance, and the deeper development of internal capabilities and resources by standalone Islamic financial institutions, there is the view that these standalone Islamic financial institutions will have the long-term dedication to Islamic finance and go the distance internationally. After all, there is no other avenue of retreat available. I would argue that relying on the model to evidence commitment is a bit one-dimensional, although it is a “quick fix” solution when taking a surface view of this evolving issue.

Part of the real solution is to create an enabling environment where all businesses pursuing Islamic finance, regardless of the business model, are governed by the same legislation, regulation, and Shariah governance framework. Malaysia is blessed with this thanks to its leaders, but this is not the case in many countries.

The question then arises in markets that are not as holistically hospitable to Islamic finance as Malaysia is: is it better to expand Islamic finance internationally (i) on a leverage basis or on a standalone basis, be it (ii) as a subsidiary of a large financial group or (iii) as a completely independent entity?

Being an independent standalone entity is not a guarantee of success. Being a successful Islamic finance institution in any market requires breadth and depth of products and services, the ability to provide liquidity, and effective delivery of those products and services. Establishing this from scratch can be prohibitively costly in terms of time and resources.

In the case where the Islamic finance institution operates independently within a larger financial group, the business may find itself struggling with internal competition and duplicating costs. The situation also may end up being one where relationships with customers and clients, be it individuals or companies, are badly managed. Operating completely on a silo basis may end up being detrimental to the group as a whole.

The third route in establishing Islamic finance in a market is establishing itself on a leverage basis, where the Islamic subsidiary is able to use the sales force, infrastructure, and systems of the larger financial group, while still maintaining Shariah standards and governance. It can then reap the benefits of synergy and accelerate business development and traction in new markets. This has proven successful in Malaysia.

### **Commitment to Islamic finance with the aim of successful international expansion**

There is an argument made by some that a standalone institution has more commitment to see the business through properly. The view is that Islamic windows and subsidiaries which leverage on a larger conventional financial group's infrastructure and resources are less committed.

To me, the only reason for anyone to undertake any business, including Islamic finance, is to create value for your stakeholders. If you are not committed, do not do the business in the first place.

When CIMB first undertook Islamic finance, there was no requirement at that point for a merchant bank to have an Islamic window. But it was decided that it needed to do so if it wanted to go into the business credibly. CIMB therefore applied for and received an Islamic window license from the central bank. Furthermore even when there was no guideline and no requirement for an in-house Shariah committee at the time, CIMB went ahead and established one, to build trust by showing unparalleled commitment.

CIMB subsequently evolved to become a universal banking operation by acquiring a standalone entity operating on a leverage model in Malaysia, and it also continues to maintain its Islamic window in the investment bank. In Singapore, the Islamic consumer banking business operates via a window in CIMB bank. So by pursuing the most appropriate model in different markets, it was able to effectively grow its Islamic finance business. CIMB now operates in 17 different

*Part of the real solution is to create an enabling environment where all businesses pursuing Islamic finance, regardless of the business model, are governed by the same legislation, regulation, and Shariah governance framework. Malaysia is blessed with this thanks to its leaders, but this is not the case in many countries.*

jurisdictions in a cost-effective manner and delivers value to consumers, shareholders, and other stakeholders.

Whatever the business model for international expansion, the crucial success factors are the financial and non-financial capabilities that determine an organisation's ability to expand into other countries. How strong is the organisation domestically? How solid is its customer base? How able are the organisation's human resource and information technology functions in scaling up across new markets?

When the organisation is part of a larger group with regional and international presence, it will aid the Islamic banking business expansion. Being able to leverage on the parent bank and its presence in the markets they compete in enables the introduction of Islamic finance to new markets. More often than not, it can also leverage the familiarity of the mother brand that has been established in the local environment to actually expand Islamic finance abroad.

Finally, it must also be noted that not all jurisdictions are ready to license an Islamic bank on a standalone basis.

### **Establishing an internationally competitive Islamic finance industry**

Having a diversity of successful business models that can compete on a level playing field will result in an internationally competitive Islamic finance marketplace. Malaysia is a case in point.

When there is a regulation change, Islamic banks operating on a leverage basis will usually react and raise the issue quickly. That helps the industry as

a whole because those operating on a standalone basis may be more likely to accept new regulation at face value and not question it. It is understandable that this happens as standalone banks only have one license and need to make it work. However in an environment where banks operating on a leverage model exist, there will be more detailed examination of issues and changes that arise.

Islamic banks which operate on a standalone basis will come to a decision more easily to invest the amount necessary to develop new products and educate the public on Islamic finance to grow their market share. This forces those operating on a leverage model to make those same investments and grow the business to ensure they do not lose ground and continue to prioritise innovation.

Finally Islamic banks operating on a leverage model have focused more on international expansion as a commonsense approach to realise economies of scale. This has forced existing banks operating on a standalone basis to urgently examine how they can be in the global market space and form relationships with other institutions to bring international capability to customers in a different manner. Ultimately, establishing this kind of enabling and competitive environment pushes all Islamic finance institutions to become better.

There is no question that Malaysia has benefitted from strong and supportive regulators. It is not easy to see this anywhere else in the world. With this supportive environment and strong Shariah governance framework, expanding internationally becomes more about market factors and corporate capabilities.

Islamic finance institutions are able to concentrate on delivering value with commitment, credibility and authenticity, irrespective of the business model.

In conclusion, the best answer to the question of how to go global is to use the best business model that delivers value to all stakeholders. If authenticity and commitment is the underlying concern, one could consider establishing an Islamic finance business in Malaysia that is regulated by the central bank of Malaysia. After all, a potential fine of up to RM25 million or jail sentence of eight years should be sufficient incentive to ensure full commitment to Shariah governance.

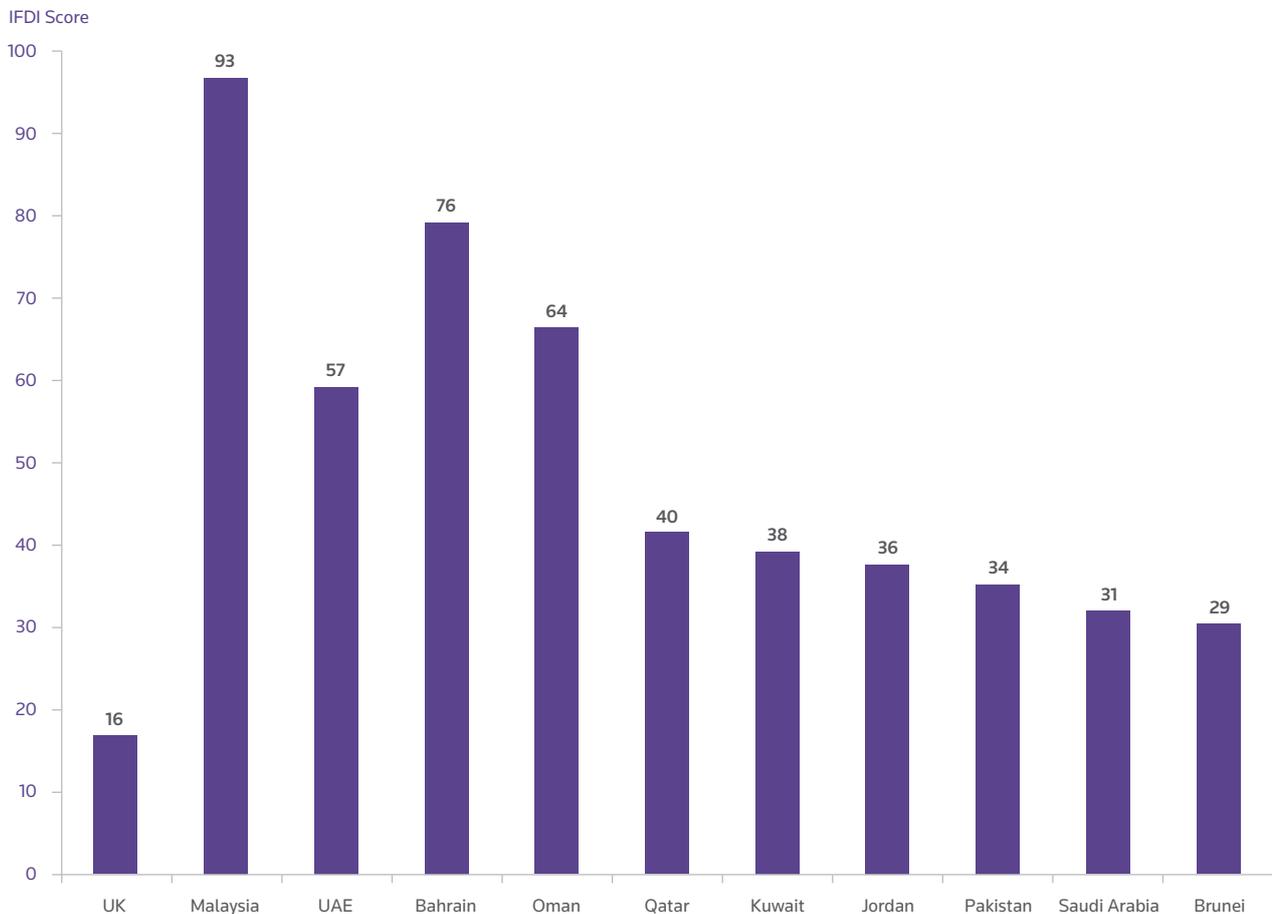
**Malaysia versus UK, UAE and the world's top Islamic finance countries**

**1. Macroeconomic leaders: UK, Malaysia, UAE**

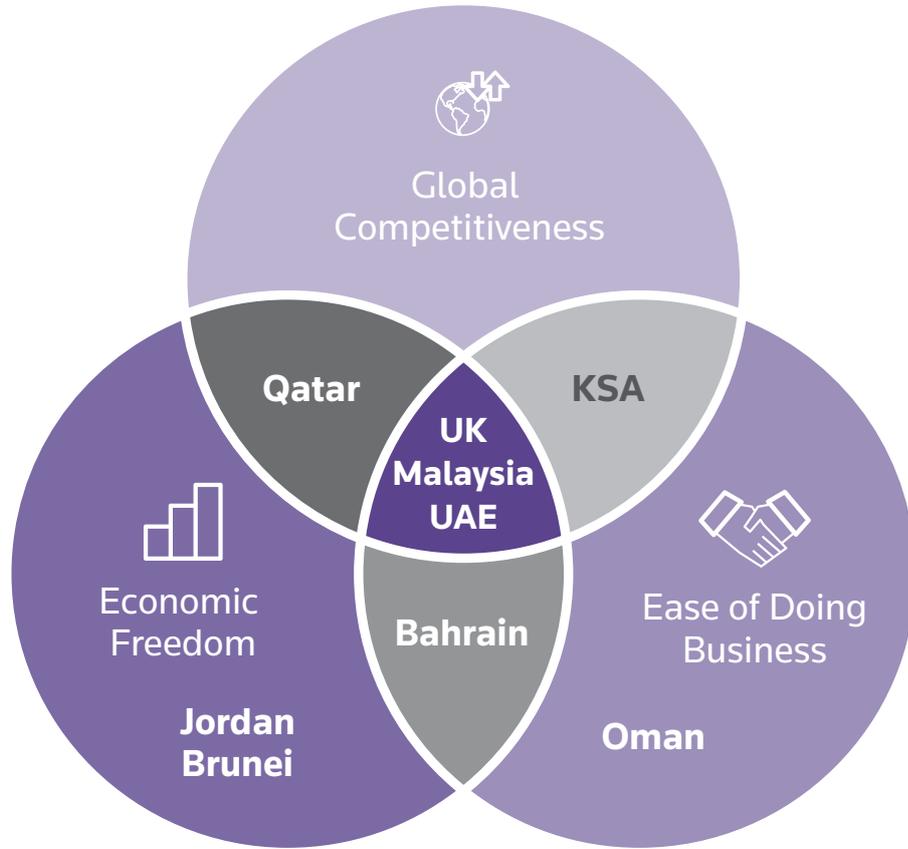
A strong and conducive macroeconomic cradle is necessary for the growth and development of any financial system. We compare the UK and the top 10 most developed Islamic finance markets (which include Malaysia and UAE) by three global Indexes: the World Bank's Ease of Doing Business Ranking (189 countries), the World Economic Forum's Global Competitiveness Ranking (144 countries) and the Heritage Foundation's Index of Economic Freedom (186 countries). The first two Indexes are most widely used to compare economies worldwide. The third measures economic freedom based on four main indicators: rule of law, limited government, regulatory efficiency and open markets.

**Economies with rankings that fall within each upper quartile would stand a better chance of attaining 'global' hub status for Islamic finance. In this case the UK, Malaysia and the UAE emerge as the only three economies that qualify.** However, for the near- to mid-term, economic growth forecasts favour Malaysia and the UAE. Bahrain, Qatar and Saudi Arabia lie on the periphery. Oman, Jordan and Brunei are not as competitive as the other eight on the global rankings and Kuwait and Pakistan do not rank in the upper quartile for any of the Indexes.

UK+ Top 10 Islamic finance countries, 2013

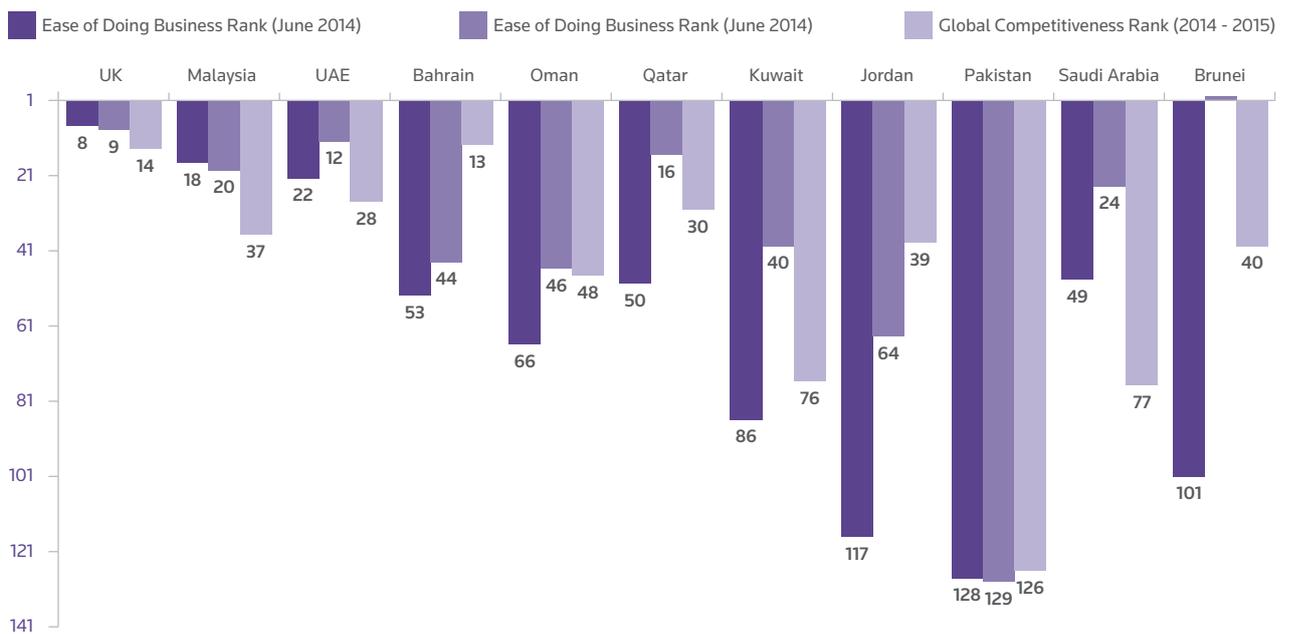


Source: Data from ICD-Thomson Reuters Islamic Finance Development Indicator 2014



Sources: World Bank, World Economic Forum and Heritage Foundation

### Global Ranking Ease of Doing Business , Global Competitiveness & Economic Freedom



Note: Brunei did not meet WEF Global Competitiveness minimum requirements and so was not ranked on the most recent Index

Global assessment of active financial centres

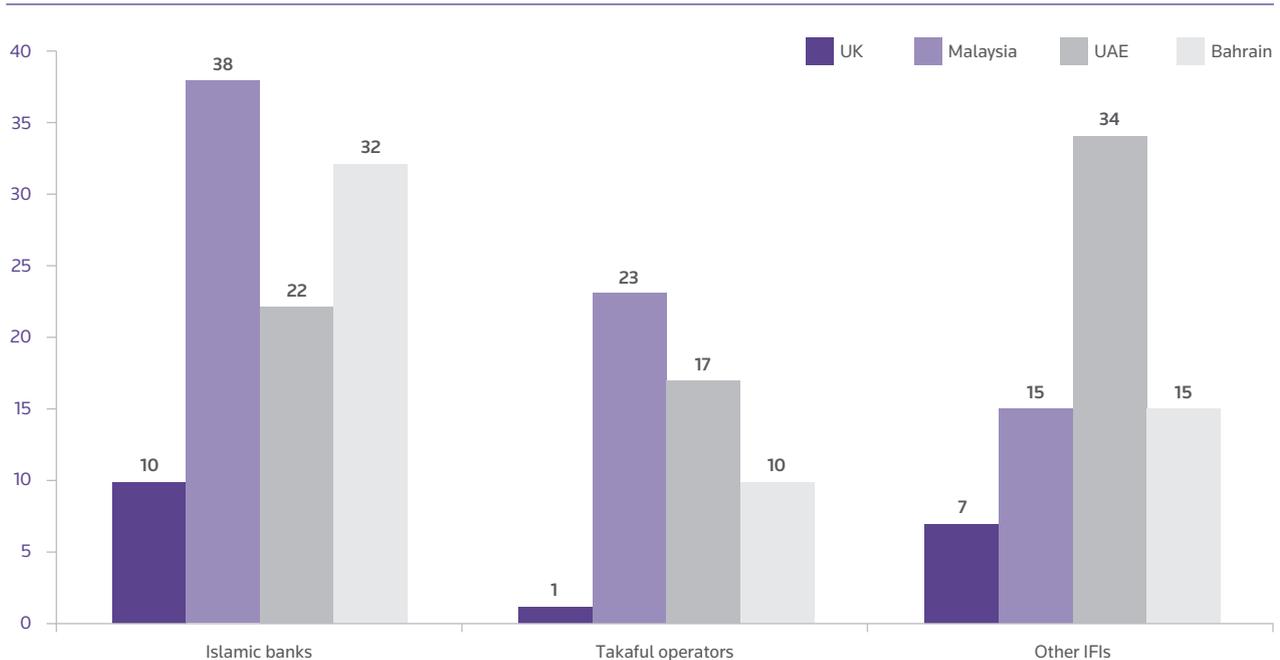
	UK	MALAYSIA	UAE	BAHRAIN	QATAR	SAUDI ARABIA
Global ranking of financial centre (GFCI 15, Z/ Yen Group)	London - 1	KL - 35	Dubai - 29	40	26	Riyadh - 31
Islamic finance infrastructure institutions based in the country		IILM IFSB		AAOIFI CIBAFI IIFM		IDB (and its subsidiaries ICD, IRTI etc)

**2. Islamic finance leaders: Bahrain to join the fight**

When we focus only on Islamic finance development it is clear that London/UK is not only very far from the levels of KL/Malaysia and Dubai/UAE but the overall Islamic Finance Development Indicator (IFDI) that measures the industry’s development across five main indicators reveals the disparity between the UK and the top 10 countries. Significantly, the UK has a very weak Islamic finance regulatory framework and is very far behind

Malaysia and the UAE on number of IFIs and total asset size. Although Bahrain falls behind in the global macroeconomics indicators it is a strong GCC Islamic finance centre which covers all aspects of regulations, and is home to a large base of Islamic finance assets and wide universe of Islamic finance institutions. Other countries such as Qatar and Saudi Arabia stand on the periphery as the economies with two global macroeconomic rankings in the upper quartile.

UK-Malaysia-UAE and Bahrain: No. of IFIs



Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014 - Quantitative Development Indicator

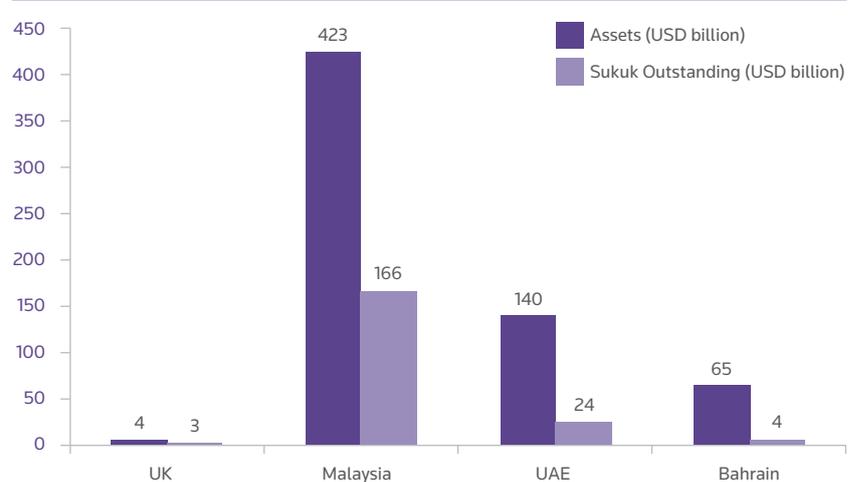
The Islamic finance leaders are strong in terms of their quantitative development as assessed in the ICD-Thomson Reuters Islamic Finance Development Indicator 2014 report. The IFDI report highlights that sukuk hold the second biggest pool of assets (17%) after Islamic banks (73%).

Malaysia has the advantage of a vibrant market in local currency sukuk. Malaysia is the runaway sukuk leader with outstanding sukuk valued at \$166 billion at the end of 2013. Its sukuk market is attracting a growing number of foreign issuers from as far afield as Kazakhstan.

Dubai lists relatively fewer sukuk on its exchanges; traditionally its state-owned companies have gone to London to issue. But a determined campaign by Dubai's government is now convincing its companies to issue at home, and could attract business from firms in neighbouring Gulf States.

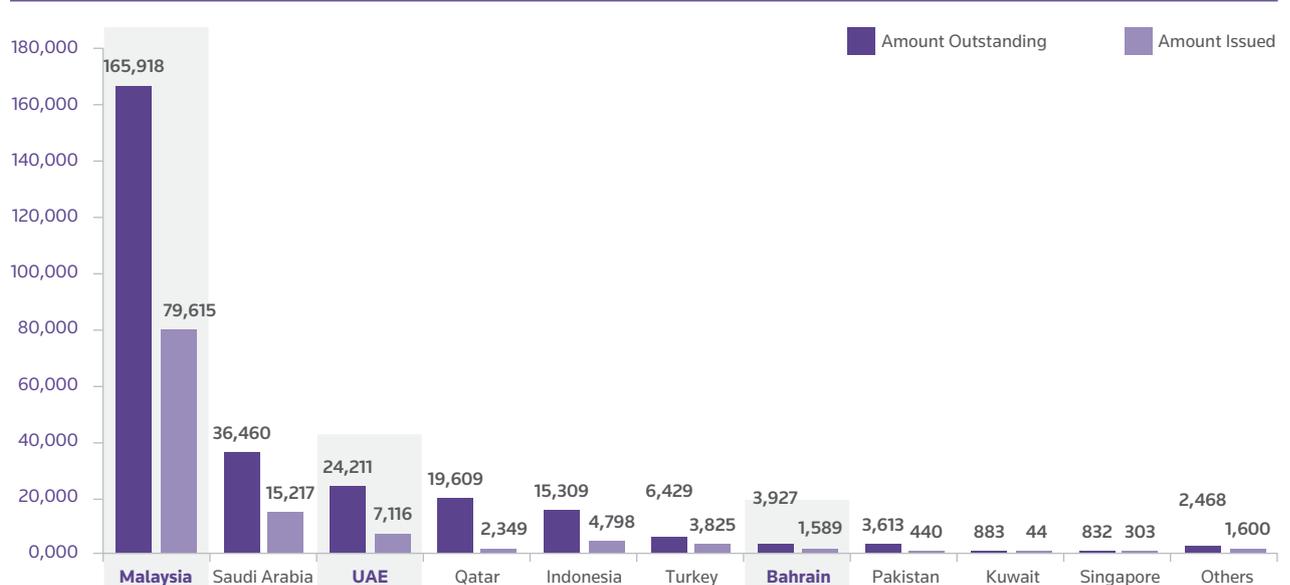
The most cut-throat area of competition between London/UK, Dubai/UAE and Malaysia is arranging sukuk. London has led in attracting issues by big international companies because of the massive size of its conventional financial markets and its globally respected legal system. However, in reality London lacks the representation globally as one of the top 10 IFDI countries when it comes to outstanding and issued sukuk.

UK-Malaysia-UAE and Bahrain: Islamic Finance Assets and Sukuk contribution to Islamic finance growth (USD billion)



Source: ICD – Thomson Reuters Islamic Finance Development Indicator 2014 – Quantitative Development Indicator

Global Sukuk as at December 31, 2013 - Outstanding vs Issued amount in \$ million

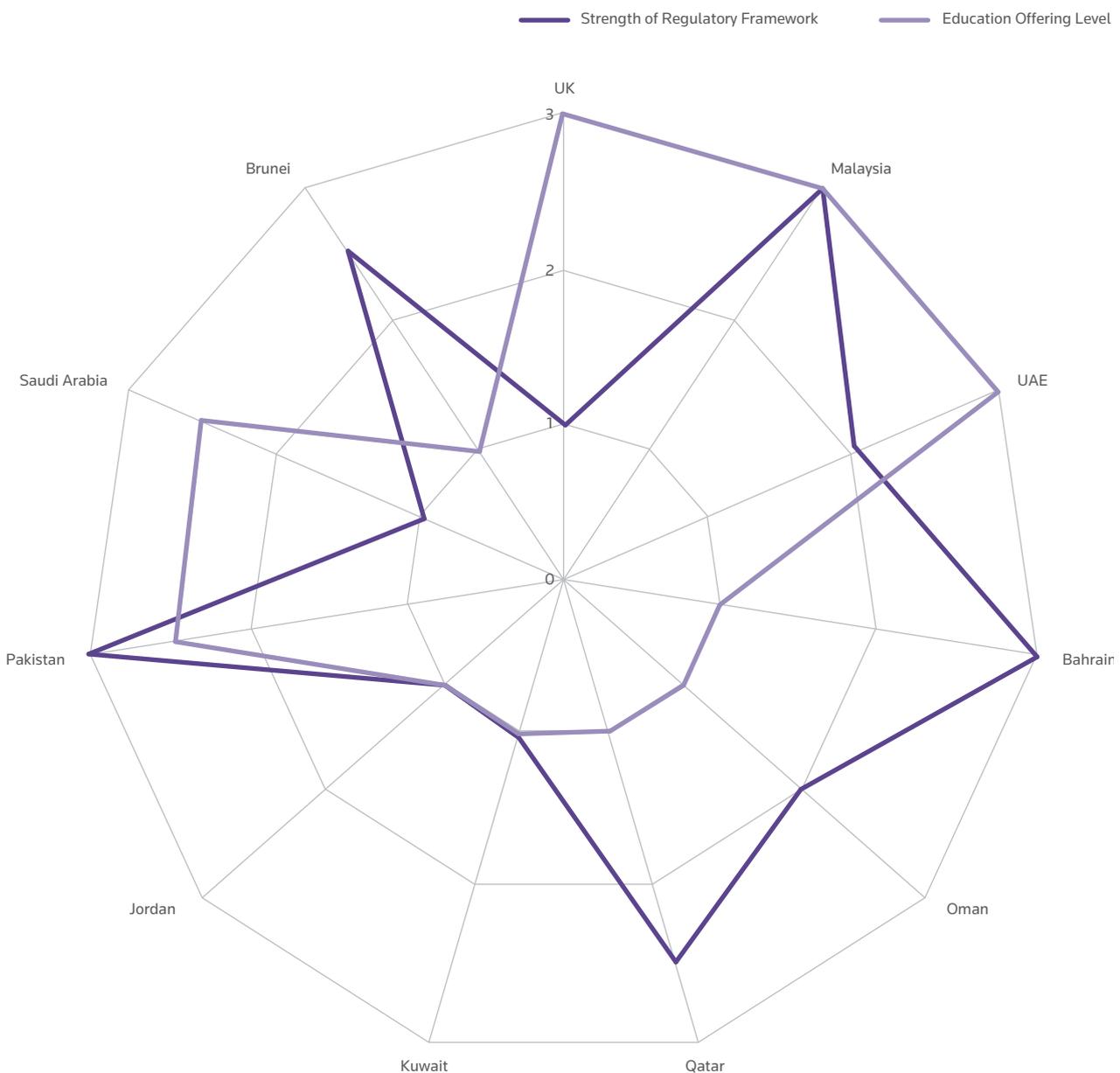


Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014 - Quantitative Development Indicator

Bahrain outperforms the UK on most of the quantitative measures. Bahrain continues to hold on to and attract Islamic institutions, which contributes to its high level of Islamic finance assets and sukuk.

It is also well-regulated. Bahrain should focus on strengthening its educational offerings to compete with its rivals.

Strength of Islamic finance regulatory framework and Education Offering Level where 3=Strongest/Highest



Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014- Governance Indicator covers Regulations, Shariah Governance and Corporate Governance and the Knowledge Indicator covers Education and Research

### Outlook: Main plans and policies of Malaysia, UAE, Saudi Arabia, Bahrain, Qatar and UK that will impact Islamic finance growth and development in the near- and mid-term

Three distinct growth drivers jump out of the page when we consider the main plans and policies of the six jurisdictions. What this exercise has revealed is the beginnings of the next phase of growth and development in Islamic finance: it is one that gravitates toward the other sectors of the Islamic Economy and is stepping out with risk-sharing products to serve the engines of the real economy — the SMEs. The first driver signals the start of a tipping of the balance of financial assets towards Shariah-compliance and the second and third are growth drivers peculiar to the Islamic Economy:

- Conversion of conventional assets to become fully Shariah-compliant
- Shariah/halal-based products closely linked to the real economy (for Islamic finance this leans towards greater use of risk-sharing instruments and financing SMEs)

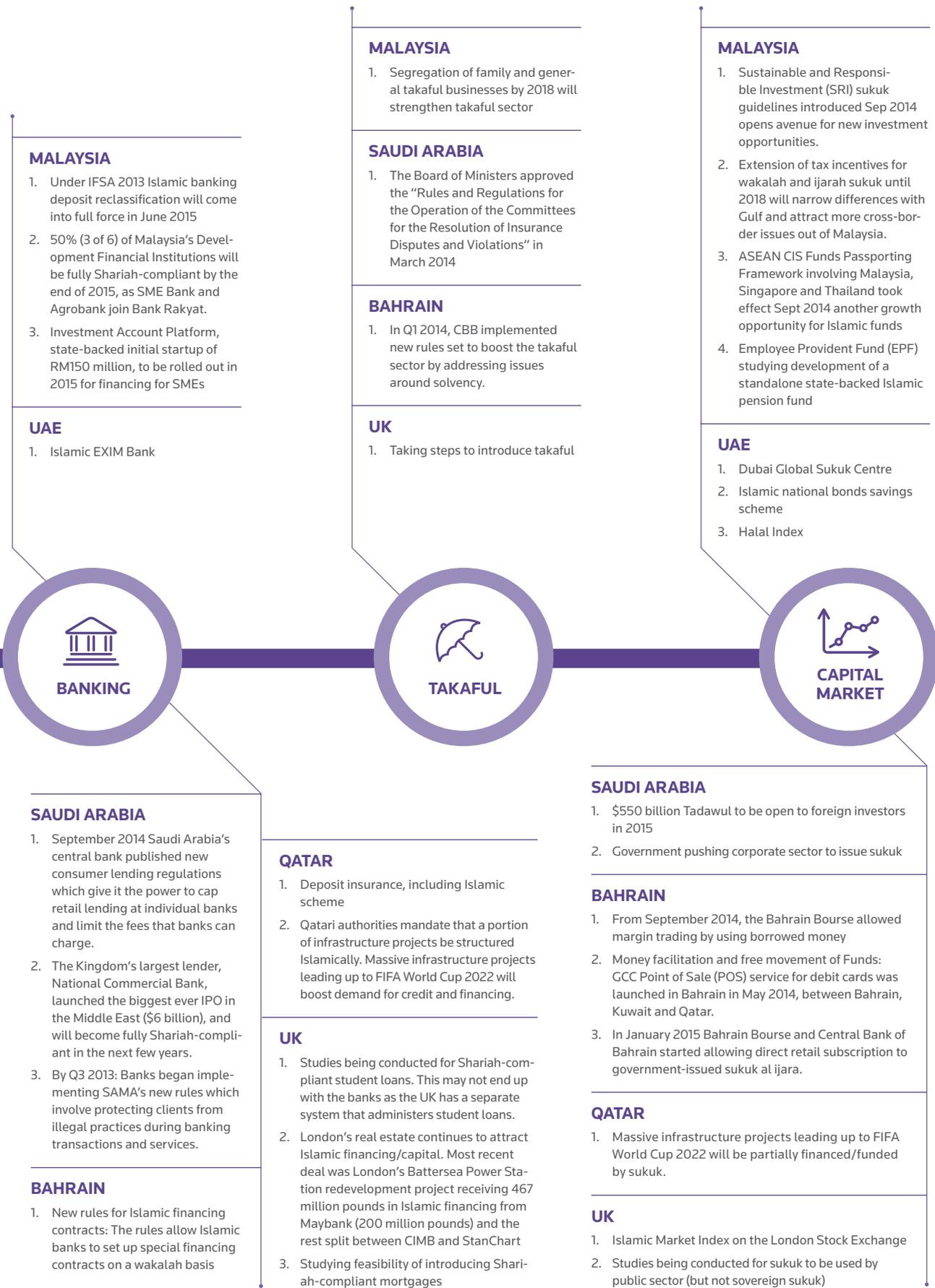
- Convergence of Islamic finance and the other Islamic Economy sectors

Malaysia looks set to harness all three growth drivers. UAE and Saudi Arabia have elements of each. Bahrain and Qatar are focused on strengthening, deepening and widening their Islamic financial frameworks and assets. The UK's main focus is on introducing and developing basic Islamic financial products.

In terms of harnessing these growth drivers we expect Malaysia to continue to be global leader in Islamic finance and the Islamic Economy with the UAE trailing. Saudi Arabia is also a big market; it is already the biggest Islamic banking market in the GCC and the world's leading takaful market. It is currently occupied with liberalising its financial sector (including opening up Tadawul to foreign investors in 2015) and this will present new opportunities for its Islamic finance and Islamic Economy sectors.



The peaks of the Petronas Twin Towers is seen in central Kuala Lumpur. REUTERS/Olivia Harris



**MALAYSIA**

1. Proposed regulatory framework for equity crowdfunding
2. In planning stages for introduction of Financial Ombudsman

**UAE**

1. Central Shariah board for Islamic finance
2. 10% of federal ministries and authorities procurement budgets for purchasing, servicing and consulting must be contracted to small and medium enterprises (SMEs),

**QATAR**

1. Enhancing regulation by developing a consistent risk-based micro-prudential framework
2. Expanding macro-prudential oversight
3. Enhancing consumer and investor protection
4. Promoting regulatory cooperation

**MALAYSIA**

Foundations set for:

1. Halal bioeconomy
2. Halal pharma and cosmetics
3. Halal logistics
4. Islamic financing for green technology
5. Halal food sector will continue to grow

**UAE**

1. Modernisation of Awqaf
2. Integrated halal zones
3. \$136.2 million Shariah-compliant hotel to be built by Palm Jumeirah by end 2016



**REGULATORY/  
LEGAL**

**Other sectors  
in Islamic  
finance  
ecosystem**

**Other Islamic  
Economy  
sectors that will  
need/attract  
Islamic  
capital**

**MALAYSIA**

1. 'International Standard Curriculum' for Islamic finance will be rolled out in the coming years

**UAE**

1. Islamic corporate governance centre for financial and non-financial corporations
2. Dubai Centre for Islamic banking and finance

**SAUDI ARABIA**

1. The commencement of compulsory and full implementation of finance laws and regulations

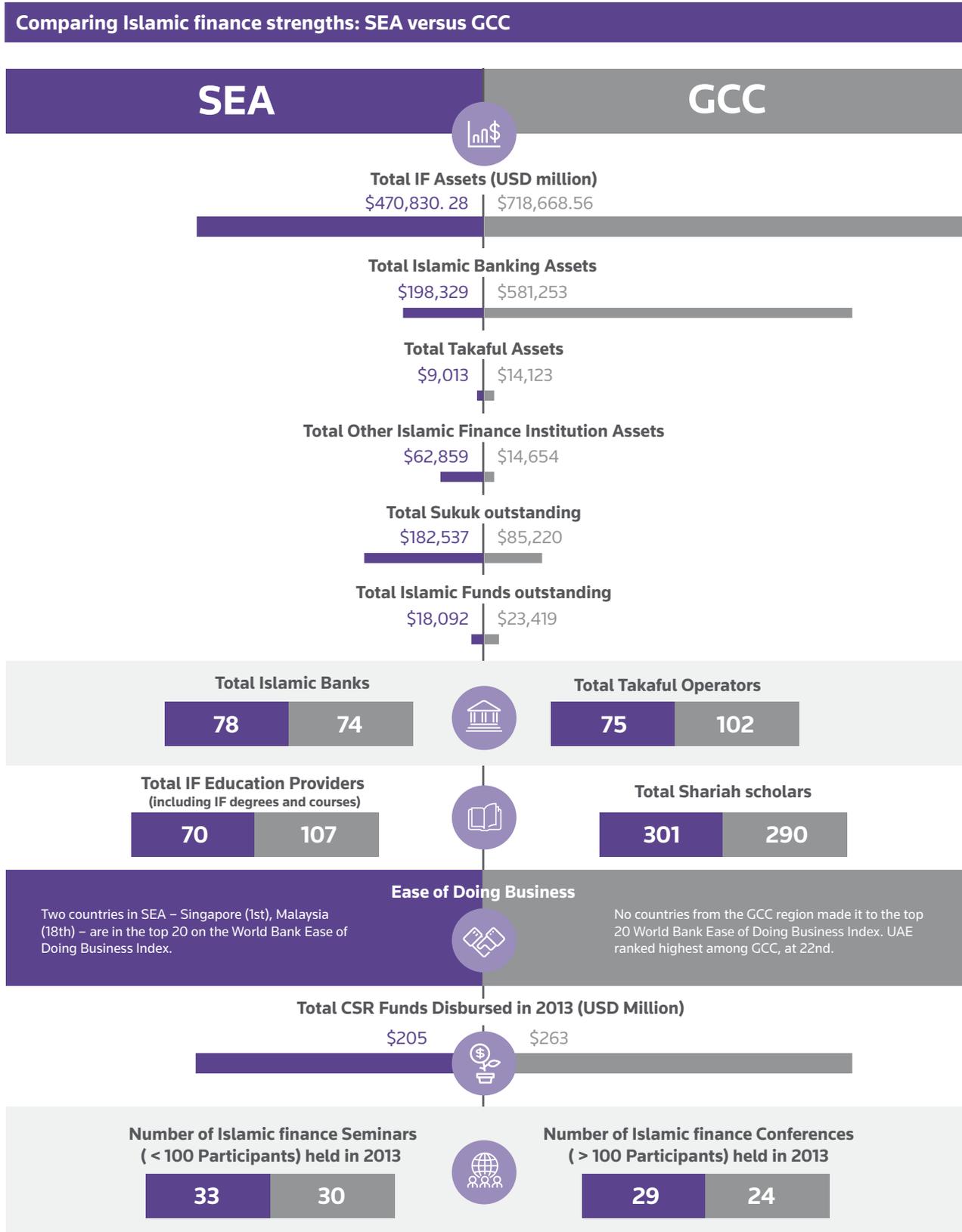
**BAHRAIN**

1. Building human capital

**UK**

1. UK-Bahrain education partnerships
2. Establishment of a UK/Bahrain Islamic Finance Working Group, and exploring an internship exchange programme.

# Malaysia's Regional Position



\* SEA countries here refers to the active Islamic finance players in SEA, which are those covered under the Islamic Finance Development Indicator 2014 universe: Malaysia, Brunei Darussalam, Indonesia, the Philippines, Singapore, and Thailand

## Southeast Asia's Islamic finance leader

In Southeast Asia, Malaysia's opportunity is to spread and strengthen Islamic finance in the region. The demographics and trading environment are

conducive. It is the political will and regulatory environments of each Southeast Asian nation that poses the biggest challenges.

### DEMOGRAPHY & LABOUR FORCE

#### Large Muslim population:

40%, or 240 million out of approximately 595 million total SEA inhabitants

#### Young population:

Median age Malaysia 26.1, Indonesia 26.9 and Brunei 29.5

Rising per capita income, purchasing power and demand for goods and services create strong investment position for the region

Lower wages compared to India and China

Growing Islamic finance talent pool

### MORE FOREIGN DIRECT INVESTMENT

FDI flows into ASEAN 5 countries (Malaysia, Indonesia, Philippines, Thailand and Singapore) surpassed China's FDI in 2013

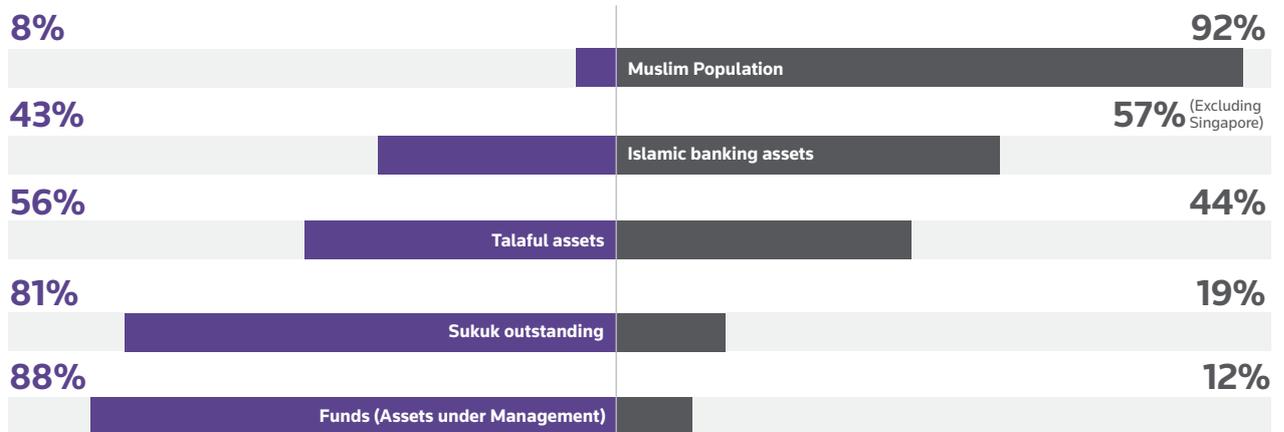
Strong trading nations that have diversified their economies

Pro-business environment

### REGULATORY ENVIRONMENT

Islamic finance regulations including Islamic banking, funds, takaful, sukuk and Shariah governance are established in most of the Southeast Asian countries.

## Malaysia vs SEA Countries



Over 30 years of Islamic finance Experience

Comprehensive Islamic Finance regulatory framework



## Leadership Article



**By Asghar Ali Syed, Counsel,  
Asian Development Bank**

Asghar Ali Syed is Counsel at the Asian Development Bank in Manila, Philippines. He is a member of ADB's Islamic Finance Working Group and is actively involved in various ADB Islamic finance related initiatives in the region. He is a member of the bar in New York and Pakistan.

### An overview of Islamic finance in Southeast Asia

Asia is home to around 60% of the world's Muslims and is at the forefront of the development of Islamic finance. Asia's Islamic banking and sukuk sectors collectively account for 20% of global Islamic financial assets.<sup>1</sup>

#### Malaysia

The efforts of Asian governments to support and develop their domestic Islamic financial services industries have been a key driver of the growth in Islamic finance in the region. Malaysia, through sound economic, financial and regulatory policies has established itself as the principle Islamic finance market in Asia and one of the leading Islamic finance markets in the world. Malaysia's Islamic financial institutions hold 21.2% of the country's total domestic banking assets and the country accounts for 10% of Islamic banking assets<sup>2</sup> globally. Malaysia similarly dominates in capital markets, accounting for 63% of global sukuk issuance in the first half of 2014.<sup>3</sup> Malaysia also finds itself in an enviable position with respect to takaful, having emerged as the world's largest family takaful market and accounting for nearly 71% of total gross takaful contributions<sup>4</sup> in ASEAN.

Malaysia can continue to play a leading role in helping to develop and shape the course of Islamic finance in Asia. Malaysia has already established itself as a principle jurisdiction for Islamic finance regulation, thought, and talent development. The country is host to

<sup>1</sup> Ibid

<sup>2</sup> Supra, note 1

<sup>3</sup> Global Primary Sukuk Market Outperforms in 1H 2014, Malaysia International Islamic Financial Centre, July 2014

<sup>4</sup> Global Takaful Insights 2014, Ernst & Young, 2014

several international Islamic finance organisations including the Islamic Financial Services Board (IFSB) and International Islamic Liquidity Management Corporation (IILM) and is home to numerous Islamic finance knowledge institutions such as the International Centre for Education in Islamic Finance (INCEIF) and Malaysia International Islamic Finance Centre (MIFC).

On the regulatory side, the Central Banking Services Unit (CBSU) of Bank Negara Malaysia's Human Capital Development Centre has played an active role in promoting and developing Islamic finance in Asia and beyond. Since 2008, CBSU has provided structured Islamic finance training programmes to central banks and other regulatory bodies and has trained over 742 officials. On the private sector side, Malaysia Islamic banks are active in promoting Islamic finance in the region and have indicated a readiness to establish Islamic banks in emerging markets where appropriate Islamic finance regulations are in place. Malaysia will need to continue to play this leadership role for some time if Islamic finance is to build, as it should, on its already sound footing in Asia.

### Indonesia

Neighbouring Indonesia – the most populous Muslim country in the world - is also fast becoming a force in Islamic finance and, at the end of May 2014, its Islamic banking assets were around \$21.4 billion, or 4.8% of Indonesia's total banking assets.<sup>5</sup> Although Islamic banking was introduced in Indonesia in 1992 through the establishment of Bank Muamalat, it was the enactment of National Act No. 21 in 2008 which ushered in a period of exceptional growth for Islamic finance in Indonesia by setting out an appropriate legal framework for the development of Islamic banking. Between 2008 and 2012, Islamic bank assets tripled, increasing by an average of 31.5% annually<sup>6</sup> and Indonesia continues to actively seek to broaden and grow its Islamic finance market.

Indonesia successfully raised \$1.5 billion through a sovereign sukuk in September 2014 which attracted the largest order book ever achieved for sovereign sukuk in Southeast Asia.<sup>7</sup> Indonesia's takaful operators similarly experienced exceptional asset growth of 43% in 2013.<sup>8</sup> Within ASEAN, Indonesia's share of gross takaful contributions is stable at 23%.<sup>9</sup>

However, Indonesia is not resting on its laurels and Otoritas Jasa Keuangan (OJK), Indonesia's financial services authority, is currently preparing a five-year plan for Indonesia's Islamic finance industry which is expected to include incentives to help boost the domestic sukuk market and address other issues including a lack of scale in the industry, sector consolidation, and the role of foreign ownership.

### Brunei

Meanwhile, Brunei, the other ASEAN country with a Muslim-majority population, has a robust Islamic finance industry with Islamic banking assets at around \$5 billion, or 40% of the total domestic market share.<sup>10</sup> On the capital markets side, the Brunei government issued a B\$100 million sukuk in October 2014 bringing its total short-term sukuk al-ijara issuance to nearly B\$8 billion since the Brunei government's maiden offering in April 2006.<sup>11</sup> Brunei also has a growing takaful industry; in 2013 takaful represented 52.7 percent of all insurance contributions in Brunei.<sup>12</sup>

### Singapore, Philippines, Thailand

Elsewhere in ASEAN, outside of the Muslim-majority countries of Malaysia, Indonesia and Brunei, the growth of Islamic finance has met with varying levels of success. Singapore is seeking to establish itself as an offshore Islamic finance hub and several foreign Islamic banks are already operating in the city state. Although Singapore accounts for a small percentage of the global Islamic finance industry, experts expect

5 Indonesia Eyes Islamic Finance Incentives in Industry Road Map, Bernardo Vizcaino, Reuters, August 2014

6 Why Islamic Banks Matter in Indonesia, Djauhari Sitorus, CGAP, July 2013

7 Indonesia's Sovereign Sukuk Attracts \$10 Billion Order Book, Reuters, 3 September 2014

8 Supra, note 7

9 Supra, note 7

10 Supra, note 3

11 Press Release, Autoriti Monetari Brunei Darussalam, October 2014

12 Annual Report 2013, Autoriti Monetari Brunei Darussalam, August 2014

*Malaysia can continue to play a leading role in helping to develop and shape the course of Islamic finance in Asia. Malaysia has already established itself as a principle jurisdiction for Islamic finance regulation, thought, and talent development.*

Singapore's Islamic banking assets to grow by 15% to 20% over the next three to five years.<sup>13</sup>

Islamic finance markets are also gently emerging in the Philippines and Thailand. The Philippines was one of the first Muslim-minority countries to recognise the importance of Islamic finance by establishing in 1973 one of the world's first Islamic banks, the Philippine Amanah Bank. This was later renamed the Al-Amanah Islamic Investment Bank of the Philippines. Notwithstanding this early start, Islamic banking in the Philippines has been slow to take off primarily due to legal and regulatory constraints. However, following the signing of the Bangsamoro Framework Agreement between the Government of the Philippines and the Moro Islamic Liberation Front, Islamic finance is now getting due attention in the Philippines. In December 2013, the Philippine Stock Exchange after several months of consultations issued its first Shariah-compliant stock list. On the regulatory side, Bangko Sentral ng Pilipinas is working with stakeholders and international organisations on legislation and regulations to promote the development of Islamic finance in the Philippines.

Thailand's Islamic finance industry is also in its infancy. Having established its first full-fledged Islamic bank in 2003,<sup>14</sup> the Islamic finance industry has not grown significantly in the intervening years. However, it is noteworthy that Thailand is one of five countries in ten-member ASEAN where takaful products are available.

### Challenges

Despite its exponential growth in Asia over the last few years, Islamic finance is facing several challenges which could slow the current growth trajectory unless challenges are managed at a country level. These challenges are particularly evident in the emerging Islamic finance markets and can be identified as follows:

**(a) Legal and Regulatory Frameworks:** In many cases, the conventional legal frameworks and institutional arrangements put into place for conventional financing are not suitable for Islamic finance operations.<sup>15</sup> In order to properly implement an Islamic financial system, there is a need to develop a holistic institutional setup that will enable Islamic banks to operate side-by-side with conventional banks and which will allow a harmonious interface between Shariah principles and the existing legal and regulatory framework.<sup>16</sup> A number of Islamic financial products require multiple transactions, which their conventional counterparts don't, to achieve functional equivalence. They are therefore subject to additional tax burdens under most existing legal and taxation systems. As such, countries that wish to develop indigenous Islamic financial markets need to consider tax and regulatory changes.

There is also a need to develop regulatory and supervisory frameworks to, among others, increase the information available to investors

<sup>13</sup> Supra, note 3

<sup>14</sup> Islamic Bank of Thailand

<sup>15</sup> Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance, and Prospects* (New York: Palgrave Macmillan, 2005), 111.

<sup>16</sup> Madzlan Mohd Husain, *Islamic Finance: Stability, Resilience and Regulatory Issues*, Asian Development Bank. Manila, November 2013.

regarding the industry, ensure soundness of the financial system, and improve control of monetary policy.<sup>17</sup> On the regional level, a key task is to ensure harmonised Shariah rulings and interpretations to create consistency, predictability, and enforcement of legal transactions to further facilitate cross-border activities and to reduce Shariah arbitrage.

**(b) Talent Development:** This will continue to be a burning issue in Islamic finance for some time to come. Outside of the traditional Islamic finance markets, there are simply not enough qualified Islamic finance professionals who are proficient in both finance and Shariah. There continues to be a shortage of scholars with a sound working knowledge of Islamic principles and modern economics and finance. Employees and management of Islamic financial institutions need to be trained in modern techniques of financial management, risk management, and information technology.<sup>18</sup> In the emerging markets, there is a pressing need for regulators to get training in Islamic finance principles. Otherwise it is difficult to see how these regulators can exercise an appropriate oversight function, or indeed, bring in necessary and appropriate regulations to govern Islamic finance transactions.

**(c) Awareness:** Apart from traditional Islamic finance markets and sophisticated institutional investors there is still a lack of understanding and appreciation of Islamic finance in both Muslim and non-Muslim countries. Many investors still see Islamic finance as a type of financing for Muslims alone. Investors need to be educated on the risk diversification benefits of Islamic financing.

---

<sup>17</sup> Supra, note 19.

<sup>18</sup> Supra, note 19.

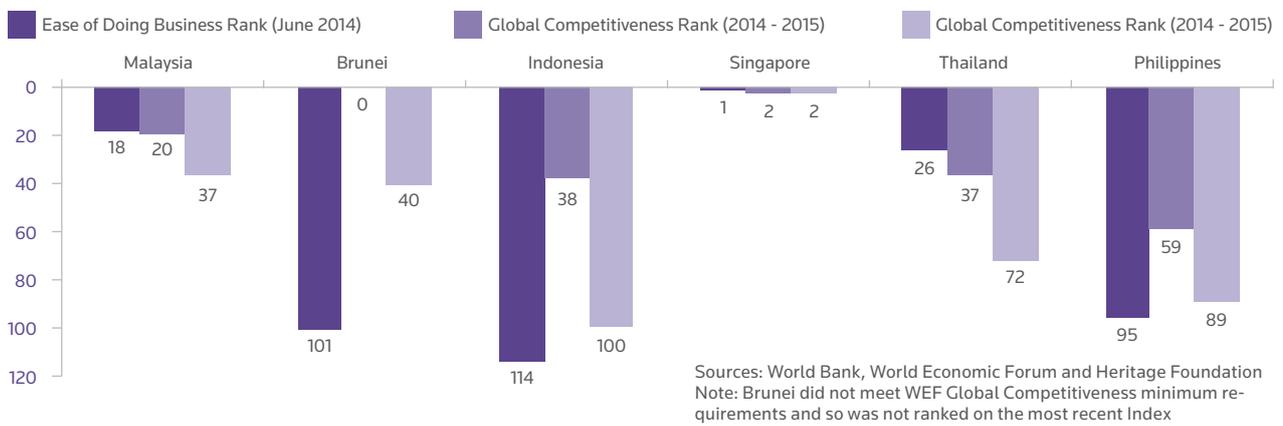
### Comparative analysis between Malaysia and active Islamic finance players in Southeast Asia

Malaysia’s opportunity in SEA is twofold: 1) for its domestic players to find new growth markets, and 2) to uplift the overall Islamic finance take-up rate in SEA by spreading its expertise and influence. Malaysia has started with Islamic banking – e.g. leading banks Maybank Islamic and CIMB Islamic already have a presence in Indonesia and

Singapore. Other opportunities lie in selling its Islamic capital market platform for use by neighbouring countries, and distribution of Islamic funds. In these respects the ASEAN framework is a key enabler. Malaysian Islamic finance expertise is also regarded highly, and thus employed, by its neighbours in SEA.

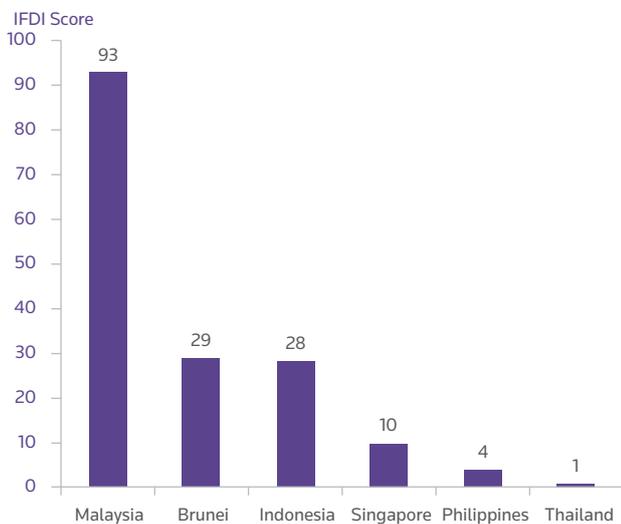
### Global macroeconomic rankings: Singapore, Malaysia, Brunei leaders in SEA

Global Macroeconomic Ranking – Ease of Doing Business , Global Competitiveness & Economic Freedom



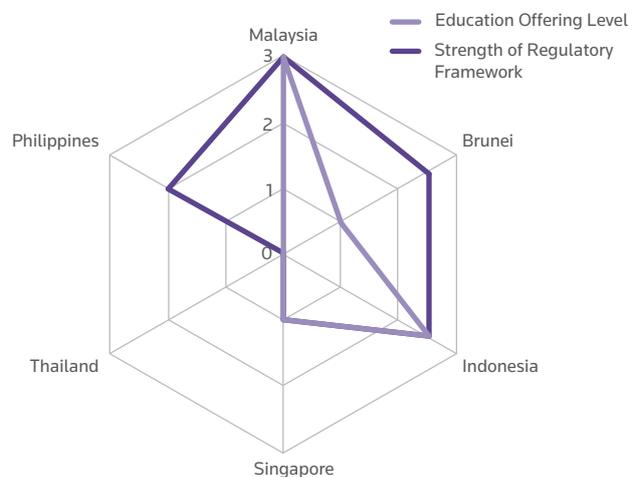
### SEA Islamic finance leaders: Malaysia, Brunei, and Indonesia

SEA - Islamic Finance Development Indicator, 2013



Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014 – Quantitative Development Indicator

Strength of Islamic finance regulatory framework and Education Offering Level, where 3 = strongest/highest



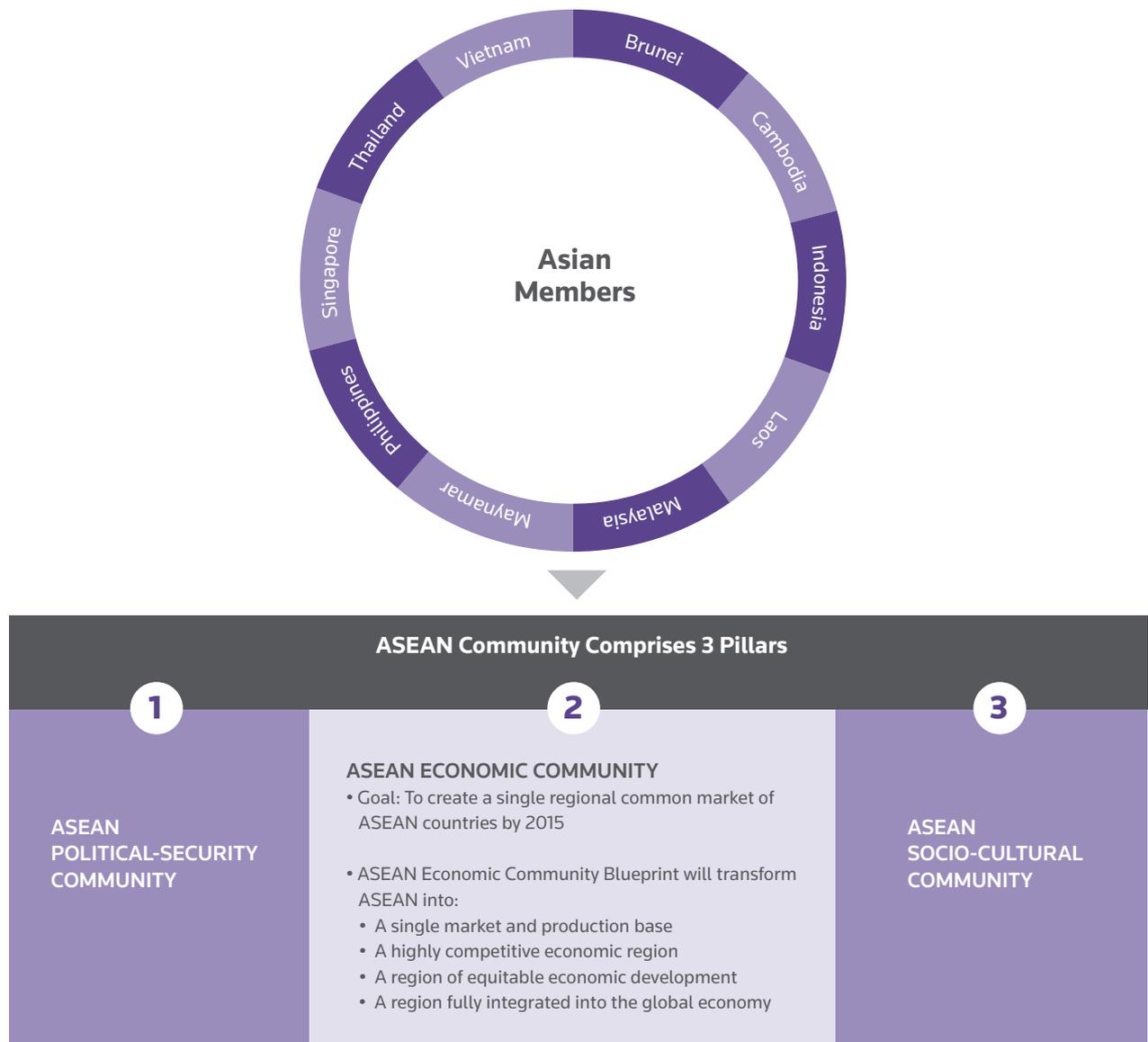
Source: ICD-Thomson Reuters Islamic Finance Development Indicator 2014- Governance Indicator covers Regulations, Shariah Governance and Corporate Governance and the Knowledge Indicator covers Education and Research

## ASEAN Focus

The ten-member ASEAN has blueprints focused on three areas: 1) Political security, 2) Establishment of a socio-cultural community, and 3) Economic integration. The over-arching economic opportunity for ASEAN lies in its ASEAN Economic Community (AEC) scheduled for launch at the end of 2015. The movement towards the AEC started with the AEC Blueprint in 2007. The

AEC is envisioned to boost intra-regional trade and attract foreign investments across the ten member countries. Islamic finance has the opportunity to spread quickly and easily using the AEC as a vehicle. In this section we assess the progress towards integration that will facilitate the easier widening and deepening of Islamic finance across the ten-member ASEAN states.

One vision, one identity, one community and Malaysia as chair in 2015





Malaysia's Prime Minister Najib Razak prepares for the plenary session of the 25th ASEAN summit at Myanmar International Convention Centre in Naypyitaw. REUTERS/Damir Sagolj

**ASEAN Economic Community Progress: How far away from integration?**

To achieve the AEC and its blueprint goals, it is important to highlight the main drivers of each sub-goal:

Firstly, a single marketplace will be created through the removal of trade barriers which will allow the free flow of goods, services, investments, capital and skilled labour.

Secondly, a competitive economic region shall be created through fostering a culture of fair

competition, strengthening consumer protection, infrastructure development, regional cooperation in intellectual property rights, bilateral agreement on double taxation and promoting e-commerce.

Thirdly, an equitable economic development will be achieved through accelerating the development of Small and Medium-Sized Enterprises (SMEs), and enhancing ASEAN integration to narrow the development gap between ASEAN countries.

Fourthly, a region fully integrated into the global

economy is aimed through promoting external economic relationships, partnerships and negotiations. This shall work toward maintaining "ASEAN Centrality"

- AEC development:** The progress towards achieving the AEC objectives is generally criticised as "too slow". The chairmanship of ASEAN is based on a rotating system between countries from year to year. This has resulted in different levels of leadership skills ranging from the strong experienced countries to weaker ones. Over the last few years, most of the chairs were held by less developed countries which may have hindered the progress of the AEC objective towards regional integration.
- Infrastructure development:** The ASEAN Infrastructure Fund, based in Labuan and administered by the Asian Development Bank, was set up in 2012 and started extending financing in 2013. The fund provides financing for infrastructure development to narrow the development gap in ASEAN. Most recent data from the ADB puts total equity contribution commitments to the fund from all ASEAN member countries and the ADB at \$458.2 million, \$150 million of which comes from the ADB. As of this writing, the fund has financed two infrastructure projects, both in Indonesia, to the amount of \$65 million.
- Financial sector development:** ASEAN is working towards financial integration and plans for that come under the ASEAN Financial Integration Framework that covers all financial sub-sectors, including payments systems and settlements (under banking integration). There are significant different levels of financial sector development among ASEAN member countries. On the one hand Singapore is the world's fourth strongest financial centre and at the other end of the spectrum Brunei, Cambodia, Laos, Myanmar and Vietnam are still establishing their stock markets. Liberalisation is a pre-condition for integration and those target areas and countries still working on meeting liberalisation targets can be found in our summary table. The ASEAN countries with

much less developed financial sectors have more ground to cover vis-à-vis liberalisation of financial sub-sectors. Malaysia's biggest target is the insurance sector.

- Competition:** ASEAN members view each other as competitors but in the future this competition should be replaced by collaboration.
- The AEC blueprint is categorised into four phases:**
  - Phase I (2008 -2009)
  - Phase II (2010 – 2011)
  - Phase III (2012-2013)
  - Phase IV (2014- 2015)



The full implementation of the AEC blueprint is scheduled for the end of 2015.

The achievements of the ASEAN Economic Community Blueprint Pillars based on the AEC scorecard

	PHASE I	PHASE II	PHASE III*	TOTAL MEASURES
<b>Pillar I: A single market and production base</b>				
Implementation Rate	95.4%	61.1%	79.2%	74.6%
<b>Pillar II: A highly competitive economic region</b>				
Implementation Rate	68.8%	78.3%	91.7%	86.3%
<b>Pillar III: A region of equitable economic development</b>				
Implementation Rate	68.8%	77.8%	16.7%	61.1%
<b>Pillar IV: A region fully integrated into the global economy</b>				
Implementation Rate	100%	77.8%	0%	75%

\*Up to October 2012  
Source: ASEAN Economic Community Scorecard – March, 2012



## Sub-sectors identified for liberalisation by 2015 under the AEC Blueprint

	SUB-SECTORS	TARGETED FOR THE FOLLOWING MEMBER COUNTRIES
<b>Insurance</b>	Direct Life Insurance	Indonesia, Philippines
	Direct Non-life Insurance	Brunei, Cambodia, Indonesia, Malaysia, Philippines, Singapore and Vietnam
	Reinsurance and Retrocession	Brunei, Cambodia, Indonesia, Malaysia, Philippines, Singapore and Vietnam
	Insurance Intermediation	Cambodia, Malaysia, Indonesia, Philippines, Singapore and Vietnam
	Services Auxiliary to Insurance	Brunei, Cambodia, Indonesia, Malaysia, Philippines, Singapore and Vietnam
<b>Banking</b>	Acceptance of Deposits and Other Repayable Funds from the Public	Cambodia, Laos and Vietnam
	Lending of All Types	Cambodia, Laos and Vietnam
	Financial Leasing	Cambodia, Laos and Vietnam
	All Payment and Money Transmission Services	Cambodia, Laos and Vietnam
	Guarantee and Commitments	Cambodia, Laos, Myanmar and Vietnam
<b>Capital Market</b>	Trading for Own Account or for Account of Customers	Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand
	Participation in Issues of All Kinds of Securities	Indonesia, Philippines (subject to constitutional and legislative limitations)
	Asset Management	Indonesia, Philippines, Singapore and Thailand
	Settlement and Clearing Services for Financial Assets	Indonesia, Philippines, Singapore and Thailand
<b>Others</b>	Provision and Transfer of Financial Information, Financial Data Processing and Related Software by Suppliers of Other Financial Services	Philippines and Myanmar
	Advisory, Intermediation and Other Auxiliary Financial Services	Philippines, Singapore, Thailand and Vietnam

**Malaysia's 2015 ASEAN Chairmanship**

ASEAN countries have less than a year to achieve the AEC objectives of creating a single market and production base. In January 2015, Malaysia took over the chairmanship of ASEAN from Myanmar. Malaysia will have the responsibility to deliver economic integration. Therefore, 2015 will be a challenging and interesting year for Malaysia towards

moving ASEAN countries to a new regional integration phase. One of Malaysia's key focus areas is funding and resourcing ASEAN. Malaysia has also indicated that it will focus on post-2015 challenges. It has the expertise and experience to lead specific sectors to a higher level in ASEAN, specifically the SME sector, the halal sector, and Islamic finance. In the next section we focus on SME development.



A visitor attends an opening ceremony of World SME Expo for small and medium enterprises in Hong Kong. by Bobby Yip

## Focus Analysis:

### Islamic finance opportunity to drive SME development in ASEAN

One of the strategic objectives of the AEC is to accelerate the development of SMEs within the ASEAN countries. SMEs are the backbone of the ASEAN economies. The AEC aims to create world-class SMEs at regional and national level through achieving a set of goals including the enhancement of SMEs marketing capabilities and increasing the internationalisation of SMEs, improving SMEs access to finance, strengthening SME human resources development, setting-up an ASEAN SME service center and regional development fund.

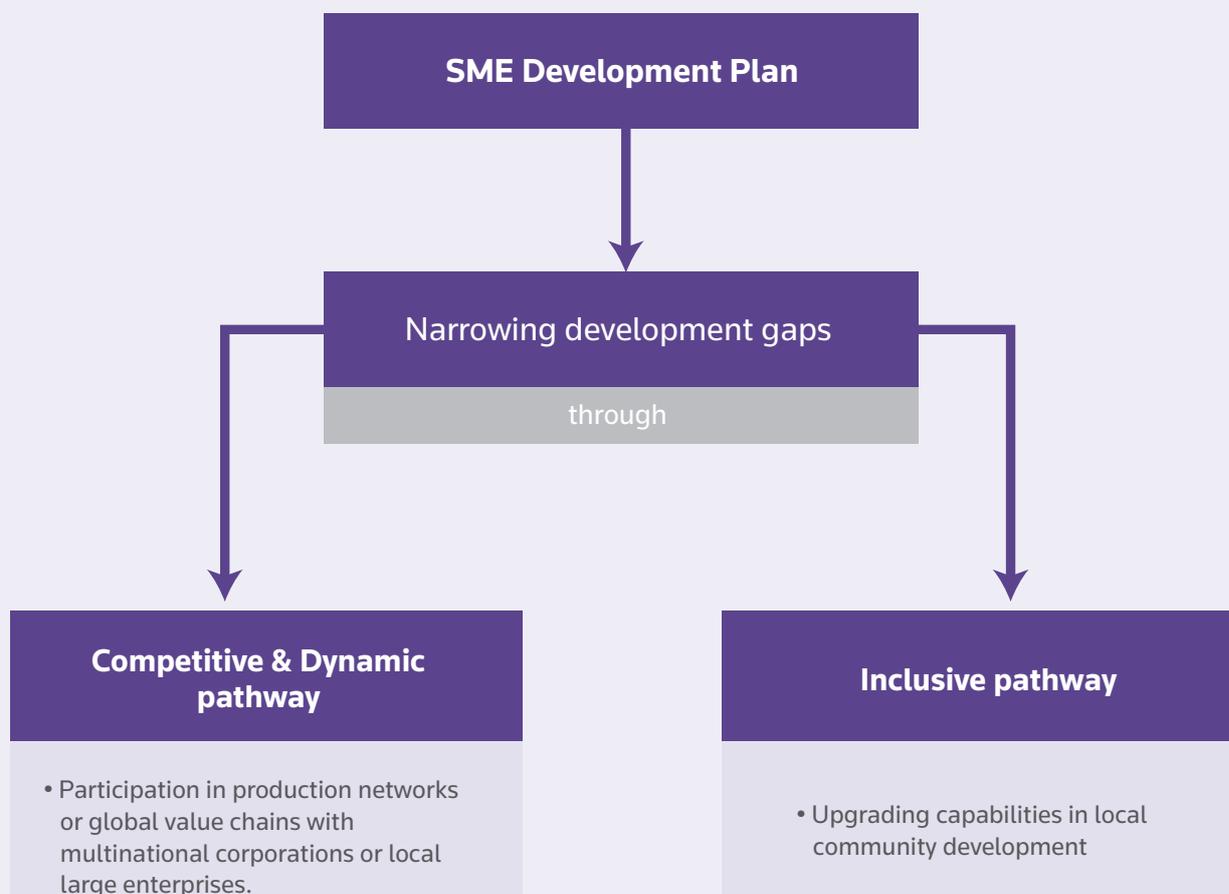
SMEs account for 96% of the total operating enterprises in ASEAN. Among the ten countries, SMEs employ from 52% (Vietnam) to 97% (Indonesia) of the total workforce. The SME sector is the largest source of domestic growth which contributes significantly to the GDP of ASEAN member countries (30%-53% of ASEAN total GDP). The SME sector still faces a wide range of structural, financial and other challenges that need to be overcome in order to achieve the AEC goals.

The SME sector in Malaysia accounts for a significant proportion – 97.3% – of all businesses operating in the country and employs approximately 60% of the working population.

**Malaysia's SME strengths**

Malaysia sees the development of SMEs as a driver that will help narrow the development gaps between the ASEAN economies and subsequently achieve a high level of integration and competitiveness. The country has three

decades of experience building a comprehensive education, business, financial and cross-border promotion and trading framework to support and develop SMEs. Crucially, the Islamic finance option is offered alongside conventional finance. As with the financial sector and capital market masterplans, there is also the SME Masterplan which is on its 2012-2020 cycle.



The progress of ASEAN SME development plan

PLAN	RESPONSIBILITY	2009	2010	2011	2012	2013	2014	2015
<b>ACCESS TO FINANCING</b>								
Establishment of SME Financial Facility in each ASEAN Member Country	AMSs, Brunei Darussalam	→	→					
Feasibility study of SME credit systems for enhancing SME access to bank lending/financing and loan guarantee in ASEAN	Indonesia		→					
Establishment of a Regional SME Development Fund	Thailand, ASEAN Secretariat , AMSs*	→	→	→	→	→	→	→
<b>FACILITATION</b>								
Development of a multi-media self-reliant system toolkit package	Malaysia, AMSs		→	→	→			
Improving technology transfers and licensing within the SME sector through the dissemination of concrete good practices and replicable success stories within and outside ASEAN								
Hyperlink national SME Portals Improve the operation of the National Service Desk	AMSs		→					
Establishing a comprehensive SME service center with regional and sub-regional linkages in AMSs	Malaysia, AMSs		→	→	→			
Dissemination of information on regional and international opportunities in trade and investment to SMEs, including FTA-related information on the liberalization of trade and investment within and outside ASEAN	AMSs		→					
<b>TECHNOLOGY DEVELOPMENT</b>								
Sharing of information on technology availability for SMEs in AMSs	AMSs		→					
Developing KPIs on SME Innovations	AMSs		→					
Development of technology incubators	AMSs		→					
<b>PROMOTION</b>								
Identification of the top 1,000 ASEAN SMEs	ASEC, SMEWG**, AMSs		→	→	→	→	→	→
Establishing ASEAN SME Innovation Awards			→	→	→	→	→	→
Promoting ASEAN SMEs to the international market					→			
Wider dissemination of information on SMEs trade fairs and festivals in each AMSs, and facilitating SMEs to participate in these events			→	→	→	→	→	→

PLAN	RESPONSIBILITY	2009	2010	2011	2012	2013	2014	2015
<b>HUMAN RESOURCE DEVELOPMENT</b>								
Establish a common curriculum for entrepreneurship in ASEAN	Indonesia, Singapore, AMSs, SMEWG					renew annually		
Establish a regional program for the promotion of internship schemes for staff exchanges and visits for skills training								

Source: ASEAN Strategic Action Plan for SME Development (2010 – 2015)

\*AMSs: Asian Members States

\*\*SMEWG: Small and Medium Enterprises Working Group

### ASEAN SME Policy Index (Per Country)



Source: ERIA - OECD – ASEAN SME Policy Index Report 2014

### Development gaps

An Index for the ASEAN SME policy has been created; the ASEAN SME Policy Index is based on Eight policy dimensions that are mentioned in the ASEAN SME blueprint. The Index reveals development gaps between the ASEAN countries in terms of SME policy. The founding members – Indonesia, Malaysia, Singapore, Thailand and the Philippines – scored well and exceeded the ASEAN average of 3.7, while the other countries scored below the average. Malaysia ranked second after Singapore in the ASEAN SME Policy Index.

Eight policy dimensions for the ASEAN SME Policy Index:

1. Institutional framework
2. Access to support services
3. Cheaper and faster start-up and better legislation and regulation for SMEs
4. Access to finance
5. Technology and technology transfer
6. International market expansion
7. Promotion of entrepreneurial education
8. More effective representation of SMEs' interests

**How can Malaysia contribute to the growth of SMEs in ASEAN?**

Malaysia can make an important contribution to the development of SMEs in ASEAN if it leverages on its experience in SME development, its strengths in Islamic finance, and providing access to finance/credit.

Malaysia has been a key advisor to ASEAN countries wishing to build their Islamic finance ecosystems. Political will and commitment are the most important hurdles to overcome. Thereafter, ‘low-hanging fruits’ are first identified to build Islamic finance. For example, the Philippines was advised to first build a

Shariah-compliant index for its stock market while legislation is worked out for an Islamic banking law. As of April 2014, there were 60 Shariah-compliant equities on the Philippine Stock Exchange. This has helped put the Philippines on the Islamic finance map and attract Shariah-sensitive investors and funds to the country.

SME financing should be a priority area for Islamic financial institutions as the sector embodies the real economy, creates employment opportunities, and moves resources that collectively work towards alleviating poverty. As ASEAN Chair in 2015, how can Malaysia further develop SMEs?

**CONSTRAINTS FACING THE SME SECTOR IN ASEAN COUNTRIES**

1. Access to finance
2. Lack of skilled human resources (technical and managerial capabilities)
3. Lack of access to information
4. Access to greater market
5. Limited access to technologies
6. Absence of a more conducive business and policy environment

**MALAYSIA'S STRENGTHS AND EXAMPLES FOR ASEAN COUNTRIES TO FOLLOW**

1. Malaysia has built a comprehensive SME development and financing framework.
  - Capitalise on its Islamic financial institutions through easing access to capital and expanding its network in neighbouring ASEAN countries where SME financing is limited. A strong signal from Malaysia with regard to SME financing and Islamic finance is the conversion of the national SME Bank to become fully Shariah-compliant by the end of 2015.
  - Malaysia’s Credit Guarantee Corporation (CGC) has been key to providing guarantees for SME loans/financing where collateral is lacking.
  - Malaysia has a microcredit/microfinance scheme – Skim Pembiayaan Mikro -- for SMEs that has helped increase levels of access to credit/financing. Outstanding loans/financing jumped from RM84 million in 2006 to RM857 million in 2013\*.
  - Malaysia’s SMEs outstanding loans increased from RM81.995 billion in 2003 to RM212.9 billion in 2013\*. Impaired loans/financing plunged from 14.5% (of loan/financing ratio) in 2003 to 3.8% in 2013\*.
2. Existence of infrastructure institutions to support the development of the SME sector, such as SME Corp, which is a one-stop shop for all matters SME. It also facilitates SMEs advisory services including redress mechanisms.
3. MATRADE, the national trade promotion agency, has been at the forefront of supporting and marketing Malaysian SMEs to the world.

\*All data from Bank Negara Malaysia



Malaysia's CIMB Chairman Nazir Razak gives the keynote address at the launch of a report "Re-drawing the ASEAN Map: How companies are crafting new strategies in Southeast Asia" in Kuala Lumpur. REUTERS/Olivia Harris

# Appendix

## 1. Selected Banking Financials

	2008	2009	2010	2011	2012	2013
<b>BANKING SYSTEM ASSETS (US\$ MILLION)</b>						
Islamic Banking	61,510.38	74,738.26	85,801.70	107,471.60	122,940.71	141,772.50
Banking System	425,804.05	455,037.64	494,937.40	570,435.51	615,541.49	673,073.52
<b>BANKING SYSTEM FINANCING (US\$ MILLION)</b>						
Islamic Banking	32,842.16	42,140.42	50,547.43	62,584.50	74,575.42	90,872.93
Banking System	226,345.67	246,169.58	277,805.42	316,650.05	351,757.68	390,688.39
<b>ISLAMIC FINANCING BY TYPE OF CONTRACT (US\$ MILLION)</b>						
Bai Bithaman Ajil	11,288.02	14,033.18	17,559.58	20,670.70	24,290.49	27,198.89
Ijarah	907.16	1,318.83	1,288.47	1,347.80	1,515.91	2,070.88
Ijarah Thumma Al-Bai	10,414.35	12,738.10	14,224.08	16,671.60	17,846.48	20,496.34
Murabahah	5,184.67	7,528.51	7,618.33	9,936.17	13,086.43	18,646.94
Musarakah	371.04	768.57	1,294.40	2,419.09	3,869.25	5,278.08
Mudharabah	102.31	122.17	90.19	82.27	46.51	47.73
Istisna'	452.66	486.10	530.07	479.12	323.53	227.67
Others	5,494.87	6,656.09	9,458.48	12,812.61	15,148.63	17,892.48
<b>BANKING SYSTEM DEPOSITS (US\$ MILLION)</b>						
Islamic Banking	50,589.07	61,752.38	70,945.65	87,111.24	100,214.33	114,108.98
Banking System	306,128.91	336,279.84	361,278.74	413,089.14	450,335.18	489,663.23
<b>NET IMPAIRED LOANS/ FINANCING RATIO</b>						
Banking System	1.69%	1.29%	2.31%	1.84%	1.37%	1.30%
Islamic Banking System	1.69%	1.65%	2.14%	1.56%	1.20%	1.00%
<b>LIQUIDITY SITUATION</b>						
Loan-Deposit	81.10%	77.90%	81.30%	80.90%	82.10%	84.60%
Financing-Deposit	73.50%	84.60%	87.70%	86.70%	89.20%	91.20%
<b>RETURN ON ASSETS</b>						
Banking System	1.50%	1.20%	1.50%	1.60%	1.60%	1.50%
Islamic Banking System	1.00%	1.30%	1.30%	1.00%	1.30%	1.20%

Sources: BNM Monthly Statistical Bulletin/BNM Financial Stability Report 2013

## Financing By Type for FYE 2013 (US\$ Million)

	Islamic Banking	Banking System
<b>OTHER TERM LOANS</b>	27,068.0	125,929.0
<b>HOUSING LOANS</b>	20,259.8	109,038.3
<b>PASSENGER CARS HIRE PURCHASE</b>	17,907.4	46,821.2
<b>REVOLVING CREDIT</b>	5,503.3	21,196.6
<b>TRADE BILLS</b>	3,141.5	18,375.5
<b>OTHERS (SPI LOANS, STAFF LOANS ETC..)</b>	2,196.1	17,818.0
<b>FOREIGN CURRENCY LOANS</b>	1,944.9	16,836.5
<b>OVERDRAFT</b>	2,053.7	16,379.3
<b>PERSONAL LOANS</b>	8,640.8	11,582.3
<b>SYNDICATED LOANS</b>	1,065.3	7,623.0
<b>OTHER HIRE PURCHASE</b>	2,293.1	5,440.0
<b>TRUST RECEIPTS</b>	199.4	1,495.0
<b>BRIDGING LOANS</b>	32.5	1,394.8
<b>LEASING</b>	409.7	411.0
<b>FACTORING</b>	0.0	346.0
<b>BLOCK DISCOUNTING</b>	0.9	115.5
<b>TOTAL LOANS</b>	92,716.4	400,801.8

Source: BNM Monthly Statistical Bulletin

## Capital Adequacy Ratios for FYE 2013

	BANKING SECTOR	ISLAMIC BANKING
<b>Total Capital Ratio</b>	14.90%	15.10%
<b>Tier 1 Capital Ratio</b>	13.50%	12.80%
<b>CET 1 Capital Ratio</b>	12.60%	12.80%

Source: BNM Monthly Statistical Bulletin

## 2. Selected Insurance Financials

	2008	2009	2010	2011	2012	2013
<b>GENERAL INSURANCE / TAKAFUL EARNED PREMIUM / CONTRIBUTION INCOME (US\$ MILLION)</b>						
General Insurance Earned Premium Income	2,942.37	3,241.06	3,503.98	3,674.58	4,061.04	4,519.67
General Takaful Earned Contribution Income	213.28	236.23	306.93	356.54	419.26	454.51
<b>LIFE INSURANCE / FAMILY TAKAFUL NET PREMIUM / CONTRIBUTION (US\$ MILLION)</b>						
Life Insurance Net Premiums	6,126.92	6,497.72	7,146.54	7,481.24	8,177.11	8,652.26
Family Takaful Net Contributions	775.96	889.40	1,109.48	1,211.11	1,496.01	1,565.72
<b>FUNDS ASSETS (US\$ MILLION)</b>						
Life Insurance Funds	35,798.31	41,167.49	46,283.39	49,714.68	54,759.92	58,484.27
General Insurance Funds	7,050.50	8,007.89	8,674.30	9,452.75	10,136.17	11,066.31
Family Takaful Funds	2,910.42	3,445.57	4,074.94	4,701.49	5,326.93	5,875.29
General Takaful Funds	545.88	624.33	738.78	840.74	901.21	973.54
<b>INSURANCE / TAKAFUL OPERATORS' ASSETS (US\$ MILLION)</b>						
Life Insurance	NA	21,968.47	24,534.32	26,730.29	29,844.60	32,295.41
General Insurance	NA	5,776.47	6,814.69	7,234.80	8,396.67	8,585.45
Composite Insurance	NA	21,756.50	24,278.14	25,688.53	28,111.15	29,664.35
Professional Reinsurers	NA	860.30	996.30	1,088.49	1,167.95	1,268.54
Family Takaful	NA	0.00	37.34	116.64	217.40	274.95
Composite Takaful	NA	4,460.12	5,284.48	6,115.58	6,991.54	7,775.09
<b>CLAIMS RATIO</b>						
General Insurance	NA	61.6%	62.8%	66.6%	57.4%	57.5%
General Takaful	NA	57.0%	59.5%	67.8%	56.9%	53.6%

Source: BNM Monthly Statistical Bulletin

## Claims Ratio by Line of Business

		MARINE, AVIATION AND TRANSIT	CONTRACTOR'S ALL RISK AND ENGINEERING	FIRE	MEDICAL EXPENSES AND PERSONAL ACCIDENT	MOTOR	LIABILITY	WORKMEN'S COMPENSA- TION AND EMPLOYERS' LIABILITY	MISCELLA- NEOUS
FYE 2013	Insurance	38.50%	54.90%	48.00%	39.70%	72.15%	25.90%	22.10%	32.00%
	Takaful	10.49%	33.97%	20.93%	32.32%	63.99%	116.73%	6.87%	72.00%
FYE 2012	Insurance	47.30%	58.90%	44.10%	41.90%	74.40%	20.00%	28.40%	40.60%
	Takaful	20.63%	20.55%	16.93%	26.51%	69.55%	89.40%	-8.44%	109.84%

Source: BNM Monthly Statistical Bulletin

	2006	2007	2008	2009	2010	2011	2012	2013
<b>MARKET STRUCTURE<sup>1</sup></b>								
<b>No. of Registered Takaful Operators<sup>2</sup></b>	8	8	8	8	9	11	12	12
<b>No. of Agents</b>	15,194	43,843	60,197	88,895	74,089	100,308	105,552	77,804
Family	11,188	32,987	44,222	55,898	42,698	66,338	68,009	58,984
General	4,006	10,856	15,975	32,997	31,391	33,970	37,543	18,820
<b>No. of Offices</b>	151	154	157	104	197	207	213	215
<b>No. of Employees</b>	2,967	2,863	2,411	2,499	2,713	2,846	2,758	3,162
<b>NET CONTRIBUTIONS INCOME</b>								
<b>Total (RM million)</b>	1,720.90	2,565.00	3,025.10	3,521.80	4,421.80	4,863.00	5,887.80	6,204.50
<b>Combined Contributions (% of GNI)</b>	0.30	0.40	0.40	0.50	0.60	0.57	0.65	0.65
Family (% of GNI)	0.20	0.30	0.30	0.41	0.46	0.50	0.51	0.51
General (% of GNI)	0.10	0.10	0.10	0.12	0.14	0.13	0.15	0.15
<b>PER CAPITA CONTRIBUTIONS (RM) ON:</b>								
Family <sup>3</sup>	46.30	73.30	85.70	97.42	119.83	127.71	155.08	160.67
General <sup>4</sup>	17.90	21.30	23.50	28.81	36.42	39.98	44.51	46.84
<b>NET BENEFITS AND CLAIMS PAYMENTS</b>								
<b>Total (RM million)</b>	557.90	753.30	866.10	1,208.20	2,019.10	2,185.40	2,263.40	2,707.40
Family	400.80	534.70	632.00	904.00	1,599.60	1,660.40	1,635.90	1,999.80
General	157.10	218.60	234.10	304.20	419.40	525.10	627.50	707.60

Source: BNM Monthly Statistical Bulletin

1. As at 31 December; 2. Direct takaful operators; 3. As per revenue account; 4. Contributions on gross rate charged to participants without deduction for commission and brokerage. GNI: Gross National Income. Numbers may not necessarily add up due to rounding.

### 3. Selected Capital Markets Data

#### Capital Market

	2008	2009	2010	2011	2012
<b>MARKET CAPITALIZATION OF LISTED COMPANIES (US\$ BILLION, CURRENT PRICES)</b>					
Malaysia	187.07	255.95	410.53	395.08	476.34
Thailand	102.59	138.19	277.73	268.49	383.00
Indonesia	98.76	178.19	360.39	390.11	396.77
Singapore	180.02	310.77	370.09	308.32	414.13
Philippines	52.10	80.13	157.32	165.38	264.14
<b>MARKET CAPITALIZATION OF LISTED COMPANIES AS % OF GDP</b>					
Malaysia	80.98	126.55	165.85	136.45	156.04
Thailand	37.64	52.4	87.09	77.67	104.65
Indonesia	19.36	33.02	50.82	46.12	45.26
Singapore	93.65	161.52	156.54	112.5	144.34
Philippines	30.01	47.6	78.82	73.78	105.56
<b>TRADED STOCKS TURNOVER RATIO</b>					
Malaysia	33.24	32.94	27.10	32.00	28.60
Thailand	78.20	112.08	104.80	85.10	70.40
Indonesia	71.30	83.27	48.10	37.20	23.30
Singapore	101.56	102.80	82.90	74.80	43.30
US	404.07	348.58	189.10	187.60	124.60
UK	227.20	146.39	101.90	98.90	84.00
Philippines	22.16	26.01	22.55	20.36	16.15
<b>TOTAL VALUE OF TRADED STOCKS (AS % OF GDP)</b>					
Malaysia	36.89	36.08	36.44	44.52	40.78
Thailand	42.84	51.17	68.34	67.24	62.70
Indonesia	21.69	21.37	18.27	16.50	10.46
Singapore	140.93	131.11	119.34	92.60	54.53
Philippines	9.91	10.22	13.42	14.66	13.86

Source: World Bank

## Sukuk

	2008	2009	2010	2011	2012	2013	2014
<b>GLOBAL VS MALAYSIA SUKUK</b>							
Global Sukuk Issued (US\$ Billion)	21.38	35.06	52.62	86.40	140.72	119.47	114.08
Malaysia Issued (US\$ Billion)	11.86	23.43	41.03	60.93	106.02	82.39	77.00
Number of Malaysian Sukuk	122.00	136.00	308.00	413.00	573.00	641.00	521.00
Number of Global Sukuk	242	270	431	546	763	831	798
<b>MALAYSIAN SUKUK BREAKDOWN BY MARKET OF ISSUANCE (US\$ BILLION)</b>							
Domestic Market	11.31	21.93	38.57	58.85	105.50	80.13	70.00
International Market	0.55	1.50	2.46	2.08	0.52	2.26	7.00
<b>MALAYSIAN SUKUK BREAKDOWN BY SECTORS (US\$ BILLION)</b>							
Corporate	4.17	2.31	6.71	5.70	13.43	16.44	13.66
Quasi Sovereign	4.52	7.82	3.07	8.74	17.48	5.14	10.89
Sovereign	3.17	13.30	31.25	46.50	75.10	60.81	52.44
<b>MALAYSIAN SUKUK BREAKDOWN BY STRUCTURE (US\$ BILLION)</b>							
Murabaha	0.93	8.17	25.49	39.84	67.51	60.36	53.67
Bai Bithaman Ajil	3.44	7.60	5.73	9.23	14.36	9.77	9.24
Wakala	0.00	0.00	1.21	2.08	3.79	1.37	8.48
Musharaka	4.00	4.35	2.38	5.57	16.51	5.71	4.37
Ijarah	1.97	2.22	4.95	2.84	1.98	2.78	0.65
Baieinah	0.00	0.00	0.13	0.09	0.00	0.60	0.58
<b>MALAYSIAN SUKUK BREAKDOWN BY TENOR (NUMBER OF SUKUK)</b>							
> 1 Year	105	83	174	231	340	400	301
< 1 Year	17	53	132	180	222	237	220
<b>MALAYSIAN SUKUK BREAKDOWN BY RATING (NUMBER OF SUKUK)</b>							
Number of Rated Sukuk	100	89	197	278	338	333	284
Number of Unrated Sukuk	22	47	111	135	235	308	237

Source: Thomson Reuters Zawya

## Islamic Funds

	2008	2009	2010	2011	2012	2013	2014
<b>GLOBAL ISLAMIC FUNDS</b>							
<b>AUM (US\$ Million)</b>	28,349.44	39,656.79	47,248.78	47,146.97	56,839.67	57,587.46	60,654.64
<b>Number of Funds</b>	756	819	909	935	960	1063	1181
<b>GLOBAL ISLAMIC FUNDS LAUNCHED BREAKDOWN BY SELECTED COUNTRIES (US\$ MILLION)</b>							
<b>Malaysia</b>	3,231.50	752.80	232.54	980.11	433.42	605.96	1,068.53
<b>Luxembourg</b>	67.90	94.46	21.07	64.86	548.45	606.75	574.96
<b>Saudi Arabia</b>	259.73	115.61	57.28	430.58	573.36	197.54	275.34
<b>Indonesia</b>	37.42	139.78	26.95		64.02	183.96	128.42
<b>Pakistan</b>	12.54	51.02	167.08	30.74	28.55	72.77	172.02
<b>United Arab Emirates</b>	7.34	56.51		15.57	54.73		35.67
<b>Jersey</b>	6.29	5.03	185.66	6.12	11.62	13.55	10.75

Source: Lipper, Thomson Reuters

	AUM (US\$ MILLION)	NUMBER OF ISLAMIC FUNDS
<b>MALAYSIAN OUTSTANDING ISLAMIC FUNDS BY ASSET TYPE (FYE 2014)</b>		
<b>Bond</b>	1,971.87	48
<b>Equity</b>	10,167.67	123
<b>Mixed Assets</b>	1,087.84	83
<b>Money Market</b>	4,987.27	53
<b>Real Estate</b>	379.34	2
<b>MALAYSIAN OUTSTANDING ISLAMIC FUNDS BY ASSET UNIVERSE (FYE 2014)</b>		
<b>Mutual Funds</b>	17,519.19	231
<b>Insurance Funds</b>	926.44	45
<b>Exchange Traded Funds</b>	89.02	2
<b>Pension Funds</b>	59.34	33

Source: Lipper, Thomson Reuters



Women pose to take pictures with an art installation behind a shop building in Shah Alam, outside Kuala Lumpur. REUTERS/Samsul Said

# Acknowledgement

---

The Malaysia 2015 Islamic Finance Country Report is part of the series of reports produced in partnership by Thomson Reuters, the Islamic Research and Training Institute (IRTI) and the General Council for Islamic Banks and Financial Institutions (CIBAFI). The Report has been developed under the support of CIMB Islamic Bank, the Exclusive Strategic Partner.

The goals and motivations of this report follow in the same vein as the previous country reports – to serve the needs of the Islamic finance industry and to provide financial institutions, governmental bodies & associations, customers and other stakeholders with high quality intelligence and insights into the Islamic finance opportunity in Malaysia in order to help all parties make informed decisions. This report reflects the efforts of a broad and diverse group of experts.

The authors extend their appreciation to Bank Negara Malaysia and the Securities Commission for their extensive support during the preparation of the report.

The authors are also grateful as well to the International Islamic University Malaysia (IIUM), one of the Public Institutions of Higher Education in Malaysia, for facilitating the distribution of the retail consumer survey across the country's major cities.

We would like also to express our appreciation to Thomson Reuters' management, particularly Nadim Najjar (Managing Director, GGO Middle East, Africa and Russia) for his trust in and commitment to our work.

Sincerely,  
IFCR Team

## Main Authors

### Thomson Reuters



**Dr. Sayd Farook**  
Global Head Islamic Capital Markets  
Thomson Reuters



**Mustafa Adil**  
Head of Research & Product Development  
Manager – Islamic Finance



**Ammar Radhi**  
Project and Team Leader  
Research & Product Development  
Manager – Emerging Markets Specialist



**Emmy Abdul Alim**  
IFG Global Editor



**Shaima Hasan**  
Research & Product Development  
Manager – Islamic Capital Markets



**Ameena Al-Haddad**  
Senior Research Analyst



**Redha Al-Ansari**  
Senior Islamic Capital Markets Analyst



**Shereen Mohamed**  
Research Analyst



**Zahraa Eid**  
Research Analyst

### Islamic Research & Training Institute



**Prof. Mohamed Azmi Omar**  
Director General



**Dr. Turkhan Ali Abdul Manap**  
Team Leader  
Senior Economist



**Dr. Abdul Ghafar Ismail**  
Manager, Research Division



**Dr. Ousmane Seck**  
Senior Economist



**Dr. Mohammed Obaidullah**  
Senior Economist



**Dr. Hylmun Izhar**  
Economist



**Yahya Aleem ur Rehman**  
Manager, Advisory Division



**Mehmet Fehmi EKEN**  
Islamic Finance Specialist



**Ahmed Fadhlan Yahaya**  
Shari'ah Specialist



**Khalid Jawakhir**  
Islamic Finance Specialist

Report Design: Kung Pik Liu, Founder, Studio of KUNG PIK LIU

#### DISCLAIMER

The data in this report are believed to be correct at the time of publication but cannot be guaranteed. Please note that the findings, conclusions and recommendations that Thomson Reuters, IRTI or CIBAFI deliver will be based on information gathered in good faith from both primary and secondary sources, whose accuracy we are not always in a position to guarantee. The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of Thomson Reuters, IRTI or CIBAFI. As such the information contained in this report is intended to provide general information only and, as such, should not be considered as legal or professional advice or a substitute for advice covering any specific situation. Thomson Reuters, IRTI or CIBAFI specifically disclaims all liability arising out of any reliance placed on this material. Thomson Reuters, IRTI or CIBAFI makes no representations or warranties of any kind, express or implied about the completeness, accuracy, reliability or suitability of this material for your purposes.

#### Thomson Reuters 2015 All Rights Reserved.

The material in this report is subject to copyright. Because Thomson Reuters, IRTI and CIBAFI encourage dissemination of their knowledge, this work may be reproduced, in whole or in part, for noncommercial purposes as long as full attribution to this work is given.

# Contribution & Interviews Conducted

---

**Tan Sri Dr. Zeti Akhtar Aziz**  
Bank Negara Malaysia Governor

**Datuk Ranjit Ajit Singh**  
Chairman, Securities Commission Malaysia

**Datuk Dr. Mohd Daud Bakar**  
Group Chairman, Amanie Advisors

**Datuk Dr. Nik Norzrul Thani**  
Chairman of Zaid Ibrahim & Co.

**Professor Datuk Rifaat Ahmed Adel Karim**  
CEO, IILM

**Badlisyah Abdul Ghani**  
CEO, CIMB Islamic

**Dr Amat Taap Manshor**  
CEO, Finance Accreditation Agency

**Rafe Haneef**  
CEO of HSBC Amanah

**Azim K. Mithani**  
CEO of Prudential BSN Takaful

**Selamat Hj Sirat**  
CEO of Al Rajhi Bank (Malaysia)

**Muzaffar bin Hisham**  
CEO, Maybank Islamic Berhad

**Ir Ahmad Hadri Haris**  
CEO, Malaysian Green Technology Corporation

**Prof. Dr. Mohamad Akram Laldin**  
Executive Director of ISRA

**Prof. Dr. Ashraf Hashim**  
CEO Of ISRA Consultancy,

**Liya Saffura Ab Rashid**  
Associate of Zaid Ibrahim & Co.

**Madzlan Hussain**  
Partner and Head, Islamic Financial Services Practice, Zaid Ibrahim & Co.

**Asghar Ali Syed**  
Counsel, Asian Development Bank

**Datin Dr. Siti Hamisah Tapsir**  
Deputy Director General, Department of Higher Education, Ministry of Malaysia

**Promod Dass**  
Deputy CEO , RAM

**Chan Yin Huei**  
Manager of Financial Institution Ratings, RAM

**Sazalina Kamarudin**  
Head of Legal & Corporate Affairs, RAM

**Roseta Mohd Jaafar**  
Vice President Corporate Communication, Al Rajhi Bank

**Arshad Mohamed Ismail**  
Executive Vice President

**Prof. Dr. Norma MD Saad**  
International Islamic University Malaysia

**Zainal Izlan Zainal Abidin**  
Executive Director, Islamic Capital Market

**Dr. Ahmet Suayb Gundogdu**  
Manager at the Corporate and Structured Finance Department ,IDB Group

**Professor Christine Ennew**  
Pro-Vice-Chancellor and Provost, University of Nottingham – Malaysia Campus

**Dr Nafis Alam**  
Associate Professor of Finance and Director of Centre for Islamic Business and Finance Research (CIBFR) , University of Nottingham – Malaysia Campus

**Dr. Marjan Muhammad**  
Director of Research, Research Affairs Department at the International Shari'ah Research Academy for Islamic Finance (ISRA)

**Shabana M. Hassan**  
Editor of ISRA Magazine and the Manager of the Advisory and Research Department



Exclusive Strategic Partner



A MEMBER OF



THOMSON REUTERS™



CIBAFI

المجلس العام للبنوك  
والمؤسسات المالية الإسلامية  
General Council for Islamic  
Banks And Financial Institutions