La Trobe Business School

Islamic Finance in Asian Hubs – *Lessons for Australia*

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Content

- **Introduction to Islamic Finance**
- **Islamic Finance in Asian Hubs**
- **Some concluding remarks**

Introduction to Islamic Finance

Introduction

The recent global financial crisis seems to have increased enormous interest around the world in the soundness and resilience of the Islamic finance model. This is plainly evident by, among others:

- initiatives undertaken by advanced economies such as France, Japan and the Republic of Korea to introduce new laws that accommodate the issuance of Sukūk (Islamic trust certificates);
- notwithstanding the liquidity crunch, Indonesia has successfully raised funds through its inaugural sovereign Sukūk and Malaysia has issued (a largest) second global sovereign Sukūk;
- at this time when 216 conventional banks have failed since 2008 up to March 2010 in the US alone*, new Islamic banks seems to be mushrooming everywhere including in China and Kazakhstan.

What is Islamic Finance?

- In a nutshell, Islamic finance is finance that is consistent with Shariah or Islamic law. It promotes the five objectives of the Shariah, namely the preservation and well-being of the religion, life, lineage, intellect and property.
- On a more technical side of it, amongst the important features of Islamic finance is that it prohibits contracts and transactions that incorporate:
  - *riba* (i.e. usury; interpreted to include all forms of interest payments);
  - *gharar* (i.e. dubious ambiguity in contracts, aimed at unjustly favouring one party at the expense of the counterparty);
  - *maisir* (i.e. excessive speculation to the level of betting/gambling); and
  - *zulm* (i.e. acts that are considered to be oppressive and abusive to the health and moral of the society. Therefore, investments in certain sectors such as alcohol, tobacco, weaponry, and gaming are strictly forbidden).
- All these prohibitions are explicitly mentioned in the Quran, which is the main source of the Shariah, and underline Islamic finance's strong objection against all forms of unjust enrichment.

How is Islamic Finance different from conventional finance?

- A direct effect of the Shariah prohibition against *riba* is of course that lending and borrowing on interest or the assumption of undue risk cannot be practised. Islamic financiers are therefore inhibited in using derivatives or other hedging contracts, short selling, insurance in the conventional sense or other interest-based risk-mitigating techniques.
- As a result Islamic finance resorts to various types of commercial contracts that can legitimately earn profits or returns to the financiers, on fair terms to the financed party. These include:
  - contracts of exchange (*‘uqud al-mu’awadat*);
  - contracts of security or collateral (*‘uqud al tawthiqat*);
  - contracts of partnership (*shirkah*);
  - contracts of safe custody (*wadi’ah*);
  - contracts pertaining to the utilisation of usufruct (*‘uqud al manfa’ah*) and
  - contracts pertaining to provide a service or manufacture a good, for e.g. under an agency (*wakalah*) or commission (*ju’alah*).
- For Shariah governance, a board of Islamic scholars is established by each Islamic bank to vet through the transactions for compliance with Shariah principles.

Islamic Finance Market is still evolving

- Islamic Financial Market will be tested in the recent global financial crisis as well as other financial crises.
- Various standards, conduct and prudential position of Islamic Finance will be challenged during a period of stress.
- This will require considerable cooperation and developmental work by academics, Shariah scholars and regulators and standard setters, such as the Islamic Financial Services Board, to work on these challenges.

Engine of Growth – Various Factors

- While it is true that the petro-dollars have been a catalyst for the growth of Islamic finance especially in recent years, it has to be acknowledged that it is not the only driver of the industry's success. Even before the world petrol price was sky-rocketing, the Islamic financial services industry has been enjoying a steady 15-20% annual growth since its first inception in the 1970s.
- By relying less on the oil boom, Islamic finance can focus on tapping other sources of funds and investments, especially in other growing industries such as hospitality and services, commodity and minerals, manufacturing and advanced technology, etc. This diversification would garner better stability into its framework.

Engine of Growth – Various Factors …(2)

- Various reports, such as by Standard & Poors, and those commissioned by the government authorities in Australia, France, and the UK, among others identified that the rapid growth of Islamic finance is driven by the following factors:
  - an increasing awareness amongst the Muslim population on the availability and feasibility of Islamic financial products that adhere to the Shariah without comprising on efficient wealth generation and risk management;
  - development of innovative Shariah compliant instruments and licensing of new market players that add depths and choices to cater for different segments of the market;
  - tax and fiscal incentives from the government, that allows competitive pricing for Shariah compliant financing and investment structures;
  - intensive restructuring and diversification of the economy, whereby countries started embarking on massive infrastructure projects that are financed through Shariah compliant means;
  - globalisation contributed to Islamic financial institutions expanding their operations beyond their traditional borders;
  - resilience of Islamic finance in surviving the financial tsunami, although not entirely unscathed, has attracted new interest in its fundamental principles and business models.

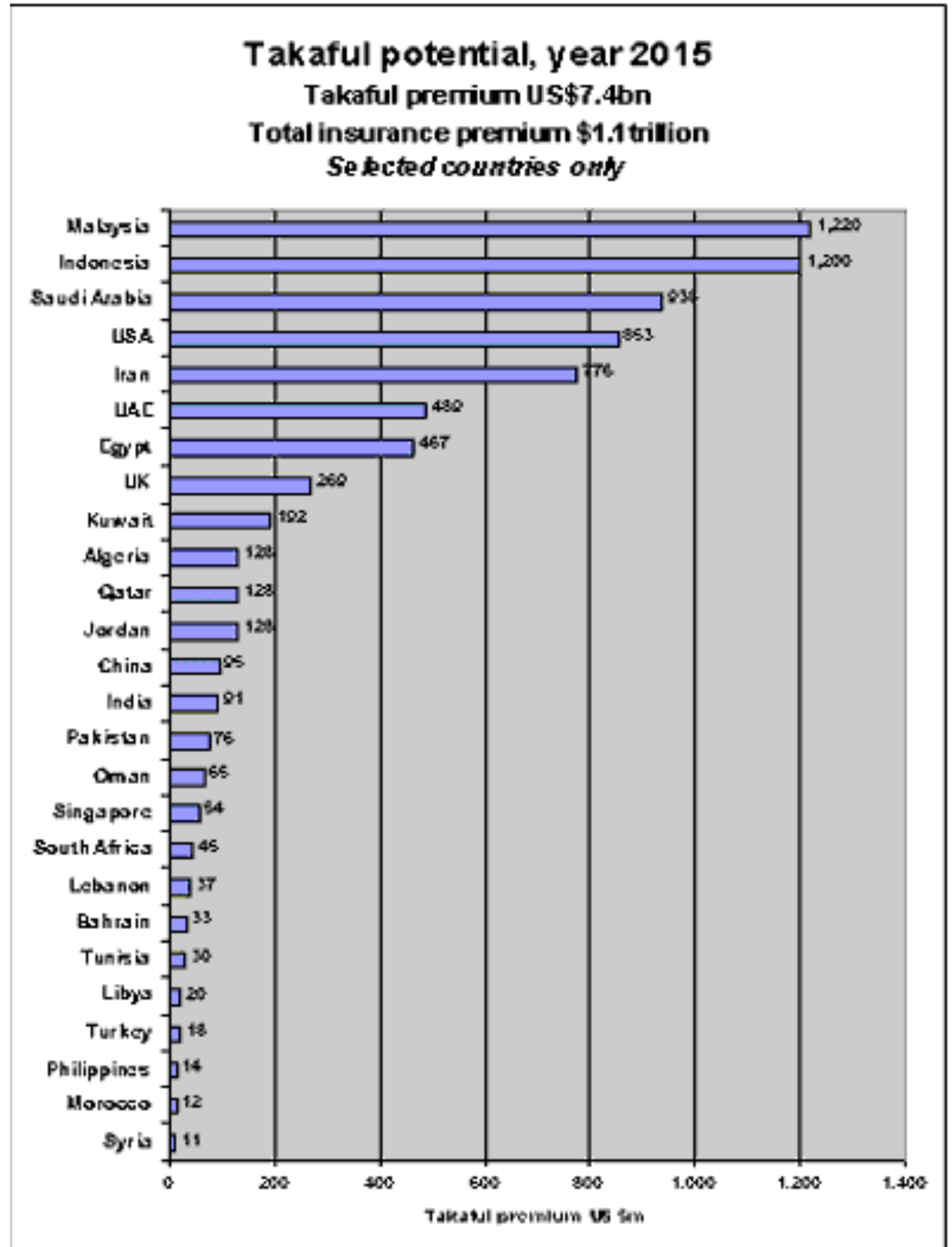
Distributions of Muslims in Asia Pacific

Engine of Growth – Various Indicators

TOP 10 COUNTRIES BY VALUE OF SHARIAH-COMPLIANT ASSETS, 2009

Rank	Country	Shariah-compliant assets US$bn
1	Iran	293.2
2	Saudi Arabia	127.9
3	Malaysia	86.5
4	United Arab Emirates	84.0
5	Kuwait	67.6
6	Bahrain	46.2
7	Qatar	27.5
8	United Kingdom	19.4
9	Turkey	17.8
10	Bangladesh	7.5

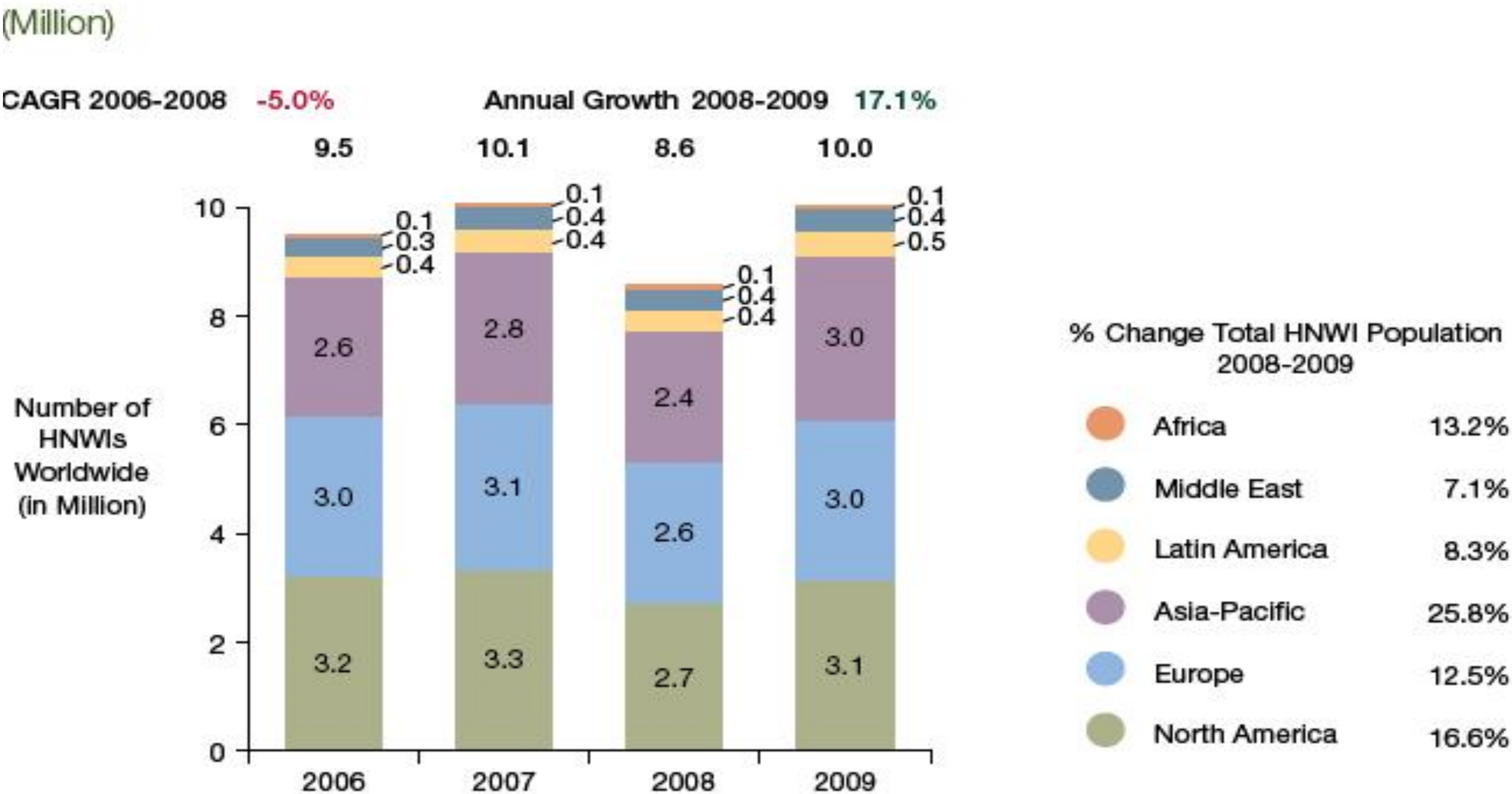
Source: The Banker, *Top 500 Islamic Financial Institutions*, November 2009, p.4.



Source: IIBI

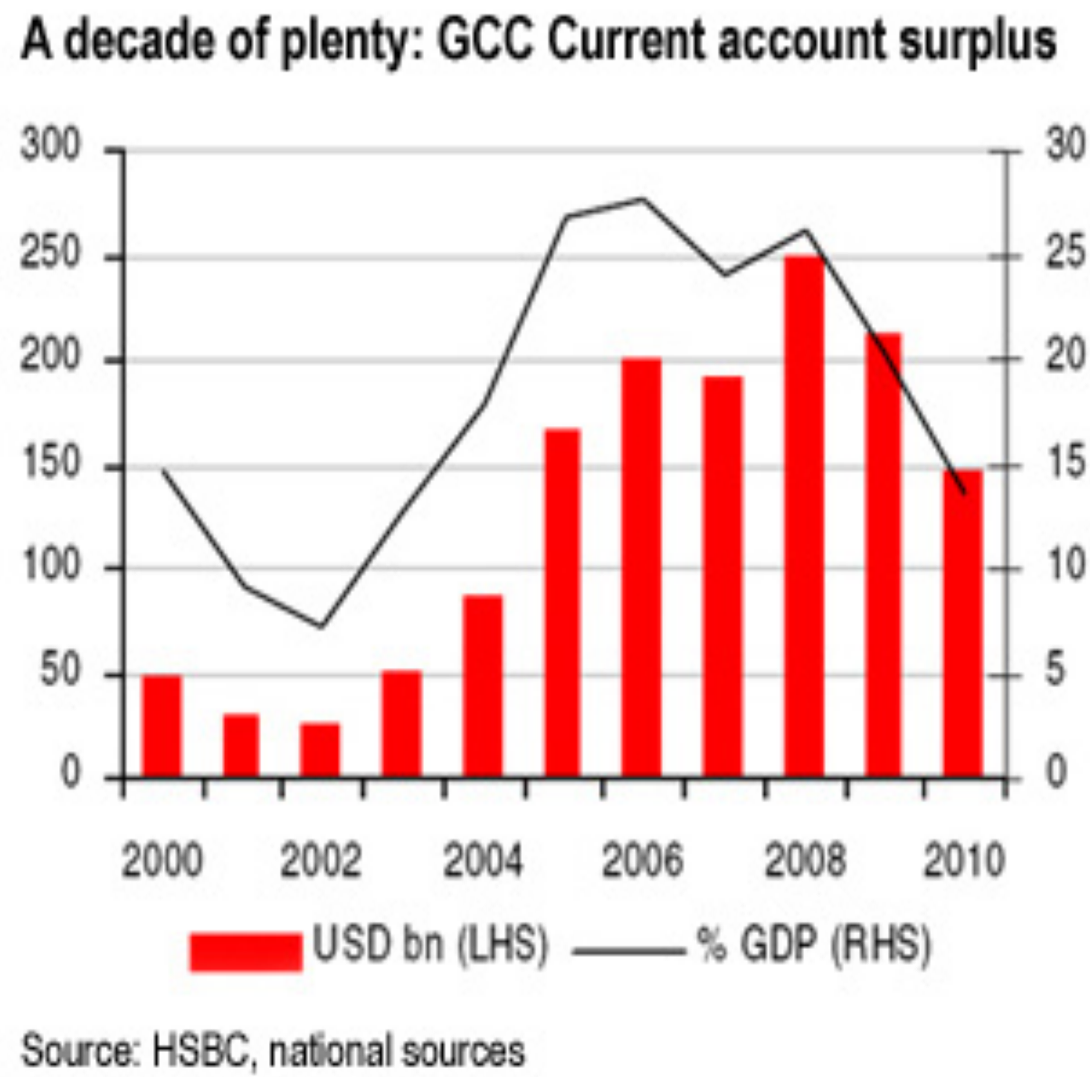
Indicator of High Net Worth Individual Wealth in Asia Pacific

FIGURE 1. HNWI Population, 2006 – 2009 (by Region)



Note: Chart numbers may not add up due to rounding
Source: Capgemini Lorenz curve analysis, 2010

WHAT THEY ARE COMPETING FOR …



Islamic Finance in Asian Hubs

Inherent risks in Islamic finance

- **Real economic shocks of large magnitude**

  E.g: Real estate bubble burst in Dubai

- **Aggressive investment strategies not backed by appropriately designed risk management framework**

  E.g: Reverse murabahah/tawarruq transactions

- **Violation of Sharī'ah principles or the fiduciary responsibilities may result in crisis of confidence**

  E.g: The Investment Dar v Blom Bank case

These risks confirmed the need for robust and consistently applied global standards of prudent risk management and other supporting infrastructure for safeguarding financial stability in the Islamic financial system

The Washington Times — MONDAY, *MARCH 30, 2009*

SPECIAL REPORT

MALAYSIA
THE CAPITAL OF ISLAMIC FINANCE

INSIDE

Understanding Islamic finance: The essence and the practice

....page 3

Ahead of the curve: Malaysia's leadership role in the growth of Islamic finance

Islamic finance is ethical finance

An interview with Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia

Question: What is the Islamic finance market learning from the global financial crisis, and how is it positioned both to survive the current period and perhaps even to emerge more successful?

Dr. Zeti: First of all, when Islamic finance is practiced, it should be embraced in its entirety, in full Shariah compliance – that is the lesson that I think has been

Malaysia's gradual & holistic approach to Islamic finance…

1983 – Inception stage
Building foundation of legal, regulatory & Shariah framework

Inception stage
Instituting foundations of Islamic finance

- Financial inclusion to fulfill Muslim's needs
- Mobilisation of deposit started by Pilgrimage Fund (1963)
- Relevant acts were enacted
- 1st Islamic bank & takaful operator
- Shariah Committee
- 1st Islamic Sukuk

1993 – Intermediate stage
Increase number of players, develop financial markets & enhance Shariah governance

Intermediate stage
Institutional building, stimulate competition, activity generation & market vibrancy

- Islamic windows
- 2nd Islamic bank (1999)
- 2nd takaful company (2000)
- Islamic money market
- Shariah Advisory Council

2001 – Advanced stage
Market liberalisation, upgrading infrastructures, strengthen overall Islamic finance landscape

Advanced stage
Strategic positioning & international integration

- FSMP – 10 year roadmap
- Foreign Islamic banks
- Islamic subsidiaries
- New takaful & retakaful licences
- Tax neutrality policy

- IBFIM
- INCEIF

Talent & research development

- ISRA
- Central Bank Act 2009
- MIFC MALAYSIA INTERNATIONAL ISLAMIC FINANCIAL CENTRE

1983 1993 2001 2010 & beyond

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

Government & regulators have pivotal role in developing progressive and sustainable Islamic finance…

Islamic Banking | Islamic Money market | Islamic Capital market | Takaful

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

- Regulates banks & insurance/ takaful
- Ensure financial sector stability with sound financial institutions & functioning financial infrastructure
- Formulates policies/ strategies to develop financial system

Suruhanjaya Sekuriti
Securities Commission
Malaysia

- Regulates capital markets activities & fund management
- Conducts regulatory functions (e.g. processing & approval of sukuk, licensing & supervising licensed person, ensuring proper conduct by market players)
- Ultimately responsible to protect the interest of investors

Government

- Issue Islamic government securities to create benchmark yield curve
- Providing tax neutrality platform
- Supportive visa application of expatriate & employments

Sources: Central Bank of Malaysia (Bank Negara Malaysia), Securities Commission Malaysia, Malaysia Deposit Insurance Corporation

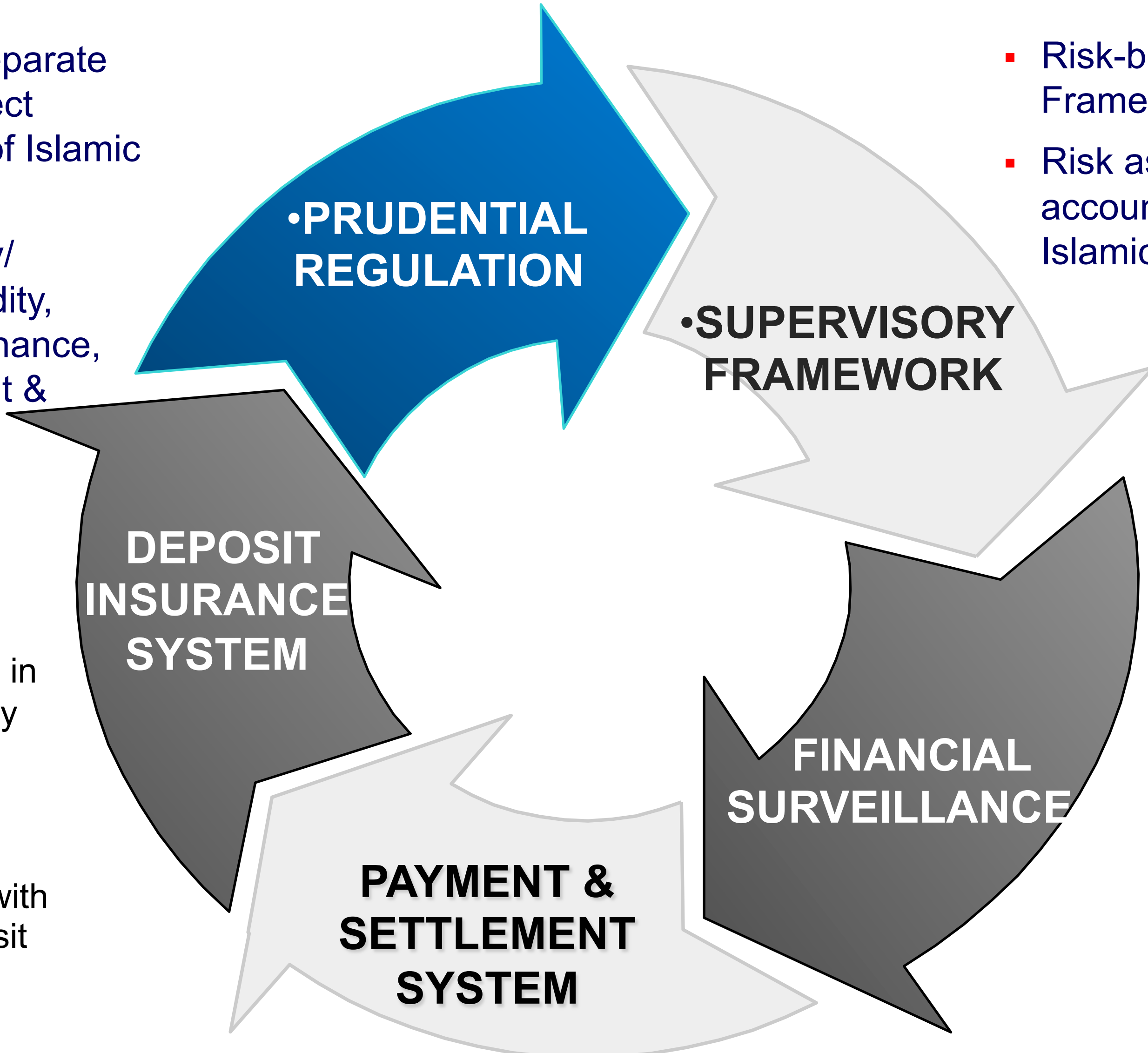
Recognition of dual financial system with conventional & Islamic financial system running in parallel…

New Central Bank of Malaysia Act 2009	**Government & BNM have been the main drivers in ensuring Islamic Finance remain competitive & robust… CBA as an impetus…**
Islamic Financial System	**Section 27: The financial system shall consist of conventional & Islamic financial system**
Distinctiveness of Malaysia	**Multi-racial & multi-religious fabric of the community warrant dual financial system policy**
MIFC	**Section 60: BNM has the role to develop Malaysia as an international Islamic financial centre**
Shariah Advisory Council as the highest authority for ascertainment of Islamic law in Islamic financial business	**Section 56(1):** **The court or arbitrator shall take into account published rulings of BNM's Shariah Advisory Council (SAC) & to refer any Shariah questions to the SAC for its ruling** **Section 57:** **Rulings of SAC shall be binding on Islamic financial institutions, courts or arbitrators and these rulings are final**

Robust regulatory & supervisory framework in ensuring financial stability of Islamic financial system…

- Formulation of separate guidelines to reflect distinct features of Islamic finance
- Capital Adequacy/ Solvency & Liquidity, Corporate Governance, Risk Management & Disclosure

- Risk-based Supervision Framework
- Risk assessment taking into account the uniqueness of Islamic banking & takaful



- Protect depositors in the event of liquidity crisis
- Separate Islamic deposit insurance operating parallel with conventional deposit insurance

- Continuous surveillance at macro & micro level that includes Islamic Financial Institutions

- Minimise settlement risks
- Separate Islamic accounts from conventional at national levels

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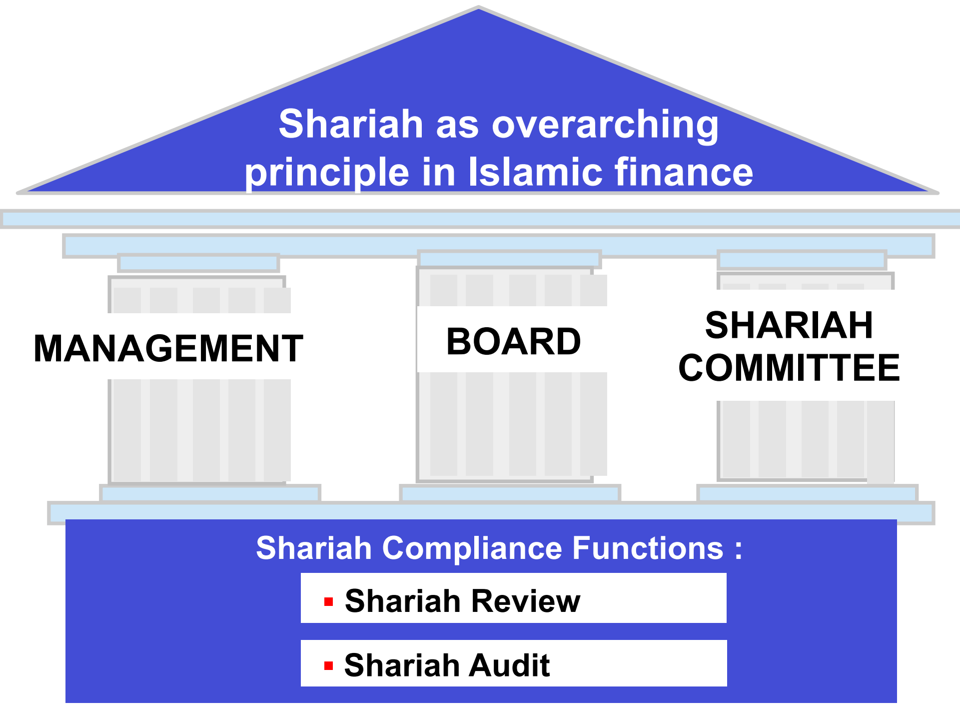
A credible Shariah governance structure that promotes integrity and confidence…



Malaysia's experience:

- Proper governance provides multi-layer assurance on Shariah compliance
  1. **Shariah Advisory Council** given legislative stature as highest authority for Shariah matters in Islamic finance
  2. Accountability of **Shariah committee of IFIs** on decision, views & opinions related to shariah matters
  3. **Board & senior management** with sufficient expertise & capability in dealing with issues specific to Islamic financial transactions
  4. Emphasise the function of **Shariah review & Shariah audit** to provide check & balance
  5. Timely disclosure on fatwa rulings
  6. Institutionalise mutual respect by recognising differences of Shariah interpretations in various jurisdiction

SINGAPORE

- All banking and financial activities in Singapore, including those by IBF Institutions, are regulated by Monetary Authority of Singapore (MAS). IBF Institutions interested in establishing a presence in Singapore will be assessed based on the existing admission framework.
- Regulations are being reviewed to accommodate and facilitate the development of IBF, for example, in September 2005, regulations were introduced to allow banks in Singapore to offer financing based on the *Murabahah* concept.
- First full-fledged IBF Institution, Islamic Bank of Asia, established in May 2007. IBF products and services are currently offered in a few conventional banks in Singapore via Islamic windows. *Takaful* has been successful, with over S$500 million *Takaful* funds under management.

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SINGAPORE (2)

- About S$2 billion *Shari'ah*-compliant real estate funds managed out of Singapore. A *Shari'ah*-compliant pan-Asian equity index was launched in 2006.
- 2010 saw several *firsts* for Singapore:
  - First S$ *Sukuk* issued by Khazanah Nasional through an SPV called Danga Capital Ltd. was the largest *Sukuk* issuance in Singapore (S$1.5b); largest fixed income fund raising by a foreign entity and the first quasi-sovereign fund raising in Singapore
  - SABANA real estate investment trust (REIT) of US$400 raised and listed in Singapore is the largest Islamic REIT ever

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HONG KONG

- **Recent Developments**
  - authorisation of the first retail Islamic fund for sale to the Hong Kong investing public in November 2007
  - Khazanah Nasional Berhad successfully issued a US$550 million Islamic exchangeable trust certificate, on the Hong Kong Stock Exchange, in March 2008. That Sukuk, which is exchangeable into shares of Parkson Retail Group, was well received by investors as the offering was 10 times over-subscribed.
  - In August 2008, the HKMA gave permission for the operation of the first Islamic banking window in Hong Kong by Hong Leong Bank ("HLBHK"), with an initial focus on Islamic deposit-taking business backed by commodity trading (Commodity Murabahah Deposits). In November 2008, HKMA also gave permission to CIMB Bank Hong Kong to operate an Islamic banking window in Hong Kong.
  - Hong Kong Monetary Authority ("HKMA") has signed MOUs with Dubai and Malaysian authorities to establish the foundation for co-operation in the development of Shariah-compliant financial products and the financial infrastructures. In particular, that MOU sets out the framework regarding the identification of the means to foster Islamic financial activities on a cross-border scale between Dubai and Hong Kong, such as the trading of Sukuks and other Shariah-compliant financial instruments, as well as to enhance co-operation of the financial infrastructures between the two regions, in particular the payment systems.

HONG KONG

- **Value Propositions:**
  - Hong Kong has been the Number 1 as the world's freest economy for the last 15 years (the Heritage Foundation league table)
  - Hong Kong has a judicial system where common law is practiced and we have no foreign exchange control.
  - In July 2008, Hong Kong's long-term foreign and local currency sovereign ratings were upgraded to "AA+" from "AA" by Standard and Poor's with a "stable" outlook. Its market also enjoys high transparency in its policies and regulations, and provides market players with a level playing field.
  - The only jurisdiction outside mainland China where banks may conduct business in renminbi – providing access to the increasingly important currency

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INDONESIA

Islamic Banking System in Indonesia

- **Regulatory Base**:
  - Central Bank Act No. 23 of 1999 (amended by Act No. 3 of 2004).
  - Banking Act No 7 of 1992 (amended by Act No. 10 of 1998).
  - Deposit Insurance Act No. 24 of 2004
  - Islamic Banking Act No. 21 of 2008.
  - Islamic Sovereign Bond (Sukuk) Act No. 19 of 2008.

- **Bank Types**:
  - Conventional Banks: Commercial Banks and Rural Banks.
  - Islamic Banks: Islamic Commercial Banks (BUS), Islamic Banking Units (UUS)and Islamic Rural Banks (BPRS).

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INDONESIA (2)

International Standard adoption (with national condition adjustment):

- IFSB (Capital Adequacy, Corporate Governance, Risk Management, Transparency and Market Discipline, Shariah Governance).
- AAOIFI (Islamic Banking Accounting Standard, Islamic Banking Accounting Guidance).

- **Islamic Financial Markets Infrastructures**:
  - Islamic Interbank Money Market (PUAS).
  - Bank Indonesia Shariah Certificate (SBIS).
  - Islamic Government Securities (SBSN).

- **Deposit Insurance Institution:**
  - Indonesia Deposit Insurance Corporation (LPS).
  - Deposits in Islamic banks are guaranteed by LPS (max IDR 2 billion).

Engines of Growth

- **Muslim Population:**
  - 237 million people (National Survey 2010).
  - 88% are Muslim.
- **Economic Performance:**
  - GDP = Rp6,422 trillion or USD700 billion (the 18th highest GDP in the world – world bank report 2009).
  - A single digit inflation in the last 2 years.
  - A stable Rp exchange rate in Rp9,000-Rp10,000/USD.

Islamic Banking Performance:

- A high growth of Islamic banking industry: 37.9% (the last 5 Y)
- A high Financing to Deposit Ratio (FDR): 89.67% (Dec 2010).
- A low Non Performing Financing (FDR): 3.02 (Dec 2010).
- Investment based financing is 34% while trade based financing is only 55% of the total financing.
- Islamic banking offices are available in all provinces.

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INDONESIA (4)

IBF Performance Indicators

	2001	2008	2009	2010
Islamic Comm Banks	2	5	6	11
Islamic Banking Units	3	27	25	23
Islamic Rural Banks	81	131	139	150
Number of Offices	96	951	1.223	1.763
Total Assets	2.7 T	51.3 T	68.2 T	100.8 T
Total Deposits	1.8 T	36.8 T	52.27 T	76.0 T
Total Financing	2.0 T	38.2 T	46.8 T	68.18 T
Deposit Accounts	328.115	3.766.067	4.537.565	6.053.658

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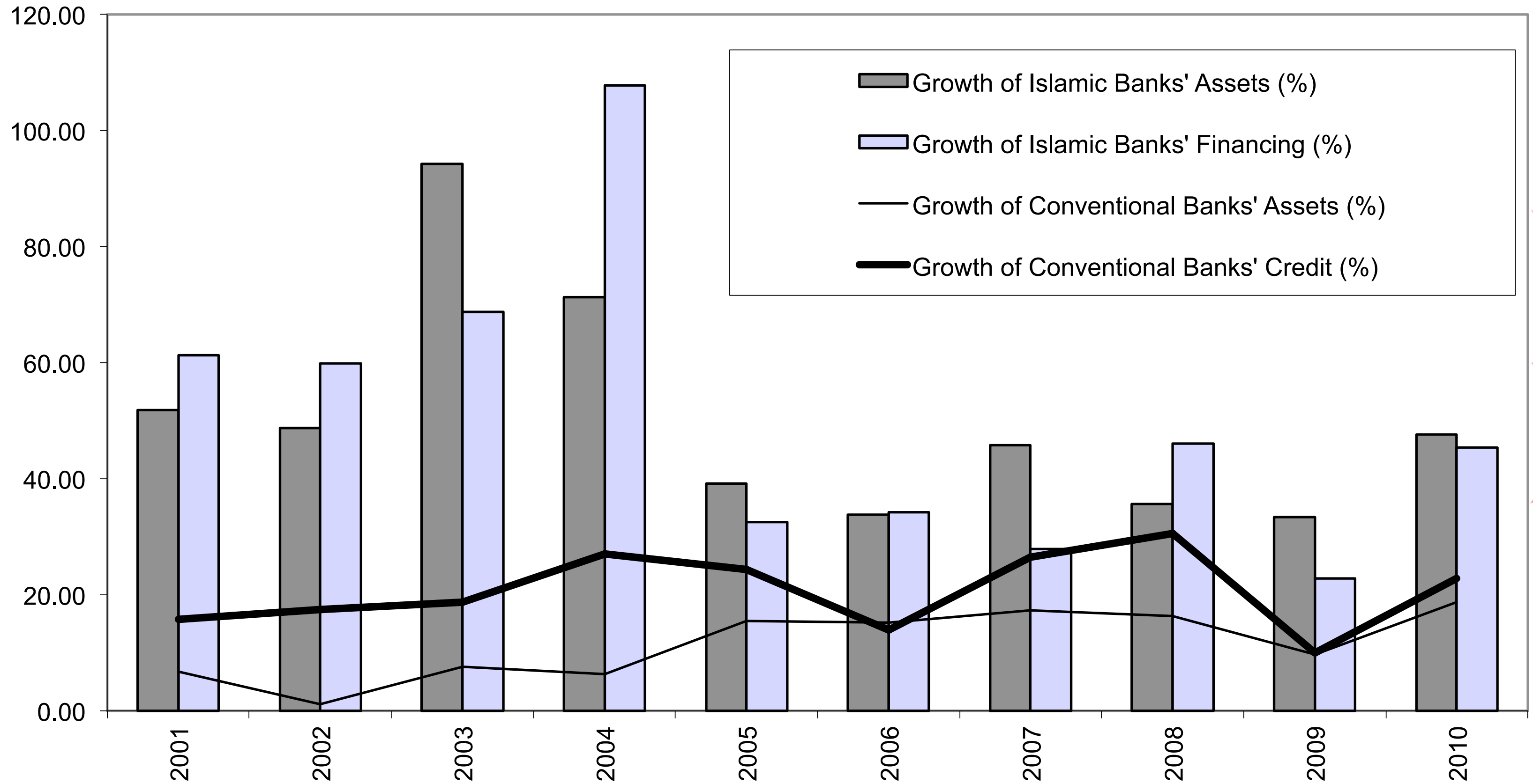
Islamic Banking Performance

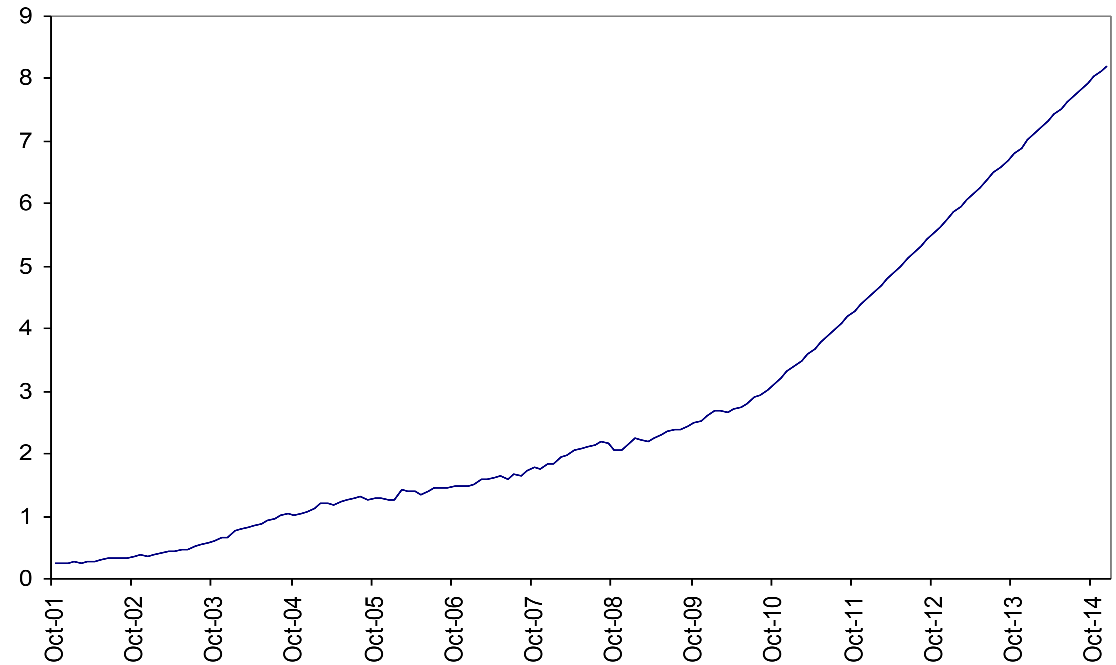
- **Office Channeling of Islamic Bank (2005-2007)**
- **Marketing & Promotion Grand Strategy (2008)**
- **Islamic Bond (Sukuk) Act (2008)**
- **Islamic Banking Act (2008)**
- **Tax Neutrality Act (2009)**

	2009	2010
Islamic Banks		
BUS	6	**11**
UUS	25	**23**
BPRS	139	**150**
BUS & UUS Offices	1.223	**1.763**
Offices Growth	19,5%	**44,5%**

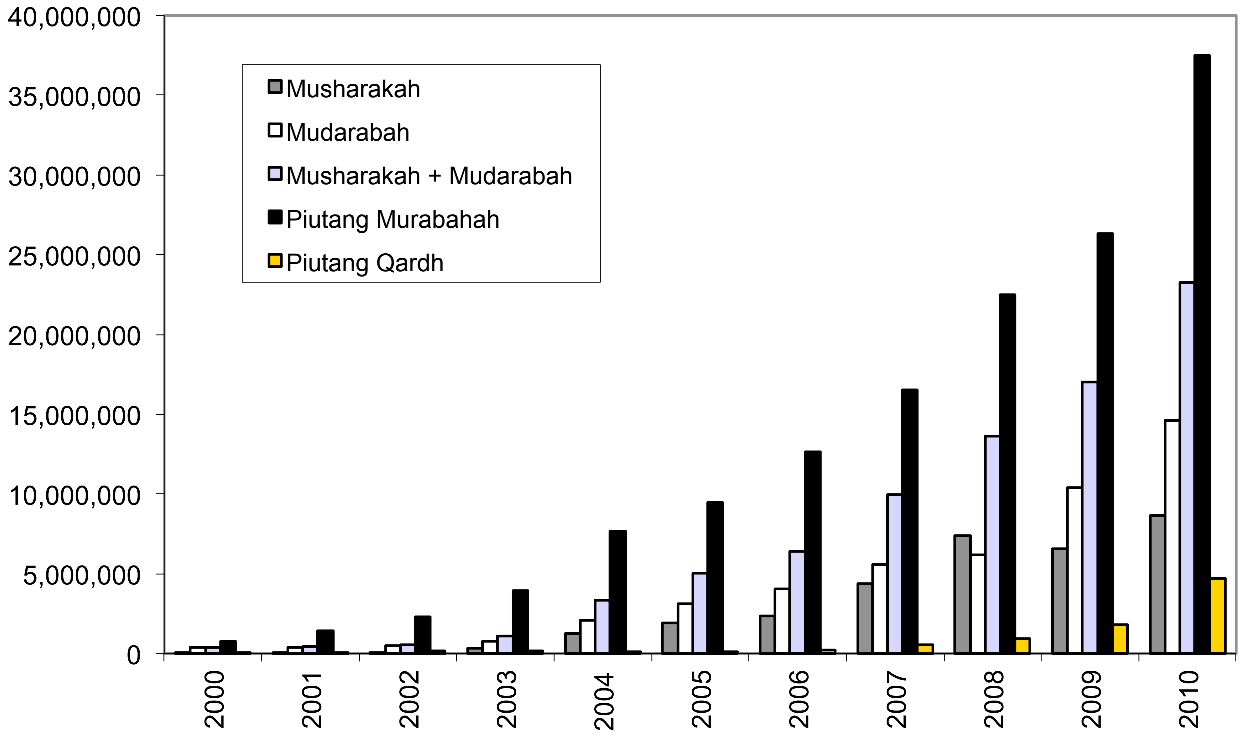


The growth of Islamic banks is higher than conventional banks

IBF Performance



Consistent Growth in the Market Share of Islamic Banking



Increasing Trend of Financing, particularly the Equity based Financing.

UAE/DUBAI

- In Dubai, investors need to be aware of the application of two different set of regulatory schemes, namely the UAE-wide framework and the framework under the Dubai International Financial Centre ("DIFC"). In this respect, there are three regulatory and supervisory authorities who oversee the financial markets in Dubai, namely the **UAE Central Bank**, the Emirates Securities and Commodity Authority ("ESCA") and the **Dubai Financial Services Authority** ("DFSA").

The DIFC

- In 2002, the Dubai government issued a decree to establish DIFC and established an independent regulatory and supervisory authority for DIFC, the DFSA. DIFC is an onshore financial centre, offering a convenient platform for leading financial institutions and service providers. DIFC has been established as part of the vision to position Dubai as an international hub for financial services, and as the regional gateway for capital and investment.

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UAE/DUBAI (2)

- The DFSA regulates all financial and ancillary services conducted in or from the DIFC; as well as licensing, authorising and registering businesses to conduct those services. The DFSA's regulatory framework was developed by a team of regulators and legal experts drawn from internationally recognised regulatory bodies and major financial institutions around the world and is based on the practices and laws of the world's leading financial jurisdictions.
- The DIFC laws are exceptional in that they form a separate framework based on English common law system, in order presumably to provide more comfort for international financial institutions and players. The DIFC even has its own court staffed by international judges. The DIFC legal system therefore attempted at departing from the existing UAE and Dubai legal system which is a civil law system based on *Sharī'ah.*
- An e.g. of the DIFC's attempt at providing a more conducive legal environment to support the growth of Islamic financial market is that, while the UAE and Dubai law does not have any trust law framework, the DIFC itself has published a dedicated framework for the registration of special purpose vehicles for *Sukūk* issuers with all the trust features in place. Thus, while many earlier *Sukūk* structures in Dubai, had to resort to setting up their SPVs in common law based offshore centres such as The Cayman Island and BVI, they can now establish such SPV under the DIFC regime.

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BAHRAIN

- Prudential Information and Regulations for Islamic Banks (PIRI) framework was introduced in 2000, covering areas such as capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management.
- The not-for-profit Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) established in 1991 and issues standards on accounting, auditing, governance and *Sharīah* practices. Islamic finance players in Bahrain are required to comply.
- First Islamic Bank is Bahrain Islamic Bank (1979). They now have about 30 Islamic finance Institutions licensed in Bahrain, including full commercial banks, investment banks and offshore banking units.
- Also host several “infrastructure institutions” such as the International Islamic Money Market (IIFM), International Islamic Rating Agency (IIRA) and General Council for Islamic Banks and Financial Institutions (CIBAFI).

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IRAN

- Revolution in 1979 brought in a fully Islamized banking system.
- Number of interest-free financial institutions increased from around 200 in 1979 to 6,000 presently.
- Usury-free law often used to be violated, forcing the Cabinet to waive the Central Bank's supervisory power hand over to the Interior Ministry and the police force – only reinstated in 2003.
- Banks are obliged to earmark a portion of their resources to help achieve the socio-economic objectives of the country through *qard hasan* loan.
- Article 15 of the Law for Usury (Interest)-Free Banking makes Islamic banking contracts as binding legal documents, enforceable even without a court order – attracting many suits.

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SAUDI ARABIA

- *Sharīah* is the law of the land, so in principle the banking system is supposed to be usury-free.
- Earliest banks in the country were foreign-owned, thus conventional. Banking Control Law 1966 does not treat conventional banks or Islamic banks differently.
- Following experience of banks failing to recover loans in *Sharīah* courts due to the delicate issue of interest/*riba,* separate committees for settlement of disputes were established for banking, insurance and securities.
- Despite the ambiguity caused by dualism of having full *Sharīah*-based legal system but largely conventional-like banking system, in recent years Islamic finance industry has been thriving in Saudi Arabia – evident by, for example, the growth of Al-Rajhi Bank as one of the largest Islamic banking group in the world, and the conversion of National Commercial Bank (eldest local bank) to full-fledged Islamic bank.

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KAZAKHSTAN

- **Regulatory Base**:
  - Islamic Banking Law 2009
- **Islamic Bank licence**:
  - Al-Hilal Bank (UAE)
  - Fattah Finance Consortium
- **Value Propositions:**
  - 16 million people (75% are Muslim)
  - Massive resources and land mass – amongst largest in the world
  - Strongest financial sector in the CIS
  - Proven oil reserves – no. 11 biggest in the world

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Some Concluding Remarks

Key Legal Considerations

Most jurisdictions have had to deal with the following in their legal and regulatory framework:

- Taxation
  - applicable to underlying structures and issuers
  - direct tax
  - stamp duty land tax
  - capital gains tax
  - withholding tax
  - value added tax
- Regulatory classification of Sukūk
  - impact of stabilisation, tradability and selling restrictions
- Availability of identifiable assets to back the Sukūk issuance
- Local law issues relating to trusts, property laws, etc.
- SPV issuer/trustee – delegation
- Rating criteria
- Sharī'ah compliance

Characteristics of an Effective Legal and Regulatory Framework for Islamic Finance

Nik Thani & Othman (2007):

- An **enabling environment** that accommodates and facilitates the development of the industry
- A clear and efficient system that preserves **enforceability** of Islamic finance contracts
- A credible and reliable forum for **settlement of legal disputes** arising from Islamic finance transactions

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Common Hurdles every where …

- To ensure a harmonized interface between Shariah principles, which form the backbone and *raison d'etre* of the Islamic financial services industry, with the existing legal and regulatory framework;
- To implement a tax regime which does not penalize or discriminate against consumers of Islamic financial services;
- To strengthen the sustainability and competitiveness of Islamic financial institutions as a business, in view of its contribution to the society and to the economy.

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An enabling environment that accommodates and facilitates the development of IFSI should have:

- Clear policy decisions and directions
- Legislation that provides for the licensing and supervision of Islamic financial institutions
- Mechanisms to ensure the Shariah-compliance system is comprehensive and rigorous
- Friendly and neutral taxation system that makes Shariah-compliant products at par and competitive with their conventional cousins
- Supporting infrastructures such as accounting standards and human resource development, and any other non-fiscal initiatives
- Participation in global initiatives, such as the Islamic Financial Services Board (IFSB)

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A clear and efficient system that preserves enforceability of Islamic financial contracts should take into consideration:

- That the legal system are bifurcated – in the case of Malaysia it comprises a hybrid of English common law, Shariah and native's customary laws
- The interaction between two or more sets of laws has led to the existence of **legal pluralism**, affecting the certainty, predictability and enforcement of legal transactions and procedures, which, if not managed carefully, may impair the smooth functioning of a banking and financial system

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A credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions may, among others, constitute:

- Special/dedicated courts/benches/committees within the judicial system comprising of judges well exposed to the Shariah principles, especially in the area of *Muamalat*
- The Court must have access to authoritative Shariah resolutions (such as by the National Shariah Council)
- As far as possible there should be dedicated efforts to publish high quality law reports to record precedents
- An internationally recognised adjudicating body (e.g. an International Islamic arbitration tribunal) to adjudicate disputes that arise in cross-border Islamic finance transactions

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- A comprehensive set of law and regulations which provides the requisite legal infrastructure not only for a satisfactory resolution of disputes, but also a general guideline for Islamic financial institutions
- Greater use of arbitration (*tahkim*) and mediation (*sulh*) by Shariah and Islamic finance experts who qualify as arbitrators to adjudicate cases of dispute. Other methods could be explored are mini-trials and hybrids of arbitration and mediation (arb-med)

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Some Additional Notes

Informative websites:

- http://www.bnm.gov.my - Bank Negara Malaysia
- http://www.mifc.com - Malaysia International Islamic Financial Centre (MIFC)
- http://iimm.bnm.gov.my - Islamic Money Market
- http://bondinfo.bnm.gov.my - Malaysian Government Securities Market
- http:// www.sc.com.my - Securities Commission Malaysia
- http://www.pidm.gov.my - Malaysia Deposit Insurance Corporation

Distinct guidelines relating to Islamic finance & streamline with international best practices…

DOMESTIC REGULATION

- Corporate Governance Guidelines for Licensed IBs
- Framework of Rate of Return
- Guidelines on Financial Reporting for Licensed IBs
- Guidelines on Introduction of New Products
- Guidelines on Governance Shariah Committee for IFIs
- Islamic Money Market Guidelines
- Capital Adequacy Framework for IBs
- Guidelines on Musharakah & Mudharabah Contracts for IBIs
- Guidelines on Recognition & Measurement of PSIA Risk Absorbent
- Property Development & Investment Activities by IBs
- Firewalls for Islamic window operation

INTERNATIONALGUIDELINES/ BEST PRACTICES

- Capital Adequacy Standard (Dec 2005)
- Guiding Principles on Risk Management (Dec 2005)
- Guiding Principles on Corporate Governance (Dec 2006)
- Transparency & Market Discipline (End-2007)
- Supervisory Review Process (End-2007)
- Capital Adequacy Requirements for Sukuk, Securitization & Real Estate Investment (1/09)
- Guiding Principles on Governance for Islamic Collective Investment Scheme (1/09)

Recently approved standards:
- Guiding Principles on Shariah Governance
- Guiding Principles on Conduct of Business
- Guiding Principles on Governance for Takaful

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- **Formulation of separate guidelines to reflect distinct features of Islamic finance**
- **Instill financial stability, market discipline and public confidence**

* IFSB- Islamic Financial Services Board. Note: BNM Guidelines can be downloaded at www.bnm.gov.my

IFSB-IDB Task Force Report on Islamic Finance & Global Financial Stability

The Task Force in its report released in April 2010 confirmed that Islamic Finance can contribute to global financial stability. Inherent features of the Islamic financial model identified as keys to its potentials in contributing to global financial and economic stability:

- ✓ Finance can only be extended to projects, trade, economic and commercial transactions. Financial assets can therefore only grow in proportion to the growth in real economic activities and, hence, the possibility of excessive leverage tends to be remote.
- ✓ "Don't sell what you don't have" is one of the fundamental principles of wealth management in Islam, which restricts the possibility of unhealthy and excessive speculation.
- ✓ Sale of debt is discouraged and rescheduling of debt on the basis of earning interest is prohibited. Hence, the creation of an inverted pyramid of debts, which is a major source of financial crises, is avoided.
- ✓ Investments in public and private equities have to pass a set of screening processes. This makes social and ethical responsibilities an integral part of investment decisions.
- ✓ Preserving genuine liquidity, further adding to the stability of the IIFS.
- ✓ Providing strong incentives for Islamic financial institutions to ensure the success of the projects and activities that they finance.
- ✓ Emphasising transparency, disclosure and documentation of contracts.