



Maybank

Islamic Banking

Where everybody profits

**Asian Bankers Association Seminar,
Hong Kong 2007**

**Islamic Banking : Trends,
Opportunities and Challenges**

By
Ibrahim Hassan
Head, Islamic Banking, Maybank

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Progressing With You

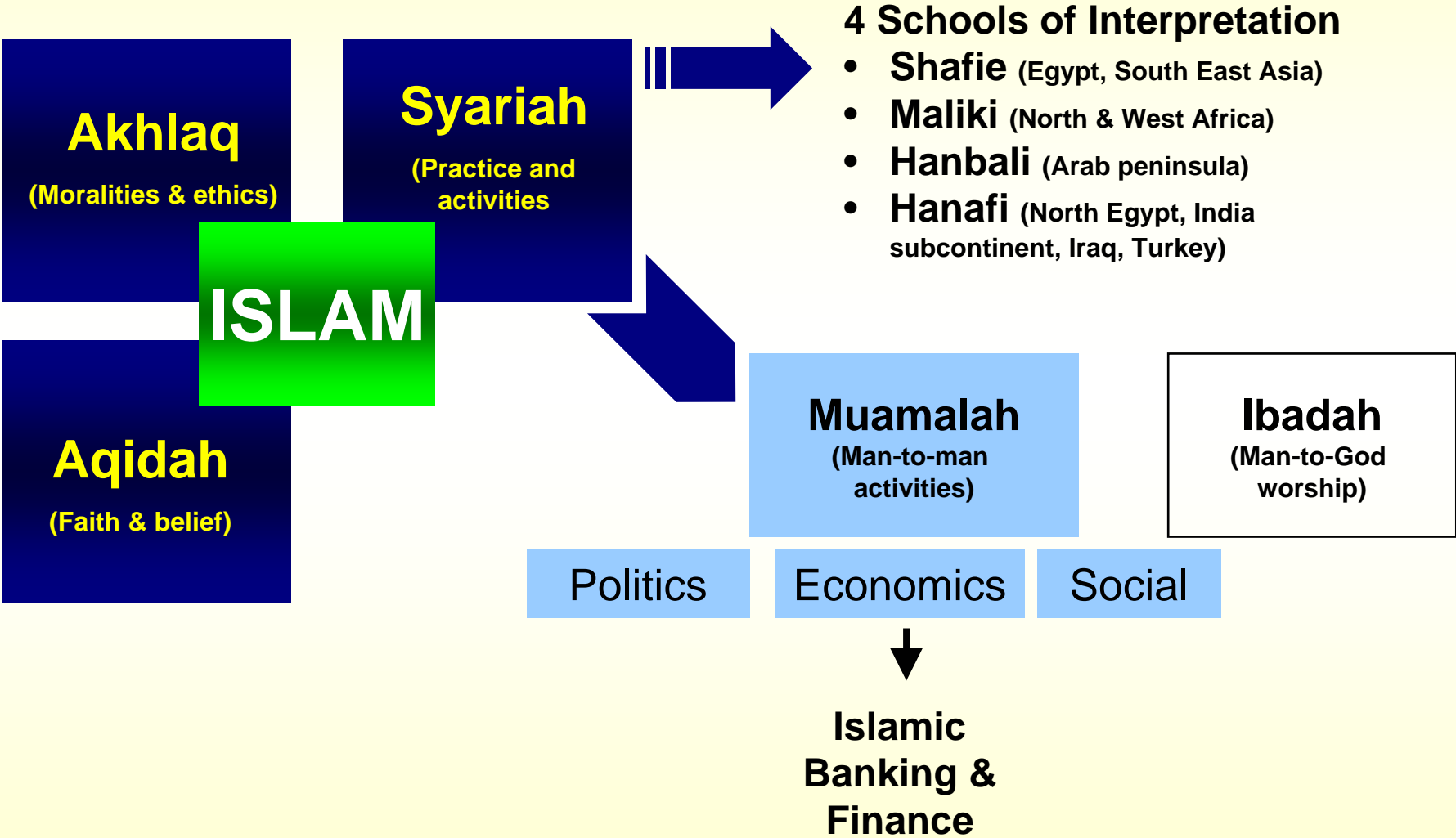
Contents

1. General concepts of Islamic banking and finance
2. Global overview of the Islamic banking & finance industry
3. Approaches in developing Islamic banking – the Malaysian experience
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1

Islamic banking and finance - General concepts

Banking and finance has a special place within the sphere of Islam



The establishment of Syariah Committee is an important element in Islamic banking and finance. The Committee is guided by a set of basic Islamic finance principles.

No element of usury/ interest (riba)

No treatment of money as a commodity

Principles of Islamic finance

Prohibition of Gharar (uncertainty) and gambling

Financial transactions must be supported by underlying “halal” economic transactions

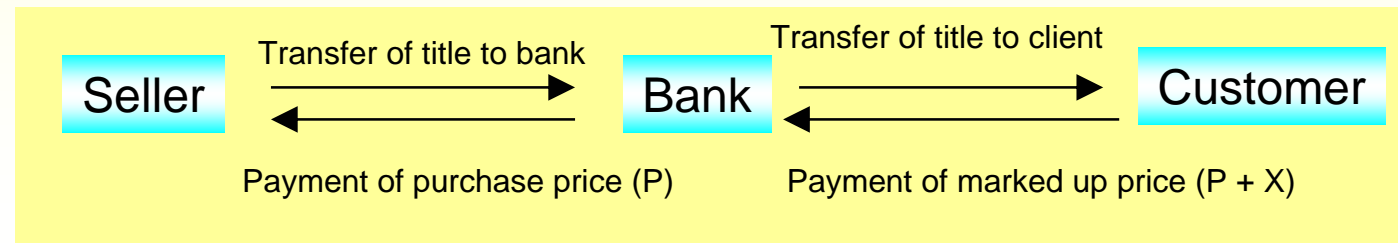
Islamic banks play **multifaceted roles**, depending on nature of financial transactions

Multi-faceted roles of Islamic banks meant relationship with depositors is unlike that of conventional banks

	Instruments	Islamic banking	Conventional banking
Sources of fund	Savings/ demand deposits	Custodian (eg Wadiah/Qard)	Debtor-creditor
	Investment deposits	Entrepreneur-Investor (Mudharabah)	
	Capital	Investor-manager	Investor-manager
Application of fund	Financing Securities Others	Various ownership structures	100% owned by bank
	RISKS	<ul style="list-style-type: none"> • Full transfer to depositor (eg mudharabah-profit sharing investment account) • Partial transfer to depositor (eg musyarakah-partnership) • Fully borne by bank (wadiad/qard) 	Fully borne by bank

The main Islamic principles currently employed

Murabaha: (cost plus sale) contracts in which a Financial institution purchase goods upon the request of a client, who makes deferred payments that cover the cost and an agreed-upon profit margin for the FI. It is the most widely used instruments in Islamic finance.

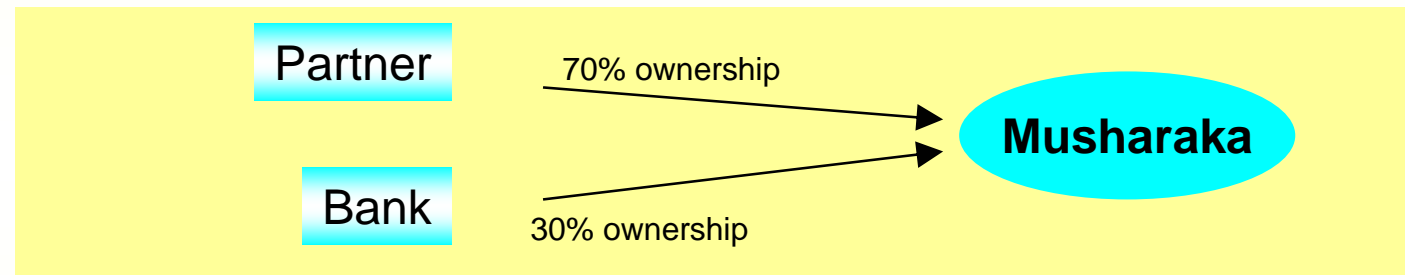


Mudarabah: (profit sharing agreement) is a contract between investors, acting as silent partners, and a FI, acting as a fiduciary/manager, to invest in an activity or a pre-determined asset class that earns each partner an agreed upon profit portion of the investment. Mudarabah investments may be made for a fixed terms and arranged through negotiable instruments (called Sukuk). The bank may also be an investor.



The main Islamic principles currently employed

Musharaka: (equity participation) A Musharaka between the FI and an enterprise in which the FI supplies and its partner share the profits which may be different from capital contributed .
Alternative: “Diminishing Musharaka” agrees to buy out the Bank’s share over a period of time



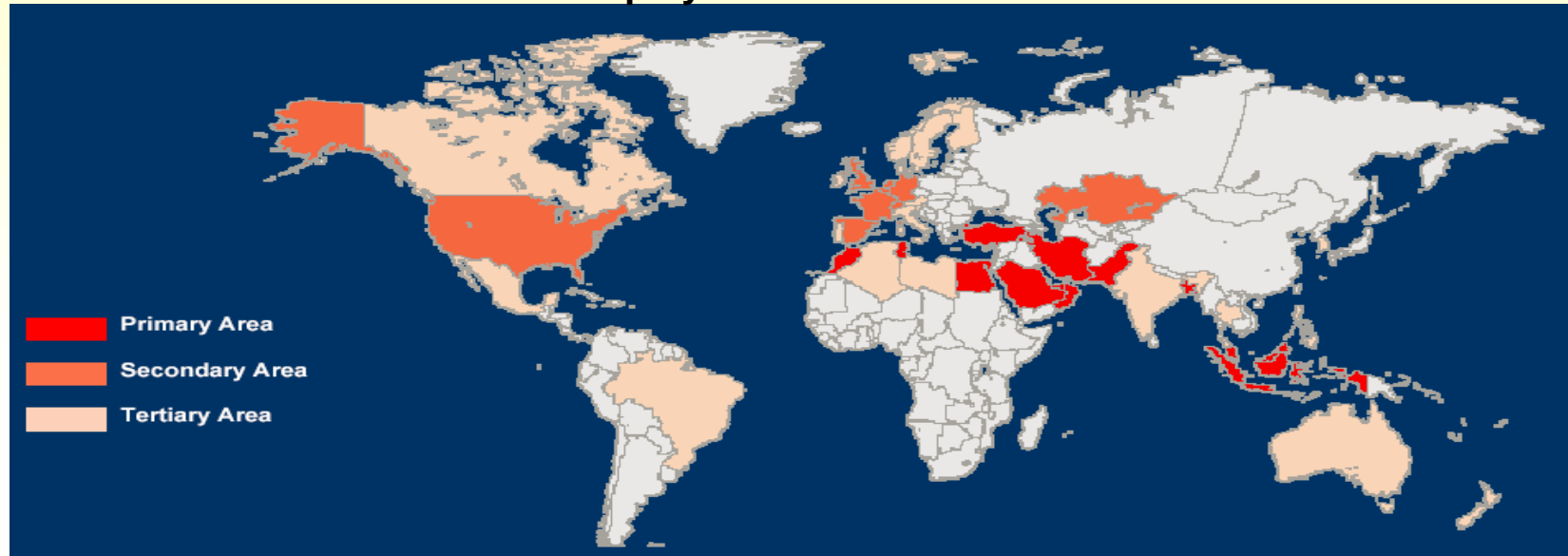
Ijarah: (Leasing) Ijarah is a lease purchase contract in which a FI purchase equipment or property and lease it to a Company (Operating Lease). Ijarah wa Iqtina is the same as Ijarah except that the lessee is obliged to buy the leased asset at the end of the contract (Financing Lease)

2

Islamic banking and finance - Global overview

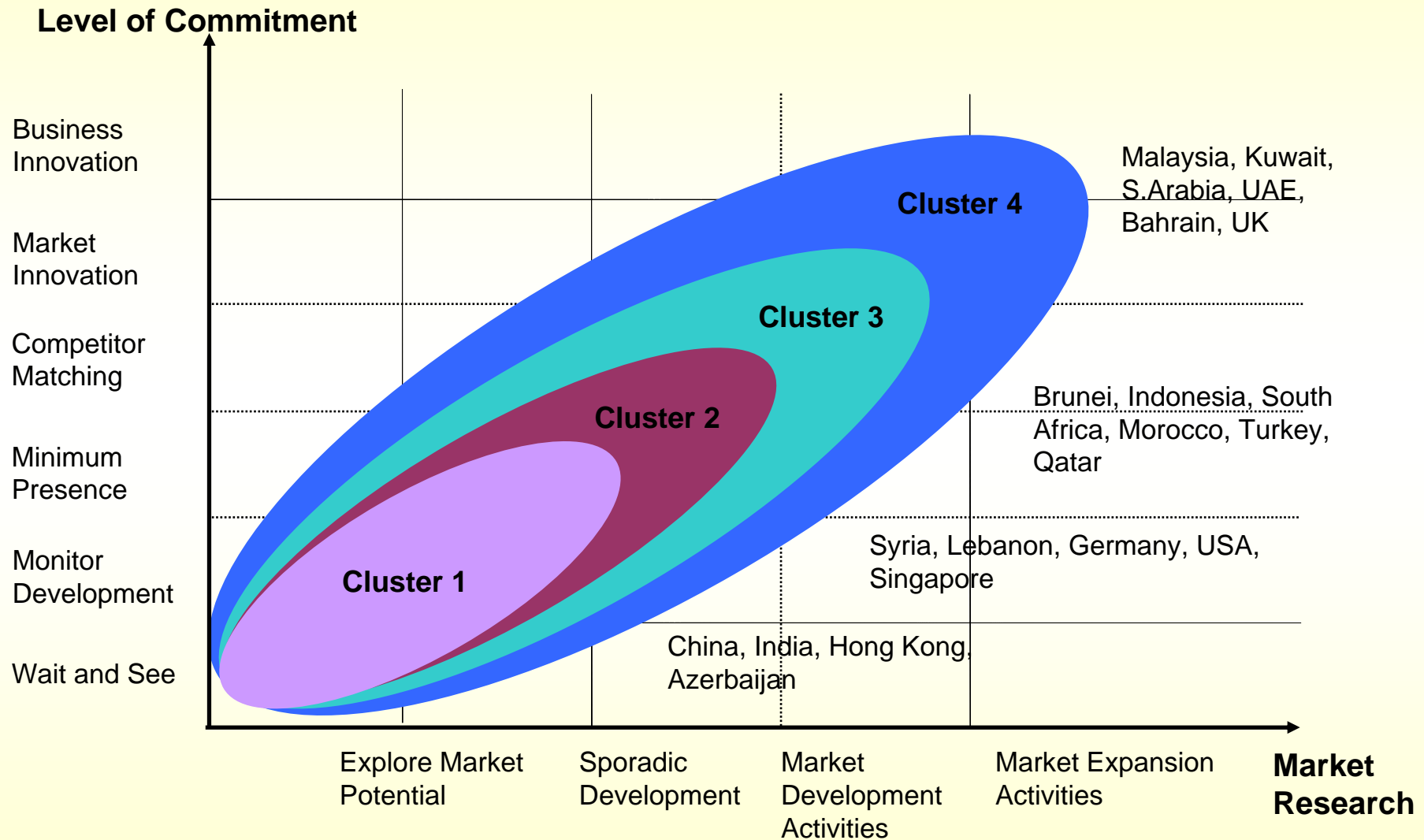
Islamic Banking and Finance : A Global View

Global Deployment of Islamic Products



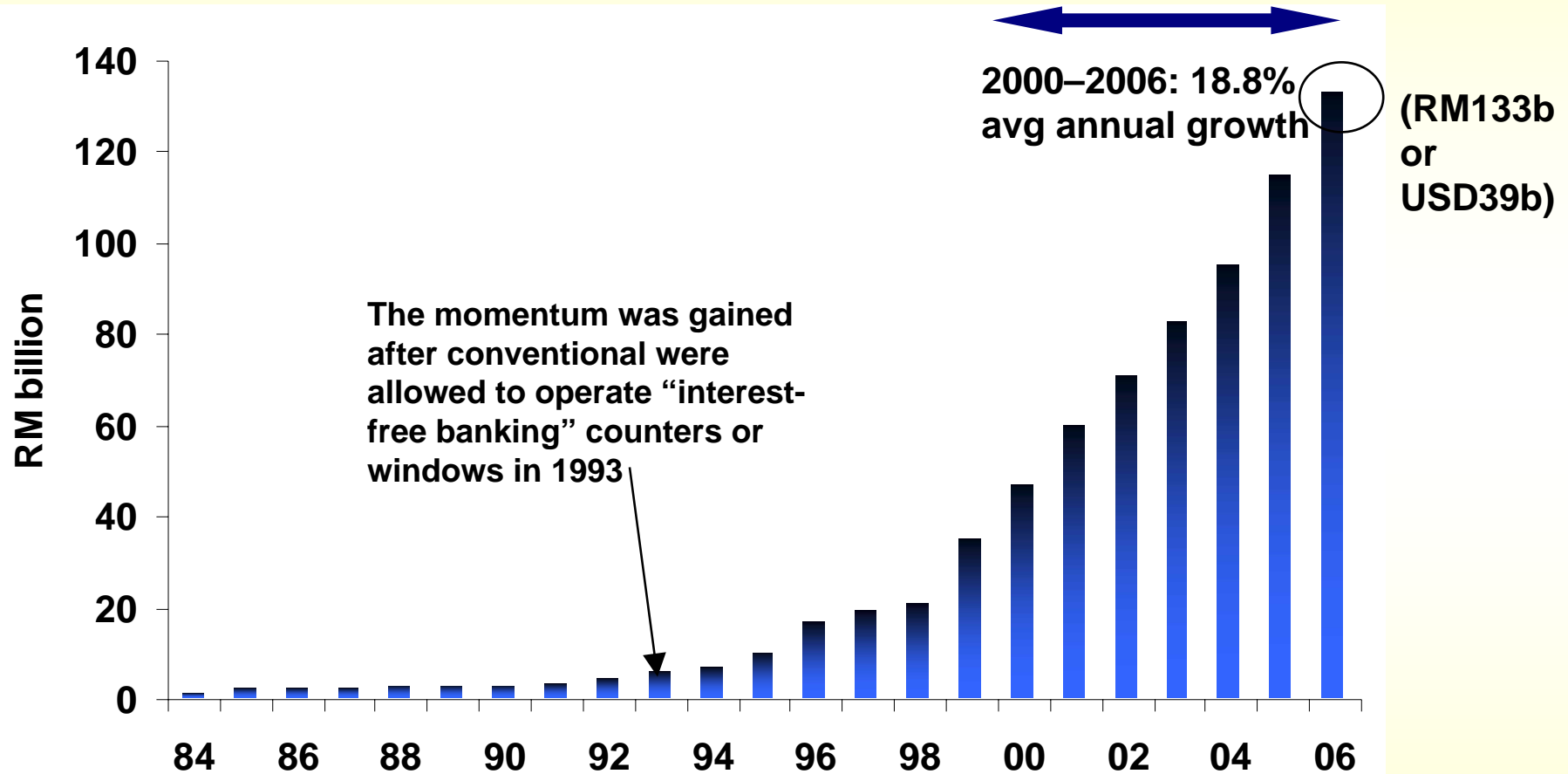
- There are more 267 Islamic financial institutions (FIs) worldwide with capitalisation in excess of USD13 billion. This includes banks, mutual funds, mortgage companies & Takaful
- Shariah-compliant financial products estimated to exceed USD250 billion with annual growth rate of 23.5% over the past 5 years
- There is approx. USD1.5 trillion of GCC fundsheld in investment assets worldwide (Treasuries/corporate bonds/equities/funds etc). Of this USD1.5 trillion, USD250 billion constitutes of High Net Worth Individuals
- The potential is huge. By 2020, there will be 2.5 billion of Muslim population worldwide from the current 1.5 billion level
- Islamic banks are expected to manage 40%-50% of total savings of Muslim population in 8 to 10 years. Therefore, potential for Islamic financial services is estimated at USD4 trillion by 2020
- It is crucial this huge amount of funds are channeled towards productive use –into GCC infrastructure/economic sectors and other emerging economies

Islamic Banking and Finance has varying degree of relevance across countries



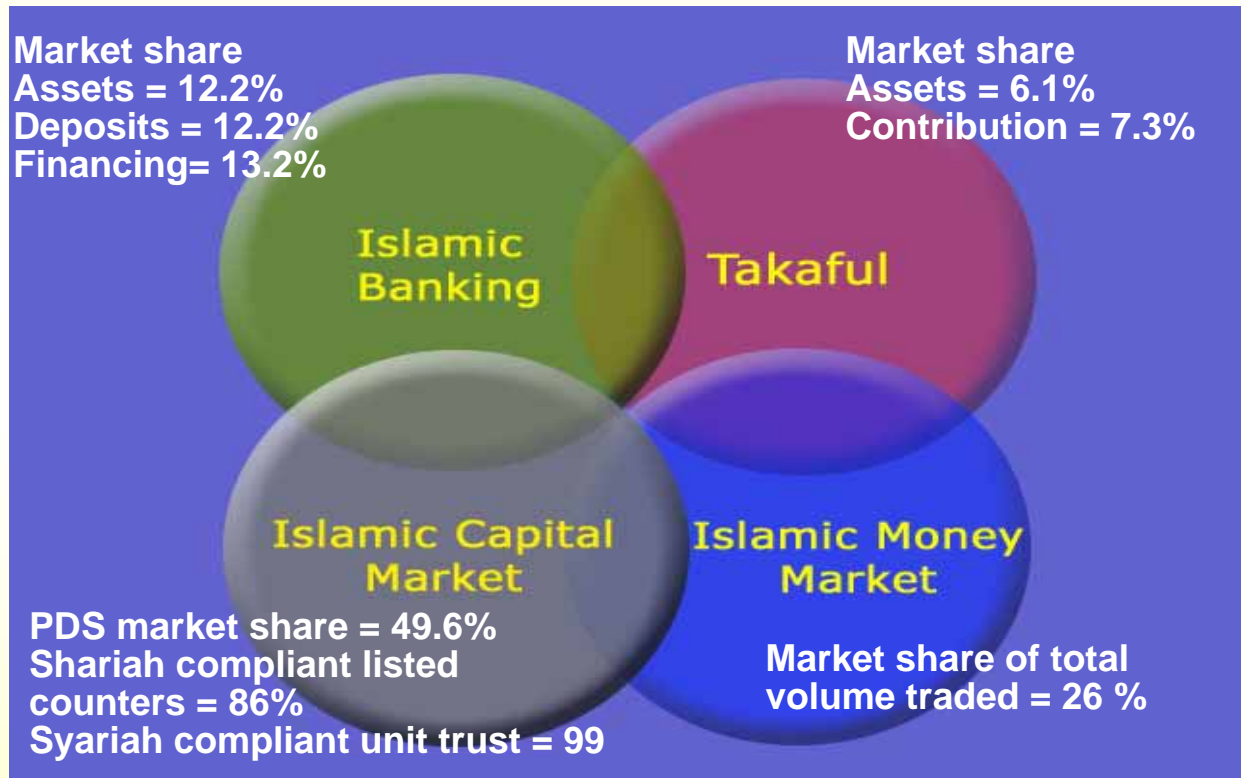
Some form of Islamic finance is now present in over 60 countries – (PricewaterhouseCoopers (PwC) Malaysia)

In Malaysia, where commitment is at its highest, there has been an exponential growth in Islamic banking total assets



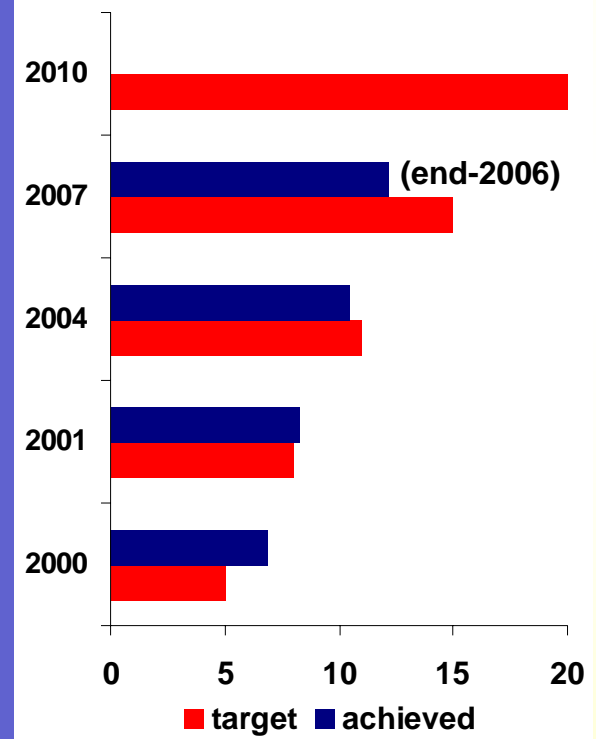
Source: Bank Negara

Contribution of Islamic banking and finance to overall industry is significant and growing



Source : Bank Negara Malaysia

Explicit targets set
 Share of Islamic banking as % of total banking industry assets

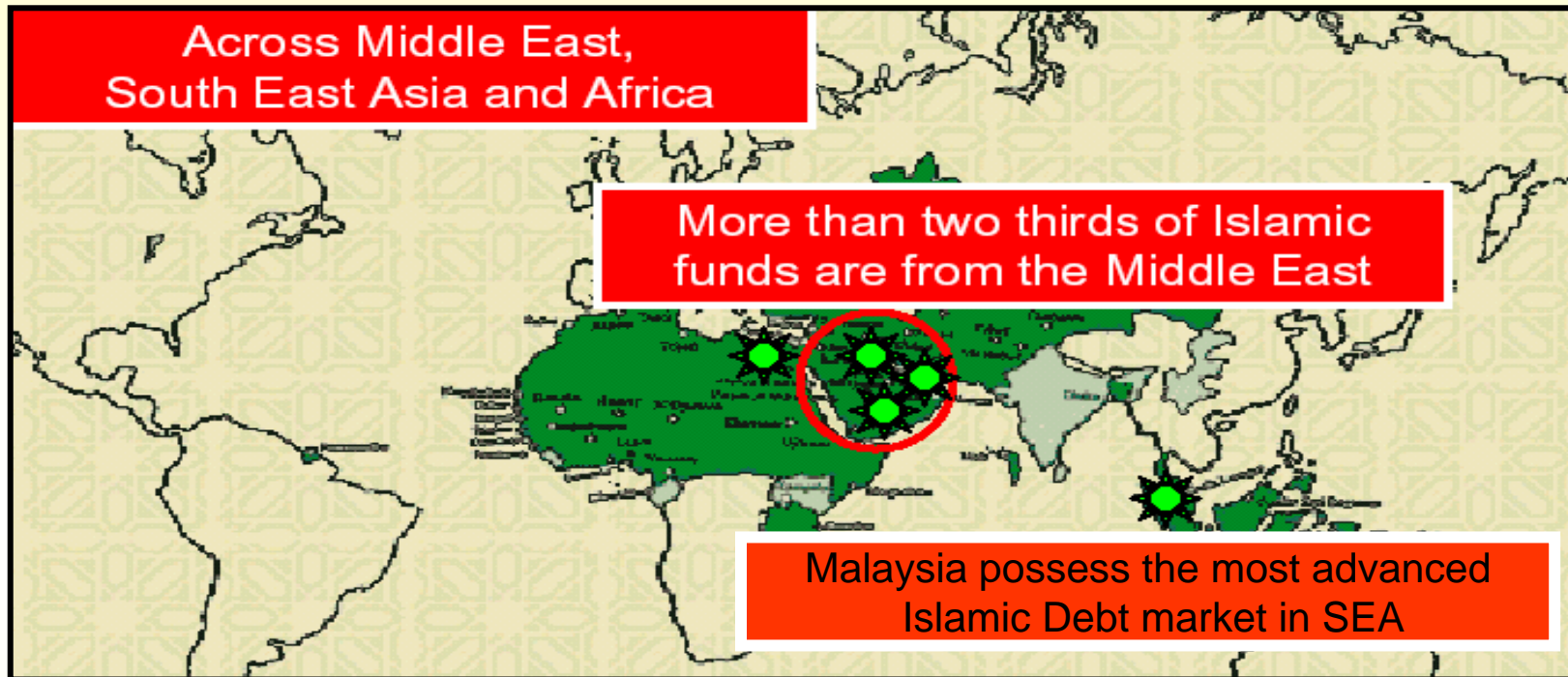


The infrastructure of Islamic banking in Malaysia is now well established

		2002	2003	2004	2005	2006
Number of institutions	Conventional	35	34	29	27	22
	<i>Islamic</i>	2	2	2	6	10
Office network	Conventional *	2386	2414	2276	2072	1952
	<i>Islamic</i>	128	132	136	766	1167
ATM Network	Conventional	4028	4184	4428	4584	4869
	<i>Islamic</i>	185	212	280	308	329
No of employees	Conventional	85296	85092	87222	89047	91741
	<i>Islamic</i>	3117	3323	4036	4434	5151

* = includes Islamic bank branches that are shared with conventional bank branches
 Conventional excludes merchant/investment banks
 Source = BNM Annual Report 2007

In Islamic finance, the growth of Islamic debt & sukuk market has been most impressive

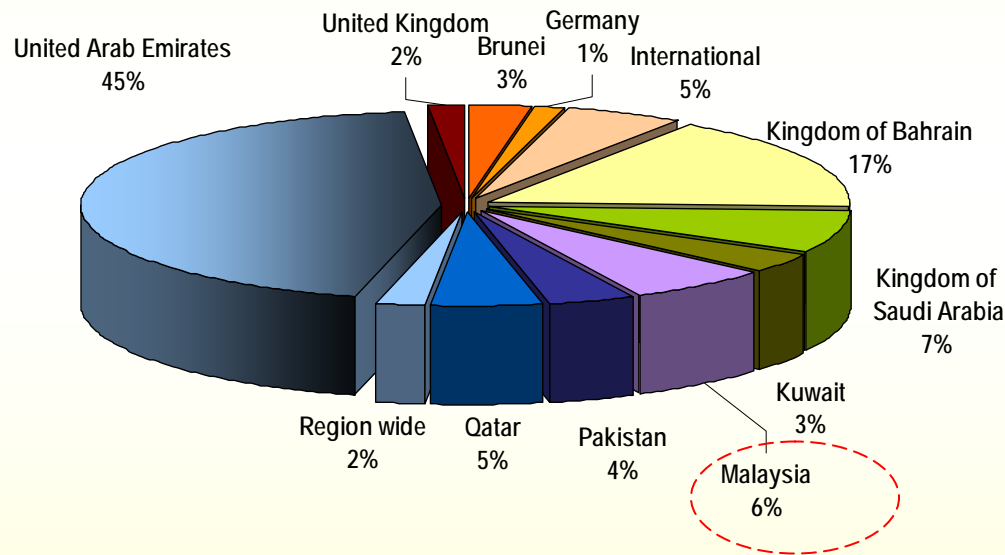


- The market for Sukuk is now maturing and increasing in momentum in the wake of interest from issuers and investors
- Sukuk market provides investment opportunities to a broad range of investors including public pension fund managers, reserve managers, central banks and Awqaf managers
- Sukuk introduce a new asset class for investment diversification and fill the gap in Shariah compatible tradable instruments

GCC have emerged to dominate international sukuk issuance in a short period of time

Breakdown of International Sukuk Issuance as at 22 March 2007

(Excluding the Malaysian domestic Sukuk issues and the Al Salam Sukuk issues)



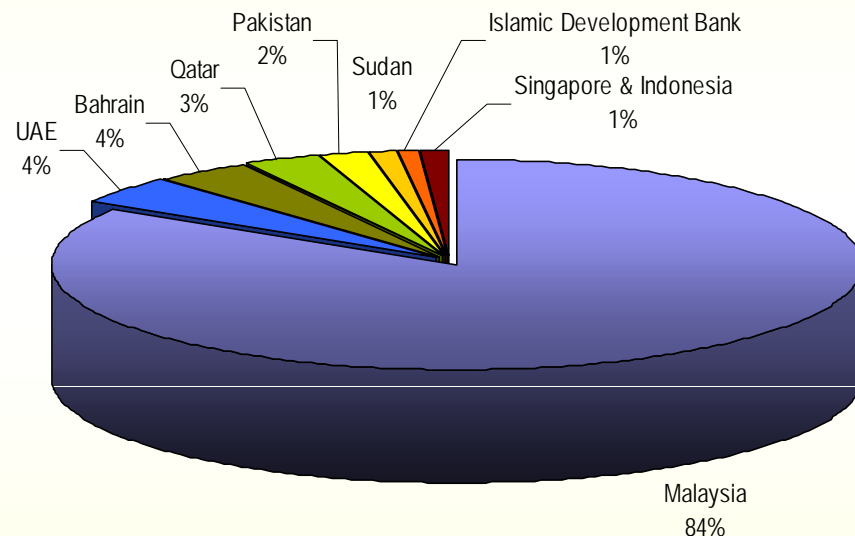
GCC & Malaysia have the largest Sukuk market

- The Islamic capital market has become increasingly popular over the last few years for raising capital both debts and equity
- The Sukuk markets continue both their rapid pace of growth and demonstrate continuous innovation
- Biggest activity in Sovereign Sukuk issuance remain in GCC and Malaysia
- Sovereign Sukuk : Total No: 84, Amount : US\$18.064 billion (LMC's global Sukuk table, last updated 29 March 2007)
- Growth Trend
 2004 : US\$6.7 billion,
 2005 : US\$9 billion
 2006 : US\$16.9 billion

(Source: Liquidity Management Centre (LMC), Bloomberg, Aseambankers)

Including local currency issues, the Malaysian sukuk market is the biggest by far

Breakdown of Local Currency & Dollar Sukuks in Global Market in 2006



Malaysian Government is promoting the KL as a global centre for Islamic capital market

- Currently, Malaysia has the largest Sukuk market. UAE, where Sukuk was non-existent in 2003, has emerged second with Bahrain at 4% share each
- In 2001, The very first global corporate Sukuk, the *First Global Sukuk Inc* (Guthrie Sukuk), created a paradigm shift in the international Islamic financial market
- The Malaysian Government Sukuk (*Malaysia Global Inc*), the first global sovereign Sukuk was issued in 2002, which was over subscribed more than two times
- The Malaysian Government is launching an initiative known as the Malaysian International Islamic Financial Centre (MIFC) to develop the Islamic financial infrastructure, to implement measures and initiatives that will strengthen current position as an international Islamic financial hub

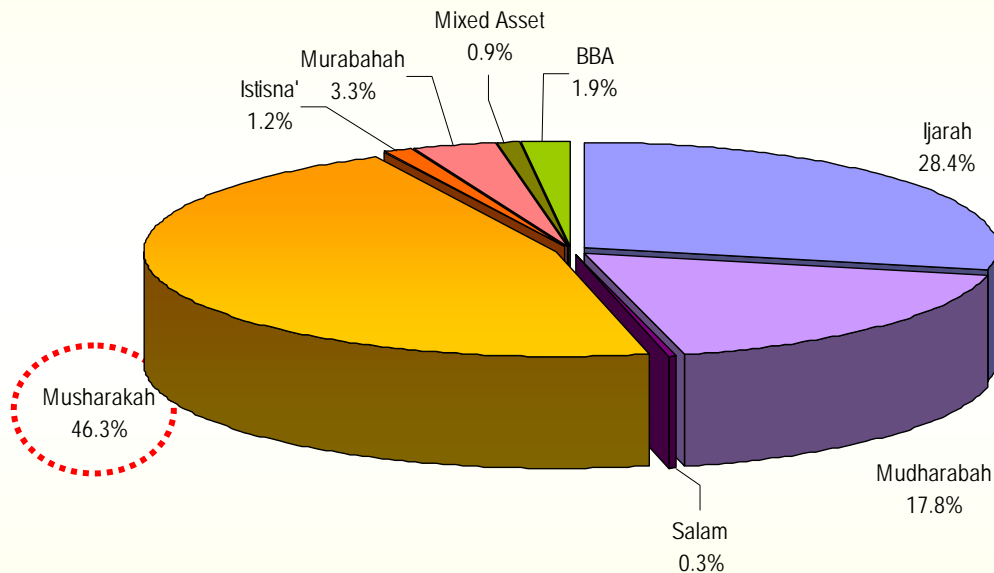
(Source: Liquidity Management Centre (LMC), Bloomberg, Aseambankers)

20 Largest International Sukuks

No	Issuer	Rating	Country	USD'm
1	PCFC Sukuk	n.a.	UAE	3,500
2	Dubai Global Sukuk FZCO	n.a.	UAE	1,000
3	SABIC Sukuk	n.a.	Saudi Arabia	800
4	Government of Qatar	S&P : AA	Qatar	700
5	Malaysian Global Inc	Moody: A3, S&P : A-	Malaysia	600
6	Pakistan International Sukuk Co Ltd	Moody: A1, S&P : B+	Pakistan	600
7	Airline Sukuk	n.a.	UAE	550
8	Wings FZCO	n.a.	UAE	550
9	IDB Trust Services	S&P : AAA	International	500
10	Islamic Development Bank	Moody: Aaa, S&P: AAA	International	500
11	Aabar Sukuk	n.a.	UAE	460
12	Solidarity Trust Services Ltd	S&P:AAA, Fitch:AA	Region Wide	400
13	Sarawak Corp Sukuk Inc	S&P:A-, Moody:Baa1	Malaysia	350
14	Maybank Sukuk Inc	S&P:BBB+, Moody:Baa1	Malaysia	300
15	Qatar Real Estate Investment Company Sukuk	n.a.	Qatar	270
16	Govt. of Bahrain – BMA Issue #9	S&P:A	Bahrain	250
17	Bahrain Monetary Agency	S&P:A	Bahrain	250
18	The Investment Dar Sukuk	n.a.	Kuwait	250
19	Amlak Finance	n.a.	UAE	250
20	Sharjah Islamic Bank Sukuk (Corporate)	S&P:BBB	UAE	225

Musharakah and Ijarah are the most popular Islamic financing structure in the global sukuk market

Composition Structure of Global Sukuk in 2006 (% of size)



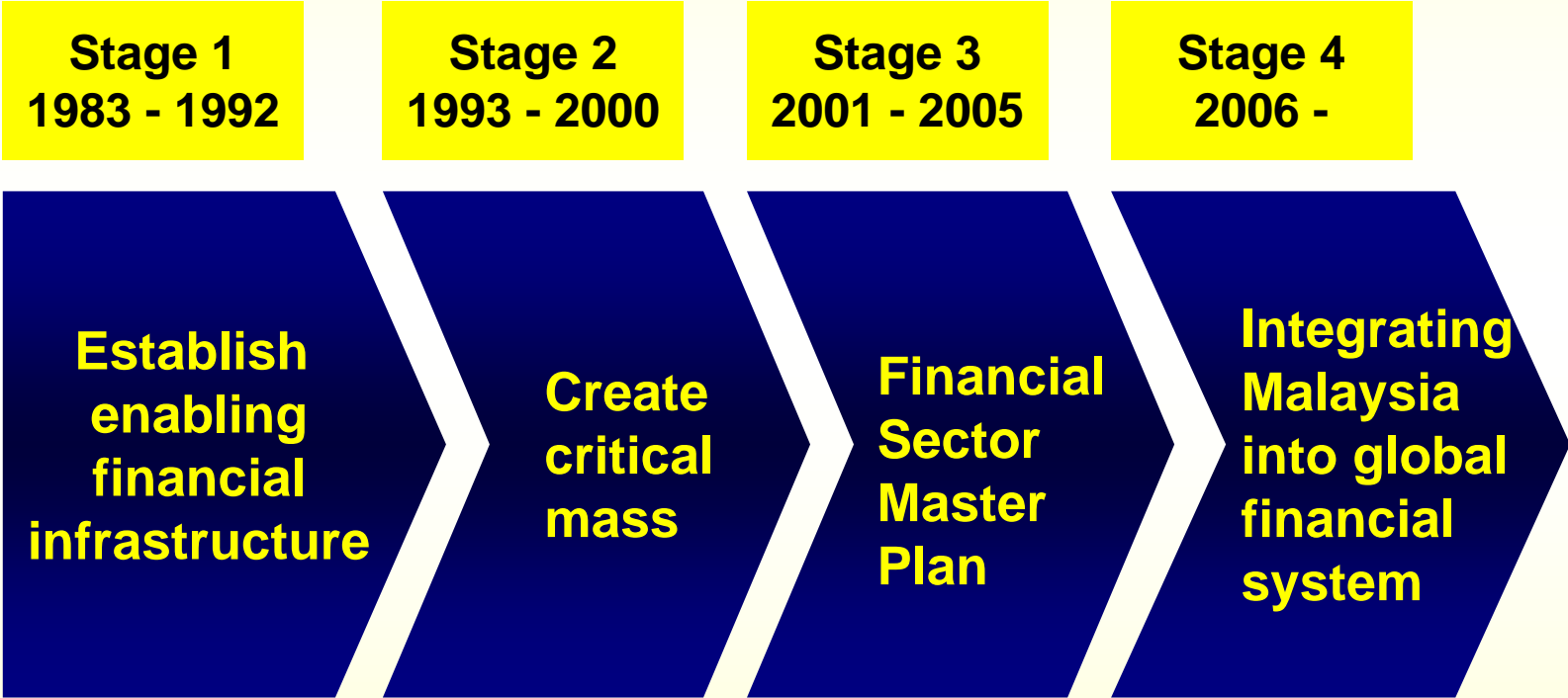
- AAOIFI has issued standards for 14 different types of Sukuk
- Common Sukuk principles include Isaiah, Murabahah, Istisna, Musharakah
- Dominated by Musharakah (in terms of amount issued) & Ijarah structure (in terms of no of issuance) due to familiarity of the principle
- In the Middle East, Ijarah Sukuk has to date been the preferred principle but institutions are now utilising different techniques such as the Musharakah and Istisna Sukuk
- Sovereign vs Corporate sukuk – trends moving towards issuance of corporate sukuk. Currently, Sukuk market (ex-Malaysia) is dominated by sovereign issuer.

(Source: Central Banks, Bloomberg, Aseambankers)

3

Approaches in developing Islamic banking and finance – The Malaysian experience

The Islamic Financial System in Malaysia progressed through 4 main growth phases



Stage 1
1983 - 1992

Establish Enabling Infrastructure

Driving considerations

- To fulfill the needs of Muslim community
- To mobilise funds for productive purposes, in particular for Muslim communities

Enabling infrastructure

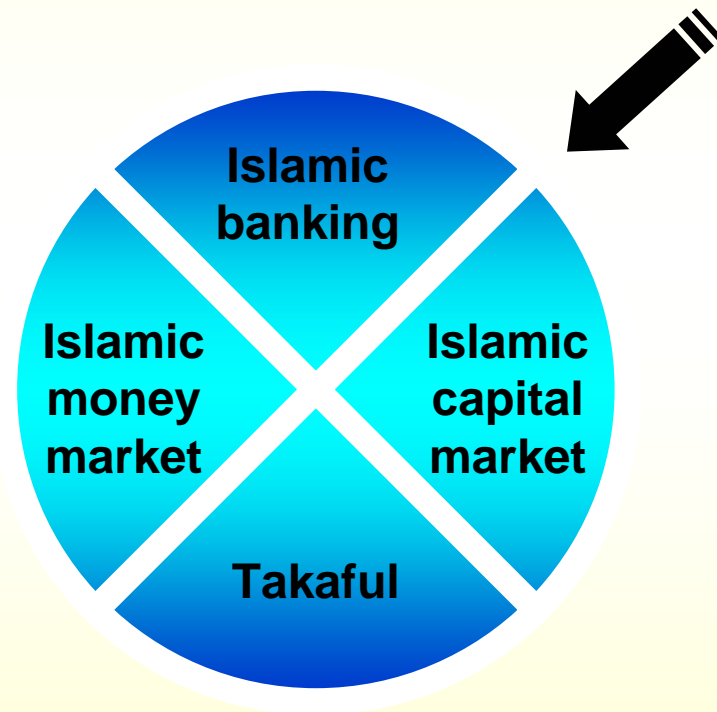
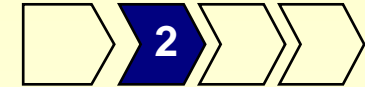
- Islamic Banking Act 1983
 - *Gave rise to the establishment of 1st Islamic bank*
 - *Granted a universal banking licence*
- Government Investment Act 1983
 - *Issuance of Government Investment Issues*
- Takaful Act 1984
 - *Gave rise to the establishment of 1st takaful operator*

Achievements

- Islamic banking proven to be a viable financial intermediation channel
- It fulfilled the needs of not only the Muslims but non-Muslims as well
- Success enable expansion into new areas and products

Stage 2
1993 - 2000

Create critical mass in Islamic banking & finance



Establish a comprehensive Islamic financial system with the following initiatives:

- **allowing “window” concept**
- **establishing an Islamic money market**
- **promoting aggressively the Islamic capital market**
- **promoting the takaful industry**

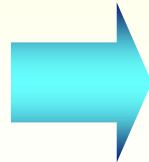
Islamic window was a critical success factor in the development of Islamic banking in Malaysia

The “window” approach		Window- enabling infrastructure	
Initiative	Conventional banks allowed to offer Islamic products and services over designated counters (“window”)	Legal	Amendments to the law
Policy Strategy	To expand Islamic banking using existing infrastructure in the shortest period at lowest possible cost	Syariah	<ul style="list-style-type: none"> • Appointmt of syariah scholars to advise financial institutions • Appt of Syariah Advisory Council at BNM to oversee uniformity of syariah interpretations
Considerations	<ul style="list-style-type: none"> • Syariah compliant • Cost effective • Optimise resources • Able to compete effectively in an established banking system • Immediate increase in delivery channel 	Regulatory	<ul style="list-style-type: none"> • Established Islamic banking division at BNM • Allocated capital for IB operations • Segregating Islamic from conventional funds (no comingling): <ul style="list-style-type: none"> – separate clearing accounts – separate membership code in RENTAS • Separate disclosure of Islamic banking operations of windows in the conventional financial statements (promote transparency & fairness)

Islamic money market – critical to developing a deep and efficient financial market

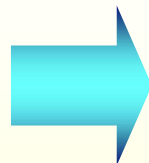
ISLAMIC MONEY MARKET

- The Islamic Interbank Money Market
- Syariah-compliant instruments
- Provides flexibility for adjusting portfolios and funding purposes



Trading of financial instruments

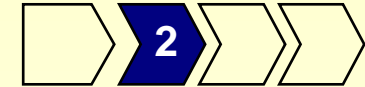
- Placement and acceptance of funds based on Mudharabah principle – profit sharing concept
- Tenor – overnight, one week, one month, three months



Mudharabah Interbank Investments

- Trading of Islamic financial instruments mainly based on debt trading principle
- Instruments – Govt Investment Issue, BNM Negotiable Notes, Islamic Acceptance bills, Islamic Debt securities

The Islamic capital market and the Takaful industry were developed concurrently, creating a comprehensive Islamic financial system



Equity market

- As at June 2007, 86% of Bursa Malaysia stocks are Syariah-approved counters
- 102 Islamic unit trusts are on offer – equity funds, balanced funds, bond funds
- 2 Islamic indices: KLSE & Dow Jones-RHB Islamic indices

Debt market

- First Islamic private debt securities issued in 1990
- Islamic PDS constitutes 31.3% (RM134b) of total outstanding PDS (June 2007)

Takaful

- Viable, progressive & resilient industry with strong growth over the last 20 years
- 9 Takaful operators with composite licence (family & general)
- As at June 2007:
 - Assets = RM7.6b
 - Share = 6.1% of insurance industry



Stage 3
2001 - 2005

Financial Sector Master Plan

- Creation of an efficient, progressive and comprehensive Islamic financial system
- Landscape in 2010
 - 20% of banking and insurance market share
 - Strong and highly capitalised players offering a comprehensive range of Islamic financial product services
 - Strong syariah and regulatory framework
 - A legal framework that could address complex legal issues
 - Well trained management teams with relevant expertise
 - Serves as a center of excellence
- 11 recommendations relating to capacity enhancement, financial infrastructure development and regulatory framework development, benchmarking etc.

FSMP's developmental focus covers 4 main areas



Initiatives

Institutional development

- Licensing of 3 foreign Islamic banks in 2004
- New takaful operators
- Foreign equity holding up to 49% in Islamic subsidiaries and takaful operators
- Diversity of players – foreign partners with specific expertise
- Facilitative environment – tax, stamp duty, operational & legal framework, immigration
- Diversity of investors

Legal, syariah regulatory

Syariah Advisory Council (SAC) of BNM

- Deliberate and provide decisions on syariah issues pertaining to Islamic banking and finance
- Promote harmonisation and uniformity of syariah interpretations
- Develop new ideas and concepts on syariah applications

Syariah Committee at Islamic financial institutions

- Advise the Board on syariah matters on Islamic banking and finance
- Endorse syariah compliance manuals and products documentation
- Provide syariah opinion and assist SAC to provide basis that support syariah decisions
- Advise related parties within the financial institutions on syariah matters

FSMP's developmental focus covers 4 main areas (cont'd)

Initiatives

Knowledge, Education

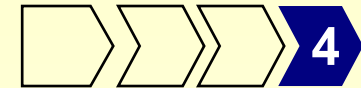
Islamic Banking and Finance Institute of Malaysia (IBFIM)
- (Elementary)
International Centre for Education in Islamic Finance (INCEIF)
- (Intermediate and advanced)
International Centre for Leadership in Finance (ICLIF)
- (Leadership programs)
Scholarship and Research

Products and market

- Successful replication of most of conventional banking products. All Islamic products identified by the suffix “ – *i*” , eg leasing-*i*
- Comprehensive product range in banking, takaful and financial markets
- Malaysian sukuks successfully marketed globally
- Sovereign and multilateral institutions attracted to issue sukuks in Malaysia

4

Current growth phase : Integrating Malaysia into global financial system

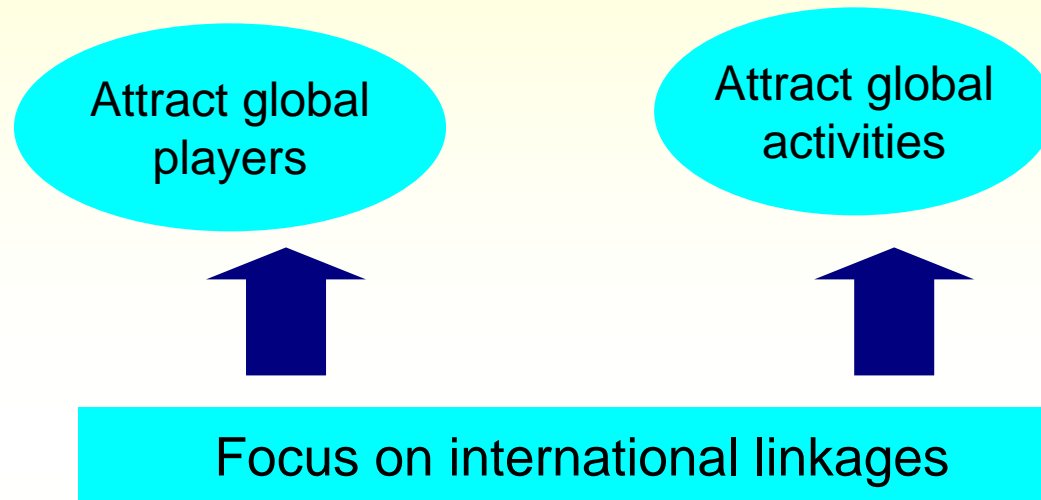


**Stage 4
2006 -**

Malaysia's vision to become Islamic Financial Hub

- Malaysia has the competitive edge to be a leading Islamic Financial Centre given:
 - the progressive development of its Islamic banking and finance sector
 - various achievements of its domestic Islamic market
 - successful integration of Islamic finance with conventional system
 - various liberalisations that have been undertaken
- The hub has been envisioned in the Financial Sector Master Plan
- There is growing interest from Middle East investors
- It is an opportunity for Malaysia to improve trade and linkages between Malaysia and other parts of the world
- The Islamic financial hub is envisioned as a source of economic growth

The focus will be to strengthen international linkages



DIVERSITY OF PLAYERS

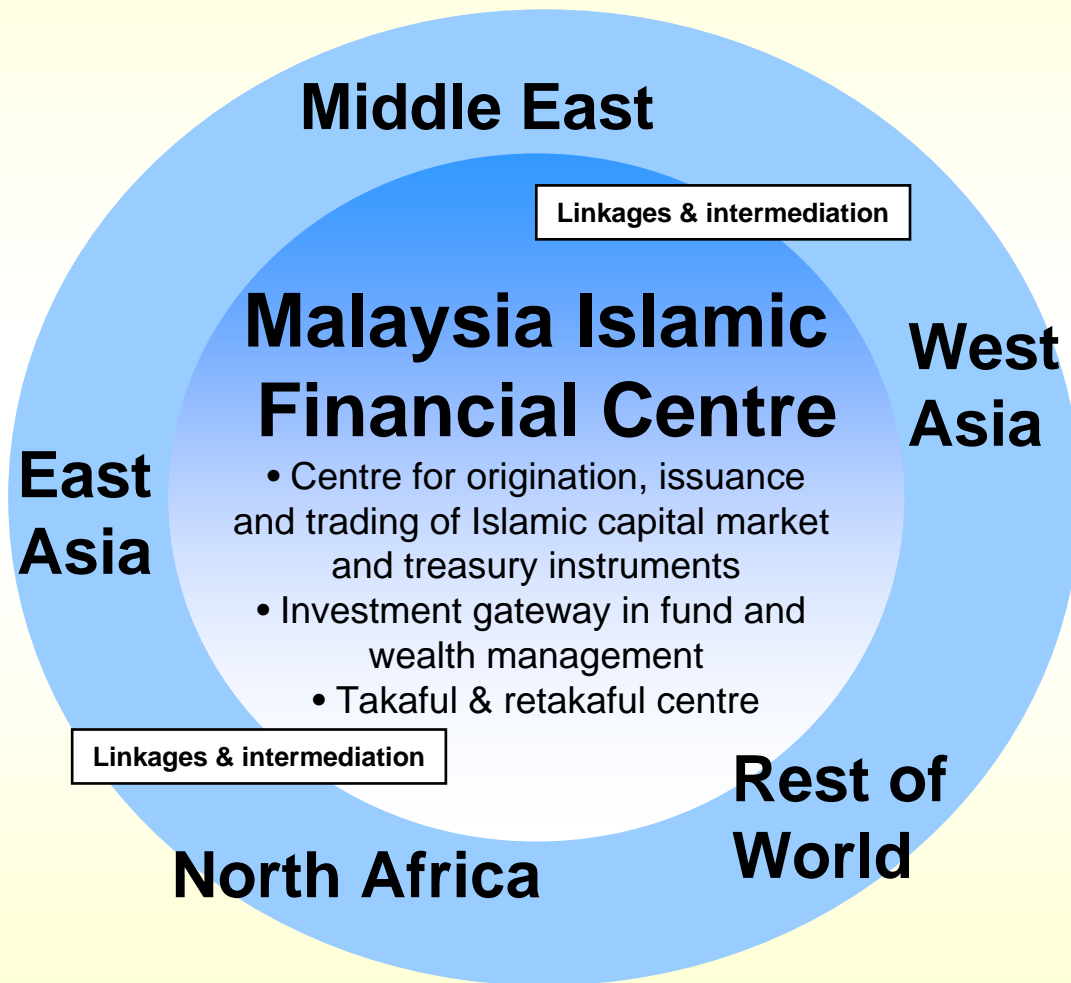
- Domestic IBIs (2 Islamic banks, 9 IS)
- Foreign IBIs (3 IBs, 5 windows)
- Takaful operators (5 domestic, 4 foreign)
- Retakaful operators (3)
- ICBUs (6)
- Fund managers

Strong in domestic business		
Islamic money market		Islamic capital market
Banking players	Capital market players	Takaful players
Solid foundation (Legal, Syariah, Regulatory)		

The Malaysian Islamic Financial Centre (MIFC) will be the gateway to stronger international linkages



Some measures to ignite the MIFC



Measures to build the base

Issuance of new islamic banking, takaful & retakaful licences

Allowing foreign equity of up to 49% in existing takaful & retakaful comp.

Issuance of licences to international islamic banks and takaful operators to conduct business in foreign currency & enjoy 10 years of tax holiday

Allowing local Islamic banks and takaful operators to set up ICBU for business in foreign currency and enjoy 10yr tax holiday

Allowing Labuan offshore entities to open operation offices anywhere in M'sia

Success of MIFC depends on generation of activities ...

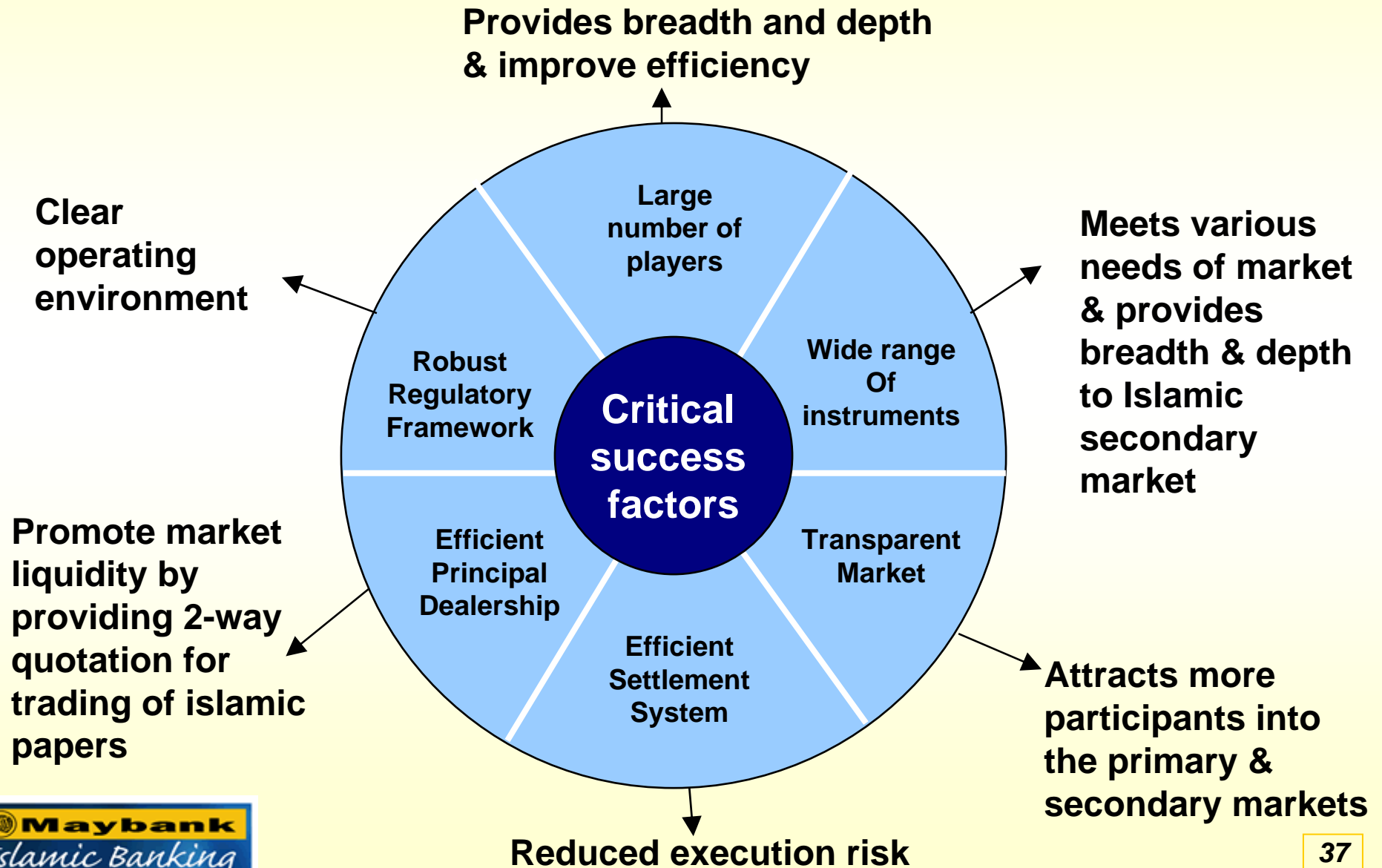
Government initiatives to ensure cost is competitive and conducive for product innovation and product offering includes:

- **Building the pool of talent and expertise – setting up of INCEIF and establishing Shariah Endowment Fund for scholarship, research & dialogues**
- **Giving additional 20% exemption in stamp duty on Islamic financial instruments on top of current exemptions.**
- **Encouraging Malaysian-owned banks including Islamic financial institutions to expand operations abroad by giving 5 year tax exemption on profits from foreign operations**
- **Liberalising foreign exchange rules to allow multilateral development banks and multinational corporations to issue ringgit denominated bonds in Malaysia.**

5

Issues and challenges

For Islamic capital market, the success in Malaysia has been due to at least 6 factors



Still, there are at least 10 issues in Islamic capital market

Shariah interpretation	Differences on Shariah interpretation due to 5 different schools of thought resulted certain product and practices in certain country not acceptable in the international market
Tradability	Certain financial instruments e.g. BBA is treated as pure debt securities and therefore cannot be traded in the secondary market either at discount or premium. In Malaysia, BBA constituted 52% of total Islamic bonds/Sukuk
Portfolio Diversification	More than 50% of Islamic bonds and Sukuk issuance are from the infrastructure sector. Portfolio diversification across different economic sector is a challenge
Risk Management	The profit rate of most Sukuks are benchmarked against comparable interest rate & investment in non-local currency denominated Sukuk is subjected to foreign exchange risk. Shariah compliant risk management tool – Islamic Currency Swap, Profit Rate Swap is still at infant stage.
Pricing of Islamic bonds/Sukuk	The Islamic benchmark yield curve is available up to 10 years. Most Sukuk for infrastructure sector is long-dated. Availability of reliable and efficient benchmark yield curve across the maturity spectrum will assist market participant on price discovery of Sukuk.

(Source: Aseambankers)

(Continue)

Issues and challenges in Islamic capital market (Cont.)

Liquidity

In the Middle East, Sukuk remains primarily a market where holders keep bonds to maturity with limited secondary market trading challenge due to demand and supply imbalances

Product Awareness

Awareness is still low especially in the Western and East Asian markets

Credit Rating

Rating is still absent in many jurisdiction in the world

Shariah Scholar

Lack of Suitably experienced Shariah scholar. The number of Shari'ah scholar is very limited to serve the need of this growing industry

Legal and Documentation

No standard documents. Thus each new issue incurs higher level of legal & documentary expenses . Documents must be clearly drafted so as to avoid confusion as the status of Shariah compliance does not have a bearing on its enforceability

(Source: Aseambankers)

6

Conclusions

Conclusions

- **In Malaysia, the collaborative efforts of many parties have contributed to the success of its Islamic banking and finance.**
- **But success at individual institutions depends on enthusiasm, commitment and leadership to pursue various initiatives**
- **To move forward, Islamic financial institutions must strive to innovate, and not only replicate its conventional counterpart.**
- **Globally, the continued strong growth in the Sukuk market cannot be denied. There is increasing standardisation of Sukuk documents in the marketplace which will drive costs down and improve the competitiveness of these instruments.**
- **The Sukuk market will require innovative product structures, a broader investor pool and a reliable trading forum if it is to sustain its strong growth rate and develop an active secondary market. Recent developments indicate that regulators, market participants and investors recognise the potential in the market, as well as the primary obstacles to its continued growth.**

Thank You