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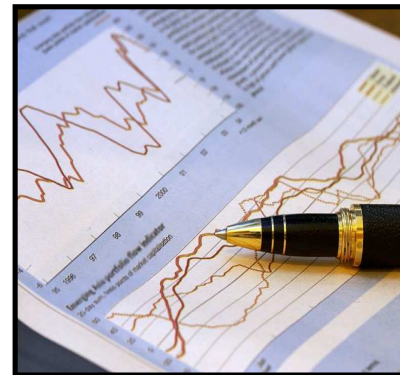
Overview of the Regulatory Framework Governing the Islamic Banking and Finance Operations in Malaysia

– Central Bank's Perspective

European Forum Of Islamic Finance

Milan, Italy

12 May 2009



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Islamic Banking and Takaful Department



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Learning and Development Learning Content



- Inherent features of Islamic finance & its relation to regulatory framework
- Approaches & strategies in formulating regulatory framework for Islamic Banking & Finance
- Components of sound & robust regulatory framework
- Emerging issues



Global financial meltdown – current financial architecture is being questioned...

C
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High **leveraging** & increased risk taking reinforces asset bubbles

Poor **underwriting** standards & insufficient **due diligence** conduct in asset back securitisation origination

Incentives & **greed** motivated by short-term profit that set aside long term value creation

Collapse of **corporate governance** & **lack of transparency**

Speculation & excessive risk taking

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Collapse of equity markets globally

World economy is entering a major slowdown, driven by worst financial crisis in 75 years

Losses by major banks, with more bank failures to emerge

Subprime crisis in US

A new global financial architecture

| BY HAROLD JAMES |

The chaotic and costly international response to the world's current financial disorder has prompted French President Nicolas Sarkozy, British Prime Minister Gordon Brown, and German President Horst Köhler, a former head of the International Monetary Fund (IMF), to call for a new Bretton Woods Conference in order to design a new global financial system. But such a demand depends on a clear understanding of what a new agreement might provide.

It is easy to see the appeal of scrap-

Woods, believed that the true lesson of the failures of the Depression-era 1930s lay precisely in the character of the large and chaotic 1933 London World Economic Conference. Keynes concluded that a really workable plan could be devised only at the insistence of "a single power or like-minded group of powers".

Keynes was basically right, but he should have added that it helps when one power can negotiate with one other power. In the past, the most effective financial diplomacy occurred bilaterally, between two powerful states that stood for different approaches to

regulated hedge funds managing the capital flows. On the other side was the Chinese solution, with increasingly costly reserve management giving way to activist sovereign wealth funds looking for strategic participation in investments abroad.

Both approaches were flawed — and liable to produce political controversy. The American model failed because banks proved to be highly vulnerable to panic once it became clear that sophisticated new financial instruments had formed a haystack spiked with sharp, dangerous, and indigestible losses. And, inevitably, today's

Need to speed up review of financial architecture

THERE is a need to speed up the review of the present financial architecture in order to prevent, manage and resolve future crises in a global environment of liberalised capital flows.

A research fellow of the Ma-

change rate in combination with some controls on destabilising capital flows would remain the most plausible option.

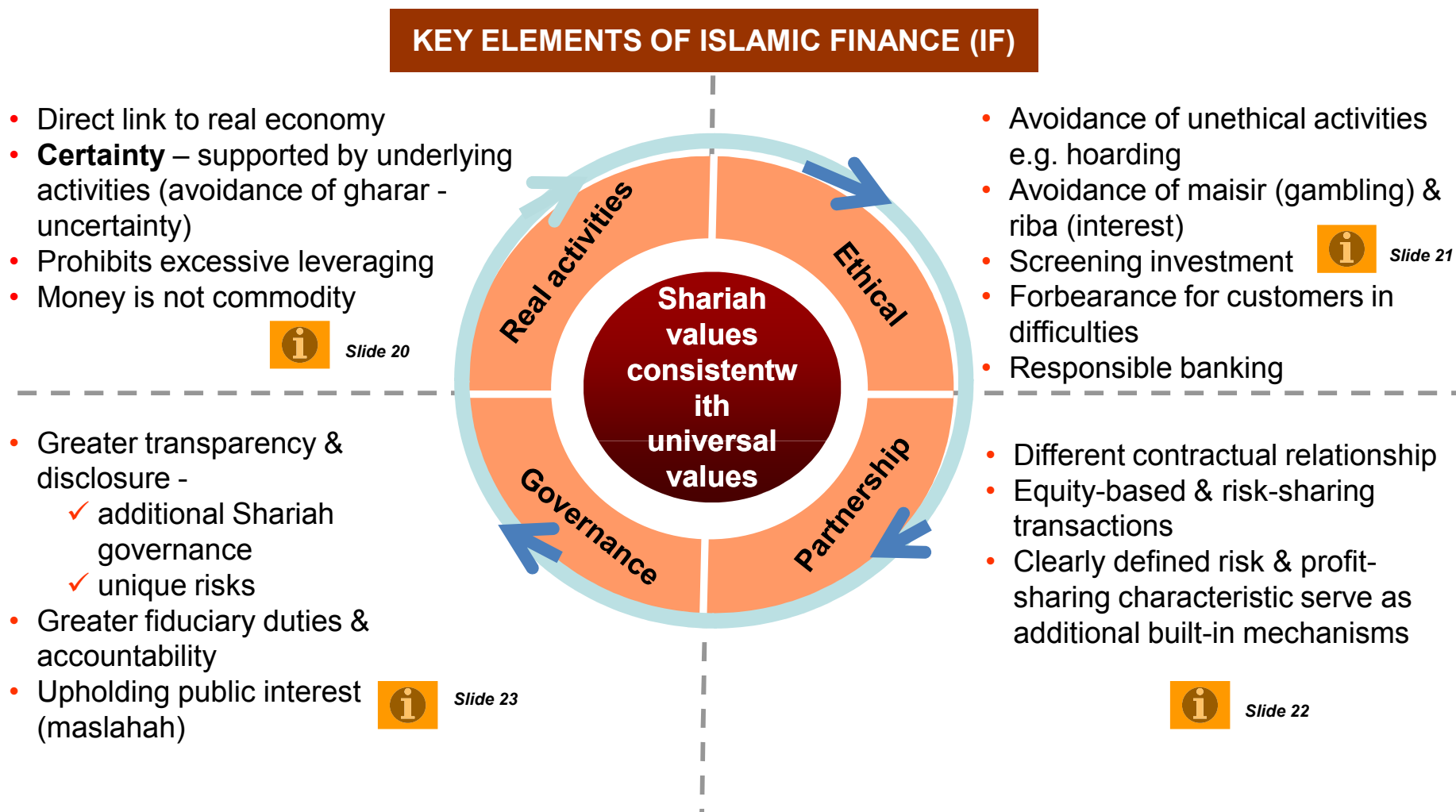
Chew said the volume of international capital flow which had experienced dramatic expansion

many economies in ways that will be beyond the control of the policymakers," he said, adding that Malaysia was right in drawing attention to these negative aspects.

"A strengthening of institutions and international arrangements

Islamic finance has been a subject of discussion and reviews ... the least affected and largely unscathed

Islamic Finance is based on Shariah principles that is universal in nature..



... universal values embedded in Shariah principles has a valuable inherent-prudential features that strengthens the safety nets of a banking system

More leaders are now voicing in support of the universal values promulgated by Islamic Finance...

BBC Low graphics Help

E-mail this to a friend Printable version

Archbishops attack City practices

The two most senior figures in the Church of England have condemned the practices of some financial traders.



Writing in the Spectator, Archbishop of Canterbury Dr Rowan Williams attacked "paper transactions with no concrete outcome beyond profit for traders".

The Archbishops of Canterbury and

Vatican Says Islamic Finance May Help Western Banks in Crisis

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By Lorenzo Totaro

March 4 (Bloomberg) -- The Vatican said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis.

"The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service," the Vatican's official newspaper Osservatore Romano said in an [article](#) in its latest issue late yesterday.

Author Loretta Napoleoni and Abaxbank Spa fixed income strategist, Claudia Segre, say in the article that "Western banks could use tools such as the Islamic bonds, known as sukuk, as collateral". Sukuk may be used to fund the "car industry or the next Olympic Games in London," they say.

ALL BUSINESS DAILY

The Malaysian Reserve

Crisis widens appeal of Islamic finance as France jumps on board

FRANCE is the latest country to woo Islamic banks, which avoided much of the damage from the sub-prime mortgage crisis by following strict principles laid out in the Quran, as the global financial crisis broadens the appeal of Islamic finance, reports news-wire AP.



FINANCIAL TIMES

Gordon Brown, British prime minister, told the annual conference of the ruling Labour party two weeks ago that his government moved to ban short selling of banks and insurers because "the interests of savers and homeowners and mortgage holders came before the interests of a few hedge funds".

Other political leaders ratcheted up the rhetoric. Silvio Berlusconi last week banned what he called "speculative attacks" on Italy's banks. Peer Steinbrück, German finance minister, went further, calling for a global ban on "purely speculative short selling".

Financial transactions undertaken by Islamic financial institutions reflected by different balance sheet composition...

Stylised balance sheet of Islamic financial institutions	Balance sheet of conventional financial institutions
Assets	Assets
Cash and cash equivalents Investment in securities Sales receivables Investment in leased assets Investment in real estates Equity financing Equity investment in capital ventures Inventories Investment in subsidiaries Fixed assets Other assets	Cash and cash equivalents Investment in securities Loan and advances Statutory deposits Investment in subsidiaries Fixed assets Other assets
Liabilities	Liabilities
Current account Other liabilities	Deposits Other liabilities
Equity of Profit Sharing Investment Accounts (PSIA)	
Profit sharing investment accounts Profit equalisation reserve Investment risk reserve	<div style="border: 1px dashed black; padding: 5px; display: inline-block;"> <i>Determination of return to depositors based on actual portfolio yield</i> </div>
Owners' Equity	Owners' Equity

Learning and Development Learning Content

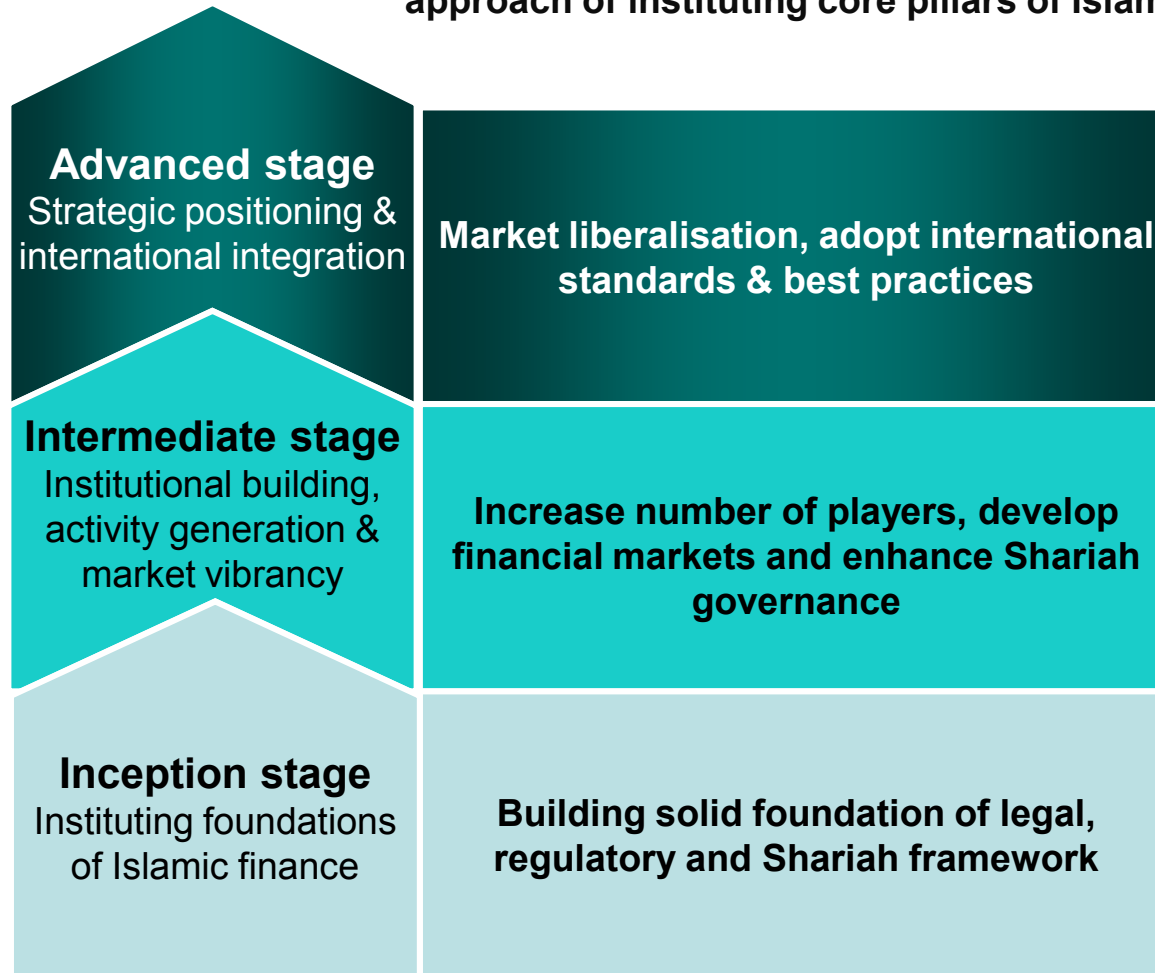


- Inherent features of Islamic finance and its relation to regulatory framework
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Pragmatic & Gradual Development Approach

...today's robust IF system is built on comprehensive & pragmatic approach of instituting core pillars of Islamic finance...



Structured measures in setting out strong regulatory foundation

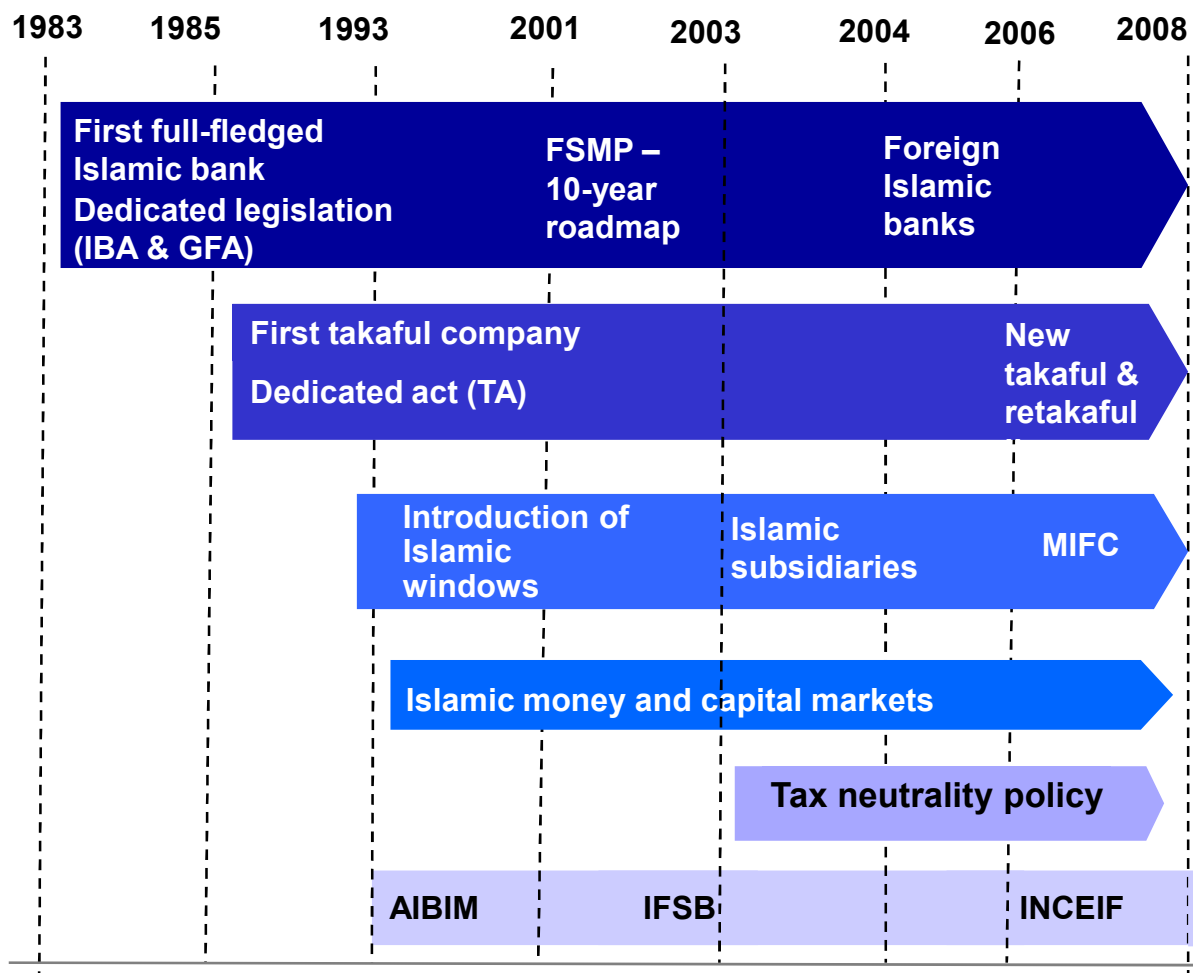


- ✓ Financial Sector Master Plan (FSMP)
- ✓ Capital Market Master Plan



Malaysia's holistic & forward looking approach... evolution with strategic direction

Flexible and facilitative policy is imperative...



- Regulation should evolve over time with changes in the structure / architecture landscape of economy
- Diversity of institutional structure
 - ✓ full-fledged Islamic banks
 - ✓ Islamic windows
 - ✓ Islamic subsidiaries
 - ✓ International Islamic Banks
- Robust financial markets
 - ✓ money & capital market, Government Funding Act (GFA)
- Tax neutrality principles
 - ✓ equal treatment vis-à-vis conventional banking – creation of “level playing field”
 - ✓ exempt additional instruments & transactions executed to fulfill Shariah requirement, from additional stamp duty & tax payment

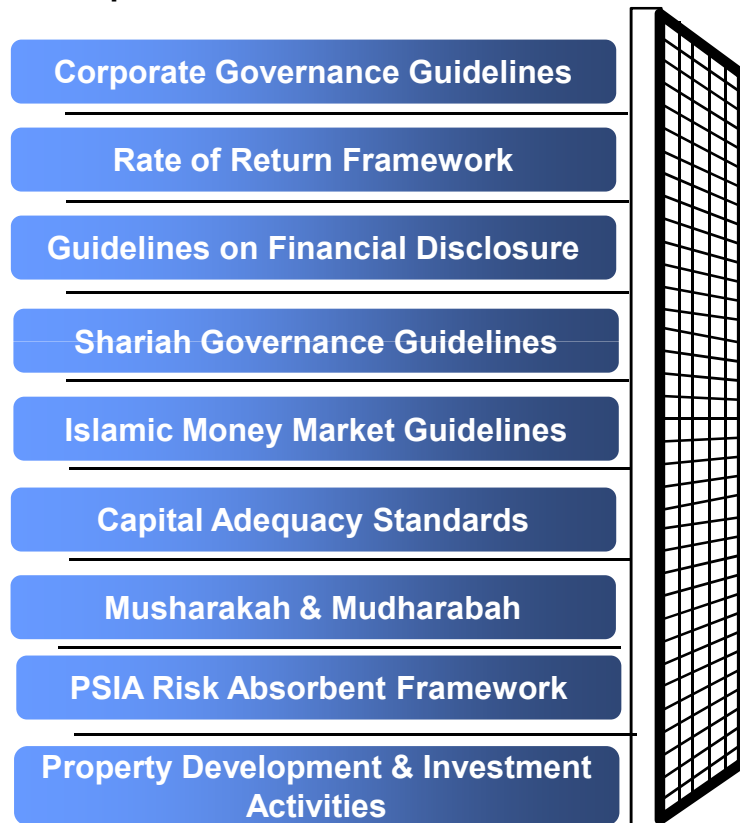
...regulation has to be effective and efficient

* IBA – Islamic Banking Act; GFA – Government Funding Act; TA – Takaful Act; MIFC – Malaysia Islamic Financial Centre; ISRA - International Shariah Research Academy for Islamic Finance; IFSB – Islamic Financial Services Board; AIBIM – Association of Islamic Banking Institutions in Malaysia

Increasing emphasis to streamline with International Standards...

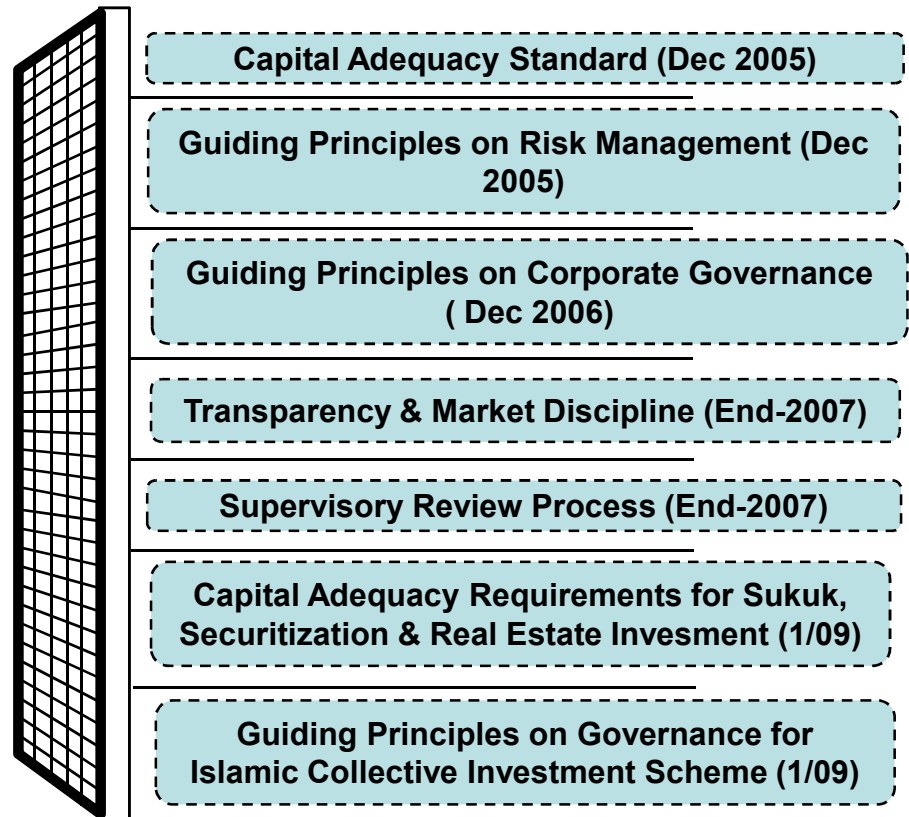
DOMESTIC REGULATION

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



INTERNATIONAL BEST PRACTICES

- IFSB made significant progress in formulating standards to address issue regulatory framework for Islamic financial institutions

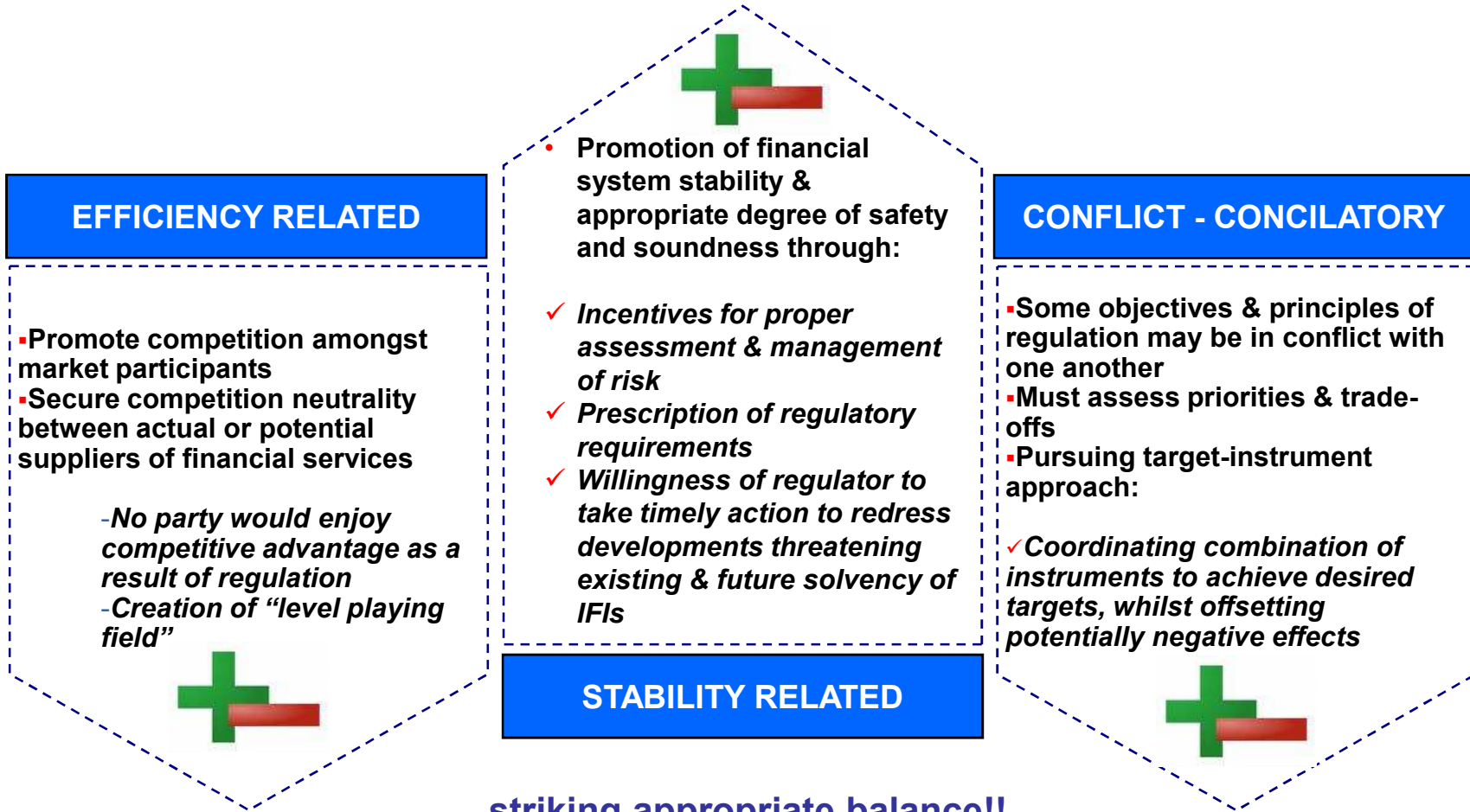


Why are international standards important?... Regulatory convergence

Note: BNM Guidelines can be downloaded at www.bnm.gov.my

* IFSB- Islamic Financial Services Board.

Principles of Regulatory Framework...



...striking appropriate balance!!



* IFI- Islamic Financial Institution

Learning and Development Learning Content



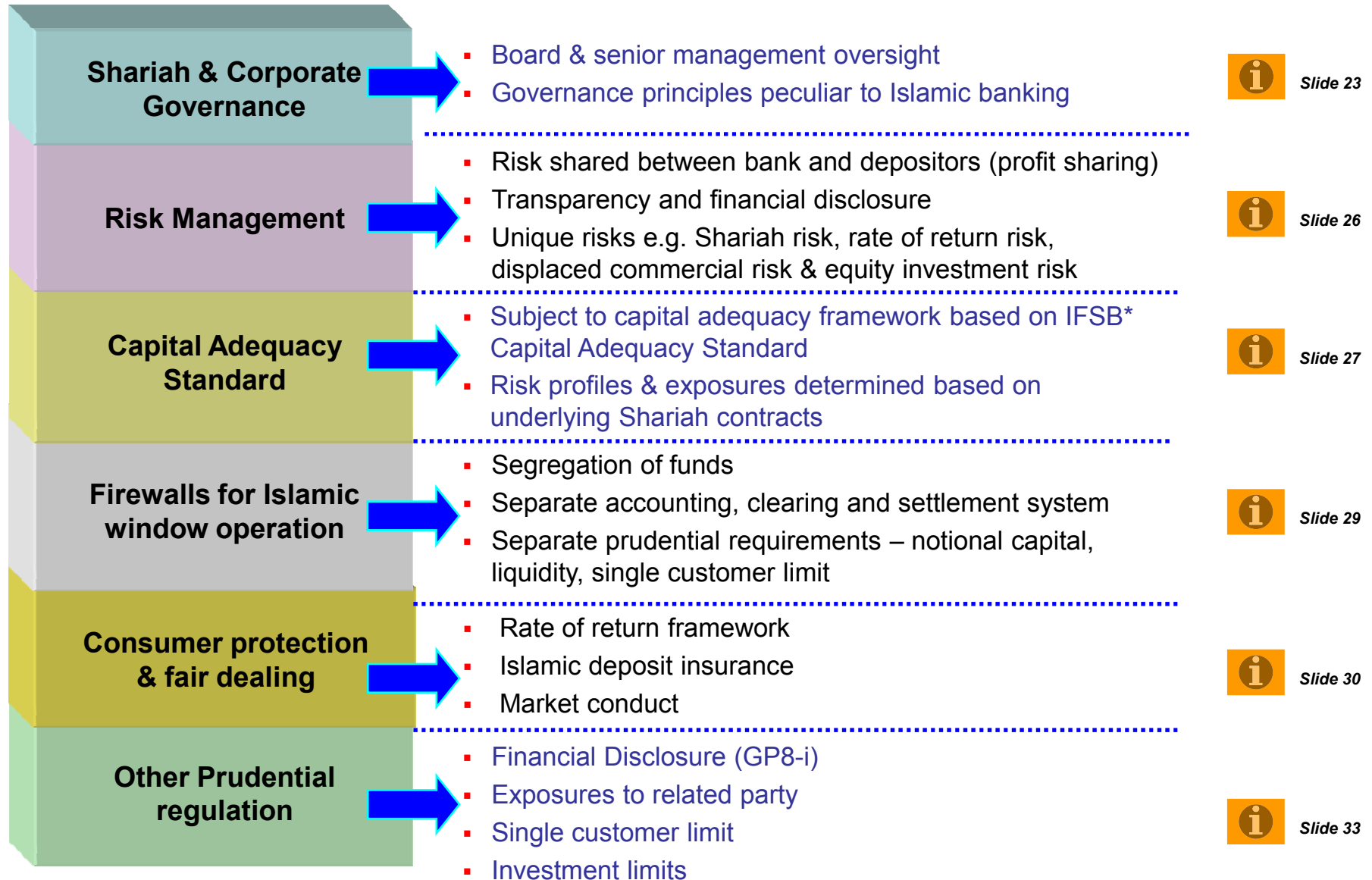
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Slide 25



Components of sound & robust regulatory framework preserve financial stability and public confidence...



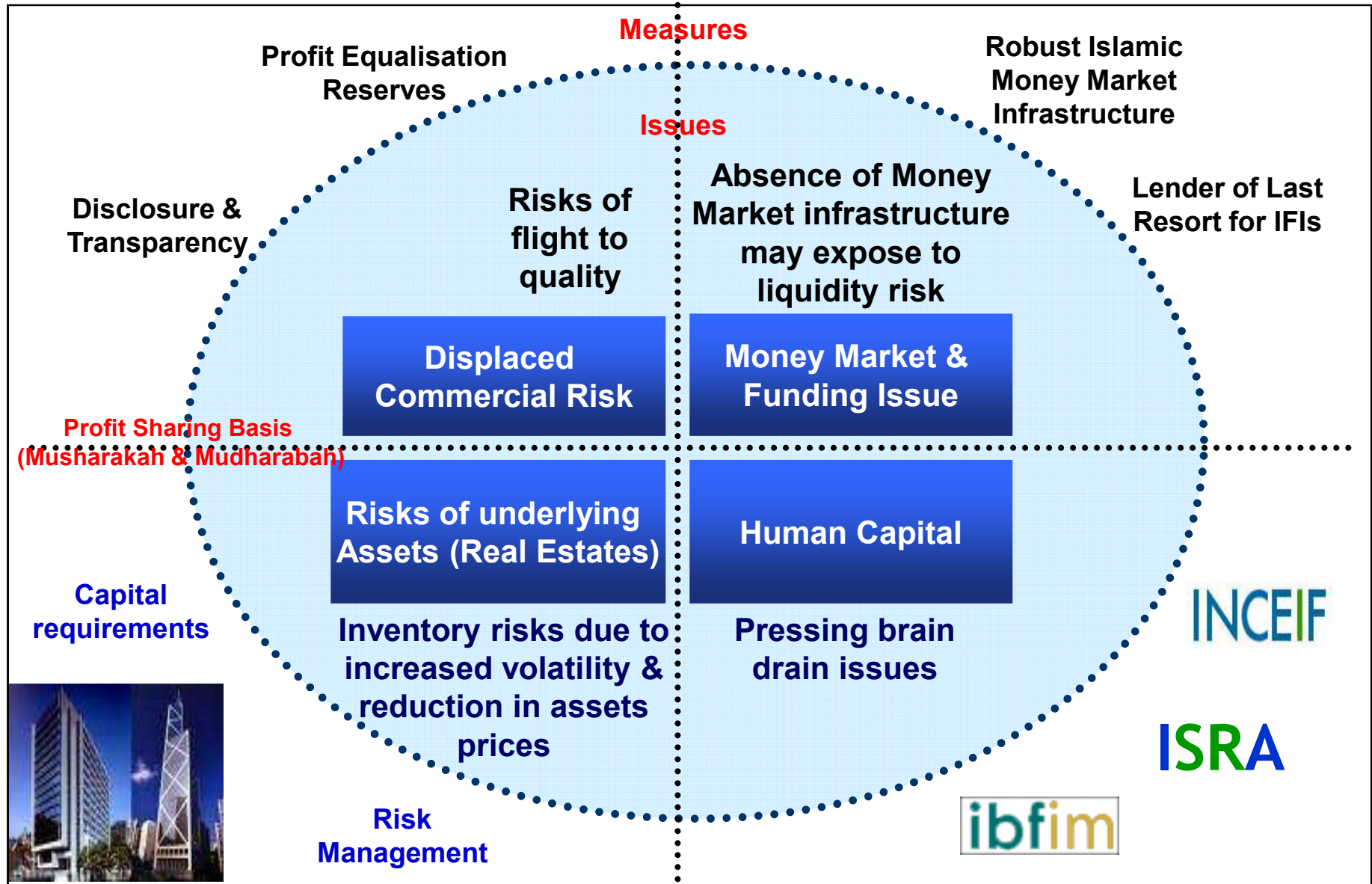
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Emerging issues... Questions to ponder...



* IBFIM - Islamic Banking and Finance Institute of Malaysia, INCEIF - International Centre for Education in Islamic Finance, ISRA – International Shariah Research Academy for Islamic Finance; IFIs – Islamic Financial Institutions

(...cont) Emerging Issues...



What is the next course of action to address these issues?

Building a **comprehensive** Islamic finance system

Governance

• Legal & Regulatory

- ✓ Islamic Banking Act
- ✓ Takaful Act
- ✓ Government Funding Act
- ✓ Capital Market Services Act
- ✓ Deposit Insurance Act

• Dispute Resolution

- ✓ Judicial system – dedicated high court
- ✓ KL Regional Centre for Arbitration
- ✓ Financial Mediation Bureau

• Shariah Advisory Council

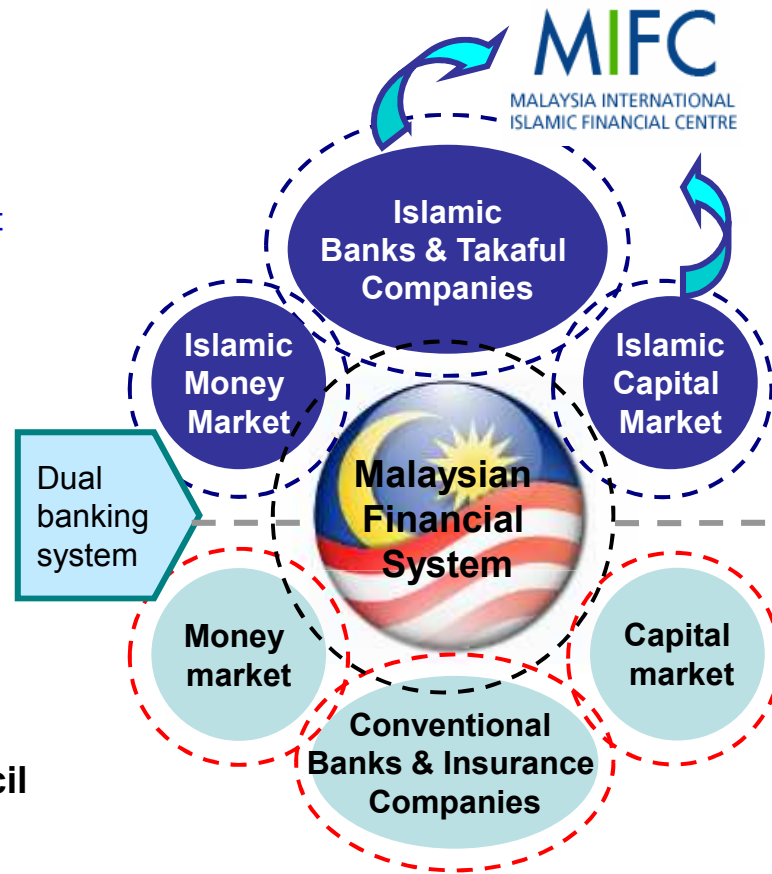
Financial Markets

• Money Market

- ✓ Islamic interbank money market
- ✓ Diverse short-term Islamic money market instruments

•Capital Market

- ✓55.9% of outstanding private debt are sukuk
- ✓87% permissible counters



Diversified Players

•Islamic Banking

- ✓17 Islamic banks
- ✓10 Islamic windows
- ✓6 DFIs offering Islamic banking
- ✓3 International Islamic Banks
- ✓14 International Currency Business Units

•Takaful

- ✓ 8 takaful operators
- ✓ 3 retakaful operators
- ✓ 1 International Takaful Operator
- ✓ 5 International Currency Business Units

• Fund Management

- ✓ 8 approved Islamic fund management companies
- ✓ 35 fund management companies with Islamic mandates
- ✓ **149 Islamic unit trust fund**

Supported by human capital infrastructure

INCEIF

ibfim

ISRA

THANK YOU

www.bnm.gov.my



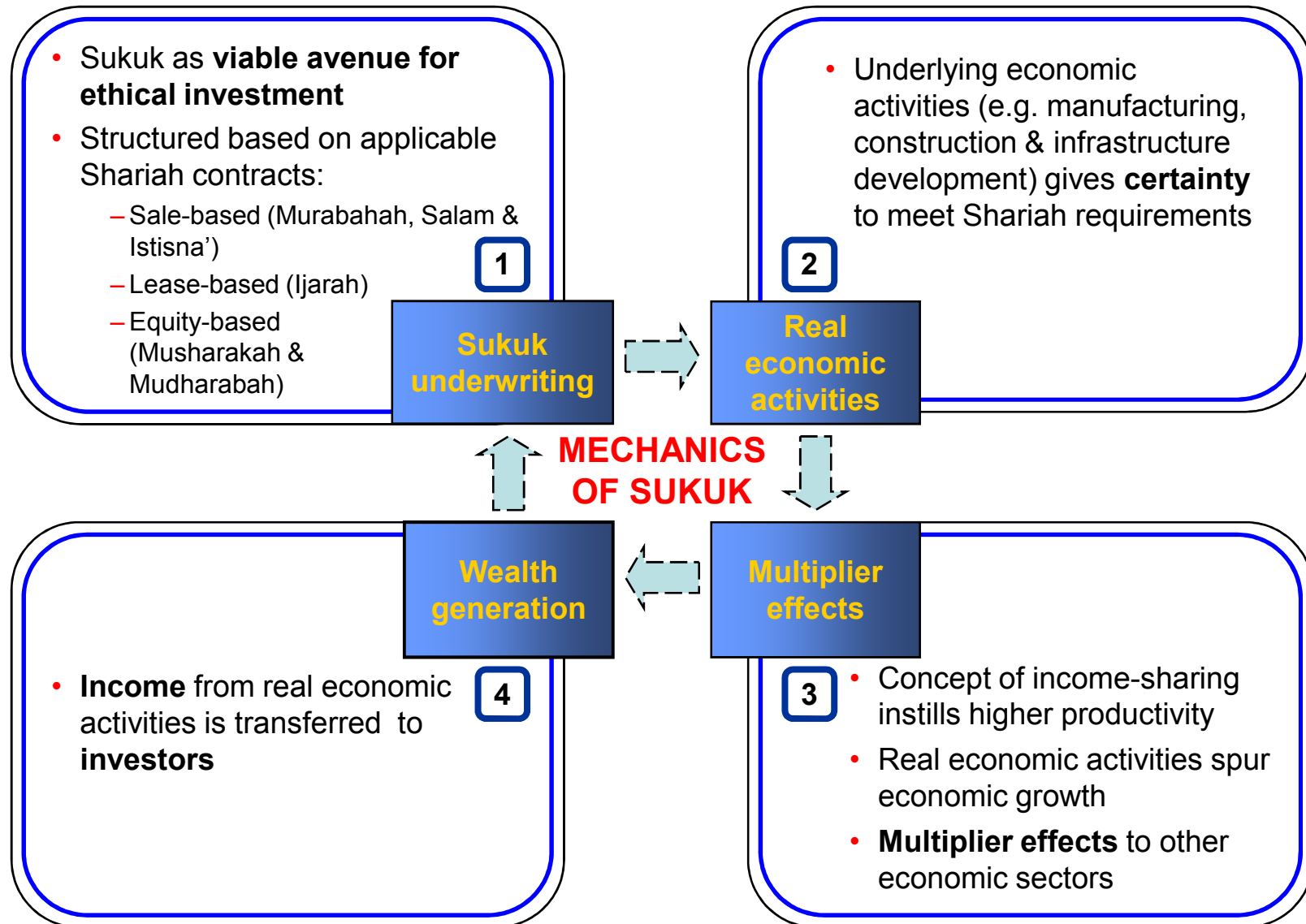
MIFC

MALAYSIA INTERNATIONAL
ISLAMIC FINANCIAL CENTRE

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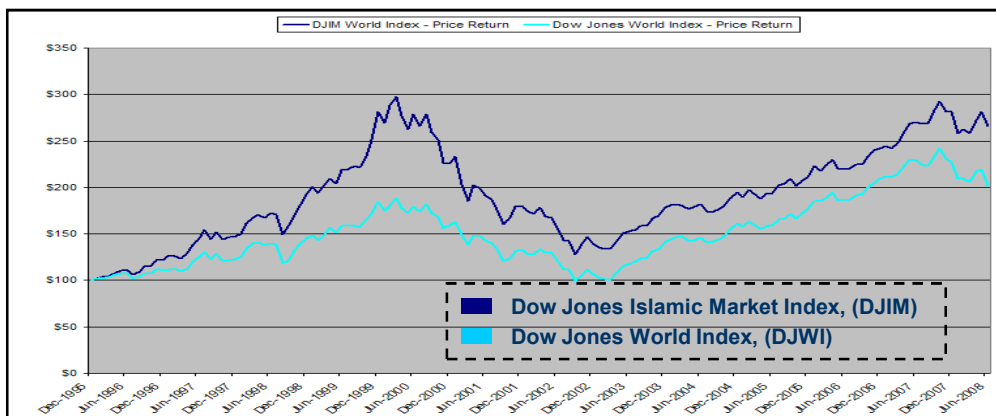
SUPPORTING SLIDES

Interlinkages between Islamic finance and **real economy** is exemplified in Sukuk structure...



Promotion of ethical finance through the application of **Shariah stock screening**...

Dow Jones Islamic Market Index	Standard & Poor Islamic Index	FTSE Islamic Index
Non permissible activities		
<ul style="list-style-type: none"> • Pork production • Non-halal food • Alcohol • Interest based institution • Gambling Inst. 	<ul style="list-style-type: none"> • Pork production • Non-halal food • Alcohol • Interest based institution • Gambling Inst. 	<ul style="list-style-type: none"> • Pork production • Non-halal food • Alcohol • Interest based institution • Gambling Inst.
Receivables		
• Acc receivables to total asset ratio < 45%	• Acc receivables to market value of equity < 49%	• Acc receivables to total asset < 45%
Leverage		
• Total debt to 12-month moving average market capitalization < 33%	• Total debt to market value of equity < 33%	• Total debt to total asset < 33%



OBJECTIVE

- Identify Shariah compliant equities through diligent screening process –

METHODOLOGY

- Assessment on **qualitative & quantitative** parameters including source of income, business activities & financial structures

BENEFITS

- Regular update on Shariah compliance status of equities
- Allow investor to make an informed decision
- Graph shows that DJIM* **exhibited better resilience** than DJWI*

* DJIM – Dow Jones Islamic Market; DJWI – Dow Jones World Index

Source: International Centre for Education in Islamic Finance, (INCEIF); Dow Jones Index 30 June 2008



Islamic banking is based on different contractual relationship including **profit sharing** basis ...

Sources of fund

Savings/ demand deposits

Custodian (e.g. Wadiah / Qard)
* Only principal is guaranteed

Investment deposits
(Profit Sharing Investment Account)

**Entrepreneur - Investor
(Mudharabah – Profit Sharing)**

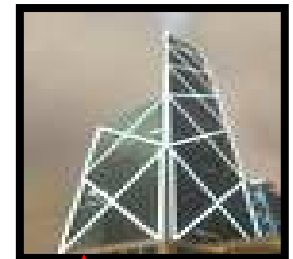
Investment Account Holders (IAH)



Provides capital



Islamic Bank



Provides business skill



Profit



Application of fund

- Financing
- Securities

Financing – Different contractual Relationship

1. Partnership Contract – Risk sharing

1. Sale Contract – Transformation of risk
2. Lease Contract – Risk on assets owned

Islamic Bank



Provides capital



Entrepreneur



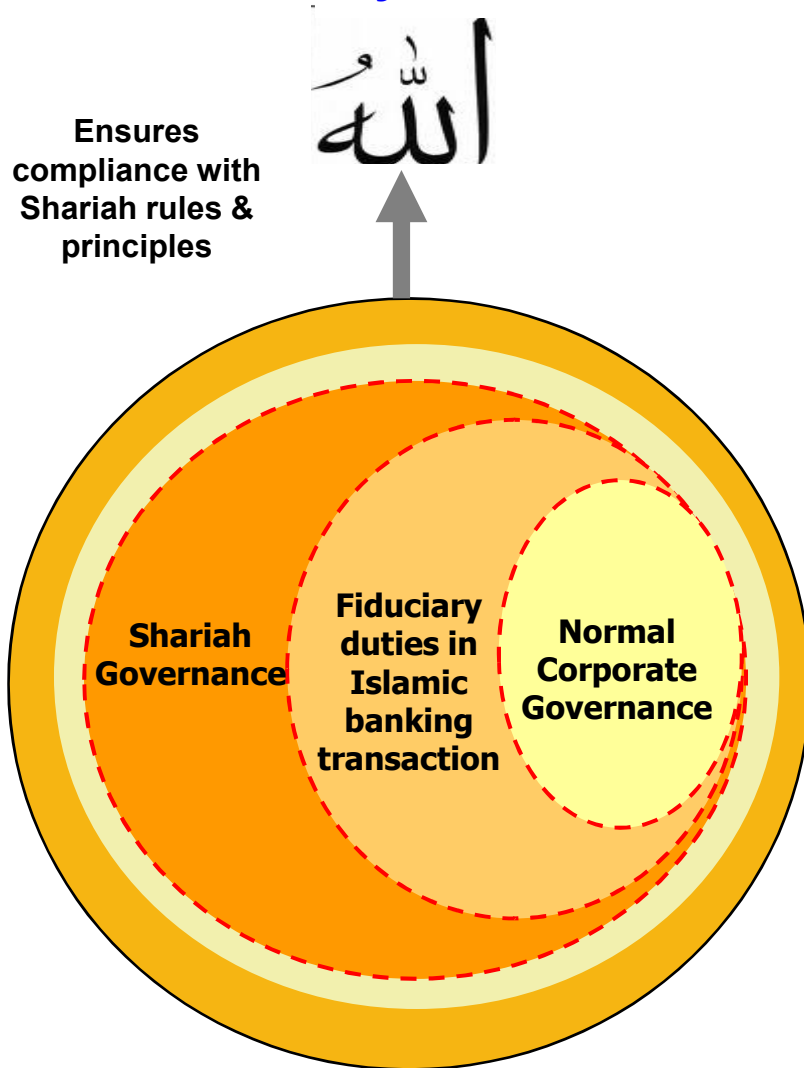
Provides business skill



Profit



Strict compliance with corporate & Shariah governance promotes financial stability...



Governance - An illustration

Liabilities

- To safeguard interest of Investment Account Holders (IAH)
 - IBI's **fiduciary responsibilities** in protecting depositors (profit sharing investment account)
 - Proper **disclosure & transparency**

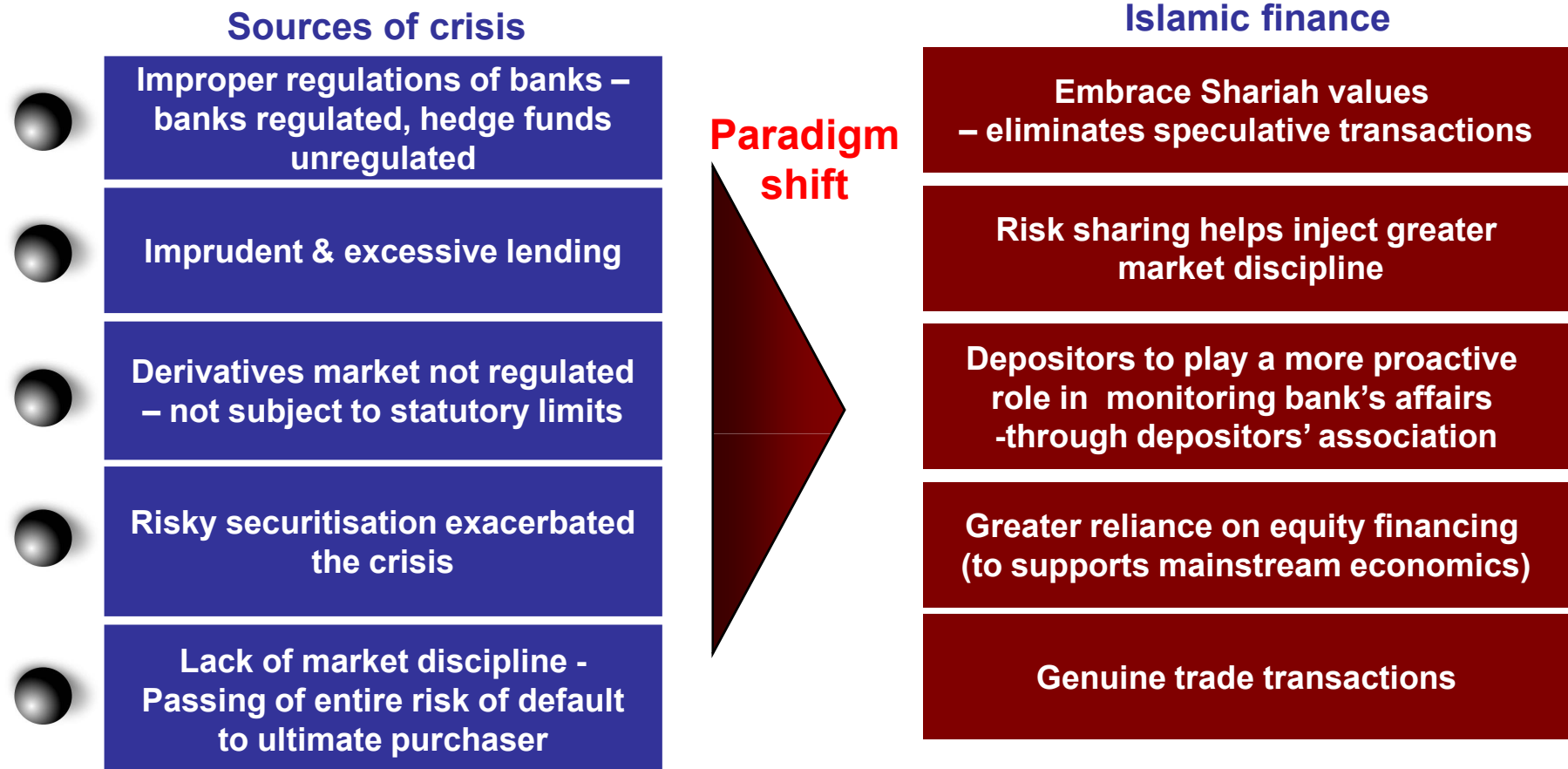
Assets

- To manage risks associated with Mudharabah (profit-sharing) & Musharakah (partnership) contracts : equity-based
 - Board to ensure IBIs have sufficient **expertise & capability**
 - Establishment of dedicated oversight function e.g. in-house property development/ research department for property investment & development activities
 - Allow appointment of Board representatives on entities involved in such transactions as monitoring mechanism

... requires higher standards of corporate governance by IBIs' Board of Directors and Management...



IDB research paper suggested that value proposition in Islamic finance may minimise severity of the crisis...



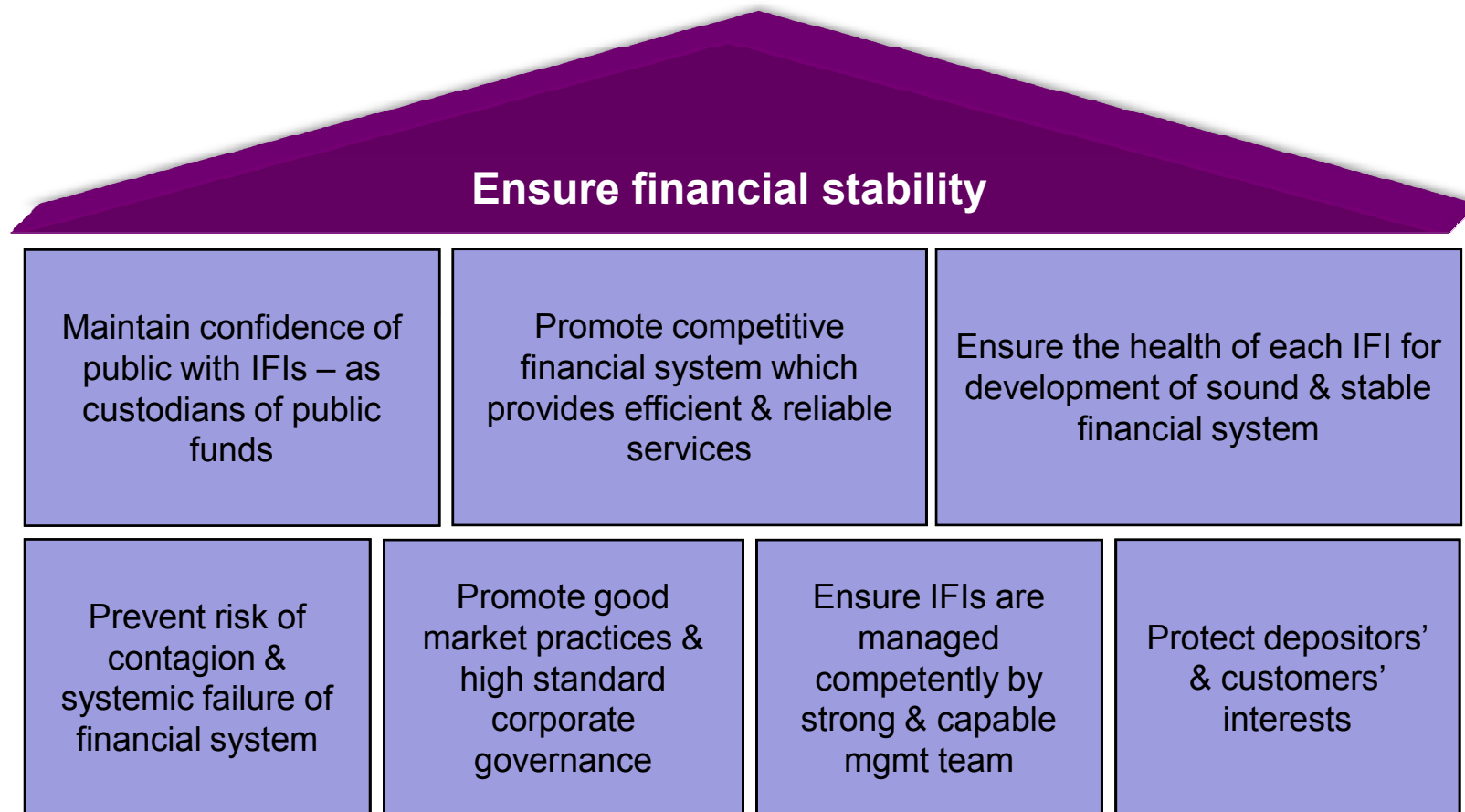
... current economic crisis is instigated by activities that are forbidden in Islam

Source: * Adopted from Umer Chapra. (2009). *The Global Financial Crisis : Can Islamic Finance help minimize the severity and frequency of such as crisis in the future?*

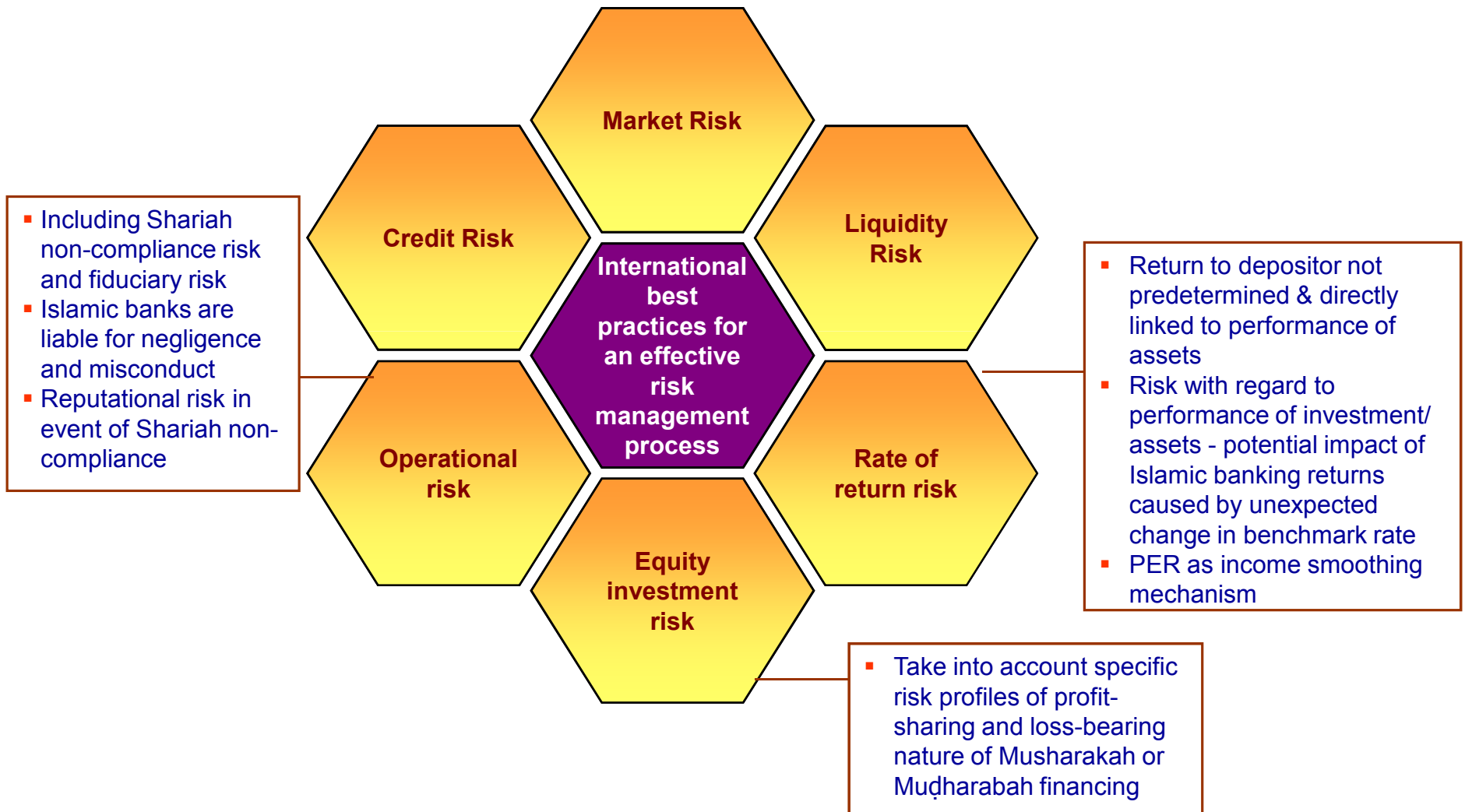


Regulatory Framework for Islamic Financial Institutions

Objective : To preserve sound Islamic financial system

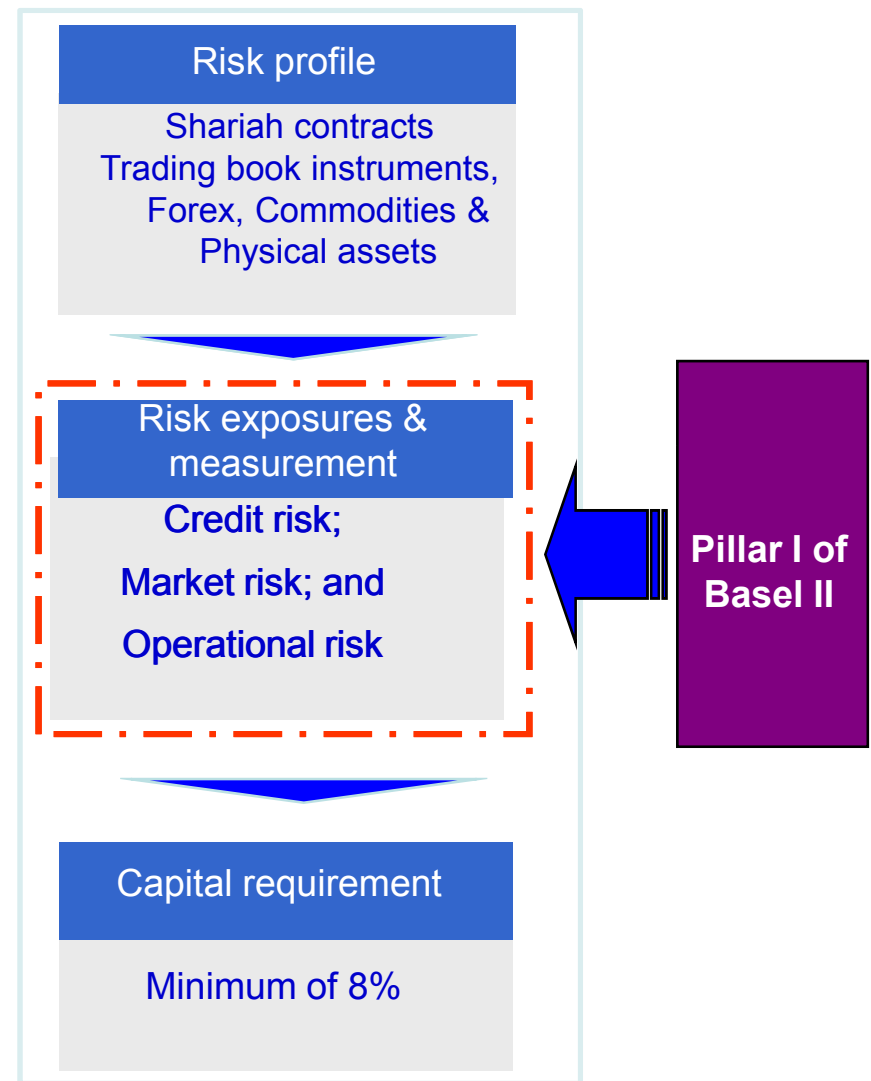


Guiding Principle of Risk Management



Capital Adequacy Standard

- Islamic banking institutions subject to the capital adequacy framework based on IFSB Capital Adequacy Standard
 - Complement Pillar I of Basel II
 - Risk profiles and exposures determined based on underlying Shariah contracts (asset-based, lease-based & equity based):
 - Adopt risk measurements, covering credit risk, market risk & operational risk
- Islamic banks allowed to migrate to Internal rating based approach (IRB) in 2010 (subject to meeting BNM's requirements)
- Minimum capital adequacy requirements of 8%, consistent with Basel requirement



Capital Adequacy Standard (cont'd)

Key consideration was given to the risk exposures arising from assets & investments funded by Profit Sharing Investment Accounts (PSIA)

- Capital amount of PSIA is not guaranteed by IFIs any losses arising from investments or assets financed by PSIA are to be borne by *Mudharabah* depositors
- Therefore, assets funded by PSIA does not require capital (credit & market risk)

Standard Formula

ELIGIBLE CAPITAL	
TOTAL: RWA (CR + MR) + ORW	LESS FUNDED BY PSIA: RWA (CR + MR)

Supervisory Discretion Formula

ELIGIBLE CAPITAL		
TOTAL: RWA (CR + MR) + ORW	LESS (1- α)	FUNDED BY PSIA: RWA (CR + MR)
	LESS α	FUNDED BY PER/IRR: RWA (CR+MR)

Minimum requirements for the recognition of PSIA as risk absorbent hinges on the key criteria as follows:

- Ensure adequate legal backing in passing the risk
- Implement tagging capability
- Establish governance of PSIA
- Undertake disclosure and transparency practices for PSIA



Firewalls for Islamic Window Operation

Firewalls for dual banking via issuance of **specific guidelines** on Islamic window operations



OUTCOMES...

- Promote strategic focus in Islamic banking business
- Ensures no co-mingling of funds
- Promote transparency and fairness
- Proper segregation of funds

Established dedicated Islamic banking division

Allocated capital for Islamic banking operation

Min. CCR (4%), RWCR (8%)

Min. Islamic Banking Fund

Islamic funds are segregated from conventional funds

Separate clearing accounts
Separate membership code in RENTAS*

Separate cheque clearing system

Separate compliance to Statutory reserve requirements, liquidity framework, provisioning & single customer limit

POLICY INITIATIVES

Separate disclosure of Islamic banking portfolio in financial statements

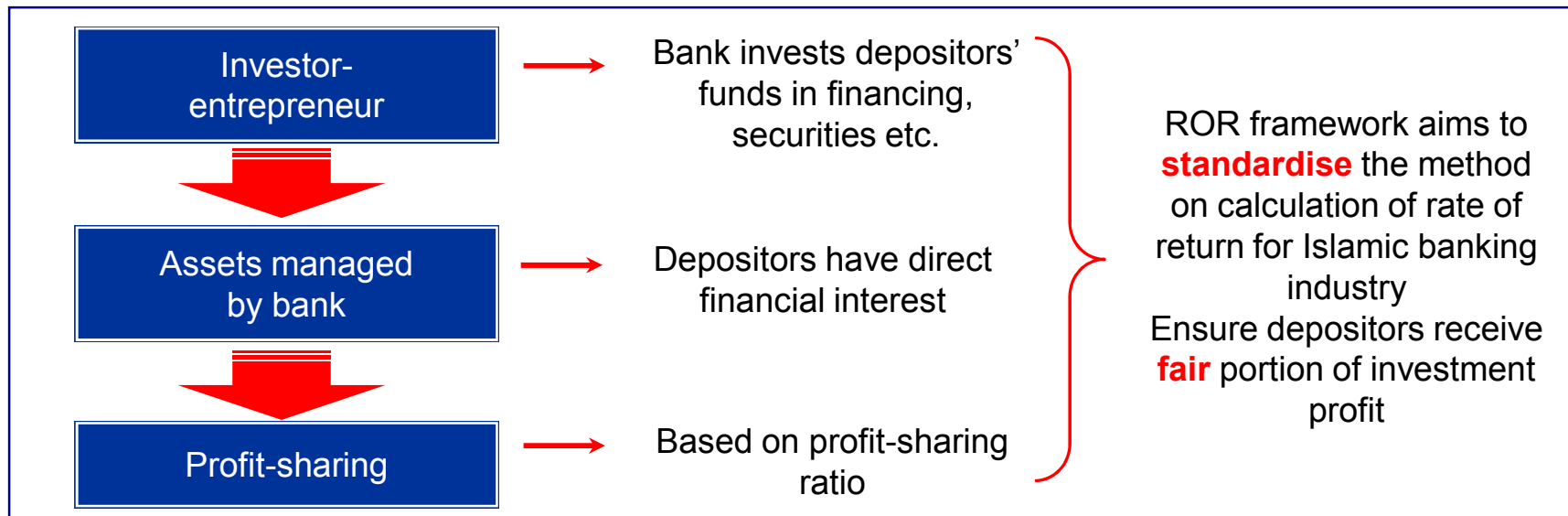
Separate submission of statistical reports in Financial Inst. Statistical System on monthly basis

* RENTAS - Real Time Electronic Transfer of Funds and Securities



Rate of Return (ROR) Framework & Profit Equalization Reserve (PER)

ROR framework arises from contractual relationship i.e. mudharabah (profit-sharing)

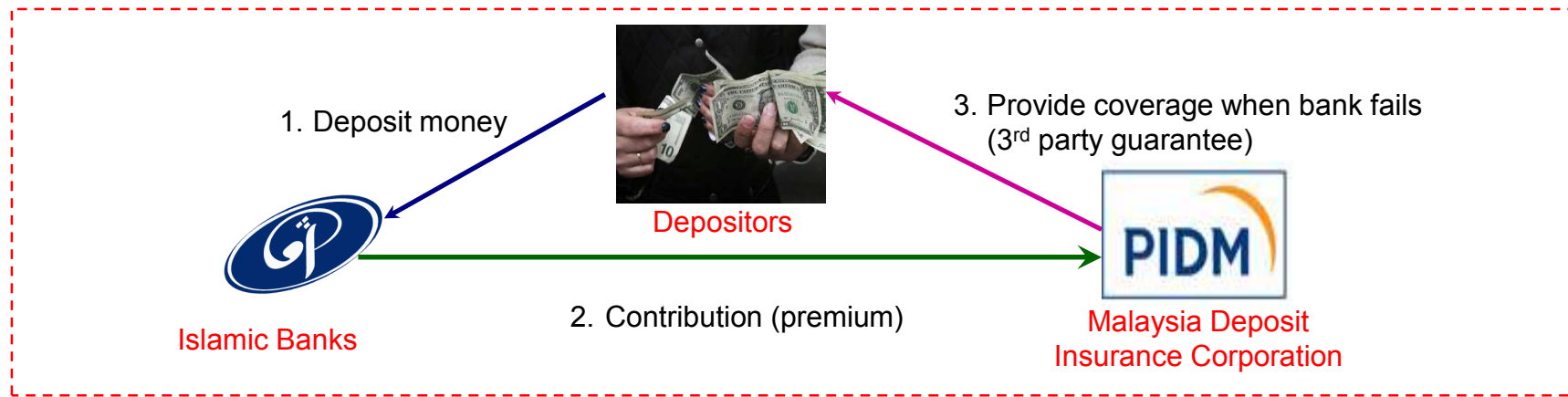


PER to mitigate/ minimize liquidity risk

- Amount appropriated out of the total gross income in order to maintain a certain level of return for depositor provision shared by both the depositors and the bank
- Monthly PER is capped at 15% of total gross income
- IBs are allowed to maintain max. accumulated PER up to 30% of total shareholders' funds



Dedicated Deposit Insurance Act empowers PIDM to manage Islamic deposit insurance



Separation & equitable treatment principles

Separate management of funds

- Funded by contribution (premium) collected from Islamic banks
- Pooled contribution (funds) managed separately
- Invest in Shariah compliant instruments

Equivalent Coverage Limit

- Islamic deposit covered separately from conventional
- All coverage limit -similar to conventional
- Up to RM60k per depositor per member institution
- Covers 90% of total depositors*

Separate Premium Assessment

- Separate deposit premium assessment system for Islamic & conventional
- Separate supervisory assessment for Islamic & conventional banking institutions (incl. windows)

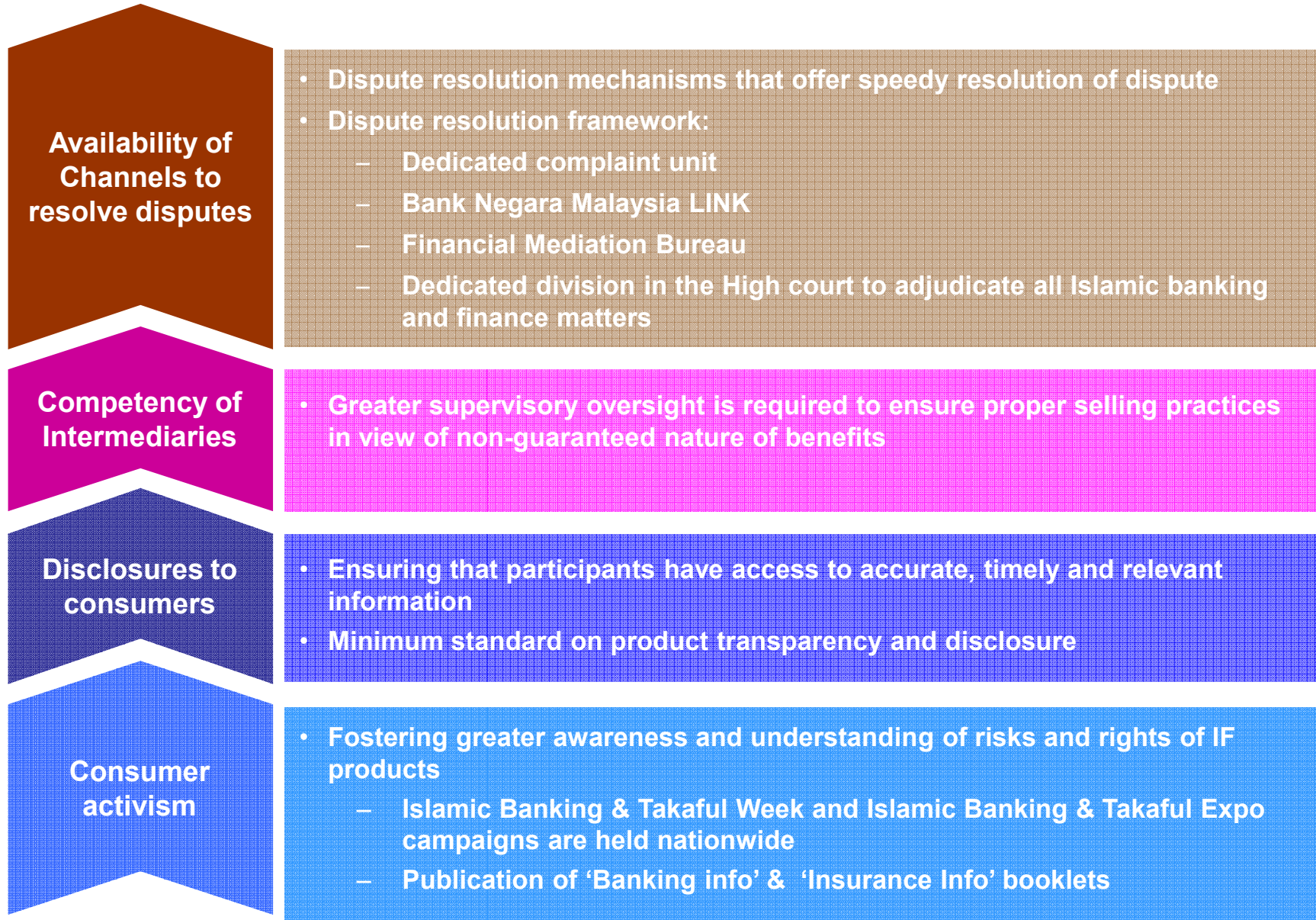
Separate Payout

- Separate payment in event of failure
- Islamic deposit insurance funds used only for Islamic banks
- Deficit contribution - can raise funds from government based on Shariah principles

* Based on BNM Survey



Market Conduct & Consumer Protection



Financial Disclosure.....

