

Creating Effective and Efficient Regulatory Framework for Islamic Capital Market

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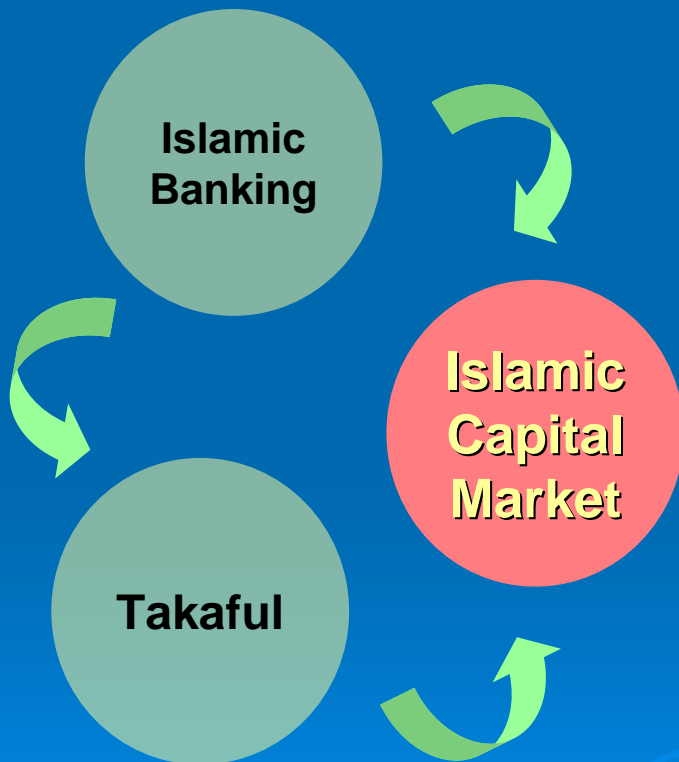
Securities Commission of Malaysia

Agenda

- Overview
- Building blocks for efficient capital markets
- Malaysian approach to develop ICM products
- Key challenges

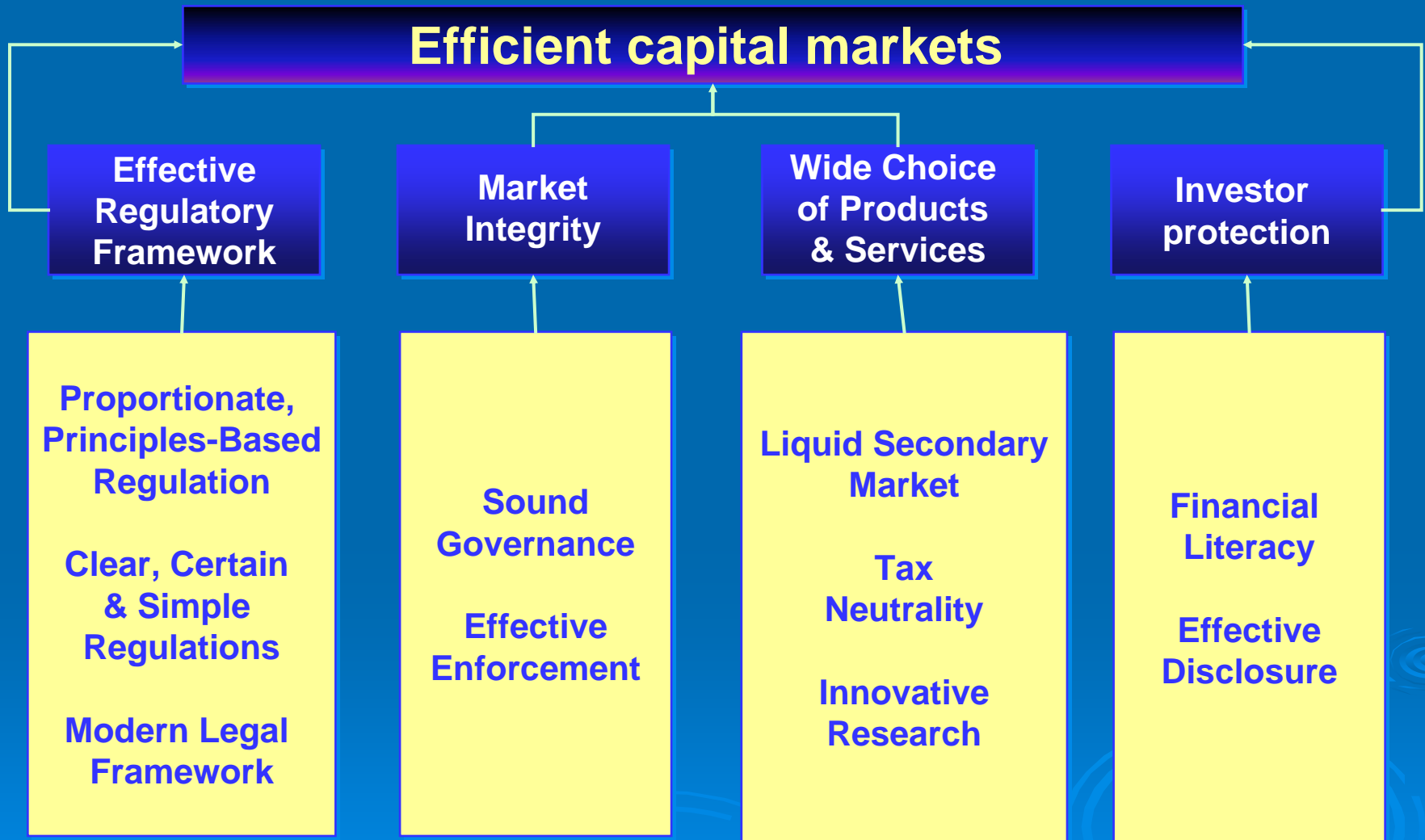
Islamic capital market is now an important component of the global financial system

Significant developments



- Increased Shari'ah compliant stocks
- Market capitalization of Global DJIMI at USD 3 trillion
- Development of sukuk
- Growing demand from the Middle East, South-East Asia, South Asia and North Africa
- Introduction of facilitative legal frameworks and tax neutrality
- Conventional investors view ICM as a new asset class

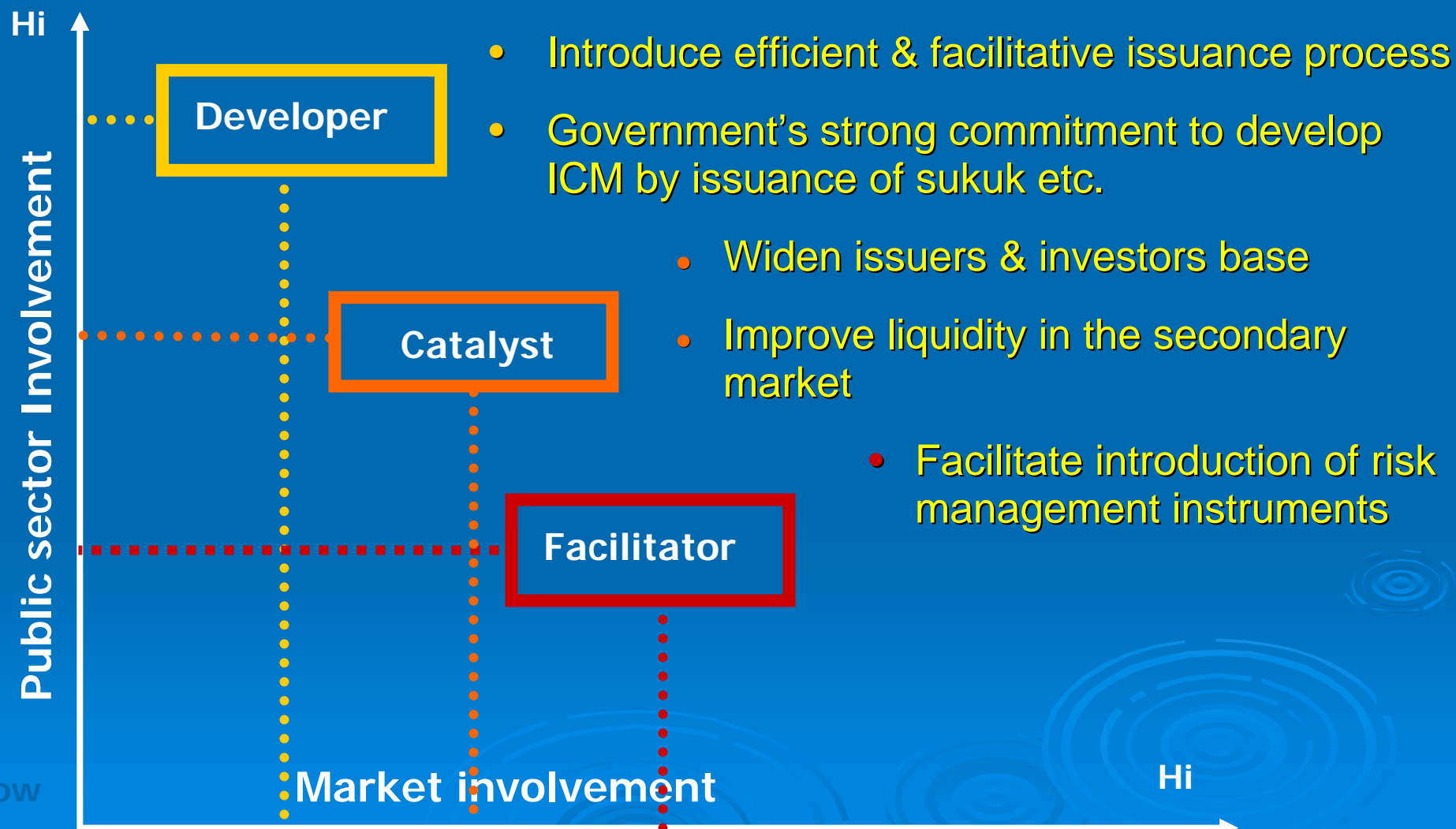
Building blocks of efficient capital markets



Policies makers can support an efficient Islamic capital market by getting the regulatory framework right for stakeholders...

Investors	Issuers	Intermediaries	Regulators
<ul style="list-style-type: none">• Access to information on timely basis• Effective enforcement• Redress when aggrieved	<ul style="list-style-type: none">• Efficient access to capital• Minimal regulatory cost to capital• Liquid markets	<ul style="list-style-type: none">• Simple, efficient and responsive regulatory structure• Responsive to innovations and new products	<ul style="list-style-type: none">• Cooperation and engagement with market participants• Adequate risk management infrastructure• Broad range of enforcement tools

Malaysia's approach to develop ICM framework



Malaysia's regulatory approach to ICM

– Two tiered structure

1st Tier – General regulatory requirements

- Guidelines on Offering of Asset-backed Securities
- Guidelines on REITs

2nd Tier – Specific requirements for Shari'ah compliance

- Guidelines on Offering of Islamic Securities
- Guidelines on Islamic REITs

- **The 2nd tier may comprise additional / differentiated disclosure requirements**
- **Appointment of Shari'ah advisers to ensure Shari'ah compliance**

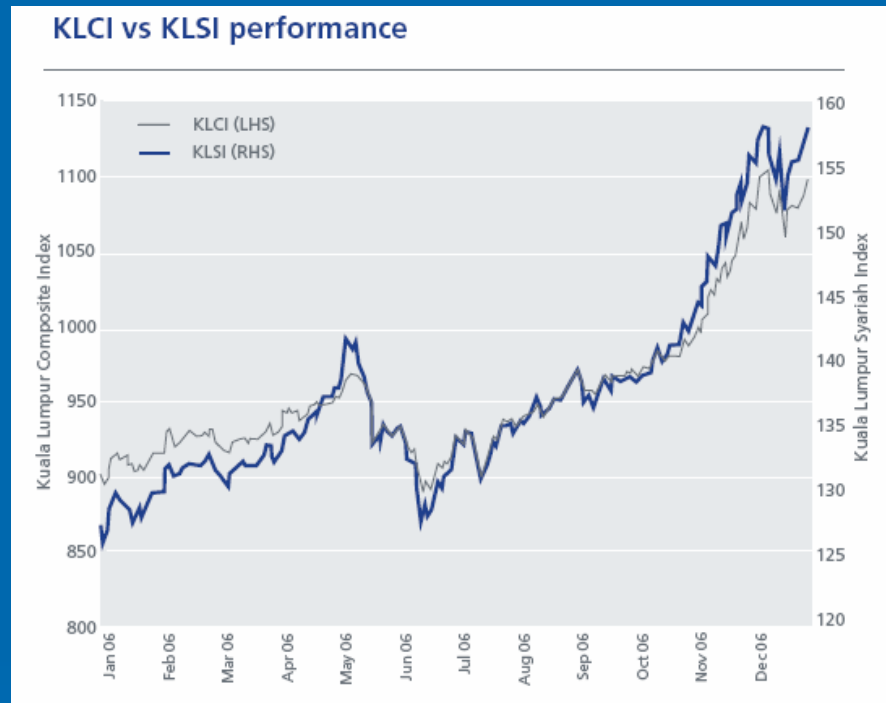
Shari'ah-compliant securities on Bursa Malaysia

Number of Shari'ah-compliant securities – 30 Oct 2006	886 securities
% of Shari'ah-compliant securities to total listed securities	86%
Market Capitalisation (end-January 2007)	(RM billion)
Shari'ah-compliant securities	591.62
Total market capitalisation	920.70
% of Shari'ah-compliant securities to total market capitalisation	64.26%

Source: SC

Performance of Kuala Lumpur Shari'ah Index vis-à-vis KLCI

Equity market indices	30 Dec 06	31 Jan 07	% change
Kuala Lumpur Composite Index	1,096.24	1,189.35	8.5%
Kuala Lumpur Shari'ah Index	157.36	169.55	7.7%
FBM EMAS Shari'ah Index ²	n/a	7,868.37	n/a



Source: SC (Oct 2006)

1. The SAC released the updated Shari'ah-compliant securities list in April and October 2006.
2. Launched on 22 January 2007.

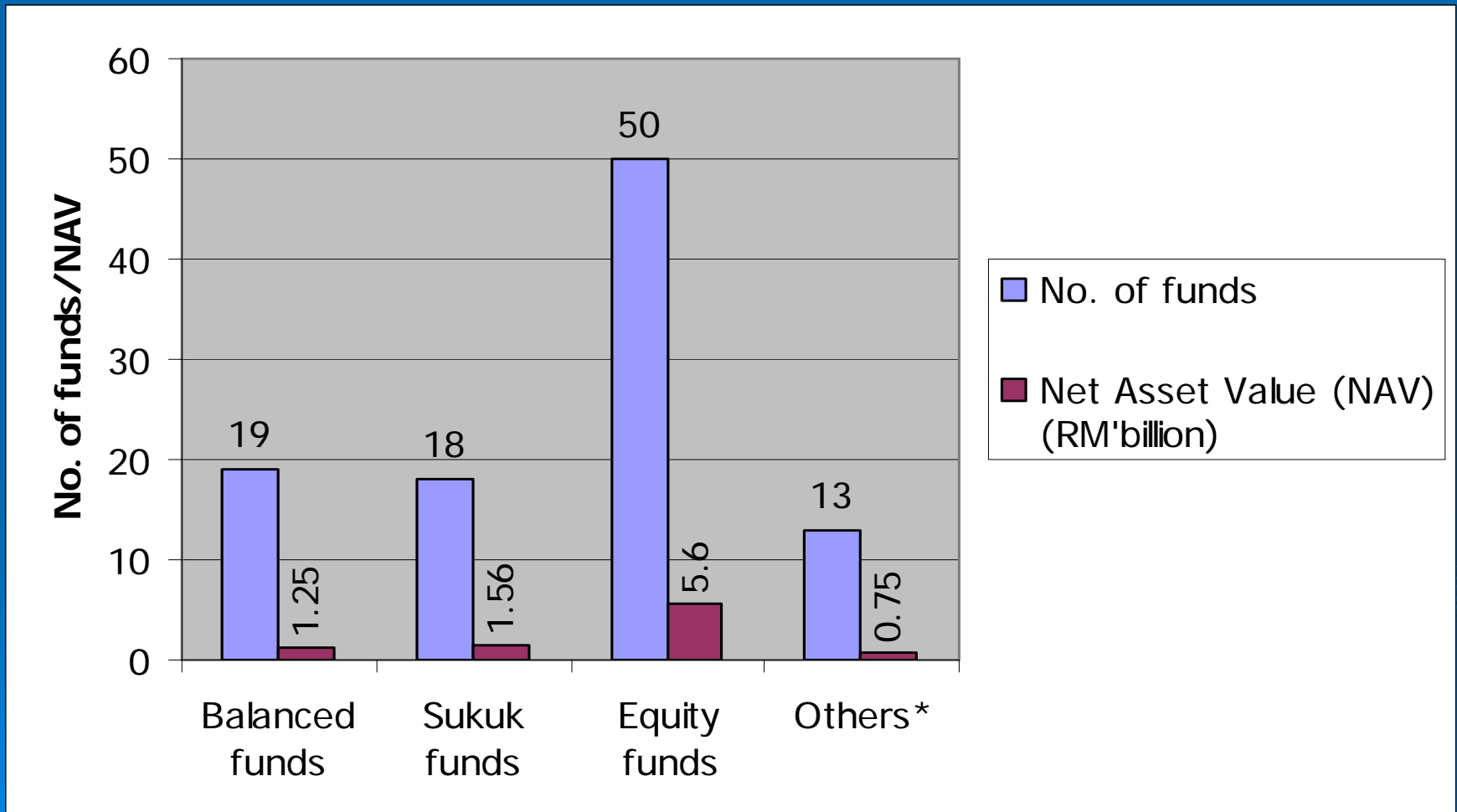
Size of Shari'ah-based unit trust funds as at 30 October 2006

Number of approved funds	2005	2006
Shari'ah-based	83	100
Total industry	340	416
Net asset value (NAV) of approved funds	2005	2006
Shari'ah-based	RM8.5 billion	RM9.2 billion
Total industry	RM98.5 billion	RM121.8 billion
% of Shari'ah-based to total industry	8.6%	7.6%

Source: SC

Broad variety of Shari'ah unit trust products

Shari'ah-based unit trust funds by category



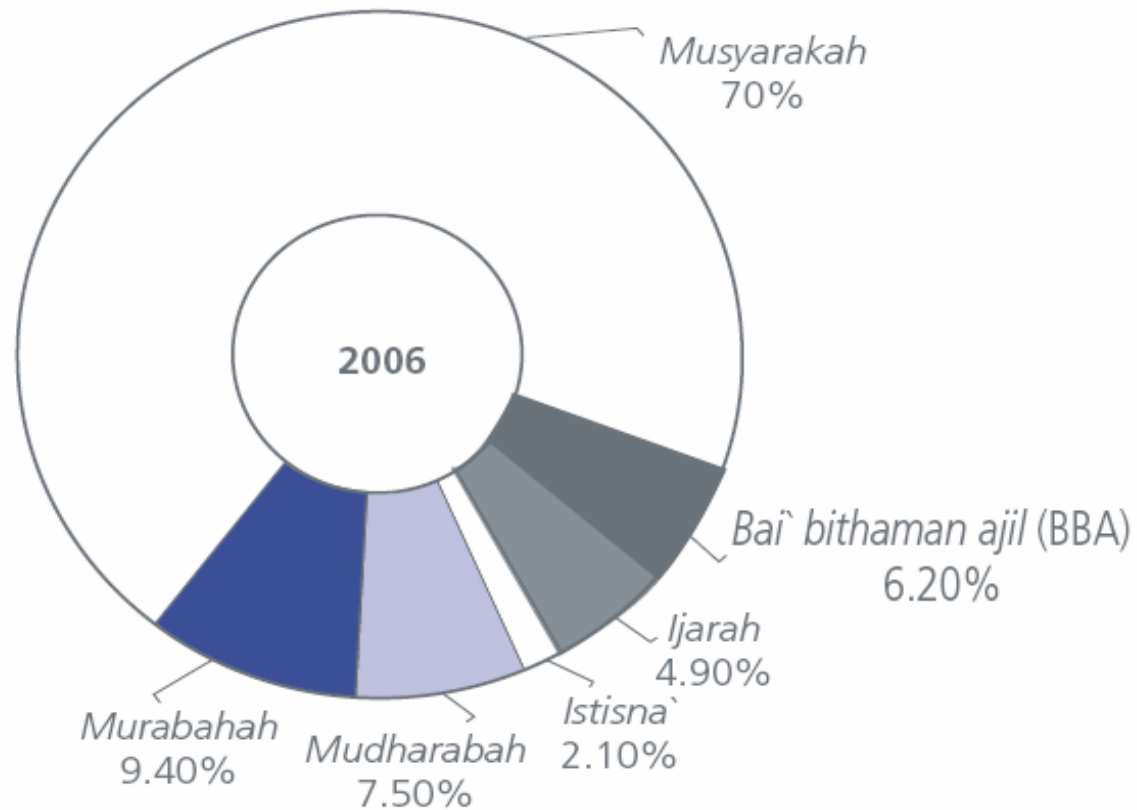
Source: SC

Growing demand for sukuk...

	2005	2006
Size of outstanding <i>sukuk</i> (excluding government <i>sukuk</i>)	RM91.3 billion	RM105.2 billion
% of outstanding <i>sukuk</i> to total outstanding bonds	43.85%	47.75%
<i>Sukuk</i> approved by the SC	2005	2006
Number of <i>sukuk</i>	77	64
Size of <i>sukuk</i>	RM43.32 billion	RM42.02 billion
Size of total bonds approved	RM60.66 billion	RM75.83 billion
% of size of <i>sukuk</i> to total bonds approved	71.41%	55.41%

Source: SC

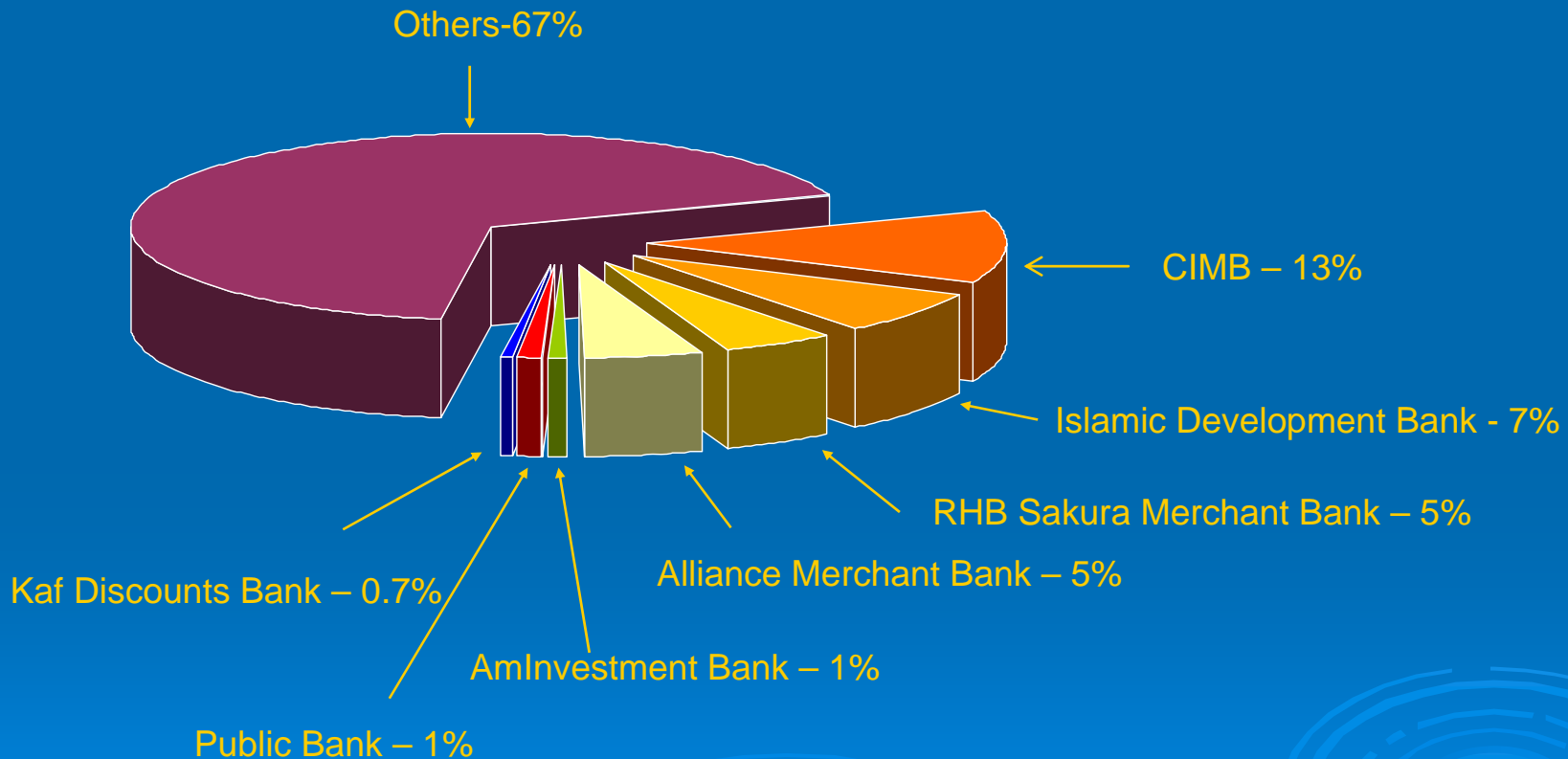
Sukuk approved based on various Shari'ah principles



Source: SC

Malaysian Islamic Bonds Bookrunners/Lead Managers - League Table 2007

Deals announced



Facilitative and transparent regulatory framework which caters for a diverse range of ICM products and services

- Market-based approach by requiring disclosure rather than merit assessment relating to offerings of ICM products
- Clear and responsive guidelines for new ICM products, e.g. Islamic REITS Guidelines, Islamic Securities Guidelines etc.
- SC is receptive to new products/concepts
- Framework for mutual recognition arrangements that allow for cross-border marketing and distribution of Islamic funds

Approach in regulating Islamic banks that offer full range of capital market services and products

- Aim is to minimise duplication and overlap by multiple regulatory agencies
- Single licensing by Bank Negara
- ICM product offerings subject to SC's approval
- Effective coordination mechanism between Bank Negara and SC

Facilitative framework for offerings of new ICM products such as sukuk

- While conventional bond is a loan of money creating a debtor-creditor relationship, an Islamic bond represents an ownership stake in an existing asset
- Trading in Islamic bonds equals to transfer of ownership interests while trading in conventional bonds is a sale of debt
- Therefore, there is a need to ensure regulations do not impede the offerings of Islamic products
- Powers given to the Minister of Finance in securities laws to disapply provisions relating to debt on Islamic securities in order to give full effect to principles of Shari'ah on such Islamic securities

Provide comprehensive and effective legal infrastructure for legal redress arising from Islamic financial transactions....

- Effective regulatory and substantive requirements in securities laws to ensure enforceability of Islamic financial contracts
- Establishment of strong Shari'ah infrastructure to ensure structuring of ICM products, construction of ICM funds and execution of ICM strategies are Shari'ah compliant as certified by Shari'ah advisers
- Shari'ah Advisory Board constituted as a committee under the Securities Commission Act 1993 to act as a reference centre at national level on ICM transactions
- Published rulings of the Shari'ah Advisory Board

Appropriate adjudication fora for dispute resolution for Islamic financial transactions...

- A dedicated High Court in the Malaysian court system to adjudicate matters relating to Islamic financial transactions
- Kuala Lumpur Regional Centre for Arbitration serves as a platform to resolve disputes on ICM transactions

Islamic Banking and Financial Services Arbitration Rules (“IBFS Arbitration Rules”)

- The IBFS arbitration rules available for settlement of disputes relating to all sectors in the financial system
- Adopts UNCITRAL rules and allows for reference to Shari’ah Advisory Committee for ICM transactions, products and services

Attractive tax framework for ICM participants

- **Income tax exemption for issuance expenses for sukuk** issued using Shari'ah principles of Ijarah, Istisna, musharakah and mudharabah
- **Tax neutrality**
 - Stamp duty exemption
 - Real property gains tax exemption
 - Income tax exemption for SPV
 - Additional 20% stamp duty exemption on top of exemption that ensure neutrality

Lower tax barriers for ICM participants

- **Foreign Investors**

- Withholding tax exemption for interest income from RM bonds
- Withholding tax exemption for interest income from foreign currency bonds issued out of Malaysia

- **Domestic investors**

- Income tax exemption for interest income from RM bonds

- **Fund Managers**

- 10 years tax exemption to local and foreign fund managers approved by SC
- Pre-commencement expenses of Islamic stock broking companies are tax deductible

Key challenges

Shari'ah compliance and convergence

- Robustness of Shari'ah approval process is critical
- Harmonised standards for regulation of Shari'ah advisory bodies who act as central reference point in assessing Shari'ah compliance of ICM products and services.
- Clear and transparent procedures for decision-making by Shari'ah advisory bodies
- Standardized requirements on eligibility and qualification of Shari'ah advisors
- Uniformity in Shari'ah interpretations

Key challenges (continued)

Application of IOSCO principles

- Determine areas where enhanced disclosures are needed to enable investors to assess Shari'ah compliance and risks and return of ICM products
- Investor education and awareness on ICM products
- Sound regulatory framework that can identify, unbundle, measure, monitor and manage risks in ICM products and services

Key challenges (continued)

Cost efficiency and tax neutral framework

- Cost of issuing and trading must be comparable to conventional products
- Tax neutrality between Islamic and conventional products

Shortage of trained personnel

- Concerted effort to build capacity
- Develop combined competencies of finance and Shari'ah

THANK YOU