

# Building the Islamic Capital Market Infrastructure

*GLOBAL ISLAMIC FINANCE FORUM*

*FINANCIAL REGULATORS FORUM IN ISLAMIC FINANCE*

*26 - 29 March 2007, Kuala Lumpur*

Ahmad Hizzad Baharuddin



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

# Outline

- Growth trend of Islamic Capital Market
- Building a Vibrant Islamic Capital Market
- Issues and Challenges
- Summary



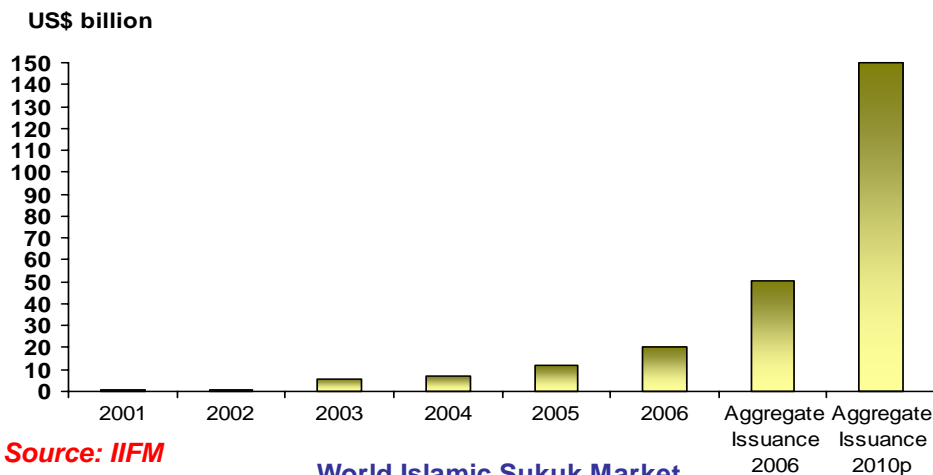
# High prospect for Islamic Capital Market... Global supply is growing fast, fuelled by greater demand for product diversification and enhanced returns...

- 1.5 billion Muslims - 24% of world population
- Over 250 Islamic financial institutions in 75 countries
- Stronger investor's confidence in Islamic capital market instruments
  - *Sukuk, Shariah compliant equity stocks, funds and unit trust*
- Surge in demand for Islamic investment - ample liquidity from Middle East
  - High net worth individuals
  - Excess petrodollar revenue
- Growing GCC region
  - Construction boom in GCC region require Islamic financing
  - Islamic compliant equity about USD20 billion
- Continuous product innovation, regulatory improvement & *Shariah* harmonisation all over the world



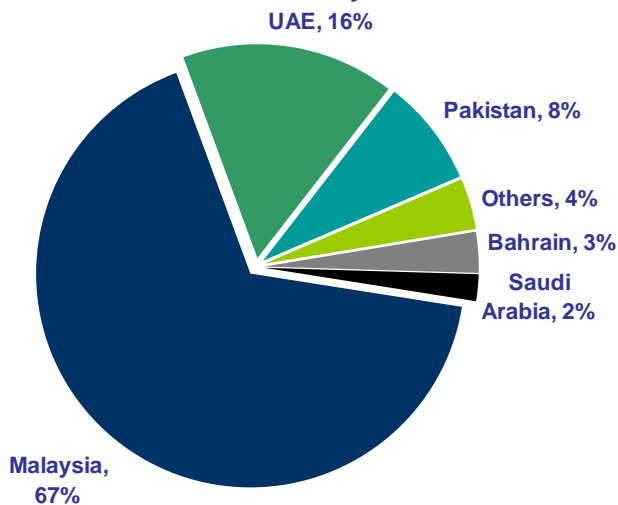
# Robust growth in **issuance of *sukuk*** reflecting growing demand around the globe...

## Sukuk Issuance Worldwide



Source: IIFM

World Islamic Sukuk Market as at 25 January 2007

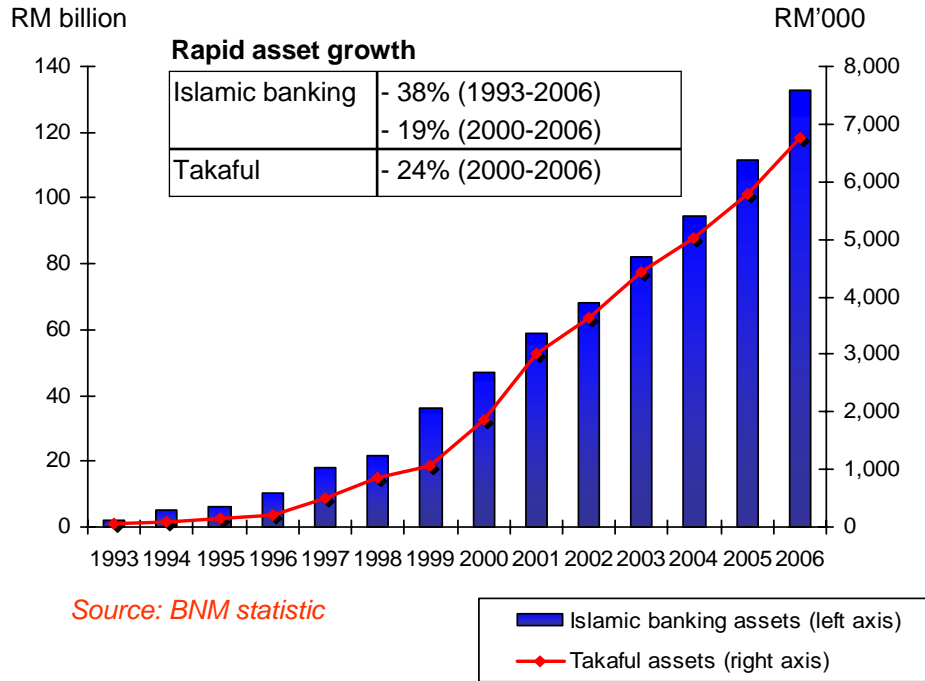


Source: Bloomberg

- *Sukuk* issuance worldwide increased more than double from USD11.8 billion in 2005 to USD20.6 billion in 2006.
- Aggregate issuance value of *sukuk* market worldwide exceeds USD50 billion as at end-Dec 2006
- Total *sukuk* issuance worldwide projected to surpass USD150 billion before end 2010.
- Market to expand in future with entrance of corporates in GCC region and non-Muslim issuers.
- Malaysia's *sukuk* represented 67% of the total global *sukuk* outstanding valued at USD46.8b



# Insights into Malaysia... promising prospect attributed by encouraging outlook...



## Total size of Sukuk as at December 2006

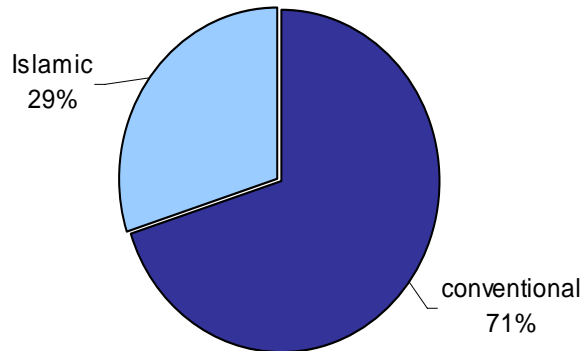
	Islamic PDS	Govt & BNM papers
Size of outstanding sukuk	RM 105bn	RM 42.5bn
% of outstanding sukuk to total outstanding bonds	47.5%	18.3%

- Growing interest for *Shariah*-compliant instruments:
  - Surge demand due to strong asset growth of IFIs
  - Investment strategies by mutual funds, pension fund managers & other FIs
  - Growing awareness on Islamic instruments
- Diversity of lead arrangers
  - Investment bank, Islamic banks, securities firms
- Increasing number of borrowers/issuers
  - Lower cost of funds/lower yield
  - Cheaper issuance cost (stamp-duty exemption for Ijarah, Musharakah & Istisna' contracts)
- Broadened investor base
  - Issuance of non-RM *sukuk* to attract global investors
  - Liberal foreign exchange rules
  - Growing presence of foreign Islamic banks
  - Growing number of Takaful Operators & Retakaful Operators
  - Growing interest by “conventional” investors
- Wide range capital market investment avenue
  - Increased issuance of Islamic bonds with diversified *Shariah* contracts
  - Over 85% *Shariah* approved counters on Bursa
  - Over 90 Islamic unit trusts

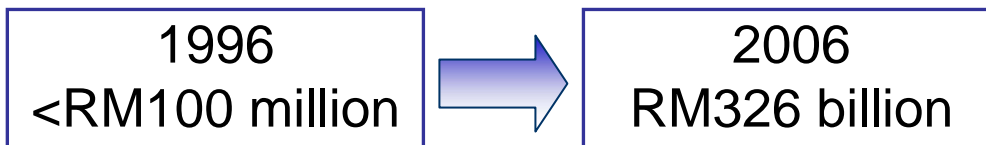


# Islamic Money Market grew in tandem with capital market development...

Islamic Money Market Funds as % of Total Money Market Funds



Increasing growth in Islamic securities trading volume...



- The development of Islamic money market made possible with Bank Negara liquidity operation
  - profit sharing facility of mudharabah interbank investment
  - Wadiah acceptance
  - Sale and buy back agreement of Islamic securities for short-term liquidity
  - Commodity Murabahah – short-term financing involving sale and buy back of underlying commodity
- Issuance of various Islamic securities issued by Bank Negara, Government and financial institutions.
  - Malaysia Islamic Treasury Bills
  - Bank Negara Negotiable Notes
  - Islamic Acceptance Bills

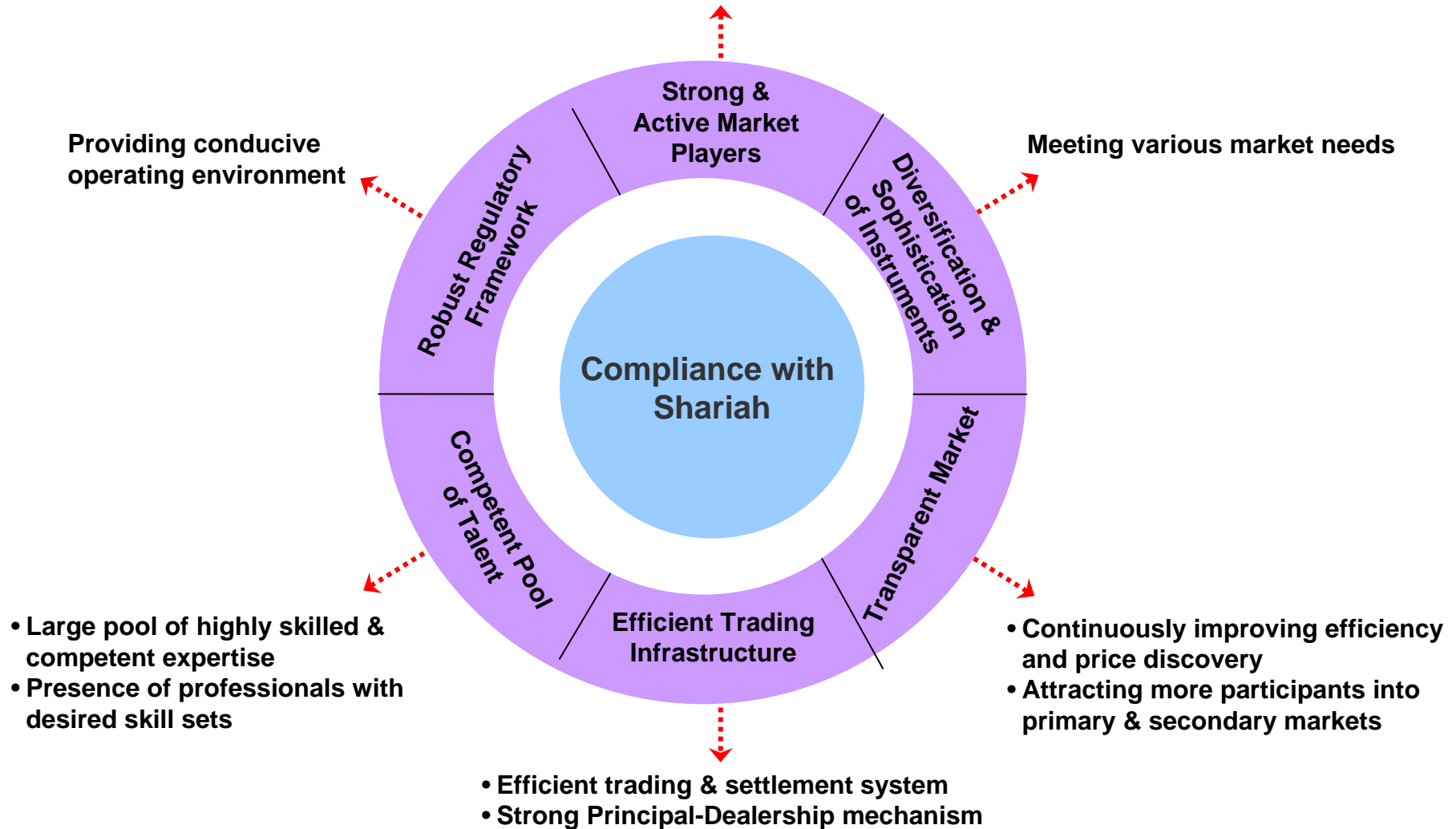
# Outline

- Growth trend of Islamic Capital Market
- Building a Vibrant Islamic Capital Market
- Issues and Challenges
- Summary



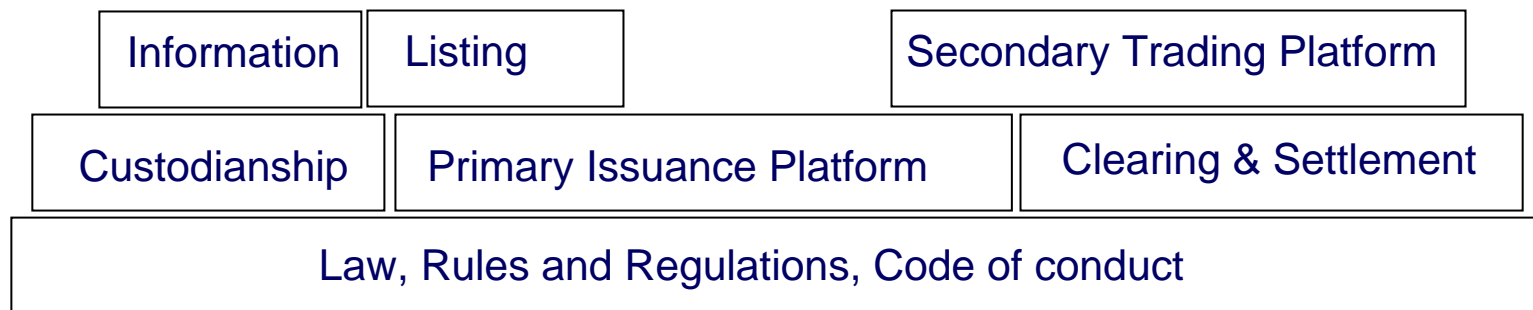
# Strategic outcomes for vibrant Islamic Capital Market...

- Providing breadth & depth with improved efficiency
- Developing market makers in *sukuk* market

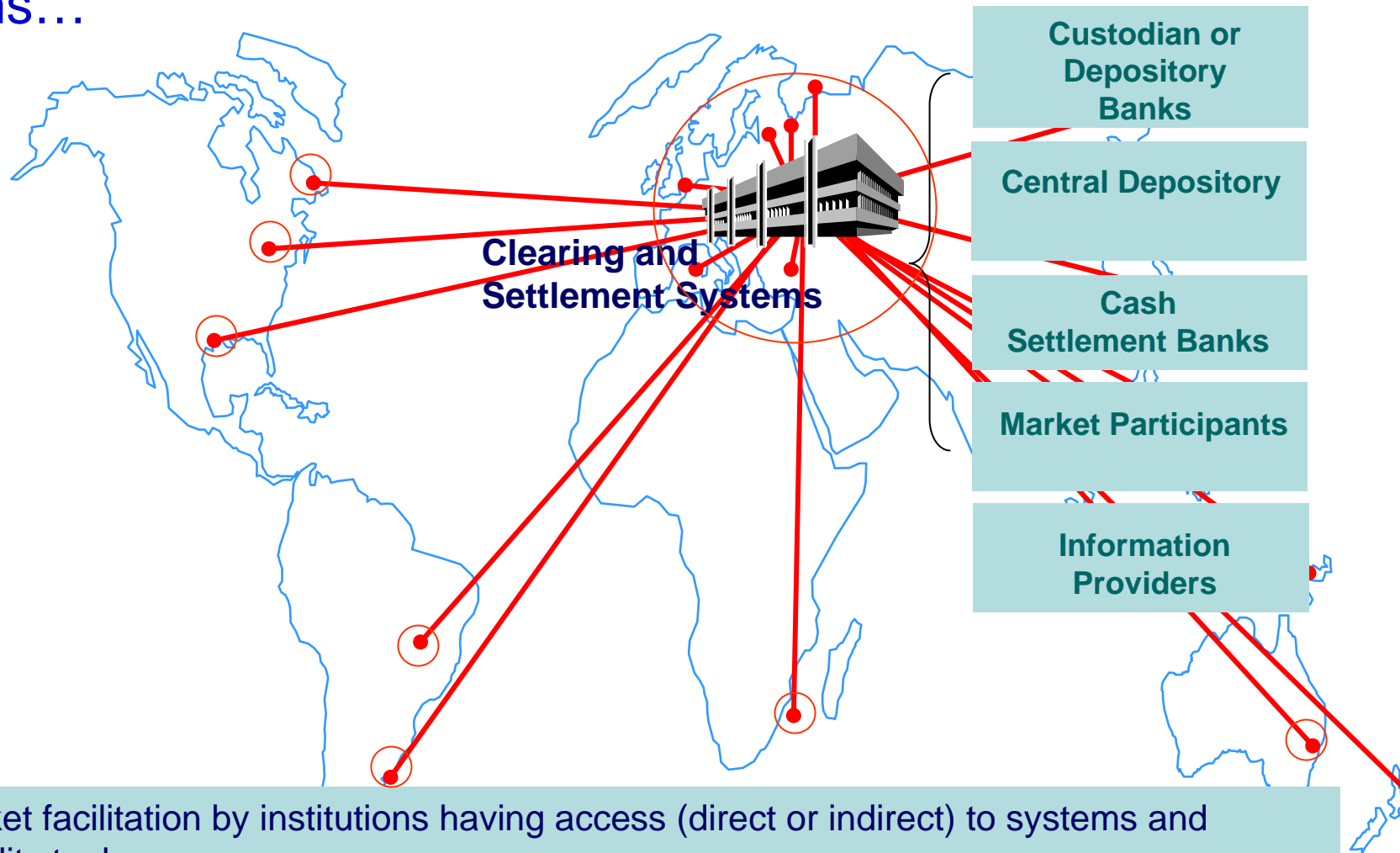


# Having a **comprehensive supporting infrastructure** is a prerequisite to a vibrant capital market development...

- Operates in an ecosystem that interacts with each other
- Underpinned by an effective set of laws, rules and regulations, and market code of conduct
- Involves multi set of institutional players in a jurisdiction and/or across global markets
  - Settlement banks (including central banks), stock exchanges that provide trading, listing, clearing and settlement mechanism
  - Information providers publishing investment information and pricing tools
  - Financial institutions providing accounts services and custodianship facilities
- Operates in automated systems to realise
  - Speed, reliability and consistency
  - Reduction of credit, liquidity, legal and operational risks



# Interact in a **global** market in an interconnected national systems...



Market facilitation by institutions having access (direct or indirect) to systems and liquidity tools

Linked with other clearing systems and agents in other countries



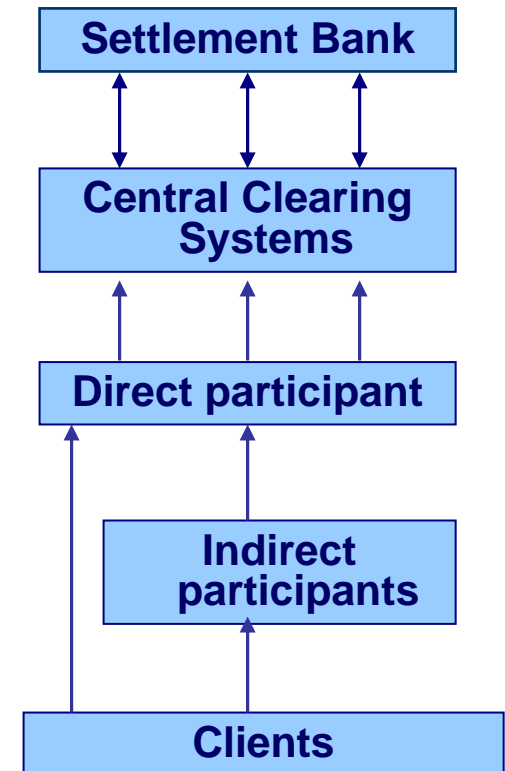
# A set of laws, regulations and agreements is the **foundation** for an effective system...

- Provides legal and technical infrastructure to transfer ownership rights - title of securities
- Provide enabling provisions to issue Guidelines, Rules and Procedures
- Establish code of conducts to ensure market stability and operational consistency
- Governed by a finality Act to ensure legal finality of settlements for systemically important payment and settlement systems
  - Central objective is to reduce systemic risk in clearing systems
  - Ensure that the failure of a participant in a system does not have spillover effects on other participants, thereby preserving system stability
  - Rules of designated payment systems take precedence over normal insolvency law
- Agreements to facilitate the smooth running of the system
  - Depository Paying Agency Agreement
  - Securities Borrowing and Lending Master Agreement
- Memorandum of Understanding between authorities to clarify roles and responsibilities on infrastructure, and strengthening the system to help reduce systemic risk and overall financial stability

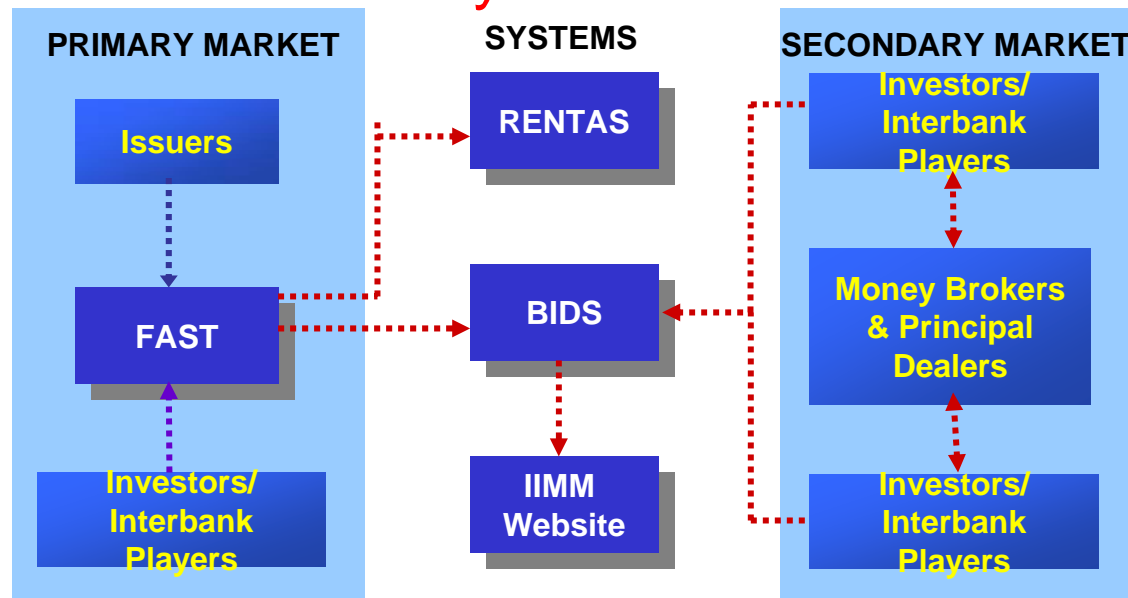


# Fair and open access to centralised system is important to achieve cost efficiency benefits...

- Central settlement system
  - Central bank operates large value payment systems and bank settlement accounts
  - Provides intraday liquidity or lender of last facility
- Central security depository or clearing house– national or international
  - Provides clearing and registrar functions
  - Coupon payment and final redemption
  - Undertake clearing and settlement function
  - Provide liquidity enhancing mechanism
- Financial institutions as members
  - Provide account facilities and enabling transfers
  - Collecting (receiver) or paying bank (sender) services
- Messaging system – provide the network for standardised message and information



# Efficient issuing and trading infrastructure ensures operational efficiency and financial stability...



**Market Players** - 35 interbank players with Islamic windows; 9 full-fledged domestic Islamic banks, 9 Islamic subsidiaries and 3 foreign full-pledged Islamic banks

**Intermediary Channels** - 8 money brokers as intermediaries and 10 principal dealers to provide two-way quotations in secondary market

**Primary and Secondary Market** - fully automated system for tendering (FAST), bond information dissemination system (BIDS) provides near real-time prices, and market information

**Settlement Mechanism** - real-time gross settlement and custodian system for scriptless securities trading, reduces settlement risks

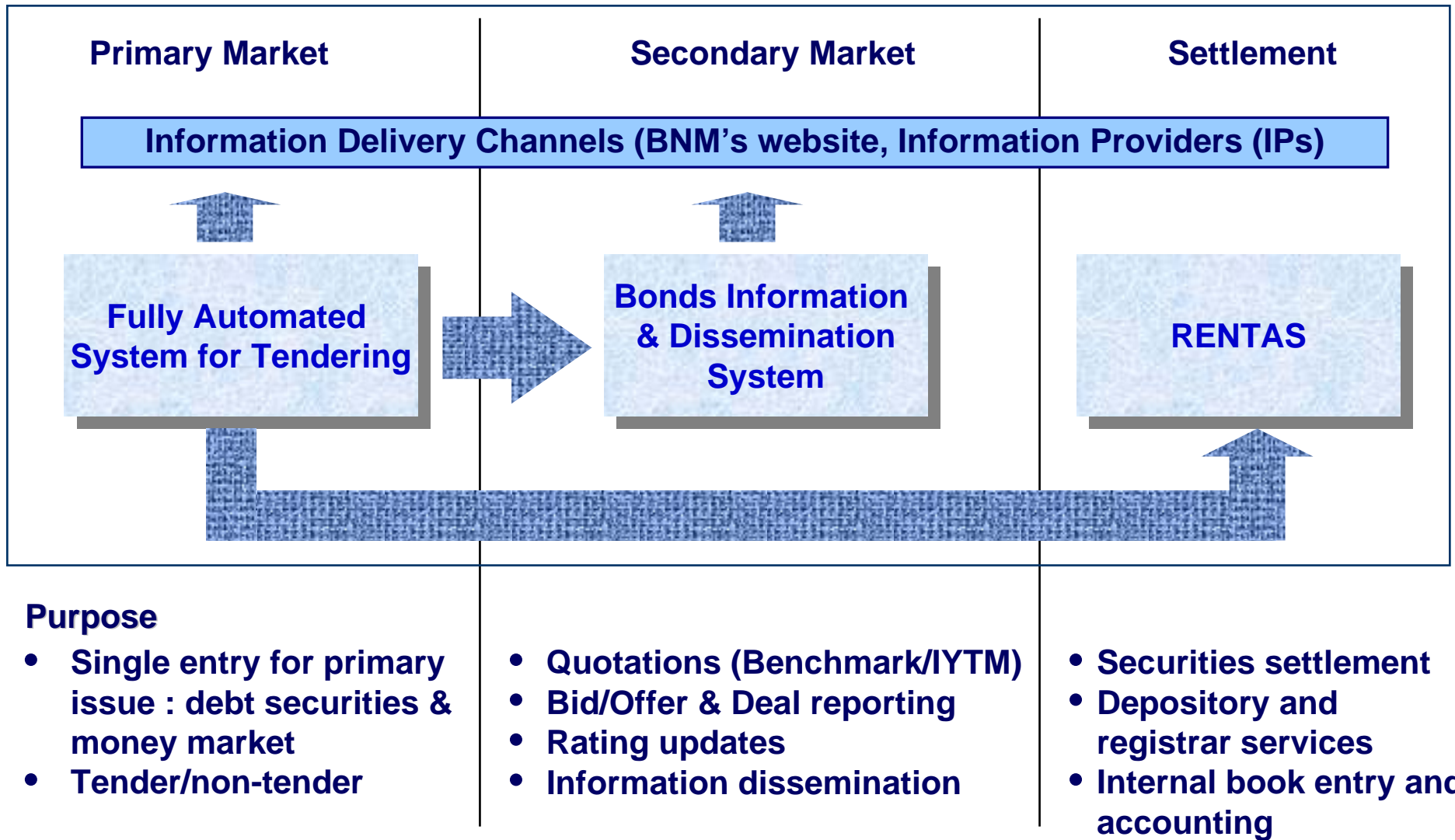
**Legal framework** – Banking and Financial Institutions Act, Islamic Banking Act, Payment System Act

**Operational & Regulatory framework** – Bank Negara Malaysia (BNM) and Securities Commission issued various guidelines e.g. repo, money broker, principal dealer and product guideline

**Accounting and tax system** - adoption of generally accepted accounting principles, easily understood tax regime



# The interaction between systems in a bond market infrastructure



# Established **rules and regulations** for market players ensure orderly market conduct, protect interest of market participants leading to smooth market operation

## Market Ethics and Code of Conduct

- To ensure smooth functioning of both the primary and the secondary market
- Issued Malaysian Code of Conduct for Principals and Brokers in the Wholesale Money and Foreign Exchange Markets in 1995
- The Model Code issued by ACI – The Financial Market Association with local addendum was adopted in May 2002.

## Rules and Regulations

- Rules on FAST, BIDS and RENTAS
- Guidance Notes on Sell and Buy Back Agreement Transaction
- Guidelines on Securities Borrowing and Lending
- Prudential Standards on Asset-Backed Securitisation



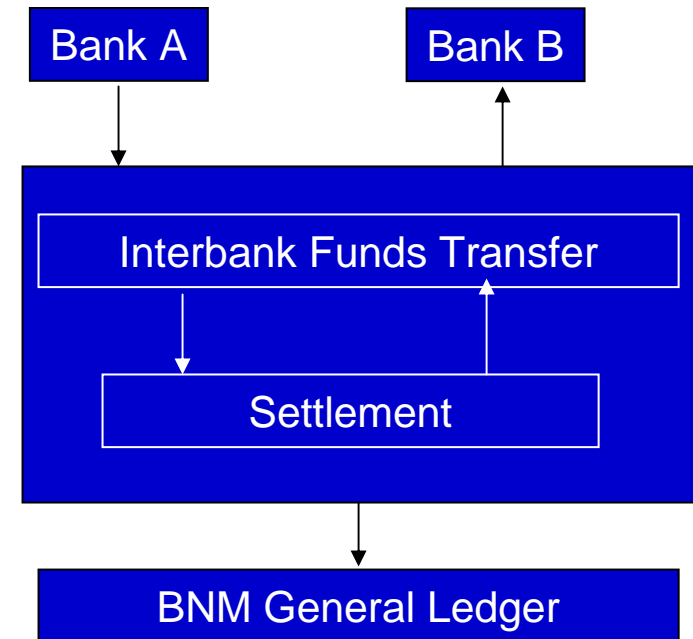
# Benefits of an integrated securities market infrastructure

- **Standardised issuance process facilitates:** efficient handling of multiple tenders, ensure timeliness & accuracy and remove extensive administrative paperwork.
- **Centralised database on domestic debt market:** facilitates price discovery for new issues and enhances liquidity and increase in secondary trading activities of over-the-counter market
- **Integrated Systems :** improve operational efficiency of day-to-day money market/capital market processes as it covers primary issues and secondary trading
- **Online interface to information providers and web page :** ensure wider coverage of information to wider group of users.



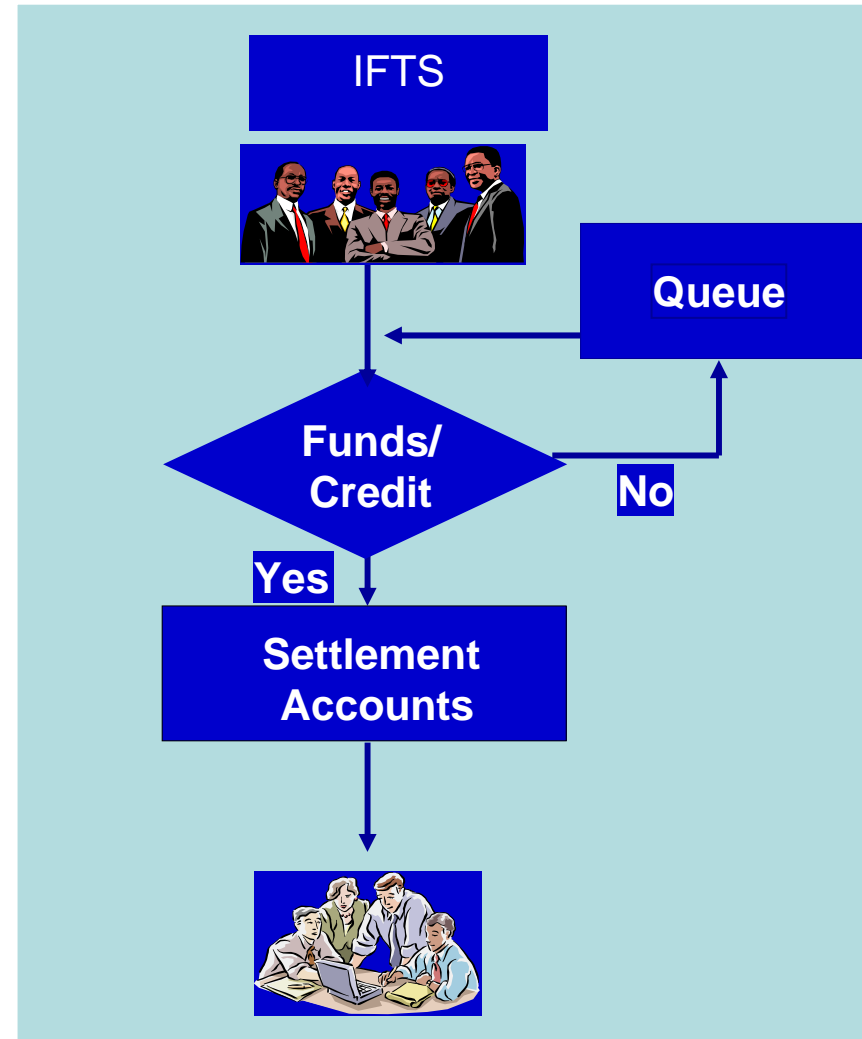
# Existing clearing and settlement system and convention is supportive of Islamic financial market

- RENTAS – Malaysia’s real time gross settlement system
- Settlement across books of BNM
- Single-tier participation structure
- Credit transfer system
- Fully collateralised intraday credit facility
- No interest on intraday credit facility
- Queue system



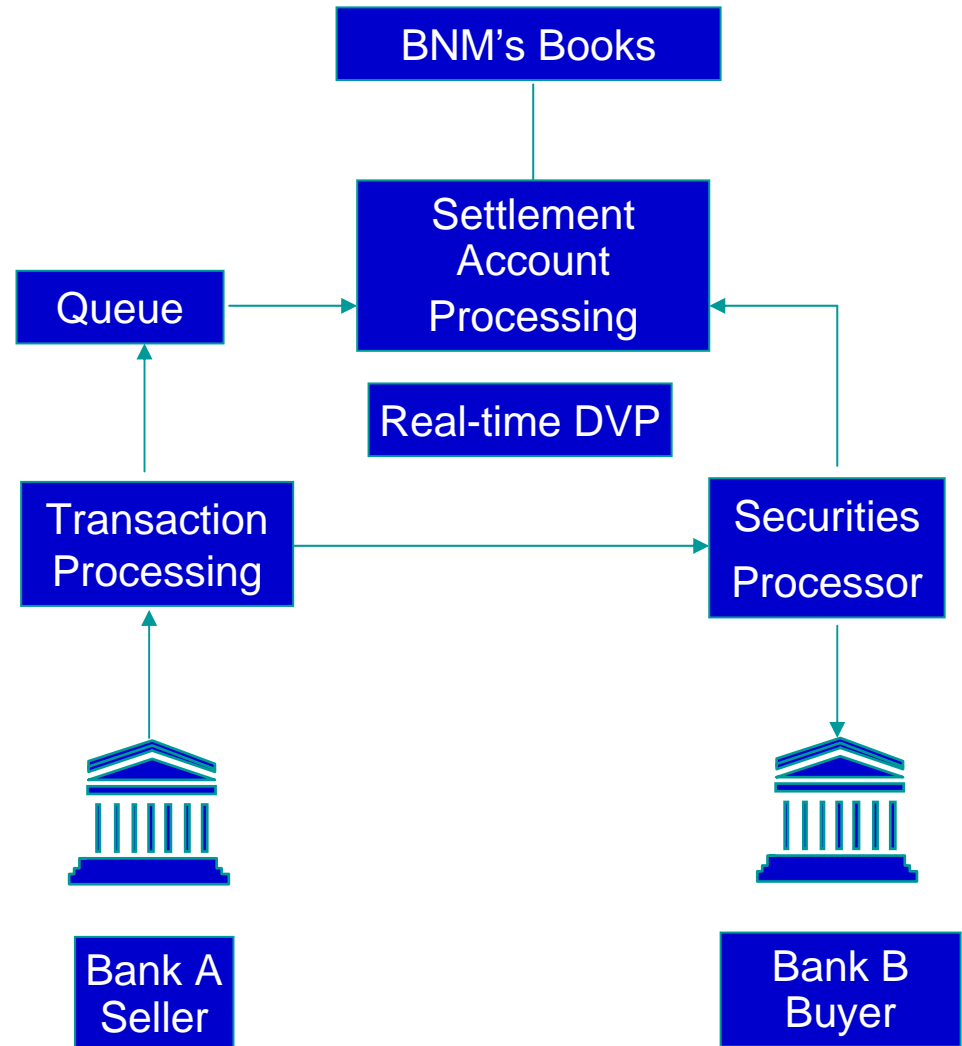
# RENTAS System Design – Interbank Funds Transfer System (IFTS)

- Participants maintain separate Islamic clearing account with BNM.
- System validates payments in chronological order.
- Immediate settlement if funds are sufficient or credit line available.
- Insufficient funds, transaction queued.
- Settlement on gross basis i.e. transaction by transaction.
- Outstanding instructions at queue at closing time automatically cancelled.
- Information on account balance and status of payment orders available to participants and BNM.

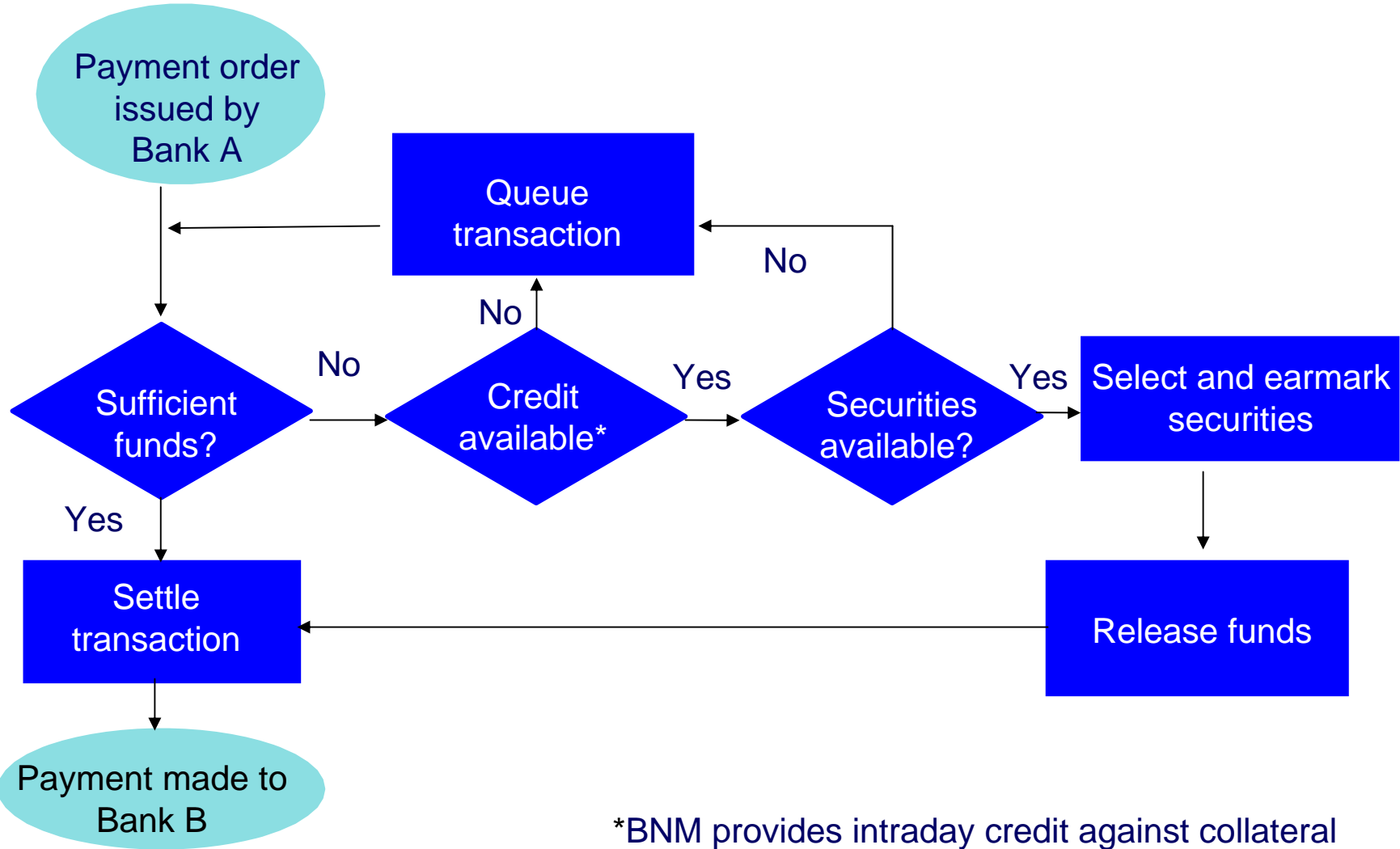


# RENTAS System Design – Securities Settlement and Trading System (SSTS)

- Participants maintain own, resident and collateral account for Islamic securities.
- Selling bank initiates transaction.
- Buying bank confirms.
- System checks on real-time basis availability of security and funds.
- Real time Delivery versus payment - security and transfer of funds automatic and instantaneous.
- If security or funds not available or insufficient, transaction will queue pending availability.
- At day-end, the system determines the balance in the security account.
- Includes module for securities borrowing and lending programme



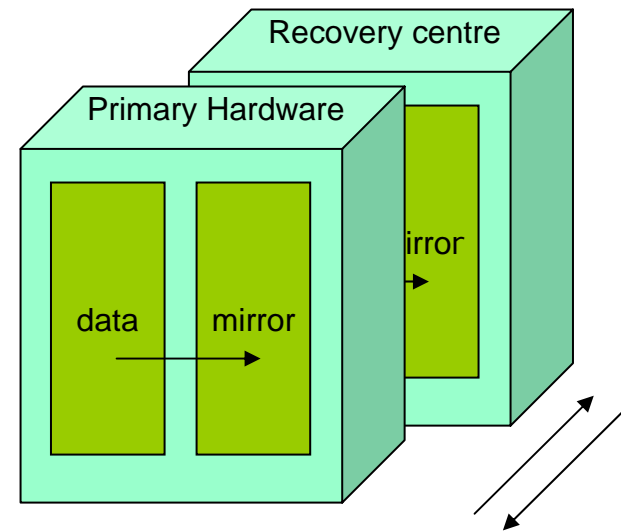
# Liquidity mechanism supports smooth functioning of systems..



\*BNM provides intraday credit against collateral

# The network and system arrangements require **effective risk mitigation measures...**

- Extensive disaster recovery plan and business continuity management
  - Definite recovery timeframe and communication plan
  - Mirroring of data and transactions between primary and backup sites
  - Regular testing with the industry players
- Have in place safety and security for:
  - Fraud control – authenticate and built in internal control
  - Confidentiality and integrity
  - Record and maintenance
  - Point-to-point secure connection



# Maximising information channels ensure information **transparency** in the market

## Primary & Secondary Market Information

- FAST captures all primary market activities of unlisted debt securities, money market tender, rating updates and auction calendar
- BIDS provides information on the terms of issue, near real-time prices, details of trades done and relevant news on various government and private debt securities
- BIDs to be transferred to an electronic trading platform operated by Bursa Malaysia, providing greater access and market information
- Bursa Malaysia provides onshore and offshore (LFX) exchanges, and Shariah Index for Shariah compliant equity investments
- BNM market operations announced in newswire such as Bloomberg, Reuters and Moneyline Telerate
- Liquidity position announced in FAST website
- A regular activity by BNM, Securities Commission and Bursa Malaysia
- Market transparency requirement for fund and unit trust managers to investors

## Central Bank Market Operations

## Meetings with market participants



# Extensive information and trading channels for Islamic equity and capital instruments...

- Promote trading efficiency and transparency
- Conventional approach-remisiers, central dealing team and branch broking
- Online trading service
- Mobile phone /PDA
- SMS trading service

Enhance accessibility & mobility and encourage retail participation

ISLM P089 n Govt ISLM  
Screen Printed

**Bloomberg**

**ISLAMIC CAPITAL MARKETS HOME PAGE**

<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2">ISLAMIC FUND</th></tr> <tr><td>1) Asset Allocation</td></tr> <tr><td>2) Debt</td></tr> <tr><td>3) Equity</td></tr> <tr><td>4) All Funds</td></tr> </table> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2">ISLAMIC CAPITAL MARKET</th></tr> <tr><td>5) ISLB Islamic Bonds</td></tr> <tr><td>6) ISBP Islamic Bond Pricing</td></tr> <tr><td>7) New Issue Monitors</td></tr> <tr><td>8) League Table</td></tr> <tr><td>9) SUKU International Sukuk</td></tr> <tr><td>10) Islamic Ratings</td></tr> </table>	ISLAMIC FUND		1) Asset Allocation	2) Debt	3) Equity	4) All Funds	ISLAMIC CAPITAL MARKET		5) ISLB Islamic Bonds	6) ISBP Islamic Bond Pricing	7) New Issue Monitors	8) League Table	9) SUKU International Sukuk	10) Islamic Ratings	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2">ISLAMIC CAPITAL MARKET RATES</th></tr> <tr><td>12) MKIS Malaysian Capital Markets</td></tr> </table> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2">ISLAMIC INDEX SERIES</th></tr> <tr><td>13) Global Indices</td></tr> <tr><td>14) FTSE Global Indices</td></tr> <tr><td>15) Dow Jones Indices</td></tr> <tr><td>16) CIMB Indices</td></tr> </table> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2">ABOUT ISLAMIC CAPITAL MARKET</th></tr> <tr><td>17) News</td></tr> <tr><td>18) ICMG Glossary</td></tr> <tr><td>19) ICMP People</td></tr> <tr><td>20) ICMW Web Site Links</td></tr> </table>	ISLAMIC CAPITAL MARKET RATES		12) MKIS Malaysian Capital Markets	ISLAMIC INDEX SERIES		13) Global Indices	14) FTSE Global Indices	15) Dow Jones Indices	16) CIMB Indices	ABOUT ISLAMIC CAPITAL MARKET		17) News	18) ICMG Glossary	19) ICMP People	20) ICMW Web Site Links
ISLAMIC FUND																														
1) Asset Allocation																														
2) Debt																														
3) Equity																														
4) All Funds																														
ISLAMIC CAPITAL MARKET																														
5) ISLB Islamic Bonds																														
6) ISBP Islamic Bond Pricing																														
7) New Issue Monitors																														
8) League Table																														
9) SUKU International Sukuk																														
10) Islamic Ratings																														
ISLAMIC CAPITAL MARKET RATES																														
12) MKIS Malaysian Capital Markets																														
ISLAMIC INDEX SERIES																														
13) Global Indices																														
14) FTSE Global Indices																														
15) Dow Jones Indices																														
16) CIMB Indices																														
ABOUT ISLAMIC CAPITAL MARKET																														
17) News																														
18) ICMG Glossary																														
19) ICMP People																														
20) ICMW Web Site Links																														

```

Quote: ISLAMIC
ISLAMIC ISLAMIC MENU ISLAMIC
To access information, double-click on the code in <> or [] brackets.

=ISLAMIC GUIDES BY COUNTRY=====
Indonesia.....<ID/ISLAMIC>
Malaysia.....<MY/ISLAMIC>

=INDICES=====
DJ Islamic Market Indices...<#DJISLAM>
KLSE Syariah Index.....<.KLSI>
RHB Islamic Index.....<.RHIS>
DJ RHB Islamic Index.....<.DJRHBMY>
Jakarta Islamic Index.....<.JKII>
FTSE Islamic Mkt Indices...<GB/INDICES>
SGX Shariah 100.....<.FTSGS100>

===FIXED INCOME=====
International Sukuks.....<#INTLSUKUK>
BNM - Islamic Bonds.....<#MYISLAMIC=MB>
BNM - Islamic MTN.....<#MYIMTN=MB>
BNM-Islamic Secondary MTN<#MYIMTN=MB>
Bank Negara Malaysia.....<BNM/MENU>
Surabaya SE Islamic bond...<#IDSYR=SU>
Surabaya SE Corp Bond.....<#IDCORP=SU>
Surabaya Corp Bond VWAP.....<SUCORP01>
RAM Islamic Debt Table.....<RAMBD30>-40
MARC Islamic Debt Table...<MRATING40>-85

=MONEY MARKETS=====
KL Islamic Reference Rates... <KLIRR>
KL Islamic Ref Rates by Banks...<KLIRR>
KL Islamic Ref Rates - 20D Hist<KLIRR2>
Amanah Butler.....<AB18><AB24><AB302>
FD & Gen Investment Account...<NEGATZ>
Islamic Glossary.....<ISL1>-<ISL11>
Islamic FAQs.....<ISL101>-<ISL112>
Islamic Principles...<ISL120>-<ISL125>

=LIPPER FUNDS=====
Syariah Equity.....<#MYL024001.LP>
Syariah Bond.....<#MYL024011.LP>
Syariah Mixed Asset.....<#MYL024013.LP>

=NEWS=====
Islamic World News.....["ISLAMIC"]
Islamic Banking news.....[ISLF]
    
```

69 920410  
Bloomberg L.P.  
07 11'51:47



# Complete infrastructure for **intellectual capital** development



**ISLAMIC BANKING AND FINANCE  
INSTITUTE MALAYSIA**

Short-term training courses,  
advisory & consultancy, and  
research & development in  
Islamic finance

**INCEIF**

KNOWLEDGE LEADER  
IN ISLAMIC FINANCE

International certification  
programmes and post-  
graduate programmes in  
Islamic finance

Institutions  
of higher  
learning

**Meeting the  
education needs of  
all levels of Islamic  
finance  
practitioners**

Other  
training  
providers



Global Perspective, Asian Insights

Leadership training  
programmes including  
specialised programmes in  
Islamic financial services



**Suruhanjaya Sekuriti**  
Securities Commission

Securities Industry Development Centre

Islamic capital market  
courses



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

# Outline

- Growth trend of Islamic Capital Market
- Building a Vibrant Islamic Capital Market
- Issues and Challenges
- Summary



# Issues and Challenges...

## Given that...

- Fast evolution of Islamic financial system
- Progressive development in well established and emerging financial centres
- Islamic capital market work within globally accepted market practices and existing systems

## There is this need to...

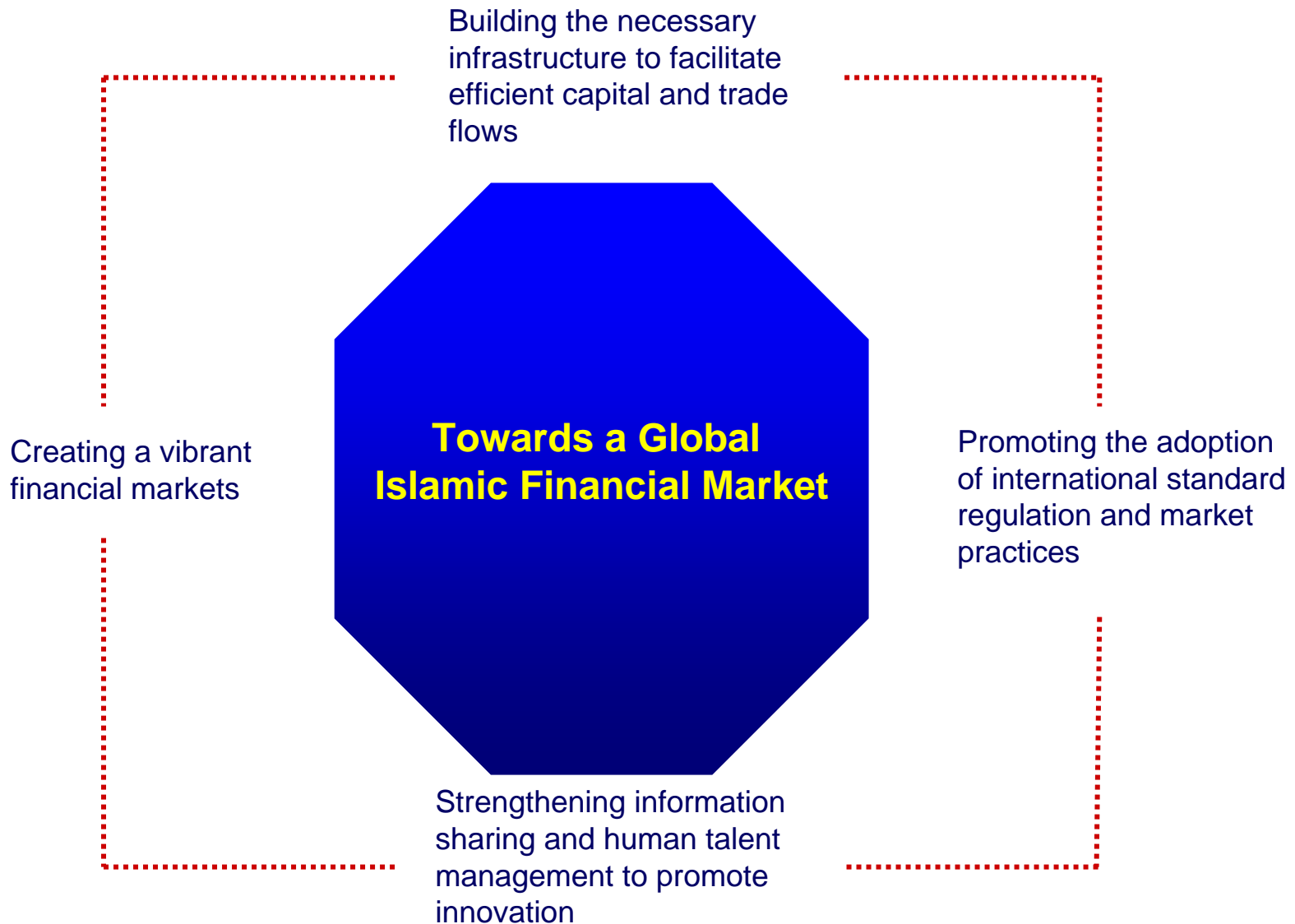
**Modernise and innovate financial infrastructure to facilitate greater integration between Islamic financial and capital markets**

## Confront and resolve issues

- Develop and standardise global Islamic capital market practices – promote uniformity to facilitate cross border transaction and global convention
- Promote multicurrency Islamic financial instruments and systems and nurture global investment bankers
- Improve transparency and price discovery processes and find solution on *Shariah* issues relating to secondary trading
- Engineer greater participation by Islamic financial institutions in various national systems
- Consider system linkages across borders to facilitate convergence of practices, increase depth and minimise co-mingling of funds.



# An integrated global Islamic Capital Market...



# Coordination and cooperation to foster sound and orderly development of the Islamic financial industry is important...

## Regulators

Central banks, Monetary Agencies, Securities Commissions etc.



### Liquidity Management Centre

Market maker for Islamic secondary market



### International Islamic Financial Market

Establish, develop and promote Islamic Financial Market



### International Islamic Rating Agency

Rating of Islamic FIs & Islamic finance instruments



### Islamic Research and Training Institute

Promote Islamic research and training

## ARCIFI

### Arbitration and Reconciliation Centre for Islamic Financial Industry

Dispute resolution services for members



### Islamic Development Bank

Foster the economic development and social progress of member countries and Muslim communities



### International Financial Services Board

Governance regulatory standards



### General Council for Islamic Banks and Financial Institutions

Enhance market understanding of Islamic finance



### Accounting and Auditing Organisation for Islamic Financial Institutions

Accounting and auditing standards



# Outline

- Growth trend of Islamic Capital Market
- Building a Vibrant Islamic Financial Market
- Issues and Challenges
- Summary



# Summary – Building Capital Market Infrastructure

- Islamic Capital Market is a growing and important component of Islamic financial system
- Islamic Capital Market infrastructure:
  - Operates under effective laws and regulations
  - Efficient and cost effective network, clearing and settlement arrangements
  - Operates under generally accepted market conventions, principles and standards
  - Promote ownership transfer and reduce risks
  - Integrated to achieve economies of scale
- Market players should take the opportunity in a growing market segment to promote Islamic finance and develop international infrastructure linkages
- Development is a progressive effort to support market and consumer needs



**Thank you**

