

investment and equity-linked products based on *murabahah*, *musyarakah* and *mudharabah*. The commodity-*murabahah*, among others, is a new feature in the Malaysian Islamic banking industry although it has been used extensively in the Middle East. It involves a parallel back-to-back arrangement between a financial institution and its customer to buy and sell certain specified commodities, such as aluminium, steel, copper and nickel which are listed on the major commodity exchanges, on a cost plus profit basis. It is structured such that a commodity is being exchanged on spot basis and the settlement arrangement will be structured in a manner to meet the various requirements. In a deposit taking arrangement, the first sale from bank to customer will be settled with cash (deposit amount) while the second sale from customer to bank will be on deferred terms at a pre-determined maturity date. Similarly, in a financing arrangement, the first sale from customer to bank will be settled with cash (disbursement amount) while the second sale from bank to customer will be on deferred terms at settlement date. The parallel back-to-back transactions involving the commodities takes place simultaneously and therefore, does not expose the parties to the price risk associated with the underlying commodity.

The submission of proposals for the introduction of new Islamic financial products to Bank Negara Malaysia has been successfully automated following the implementation of the Product Approval and Repository System (PARS) in February 2006 to expedite the processing of new products for approval and provide for a repository of Islamic banking products. The new secured online application system

will streamline the submission of new product applications from Islamic financial institutions and simplify the process for users by providing them, among others, the ability to submit data on new product application; review the application history; update existing approved products; and interact with external parties in seeking feedback on the submitted products.

In the area of liquidity management, Bank Negara Malaysia has introduced a new Islamic monetary instrument, namely, Bank Negara Malaysia Sukuk Ijarah. The Bank Negara Malaysia Sukuk Ijarah was issued in February 2006 through a special purpose vehicle, BNM Sukuk Berhad with an issue size of RM400 million. The proceeds were used to purchase Bank Negara Malaysia's assets which were then leased back to the Bank for rental payment consideration and to be distributed to investors as returns on a semi-annual basis. Upon the maturity of the sukuk, which would coincide with the end of the lease tenure, BNM Sukuk Berhad will resell the assets to Bank Negara Malaysia at a pre-determined price. The Bank Negara Malaysia Sukuk Ijarah will be issued on a regular basis with subsequent issues ranging from RM100 million to RM200 million. The Bank Negara Malaysia Sukuk Ijarah will add to the diversity of liquidity instruments used by Bank Negara Malaysia in managing liquidity in the Islamic money market as well as to serve as a benchmark for other short to medium-term Islamic bonds.

Strengthening Shariah Framework

Bank Negara Malaysia continued to monitor the implementation of the Shariah governance framework following the issuance of the Guidelines

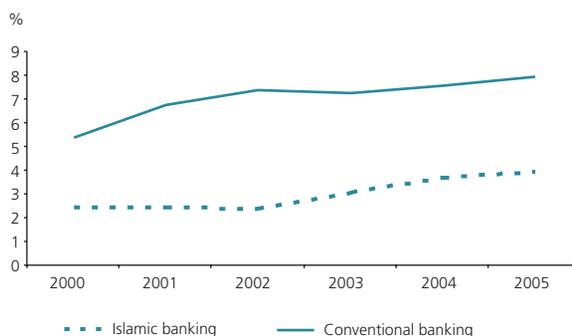
Maximising the Potential of Islamic Banking Business

The Islamic Banking Act 1983 (IBA) accords a universal banking stature to the licensed Islamic banks. Under the IBA, the Islamic banks are allowed to conduct the full spectrum of banking business in line with Shariah principles, ranging from the retail-based commercial banking business to the more sophisticated investment banking business that includes, among others, corporate finance, private equity and wealth management activities. Up till the present, the banking business activities conducted by the Islamic banks in Malaysia have largely been based on the traditional banking business model. Similar scenario also exists in the Islamic banking activities conducted by the conventional banking institutions participating in the Islamic Banking Scheme. Approximately 70% of the financing extended by the Islamic Banking Institutions (IBIs) are sales and lease-based modes of financing which are mainly directed to the retail sector to finance the purchase of residential property and passenger cars.

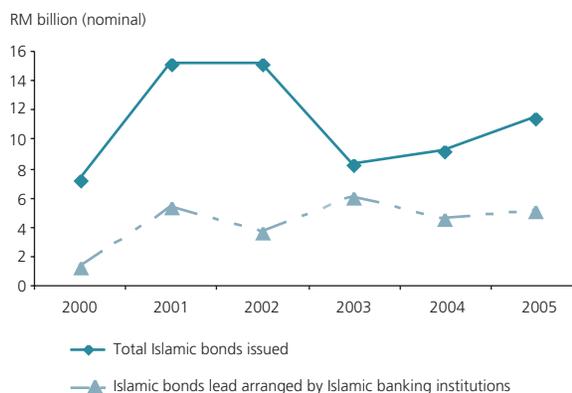
The universal nature of Islamic banking business, particularly in the field of investment banking, has yet to be fully exploited. While the ratio of fee-based income from investment banking-related activities to the total

income of IBIs has been increasing over the recent years, fee-based income still constitute a small portion of the total income of the IBIs. In the Islamic capital market, significant potential still remains to be tapped in the origination of Islamic bonds.

Graph 1
Ratio of Fee-based Income to Total Income



Graph 2
Participation by Islamic Banking Institutions in Origination of Islamic Bonds



As competition intensifies in the retail banking market following the progressive liberalisation of the financial sector, IBIs need to take strategic moves towards enhancing their capacity and capabilities to expand the traditional scope of banking business and tap the full potential that a universal Islamic banking licence offers. This includes venturing into new growth areas such as private equity investments, real estate investments, private banking, and fund and wealth management business. Such a move would diversify the sources of earnings for IBIs, enhance returns to shareholders and depositors as well as strengthen the capacity to sustain strong financial performance.

In addition, the Islamic banking licence allows IBIs to diversify the sources of funding from the traditional deposit products to take full advantage of the profit-sharing investment accounts (PSIA). PSIA provides the opportunity to customise the risk and reward profiles of the financing and investment activities on the asset

side in accordance with the distinct investment preferences and risk appetite of the PSIA holders on the liabilities side. Under the Capital Adequacy Standard issued by the Islamic Financial Services Board (IFSB), the risk-weighted assets funded by the PSIA would not attract a capital charge, thereby providing an added advantage to the IBIs.

By exploring beyond the traditional sectors, the IBIs would also enrich the diversity of new asset classes for Islamic investment and further enhance the depth of the Islamic financial markets. This would not only increase the efficiency of the financial intermediation process in the Islamic financial system but would also enhance Malaysia's position as an attractive international hub for Islamic finance.

Under the Financial Sector Masterplan, the Islamic financial infrastructure has been progressively developed to build the capacity of IBIs to capitalise on the universal nature of Islamic banking business. These, among others, include the transformation of Islamic windows into dedicated Islamic subsidiaries, the licensing of foreign Islamic banking players with distinct capabilities in Islamic investment banking activities and the divestment of up to 49% equity interest in IBIs to strategic institutional domestic and foreign investors. IBIs are thus able to leverage on this progressive liberalisation policy to forge strategic alliances as well as tap new expertise and growth opportunities within the domestic environment and abroad to maximise the potential of Islamic banking business.

on the Governance of Shariah Committee for the Islamic Financial Institutions (GPS1) which came into effect on 1 April 2005. Following the Guidelines, the number of Shariah advisers in the Shariah committees of Islamic banking institutions and takaful companies has increased significantly, and would serve as a base to enlarge the number of competent Shariah experts in the country. Although a majority of the Shariah advisers are academicians in the field of *Fiqh Muamalat*, the committee also includes former judges, legal practitioners and economists. It is expected that, with a combination of their diverse background and expertise, Shariah deliberations not only be thorough but also add value to the further development of the industry.

In terms of Shariah supervision, the Bank continued to assess the compliance of Islamic financial institutions with the Shariah principles and governance process. The Bank also evaluates the effectiveness of Shariah committees in providing proper advice and validating the Shariah compatibility of the daily operational matters, such as observing the adequacy of firewalls to ensure no co-mingling between the Islamic and conventional funds in the Islamic window operations. Similarly, the internal auditors are also required to consciously play their role in ensuring that Islamic banking institutions comply with the Shariah principles by formulating a comprehensive audit programme for Shariah compliance and equipping themselves with the required knowledge in performing their duty.

In developing and promoting Shariah dynamism and convergence on the international front, Bank Negara Malaysia undertook two important initiatives in 2005. The first initiative is the Shariah Scholars Dialogue held from 22 to 23 June 2005 in Kuala Lumpur. The main objective of the Dialogue is to promote convergence and harmonisation of Shariah interpretations and appreciation among the Shariah scholars in the development of Islamic banking and finance at the global front. The Dialogue gathered more than 40 eminent Shariah scholars from several countries including Saudi Arabia, Tunisia, Iran, Bahrain, Pakistan, Bangladesh, Indonesia and Brunei Darussalam. The Dialogue has provided a good networking platform to bridge the gap amongst Shariah scholars in terms of fostering understanding and appreciation of Shariah implementation in various jurisdictions and to facilitate the integration of the domestic Islamic financial system with the global Islamic financial system.

The second initiative undertaken by Bank Negara Malaysia is the establishment of the RM200 million Fund for Shariah Scholars in Islamic Finance. The Shariah Fund will provide the resources to finance Shariah research activities, scholarships for Shariah studies as well as organising the annual international Shariah scholars' dialogue. The Shariah Fund will facilitate the creation and development of competent Shariah scholars equipped with sound knowledge and expertise in both Islamic laws and *Fiqh Muamalat* to deal with the ever-changing and dynamism of the Islamic financial industry.