Reinforcing the unique value proposition of Islamic finance

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IFN Asia Forum: Investors' Day

October 27th 2010

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Distinguished guests, ladies and gentlemen

1. Good morning. It is a pleasure to be with all of you here today, and I am grateful to Islamic Finance News for their invitation to address the 2010 Issuers & Investors Asia Forum. Now, I understand the first forum took place in 2006; well, certainly much has changed in the world of finance, and indeed Islamic finance, since then.

2. A quick glance through the business sections of most newspapers nowadays suggests, more than ever, that we are living in interesting times. Panic over private debt has been replaced with concerns over public-sector liabilities. Subsequent tensions over currency arrangements are adding to the jitteriness of markets. And, amid current policy discussions and debates, the big question on everybody's minds is whether the global economy will succumb to a "double-dip" recession next year.

3. Yet, despite these issues—or perhaps because of them—Islamic finance has continued to advance, attracting investors who, in the words of one commentator, are seeking alternatives to products that have let them down in the past. Worldwide demand for Shariah-compliant products and services from the investing public, international institutions and companies

certainly seem to have bounced back to pre-crisis levels—and not just in the customary markets.

4. In August, the UK saw the launch of its first sukuk, by a small British technology company for US$10 million. Reports say the deal is likely to be the first of many sukuk fundraisings in the UK. The month before saw Nomura completing a US$70m offer, while the Philippines' state-owned Al-Amanah Islamic Bank recently announced plans to sell the country's first sukuk. These developments follow the issuance by General Electric, Indonesia and Singapore of their first Islamic papers last year. Among the customary issuers, the Dubai Electricity and Water Authority issuance in May was the first sukuk paper from the Gulf region in nearly seven months; the US$1 billion offering was oversubscribed 11 times. Around the same time in Asia, the Malaysian government issued a US$1.25 billion sukuk that similarly attracted strong demand.

5. Demand outside of the sukuk market, admittedly the most prominent segment in the Islamic finance space, is also said to be growing rapidly. As the industry develops, risk management is becoming vital. Therefore, the structuring and use of hedging instruments by the Islamic finance industry is also gaining ground. Malaysia has had a pro-forma master agreement for the documentation of such instruments since 2006. But recently, the International Islamic Financial Market, a capital markets industry body based in Bahrain, and the International Swaps and Derivatives Association has drafted a *Tahawwut* master agreement with standardised documentation for Shariah-based hedging, thus creating impetus for growth in this nascent segment of the market.

6. In relation to demand for Islamic financial services in general, potential demand out of emerging markets is reportedly strong. For instance, China, a country with 83 million Muslims, awarded its first Islamic banking licence to Bank of Ningxia in September last year; this came amid greater acknowledgement by the country's conventional banks of the need for Shariah-compliant products and services. Investors and financiers are reportedly looking more at ways to develop Islamic finance in Russia, while some larger African countries, like Kenya, are taking steps to establish Islamic financial institutions in their home markets.

Shariah compliance: the core value proposition of Islamic finance

7. These are certainly welcome developments to stakeholders in Islamic finance. Nevertheless, as stakeholders, it is perhaps useful for us to step back and consider the implications of such growth on the broader role and practice of Islamic finance. If the crisis and subsequent market developments have taught us anything, it is that the more financial activity prospers, the more we should not lose sight of its economic role. At the inaugural World Capital Markets Symposium last year, Tan Sri Nor Mohd Yakcop, the Malaysian minister for the Economic Planning Unit of the Prime Minister's Department, reminded us that:

> The role of finance is to promote economic growth, to help industries to obtain financing efficiently and cheaply. But along the way something happened. The world of finance took a momentum of its own, not quite related to the real world of industry, manufacturing, services, agriculture.

8. If the role of *general* finance then is to promote economic growth through allocating financial resources and managing financial risks, then the core

role of *Islamic* finance is arguably to provide such economic functions under "a unique set of disciplines" as defined by Shariah. Indeed, compliance with these disciplines is what gives Islamic finance its unique value proposition. Our goal therefore, as involved stakeholders, must be to ensure that as the Islamic finance industry grows more sophisticated, it continues to support this key value proposition.

9. Shariah compliance is the defining characteristic of Islamic finance and therefore the basis for its value proposition. A Shariah-compliant investment that makes losses year after year is still a Shariah-compliant investment; but if it breaches the Shariah, it is not Islamic, however profitable. Now it is not my intention this morning to delve into the issue of what constitutes Shariah-compliance. Rather, my point is that from a regulatory perspective, confidence in Islamic finance hinges on certainty, transparency and discipline afforded by **full disclosure**, **strong governance** and **clear regulation**. Allow me to touch on each of these in turn.

The significance of disclosure in representing Shariah compliance

10. The marketing of any product as "Islamic" or "Shariah compliant" constitutes a representation to investors. Therefore, disclosure requirements form an important part of the discussion on Shariah compliance. What this implies is that financial products designed to adhere to a specific set of religious or ethical principles may, by definition, require the communication of a wider set of material information to investors. Where Shariah-compliant products and activities are concerned, this might include disclosures of the names of Shariah advisors, their roles and responsibilities, and a pronouncement that the product is Shariah-

compliant. This last point might also require disclosing the basis upon which this decision is reached, and has implications for Shariah governance to which I will turn shortly.

11. There are variations in treatment of such disclosures around the world: some jurisdictions have mandated specific disclosures relating to Islamic products; others have general disclosure requirements for all products. In general, however, non-financial disclosures are voluntary; nevertheless, securities regulators are widening the scope of what constitutes relevant non-financial information as part of efforts to encourage disclosures in relation to meeting the specific investment needs of investor groups—be they ethical or those seeking Shariah-compliant investments.

12. The need for proper disclosure applies to Islamic capital market issuers, offerings and listings. But it equally applies to periodic reports and reports of material events, including takeovers or changes in control or interest associated with the holding of a publicly traded security. Indeed, the requirement for Shariah compliance is a continuous process, because business activities of the issuer may change over time—for instance, arising out of mergers and acquisitions—resulting in a company or investment product no longer being Shariah compliant. Therefore, Shariah-compliance assessments need to be conducted continuously as well.

13. While on the subject of disclosure, a sign of growth and increasing maturity of Islamic finance is that there are increased demands for more specific disclosure and standards to address features of Islamic products and services. International Islamic financial institutions, such as the Accounting and Auditing Organisation for Islamic Financial Institutions, have responded accordingly for instance by setting international Islamic accounting

standards. While some countries do support separate accounting standards for Islamic finance, the challenge is that, with Islamic finance still undergoing substantial development and innovation, many countries continue to apply international (albeit modified) accounting standards for Islamic financial reporting.[1]

The role of governance in meeting Shariah compliance

14. Moving from the significance of disclosure in *representing* Shariah compliance, I would like to turn to the role of governance in *meeting* Shariah compliance. Shariah governance can be broadly be classified into three main approaches:

    - The first is a **conventional approach**, in which regulators do not possess the remit to regulate Shariah compliance directly; however, the regulators may require disclosure of material information to investors, which includes, as the case may be, details of Shariah compliance.
    - The second might be called a **Shariah systems approach**, where firms are required to have their own Shariah boards. The governance, function and operation of Shariah board decisions are regulated.

[1] The International Organisation of Securities Commission has recommended that accounting disclosures be based on internationally acceptable standards (such as IFRS). Nevertheless, IOSCO suggests that regulators, in considering their accounting requirements, should give due regard to the specific characteristics of Islamic securities markets. It adds that standard-setting agencies such as the International Accounting Standards Board may wish to consider the application of Islamic financial reporting standards to Islamic financial instruments with other bodies (such as AAOIFI). See *Analysis of the application of IOSCO's objectives and principles of securities regulation for Islamic securities products*, IOSCO Executive Committee report, September 2008.

- Finally there is a **centralised approach**, which include both firm-based Shariah boards, as well as a central Shariah board which assesses the compliance of financial products and institutions.

15. This contrasts with conventional finance, which has adopted a standardised approach to governance. Even so, the recent crisis has prompted much thought on how financial institutions ought to be governed, and the likes of the Walker report in the UK is one of several to make recommendations on improving the definition of powers and responsibilities of boards of directors, and the creation of board committees with more clearly defined roles.

16. Nevertheless, it is recognised that the current framework for Shariah governance is not yet comprehensive enough. Still, it is heartening that the industry is cognisant of these issues and, through efforts such as the Malaysian Rating Corporation's *Islamic Financial Institution Governance Rating* initiative, are doing their part in drawing attention to Shariah governance. This particular initiative should help contribute to governance transparency in the market, and complement the role of credit ratings, as it draws on evidence that companies with high credit ratings typically uphold strong governance standards.

17. In this regard, particular attention has focused on the relationship between an institution's Shariah scholars and its management. Their role has been seen as reactive to business needs, focusing on auditing transactions and products. Arguments have been made for such scholars to have an enhanced and more forward-looking role, specifically in coming up with Shariah strategy. In response, international organisations have been working to remedy the situation. In November last year, for instance, the

International Financial Services Board released a set of guiding principles on Shariah governance systems for Islamic financial institutions. AAOIFI has also published governance standards on the composition and work of Shariah boards. These efforts address the scope of Shariah governance within an organisation, and both open the way for Shariah boards to take an expansive view of their role, rather than a more narrow, compliance-based role. The key challenge, however, is to ensure that the views of Shariah boards are not disregarded.

The importance of regulatory certainty and clarity in relation to Islamic finance

18. I have spoken about disclosure, as well as about the governance of Islamic financial institutions. The third leg of reinforcing the value proposition of Islamic finance involves enhancing regulatory certainty and clarity. As the pace of market evolution and development quickens, regulators face the constant challenge of optimising their resources and capacity in a way that enables adequate monitoring of the market and a timely regulatory response to risks. In general, what clearly has been lacking is an understanding of how different jurisdictions regulate Islamic financial activities. Most jurisdictions augment conventional regulation with provisions relating to Shariah compliance; however there does not appear to be a common framework for making regulatory decisions pertaining to specifically to Islamic financial activities. Furthermore, recent developments, such as the Nakeel default, has raised many regulatory issues concerning Islamic finance that need to be assessed and addressed.

19. As far as securities regulation is concerned, the International Organisation of Securities Commissions has studied the implications of Islamic financial activity for its core objectives and principles of regulation.[2] An important conclusion from this work is that Islamic capital market activities can be adequately regulated within the framework of the conventional market. This suggests the applicability of the IOSCO principles to the Islamic capital market.

20. Nevertheless, the studies suggest that implementation of the principles may benefit from further consideration in some specific areas. Among other things, regulators are encouraged to co-operate more and share information on Islamic capital markets, in particular in the area of disclosure standards for Islamic funds and sukuk. IOSCO also recommends that securities regulators consider classifying Islamic securities products so that they can be more easily treated in a fair, transparent and consistent manner. Moreover, while it has made no judgement on which governance approach jurisdictions should take with regard to Shariah compliance, IOSCO's view is that it would be beneficial to the market if individual regulators were to clarify their position on which approach(es) they recognise.

21. In practice, most countries have opted for a system of co-existence rather than exclusivity. Efforts are being taken to adopt best practices in the area of product disclosure and suitability for end-clients as they would in the conventional market. Countries are paying particular attention to friction

[2] *Islamic Capital Market fact finding report*, Islamic Capital Markets Task Force, July 2004; and *Analysis of the application of IOSCO's objectives and principles of securities regulation for Islamic securities products*, Executive Committee report, September 2008. International Organisation of Securities Commissions.

costs, such as tax and other non-regulatory issues, so that the Islamic finance system operates on a level playing field with the conventional side. Regulators are also heeding calls for improving international co-operation and linkages. For example, the establishment of the International Islamic Financial Market has strengthened links between Malaysia, Bahrain, Brunei, Indonesia, Sudan and the Islamic Development Bank. Another international initiative, the Liquidity Management Centre, addresses the issue of poor liquidity in Islamic financial instruments.

The need for engaged investment

Ladies and gentlemen

22. **Disclosure**, **governance** and **regulation**: all three are key to realising the value proposition of Islamic finance. Let me conclude by highlighting a fourth factor—that is, a need for **engaged investment**. The recent credit crisis served as a painful reminder to not just invest in the product, but to invest in the offeror: If only the right questions were asked; if only the products or funds were fully understood. This view is reflected in various reports, including those by Lord Myners and Sir David Walker, who have sent a clear signal to investors that they need to raise their game.

23. For Islamic funds there are lessons from initiatives like the UK Institutional Shareholders' Committee code on the responsibilities of institutional investors. Institutional investors must engage with their clients about stewardship, and vice-versa. They should clarify and elaborate on how they seek to fulfil their responsibilities. In turn, clients must be prepared to challenge and encourage their investment managers on stewardship and

engagement. Likewise, Islamic institutional investors must themselves engage with the companies or issuers in which they are invested, to challenge and encourage them on strategy and performance.

24. In the co-operative spirit that underscores the philosophy behind Islamic finance, all parties must work together in bringing greater clarity and accountability to their relationship. This is true for Islamic financial activities as it is for the conventional market. For, at the end of the day, if the crisis has taught us anything, the sustainability and value proposition of any financial undertaking ultimately rests on a deep sense of stewardship and a strong moral compass.

25. Thank you.