The Islamic Financial System

The Islamic Financial System

MANAGEMENT OF THE ISLAMIC BANKING SYSTEM

The Islamic financial system in Malaysia showed significant progress in an increasingly liberalised and competitive environment in line with the increased integration of the Malaysian Islamic financial system into the global Islamic financial landscape. The liberalisation of the Islamic banking market saw the opening in August 2005, of the first foreign Islamic bank licensed under the Islamic Banking Act 1983 (IBA). Following the liberalisation of the foreign exchange administration rules in 2004, greater market depth was demonstrated in the Islamic financial market in 2005 as further ringgit-denominated Shariah-compliant financial instruments were raised in the domestic bond market by foreign entities. This not only boosted confidence in the domestic capital market but contributed to strengthening the depth and breath of the market.

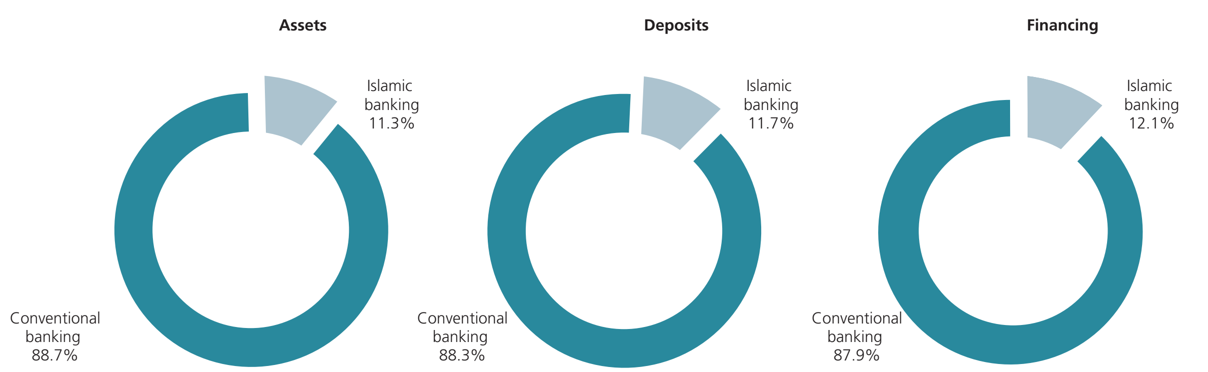
The institutional capacity and capability of the Islamic banking players as well as the financial infrastructure and regulatory framework were further strengthened to achieve the objectives as embodied in the second phase of the Financial Sector Masterplan. Strengthening the corporate governance and risk management system of the Islamic banking institutions remained as the core agenda throughout the year in pursuit of an Islamic financial industry that is robust, stable and with a global outlook in facing the rising challenges in the overall banking and financial environment. Islamic subsidiaries of some domestic banking groups have commenced operations to capitalise on the full extent of operational flexibility accorded by the Islamic banking licence. The International Centre for Education in Islamic Finance (INCEIF) will be in operation in the second quarter of 2006 to offer professional certification and postgraduate programmes as part of the efforts to build the necessary talents and skills in Islamic finance. These developments are among important building blocks in the effort to position Malaysia as a premier international Islamic financial centre.

Strengthening the corporate governance and risk management system of the Islamic banking institutions remained as the core agenda throughout the year.

In conjunction with the 30th Board of Governors Annual General Meeting of the Islamic Development Bank held in Malaysia, a seminar on the 10-Year Master Plan for Islamic Financial Services Industry to chart the roadmap for the Islamic financial services industry worldwide was held on 22 June 2005. It provided a platform to deliberate and provide the foundations for the development of a master plan that would outline the blueprint and strategic direction for a sustained development of the global Islamic financial services industry.

In terms of financial performance, the Islamic banking industry as a whole showed commendable results in 2005, with profitability and assets surpassing for the

Graph 6.1
Market Share of Assets, Deposits and Financing as at end-2005



first time the RM1 billion and RM100 billion thresholds respectively. Assets increased to RM111.8 billion, registering a strong growth of 17.7% and accounting for 11.3% of the total assets of the entire banking system. The market shares of Islamic deposits and outstanding financing also increased to 11.7% and 12.1% of the industry's total respectively. Total outstanding financing grew by 16.5%, attributed by the growth in new financing approved and disbursed of 55.1% and 19.4% respectively, while net non-performing financing ratio declined further to 4.8% at the end of the year. The Islamic banking sector remained well-capitalised with the risk-weighted capital ratio (RWCR) sustained above 12% throughout the year.

Strengthening Financial Infrastructure

Following the issuance of three new Islamic banking licences under the IBA to foreign Islamic financial institutions, the first foreign Islamic bank commenced operations in August 2005 while the other two foreign Islamic banks would commence operations later in 2006. The expertise brought in by the foreign Islamic banks ranging from retail banking to the more sophisticated investment banking, wealth and fund management, real estate development and venture capital business would further enhance the competitiveness of the domestic Islamic banking industry, its global linkages and Malaysia's position as an international Islamic financial centre. On the other hand, it would entail new regulatory and supervisory challenges to Bank Negara Malaysia in view of the different business models adopted by these banks.

In tandem with the progressive liberalisation of the Islamic banking industry, strategic initiatives were undertaken to further strengthen the institutional capacity and financial resilience of the domestic Islamic banking institutions. In this regard, Bank Negara Malaysia has approved to date, the transformation of the "Islamic window" institutional structure of seven domestic banking groups into Islamic subsidiaries (IS) licensed under the IBA within their respective banking groups to carry out Islamic banking business. Three IS commenced operations in 2005 while four others would commence operations in 2006. The IS structure allows the domestic banking groups to maximise the full potential accorded by the universal nature of Islamic banking licence under the IBA which provides wider strategic focus for Islamic banking institutions to strengthen their competitiveness through diverse and innovative product offerings. These range from retail banking products to the higher end corporate finance and investment banking products that include private wealth and fund management as well as private equity and real estate investments.

The IS structure allows the domestic banking groups to maximise the full potential accorded by the universal nature of Islamic banking licence under the IBA.

In contrast to the Islamic window structure, where Islamic banking operations reside within the conventional banking entity, the incorporation of IS also provides the opportunity to potential institutional investors, both domestic and foreign, to participate in the Islamic financial activities through direct equity participation. The liberalised shareholding policy in the IS, whereby the equity of the IS can be owned up to 49% by foreign institutional investors, will increase the potential for building strategic partnerships to acquire new expertise, tap the best international talents from a broad range of fields and develop new value-added activities that would enhance competitiveness and stimulate greater innovation in the Islamic banking industry. In addition, it will support the capital expansion exercise for the IS, increase the potential to tap regional and international business opportunities as well as enhance the global integration of the domestic Islamic banking industry.

While the IS structure allows the leveraging of certain functions of the group, institutions subscribing to the IS structure are encouraged to invest in dedicated internal risk management system as part of the measures to strengthen the financial resilience of these institutions in line with the prudential regulatory and supervisory standards that have and will be issued by the Islamic Financial Services Board (IFSB). In February 2006, the IFSB issued two standards, namely the Capital Adequacy Standard (CAS) and the Guiding Principles of Risk Management (Guiding Principles) for institutions offering Islamic financial services. The CAS provides guidance on the requirements for minimum capital adequacy to cover for credit, market and operational risks of the Islamic banking institutions that is equivalent to the Basel II Capital Framework adopted by the conventional banking institutions. A significant differentiation in the CAS as opposed to Basel II is in the computation of RWCR. In Islamic banking, given that the risks on asset financed by profit-sharing investment account (PSIA) holders do not represent risks to the capital of Islamic banking institutions, the CAS allowed the risk-weighted assets

Calculation of RWCR

$$\text{RWCR} = \frac{\text{ELIGIBLE CAPITAL}}{\text{TOTAL RWA (Credit Risk + Market Risk) + Operational Risk Weighted} \;\; \text{LESS} \;\; \text{RWA FUNDED BY PSIA (Credit Risk + Market Risk)}}$$

(RWA) that are funded by the PSIA holders to be deducted from the total risk-weighted assets in the calculation of RWCR.

The Guiding Principles provides specific guidance in establishing and implementing effective risk management practices to cater for the specificities of the Islamic financial institutions. The Guiding Principles set out 15 principles in managing six categories of risk associated with the specific features of Islamic contracts, namely, credit, equity investment, market, liquidity, rate of return and operational risks.

The CAS and the Guiding Principles are the first two international standards that govern the prudential regulatory and supervisory framework for Islamic banking institutions issued by the IFSB. Thus, Bank Negara Malaysia will collaborate with the Islamic banking institutions to ensure a smooth and successful implementation of both standards.

In November 2005, Bank Negara Malaysia introduced additional measures to further strengthen the risk management of the conventional banking institutions operating under the "Islamic window" institutional structure. These measures include separate compliance on the single customer limit for financing facilities based on the capital funds of the Islamic banking portfolio; separate compliance on the new liquidity framework and statutory reserve requirement for the Islamic banking portfolio; and apportionment of overhead costs and other expenditure incurred in managing the Islamic banking portfolio. These new measures are in addition to the current requirement to observe a separate compliance with the minimum RWCR framework for the Islamic banking portfolio in the conventional banking institutions.

Improvements were also made to the Guidelines on Financial Reporting for Licensed Islamic Banks (GP8-i) in June 2005 to incorporate new requirements on accounting policy for securities, in particular, the classification and measurement of financial securities under the fair value accounting. The revised GP8-i requires the Islamic banks to classify their securities under the categories of "Held for trading" (HFT), "Available for sale" (AFS) and "Held-to-maturity" (HTM). Islamic banks are required to measure securities classified under the HFT and AFS based on current market price or "mark-to-market" valuation technique following their intention to trade further these financial securities in the secondary market. Securities under the category of HTM are measured based on amortised cost given the intention to hold these securities as long-term investment. The GP8-i also specified the rules on reclassification of securities from one category to another to instil discipline in ensuring that consistent accounting policy is adopted on the classification and measurement of financial securities.

Other improvements made to the GP8-i were the requirements for the submission and publication of annual and interim financial reports and enhancement of disclosure of the profit equalisation reserve and unrealized gains or losses on AFS securities to reflect the apportionment between the depositors and the Islamic banks. The revised GP8-i will further enhance the transparency, comparability and timeliness of information on the financial condition of the Islamic banks to the various stakeholders.

In 2005, several new Islamic financial products were introduced that include residential mortgage-backed securities, commodity-based financing as well as 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

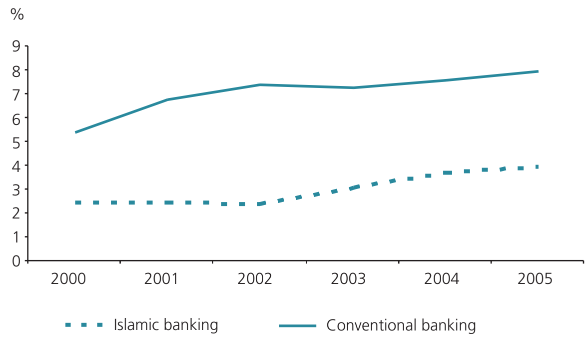
Bank Negara Malaysia continued to monitor the implementation of the Shariah governance framework following the issuance of the Guidelines

Maximising the Potential of Islamic Banking Business

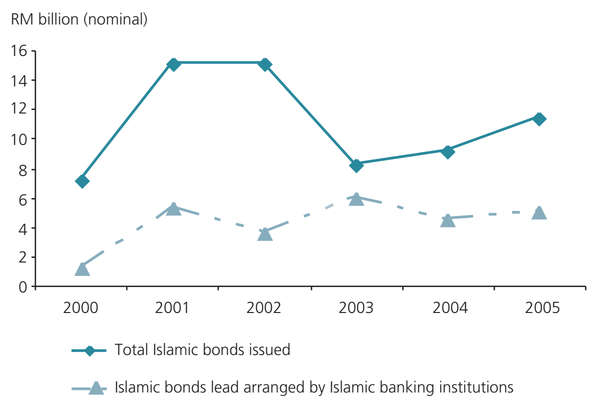
The Islamic Banking Act 1983 (IBA) accords a universal banking stature to the licensed Islamic banks. Under the IBA, the Islamic banks are allowed to conduct the full spectrum of banking business in line with Shariah principles, ranging from the retail-based commercial banking business to the more sophisticated 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.

During the year, the Shariah Advisory Council (SAC) of Bank Negara Malaysia deliberated on a number of issues pertaining to Islamic finance and among the main decisions made by the SAC are as follows:

a) **Permissibility of Forward Foreign Exchange Mechanism**
The SAC approved a mechanism for forward foreign exchange transaction based on a binding unilateral promise that does not tantamount to a contract before the settlement date. In the event of default of the binding promise, the compensation charge is allowed to be imposed on the defaulter.

b) **Application of Compensation Charges for Late Payment of Judgment Debt**
The Court may grant compensation charges for late payment of judgment debt in Islamic finance cases based on the average Islamic money market rate or 8% per annum, whichever is lower and shall not be compounded.

c) **Review the Application of *Qardh Hasan* in Islamic Banking Transactions**
As banking businesses involve mainly commercial deals with the purpose of earning profit, the principle of *qardh hasan* is not appropriate to be applied as a main contract for financing. *Qardh hasan* is more suitable for charity purposes as it is a benevolent loan contract with the possibility of the principal amount being waived. As an alternative, the principle of *qardh* (interest-free loan) may be used as a secondary or complementary contract wherever necessary.

d) **Application of *Kafalah* Contract for Guarantee Scheme in Islamic Banking**
The SAC approved the Islamic guarantee scheme based on the *kafalah* contract for credit enhancement of the small and medium enterprises (SME). Originally, *kafalah* is regarded as *tabarru'* contract in which the guarantee is provided based on the spirit of brotherhood without any consideration. However, current banking and financial transactions have made guarantee as a commercial contract with the charging of fees. The charging of fee for *kafalah* is allowed based on the necessity (*hajah*) for SME to obtain financing.

Strengthening Legal Framework

In a heightened competitive environment in the Islamic banking and finance industry, it is imperative that specific attention be given towards harmonising laws and regulations to give full effect to Shariah requirements given the differences between the principles of Shariah and the conventional legal system. In December 2005, the Attorney General's Chambers launched the Shariah Community, a smart networking platform with the main objective of addressing the Shariah issues and challenges in the context of Malaysian regulatory framework and legislation. Islamic finance and takaful have been identified as two of the areas being studied in collaboration with Bank Negara Malaysia.

As part of the measures to be continuously consistent with Shariah, to remove impediments on Shariah compliant product innovation and diversification, and to encourage participation in Shariah compliant instruments, the Hire Purchase Act 1967 is being reviewed to cover Islamic hire purchase whilst other relevant legislation including the National Land Code, Companies Act 1965, Civil Law Act 1956 and Contracts Act 1950 are being studied to cater for the ongoing developments of Islamic banking and finance. This is in addition to the ongoing review of the Islamic banking and takaful legislation by Bank Negara Malaysia. To further promote the tax neutrality policy, recent amendments to the Stamp Act 1949, which took effect in October 2005, included a new provision which accords instruments for the purchase of goods within the meaning of the Hire Purchase Act 1967 under the concept of *bai' bithaman ajil*, the same stamp duty as conventional instruments of the same nature.

In response to the continuous rapid expansion of the Islamic financial industry that has correspondingly increased demand for Islamic financial instruments, the Government Investment Act 1983 was amended in June 2005 to allow the Government to issue a wider range of Islamic securities. The amended legislation, renamed as the Government Funding Act 1983, accorded greater flexibility for the Government to source funds from the capital market through the issuance of lease-based and asset-based Islamic financial instruments. Apart from the traditional Government Investment Issues, the Government initiated the issuance of Islamic Treasury Bills, a short-term Islamic securities with a maturity tenor of less than one year based on the sell and buy back of asset transactions.

Enhancing Intellectual Capital Development

A significant milestone that took place during the year has been in the area of promotion human capital development with the establishment of the International Centre for Education in Islamic Finance (INCEIF) that will commence operations in 2006. The establishment of INCEIF serves as a catalyst in creating a large pool of world-class experts and high calibre professionals in Islamic banking and finance, to meet the talent requirements of the industry both domestically and internationally.

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The International Centre for Education in Islamic Finance

Building skills talent is one of the key pre-requisites in supporting the progressive developments of Islamic finance. Human intellectual capital is a critical asset that is much needed to drive innovation and sustain market competitiveness to meet challenges in the Islamic financial industry. With the rapid growth of the Islamic financial system, Bank Negara Malaysia has taken a strategic move to establish an international education centre in Islamic finance to produce the needed pool of professionals and specialists in Islamic finance for the domestic and global markets. The establishment of the International Centre for Education in Islamic Finance (INCEIF) will promote greater linkages between the domestic and international Islamic financial system and make Malaysia as a leading centre of education in Islamic finance.

The establishment of INCEIF was announced by the Prime Minister of Malaysia at the 3rd ASEAN Business and Investment Summit in December 2005. Extensive pre-operating work is underway for INCEIF to commence operations in the second quarter of 2006. Bank Negara Malaysia has set up an endowment fund of RM500 million to support this initiative.

INCEIF is to be a leading international centre for educational excellence in Islamic finance with the objectives of:

- facilitating the coordination, planning and implementation of human capital initiatives for the global Islamic financial industry;
- developing superior talents for the global Islamic financial system;
- offering internationally recognised professional certification and postgraduate programmes; and
- supplying talented researchers and educators in Islamic finance.

Programmes

INCEIF programmes are designed to provide the latest onsite and online teaching techniques with unique value elements. INCEIF will also form strategic alliances with renowned local and international institutions of higher learning to provide joint education programme through visiting professor and scholar-in-residence schemes.

INCEIF programmes are categorised into three main areas:

1. Professional certification programme
   INCEIF will award professional certification, namely, Certified Islamic Finance Professional to qualified Islamic finance practitioners. The certification programme, which will commence in June 2006, consists of three parts:

   - *Part I: Building knowledge*
     Candidates will acquire the necessary knowledge in Islamic finance from theory and ethics to wealth planning and management. Validations are done through examinations, written case studies and project papers before candidates are conferred as Associate Members.

- *Part II: Building skills*
  Candidates will obtain the required skills in handling operational issues and Islamic financial transactions such as structuring corporate financing and issuing Islamic securities. Candidates have the option of specialising in specific areas of Islamic banking and/or takaful. To be conferred as Proficient Members, candidates have to pass examinations, undertake project papers, develop new products and prepare transactional documentations.

- *Part III: Building competency and experience*
  This final part is designed to provide articleship programmes where various activities will be designed to provide candidates with practical experience in the Islamic financial services industry. These include a mentor-mentee programme at pre-approved participating Islamic financial institutions and running a simulation bank via financial laboratory. Candidates will have to go through validation processes such as solving problems, restructuring exercises, simulation and management games, product conversion exercises, Shariah and audit compliance, and interviews in order to be conferred as Practising Members.

2. <u>Postgraduate programmes</u>
   INCEIF will embark on its own Masters and Ph.D. programmes to produce graduates with strong foundation in Islamic finance, coupled with strong research and development capabilities. The Masters programme of INCEIF will be on a highly specialised field of Islamic finance such as Islamic Wealth Management. Candidates will also participate in internship programmes. The programme will commence latest by end 2006.

3. <u>Research and publication programmes</u>
   INCEIF will set up a world-class resource centre and will intensively engage in research and development projects in Islamic finance as well as publication of books, journals and working paper series. The certification and postgraduate programmes will facilitate and enhance this programme by supplying the relevant research materials and publications for academic references. INCEIF Educational Colloquium to be held in April 2006 will also serve as a platform for INCEIF to assess research materials relevant for its research programmes. INCEIF will also develop a comprehensive domestic and international financial database.

Governance

INCEIF will be headed by a Chief Executive Officer who reports to the Board of Directors (BOD). The INCEIF Governing Council, comprising prominent local and international personalities, has been established to advise the BOD on INCEIF strategic directions and provide visionary global insights on the learning needs of the Islamic financial services industry that will enhance the prominence of INCEIF. The Professional Development Panel has also been set up as the highest authority in academic matters that is responsible for reviewing and approving the certification and postgraduate module programmes and to ensure INCEIF offers the highest quality of module content and standards for all its programmes.

The establishment of INCEIF completes the talent development infrastructure in Malaysia's Islamic financial industry. The industry-owned Islamic Banking and Finance Institute of Malaysia (IBFIM) and the Securities Industry Development Centre (SIDC) focus their training programmes to meet the industry needs at the technical level whilst INCEIF will provide intermediate and advanced knowledge and skills in Islamic finance. The International Centre for Leadership in Finance (ICLIF) provides leadership programmes to top management that include top management of Islamic financial institutions. This allows Malaysia to offer a full range of Islamic finance talent development programme for the global needs of the Islamic financial services industry.

INCEIF reflects Malaysia's continuous effort and commitment towards development of a progressive Islamic financial industry by developing and enhancing human intellectual capital in Islamic finance. It is envisaged that the establishment of INCEIF would contribute towards supporting the growth and development of the global Islamic financial system.

Consumer Education

During the year, concerted efforts continued to be accorded to further strengthen the consumer education and awareness in Islamic banking and finance. Bank Negara Malaysia participated actively in the Islamic Banking and Takaful Roadshow 2005 (IBTR) organised by the Association of Islamic Banking Institutions Malaysia (AIBIM). Bank Negara Malaysia participated in six IBTRs, namely, in Shah Alam, Ipoh, Alor Setar, Johor Bahru, Putrajaya and Pulau Pinang, which managed to gather an average of 20,000 visitors per each IBTR. Bank Negara Malaysia also participated in the exhibition on Islamic banking and finance at the OIC Trade Exhibition organised by the Malaysian External Trade Development Corporation (MATRADE) which was held from 20 to 24 June 2005 and an exhibition in conjunction with the Investors Conference from 22 to 23 June 2005. For the second consecutive year, Bank Negara Malaysia participated in the Malaysia International Halal Showcase, organised by the Islamic Da'awah Foundation, which was held from 28 to 31 July 2005.

Moving Forward

With the development of a comprehensive Islamic financial system that is increasingly becoming more liberalised and integrated with the international financial system, Malaysia is well positioned to develop as an international Islamic financial centre. To meet the rising challenges, the focus will be to strengthen the innovativeness and competitiveness of the Islamic financial services industry in Malaysia, underpinned by high calibre human talents, world-class infrastructure and best international standards. Malaysia is set to serve as an important gateway for institutional and high-networth investors to tap investment opportunities in this rapidly growing region.

With the development of a comprehensive Islamic financial system that is increasingly becoming more liberalised and integrated with the international financial system, Malaysia is well positioned to develop as an international Islamic financial centre.

Initiatives are being directed at enhancing Malaysia's strength in the origination, issuance and trading of Islamic capital market and treasury instruments, Islamic fund and wealth management, offshore Islamic financial services market, and takaful and retakaful activities. To complement these initiatives are efforts targeted at making Malaysia a centre of excellence in Islamic banking and finance education, training, consultancy and research. This is in view that talent and product innovation are key factors in sustaining the global development in Islamic finance. In addition, it is envisaged that the domestic Islamic banking institutions will continue to expand overseas to become regional Islamic financial players with the long-term objective of becoming global players. The policy direction will be to enhance the resilience, efficiency and capacity of the domestic Islamic financial institutions and the Islamic financial infrastructure with the aim of intensifying the robustness and stability of the Islamic financial system.

PERFORMANCE OF THE ISLAMIC BANKING SYSTEM

The Islamic banking system continued to show strong performance in 2005, with higher profitability and positive trends in all key financial soundness indicators. At the same time, the level of capitalisation in the Islamic banking system was further strengthened through new capital injections, enabling the industry to expand with vigour and able to withstand unexpected future shocks. The main highlights of the performance of the Islamic banking system were:

- Profitability was higher, contributing to improved returns on assets and equity;
- Financing activities were active with higher demand from households for the purchase of residential properties and passenger cars;
- Non-performing financing ratio continued to trend downwards, improving further the asset quality;
- Liquidity remained ample with financing to deposits ratio at around 80%;
- Rates of return on *mudharabah* general investment deposits was marginally lower; and
- High capital adequacy ratios due to strong capitalisation level.

Profitability

There was further improvement in the profit before tax and zakat recorded by the Islamic banking sector due to higher income and lower provisions for non-performing financing, despite increases in overhead and staff costs. In calendar year 2005, the Islamic banking sector recorded an increase of RM712.5 million or 28.7% in net income (2004: RM307 million or 14.1%), while other income increased by RM47.4 million or 12.9% (2004: RM88 million or 11.8%). At the same time, overheads rose by RM259.3 million or 61.5% (2004: RM37 million or 9.6%),

Table 6.1
Islamic Banking System: Income and Expenditure

	For the calendar year 2004	2005*p*	Annual change	
	RM million			%
Income[1] net of income-in-suspense	4,298.6	5,220.2	921.6	21.4
(Income-in-suspense)	*306.2*	*234.5*	*-71.7*	*-23.4*
Less: Expense[1]	1,813.9	2,023.0	209.1	11.5
Net income	2,484.7	3,197.2	712.5	28.7
Add: Other income	368.1	415.5	47.4	12.9
Less: Staff cost	267.0	431.8	164.8	61.7
Overheads	421.5	680.8	259.3	61.5
Profit before provisions	2,164.3	2,500.1	335.8	15.5
Less: Financing loss & other provisions	1,176.2	945.3	-230.9	-19.6
Pre-tax profit	988.1	1,554.8	566.7	57.4
Return on assets (%)	1.1	1.5		
Return on equity (%)	15.7	21.0		

[1] From financing activities and securities
p Preliminary

while staff cost rose by RM164.8 million or 61.7% (2004: RM38 million or 16.6%). After allocating financing loss and other provisions of RM0.9 billion (2004: RM1.2 billion), the Islamic banking sector recorded profit before tax and zakat of RM1.6 billion for the calendar year 2005 (RM988.1 million in 2004). The better profitability has increased the return on assets and return on equity to 1.5% and 21% (2004: 1.1% and 15.7%) respectively, despite the increase in asset size and capital funds.

Table 6.2
Islamic Banking System: Sources and Uses of Funds

	Annual change 2004	2005*p*	As at end-2005*p*
	RM million		
Sources			
Capital and reserves	1,137.4	2,615.2	10,051.7
Deposits	16,907.1	11,047.9	83,874.8
Funds from other financial institutions	-2,902.9	429.5	4,459.1
Other liabilities	2,542.4	2,697.0	13,437.9
Total	**17,684.0**	**16,789.6**	**111,823.5**
Uses			
Cash	15.9	58.6	329.2
Reserve with Bank Negara Malaysia	-158.3	567.5	1,925.9
Deposits with other financial institutions	7,239.7	4,314.8	20,374.9
Financing	9,227.5	9,523.2	67,364.6
Securities	-1,776.2	4,600.7	20,800.9
Other assets	3,135.4	-2,275.2	1,028.0

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Assets

During the year, the total assets of the Islamic banking sector increased significantly by RM16.8 billion or 17.7% to RM111.8 billion with more than half of the increase attributable to a 16.5% (RM9.5 billion) growth in total financing. As at end-2005, total outstanding financing amounted to RM67.4 billion (2004: RM57.8 billion) or 60.2% of the total Islamic banking assets. Investment in securities increased by 28.4% (RM4.6 billion) during the year to account for RM20.8 billion or 18.6% of the total assets. At the same time, deposits placed with other institutions also rose by 26.9% (RM4.3 billion), to account for another RM20.4 billion or 18.2% of the total Islamic banking assets. In terms of market share, the largest portion of Islamic banking assets remained with the commercial banks in the Islamic Banking Scheme (IBS) with a share of 53.4%, followed by the Islamic banks (38.8%) and the IBS discount houses (5.3%). In terms of the growth in assets, Islamic banks recorded the highest growth of 74.7% arising from the transformation of three "Islamic windows" into Islamic banks, followed by IBS commercial banks (10.7%) and IBS discount houses (0.5%).

Financing Activities

During the year, there was a higher number and amount of financing applications received by the Islamic banking institutions. In tandem with the increase in financing approvals of 55.1%, financing disbursements increased by 19.4%. Financing repayments also recorded an increase of 25.3% as the overall economic condition improves.

Arising from the active financing activities, total financing expanded by 16.5% or RM9.5 billion in 2005, (19% or RM9.2 billion in 2004). Supported by the strong consumer spending, consumer financing

Table 6.3
Islamic Banking System: Financing Activities

	For the year 2004	2005*p*	Annual change (%)
	RM million		
Financing approvals	17,273.0	26,789.2	55.1
Financing disbursements	41,088.6	49,058.7	19.4
Financing repayments	33,679.0	42,207.5	25.3
	As at end- 2004	**2005*p***	**Annual change (%)**
	RM million		
Outstanding financing	57,841.3	67,364.6	16.5

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continued to account for the largest component (36.2%) of financing extended by the Islamic banking institutions, mainly for the purchase of passenger cars, while the broad property sector recorded the second largest component of financing, comprising 34% of the total financing, extended mainly to the residential property sub-sector. In 2005, financing for the purchase of passenger cars constituted 29.9% of the total financing, while financing for the purchase of residential properties constituted 23.8%. The higher household demand was as the result of attractive and competitive financing packages offered by the Islamic banking institutions. Under the business sector, financing extended to the manufacturing sector accounted for 11.2% of the total financing as at end-2005 (end-2004: 10.6%). In terms of financing concept, financing based on the *bai' bithaman ajil* concept remained dominant, constituting 40.7% of the total financing, albeit at a lower percentage compared with last year (49.9%). In contrast, financing based on *ijarah* increased to 31.6% of the total financing (2004: 24%) following the increase of RM5.8 billion in passenger car financing.

Table 6.4
Islamic Banking System: Direction of Financing

	Annual change		As at end-2005*p*
	2004	2005*p*	
	RM million		
Agriculture, hunting, forestry and fishing	466.9	40.8	2,369.3
Manufacturing	1,725.8	1,406.9	7,519.5
Mining and quarrying	13.1	28.3	104.9
Electricity, gas and water supply	470.3	-300.2	419.1
Wholesale and retail trade, restaurants and hotels	1,273.9	317.1	3,388.0
Wholesale trade	*1,141.3*	*148.9*	*2,392.2*
Retail trade	*126.5*	*167.1*	*905.0*
Restaurants and hotels	*6.1*	*1.1*	*90.8*
Broad property sector	1,926.2	512.4	22,923.1
Real estate	*94.5*	*66.3*	*972.7*
Construction	*597.4*	*-199.3*	*3,331.6*
Purchase of residential property	*1,047.0*	*581.7*	*15,974.7*
Purchase of non-residential property	*187.3*	*63.6*	*2,644.1*
Transport, storage and communication	152.2	111.0	1,287.5
Finance, insurance and business services	172.0	22.0	1,999.0
Financial services	*-37.8*	*178.7*	*1,376.3*
Insurance	*-0.4*	*-1.7*	*1.4*
Business services	*210.2*	*-154.9*	*621.3*
Consumption credit	3,458.9	7,255.1	24,376.1
Personal uses	*811.3*	*1,289.9*	*3,738.2*
Credit cards	*155.8*	*155.1*	*467.1*
Purchase of consumer durables	*-10.5*	*-5.6*	*38.0*
Purchase of passenger cars	*2,502.3*	*5,815.8*	*20,132.8*
Purchase of securities	-43.0	42.4	920.3
Purchase of transport vehicles	-525.2	25.1	706.6
Community, social and personal services	115.2	216.7	635.2
Others	22.0	-154.4	716.0

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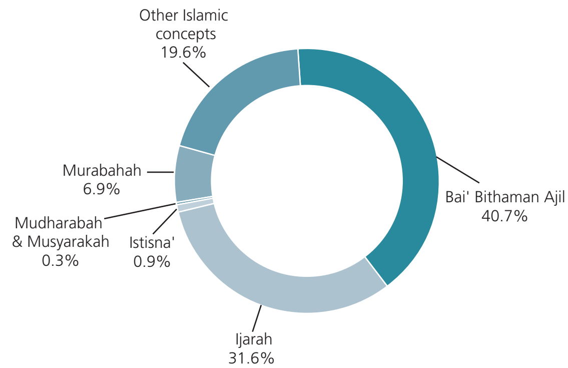
Graph 6.2
Islamic Banking System:
Major Financing Concepts as at end-2005



The Islamic banking sector continued to support the expansion of small and medium enterprises (SME). In 2005, financing approvals and disbursements to SME increased by 32.7% and 19.7% respectively. Total financing to the SME provided by the Islamic banking institutions increased by 7.7% to reach RM8.6 billion as at end-2005 (end-2004: RM8 billion) to account for 33.6% of the total Islamic business financing as at end-2005.

Asset Quality

The asset quality of the Islamic banking sector improved further during the year. The gross and net non-performing financing (NPF) ratios as at end-2005 stood at 7.7% (2004: 8.1%) and 4.8% (2004: 5.2%) respectively based on a 6-month classification. The net NPF ratio of the Islamic banking institutions sustained within the range of 4.7% to 5.3% throughout the year. Financing loss coverage remained high at 58.7% of the total NPF as at end-2005 (2004: 61.6%). In terms of absolute amount, financing loss coverage increased to RM3.5 billion as at end-2005 from RM3.1 billion as at end-2004. The general and specific provisions set aside by the Islamic banking institutions increased by 16.7% and 27% respectively during the year, while income-in-suspense decreased by 11.1%. The general provision for

Table 6.5
Islamic Banking System: Non-performing Financing and Financing Loss Provisions

	As at end-					
	2004			2005*p*		
	Actual[1]	Classification		Actual[1]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Islamic banking system						
Total financing	57,841.3			67,364.6		
General provisions	1,236.5	1,236.1	858.9	1,443.0	1,443.4	1,053.0
Income-in-suspense	640.5	661.2	633.8	569.5	582.6	554.6
Specific provisions	1,183.2	1,239.4	1,170.6	1,502.5	1,547.2	1,461.6
Non-performing financing	4,968.2	6,313.4	4,710.5	5,991.8	6,653.1	5,167.3
Net NPF ratio (%)[2]	5.6	7.9	5.2	6.0	6.9	4.8
Total provisions/NPF (%)	61.6	49.7	56.5	58.7	53.7	59.4
Islamic banks						
Total financing	11,423.1			20,627.1		
General provisions	163.4	163.4	163.4	353.0	353.0	353.0
Income-in-suspense	204.1	215.3	204.1	278.7	291.8	276.3
Specific provisions	468.1	501.7	468.1	626.8	661.5	621.6
Non-performing financing	1,668.7	2,152.7	1,668.7	2,399.6	2,957.1	2,320.5
Net NPF ratio (%)[2]	9.3	13.4	9.3	7.6	10.2	7.2
Total provisions/NPF (%)	50.1	40.9	50.1	52.4	44.2	53.9
Commercial banks[3]						
Total financing	38,802.1			45,398.5		
General provisions	930.6	930.2	553.0	1,056.8	1,057.2	666.8
Income-in-suspense	328.3	330.4	321.6	260.2	260.2	247.7
Specific provisions	558.0	565.6	545.4	797.0	803.5	761.3
Non-performing financing	2,800.1	3,411.7	2,542.4	3,422.0	3,445.6	2,676.6
Net NPF ratio (%)[2]	5.0	6.6	4.4	5.3	5.4	3.8
Total provisions/NPF (%)	64.9	53.5	55.9	61.8	61.6	62.6
Finance companies[3]						
Total financing	6,823.4			1,070.9		
General provisions	129.6	129.6	129.6	26.8	26.8	26.8
Income-in-suspense	100.5	107.9	100.5	22.7	22.7	22.7
Specific provisions	138.6	153.6	138.6	49.2	52.7	49.2
Non-performing financing	389.6	639.2	389.6	122.9	203.1	122.9
Net NPF ratio (%)[2]	2.3	5.8	2.3	5.1	12.8	5.1
Total provisions/NPF (%)	94.7	61.2	94.7	80.3	50.3	80.3
Merchant banks[3]						
Total financing	792.7			268.1		
General provisions	12.9	12.9	12.9	6.4	6.4	6.4
Income-in-suspense	7.6	7.6	7.6	7.9	7.9	7.9
Specific provisions	18.5	18.5	18.5	29.5	29.5	29.5
Non-performing financing	109.8	109.8	109.8	47.3	47.3	47.3
Net NPF ratio (%)[2]	10.9	10.9	10.9	4.3	4.3	4.3
Total provisions/NPF (%)	35.5	35.5	35.5	92.3	92.3	92.3

[1] Financing classified as NPF based on individual banking institution's NPF classification policy i.e. 3-month or 6-month classification
[2] Net NPF ratio = (NPF less IIS less SP) / (Gross financing less IIS less SP) x 100%
[3] Refers to Islamic banking portfolio of conventional banking institutions participating in Islamic Banking Scheme and represents a subset of the figures reported under the total banking system for commercial banks, merchant banks and finance companies
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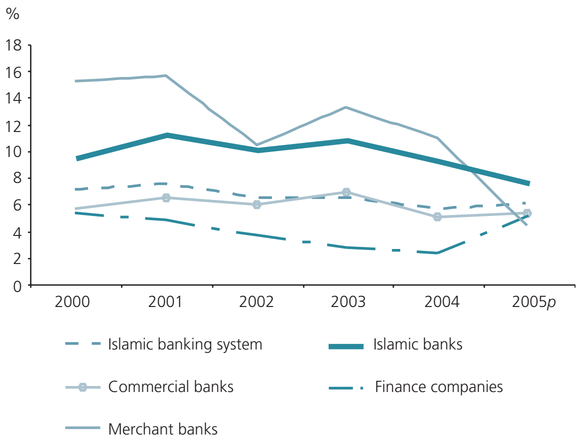
the Islamic banking sector remained at 2.2% of the total net financing, reflecting the prudent stance adopted by the Islamic banking institutions.

The broad property sector continued to account for the largest share of NPF, at 60.6% (2004: 66.7%). The high NPF in the broad property sector was recorded in the residential property, which increased by RM383.9 million (21.4%). The NPF level of the residential property increased from 36% as at end-2004 to 36.3% as at end-2005. Apart from the broad property sector, there was also an increase of RM258.1 million in NPF in financing for the purchase of transport vehicles.

Liquidity

There was ample liquidity in the Islamic banking system throughout 2005. Total deposits recorded a significant growth of 15.1% or RM11 billion to reach

Graph 6.3
Islamic Banking System:
Net Non-Performing Financing Ratio[1]



[1] Based on actual classification

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RM83.9 billion as at end-2005. The IBS commercial banks contributed the major share (51%) of the total deposits in the Islamic banking sector (2004: 54.6%), followed by the Islamic banks of 42.5% (2004: 28.5%). Among the Islamic banking players, the Islamic banks recorded the highest growth rate in deposits of 71.7% mainly due to the transformation of three "Islamic windows" into Islamic banks, followed by the IBS of commercial banks which recorded a growth of 7.5%.

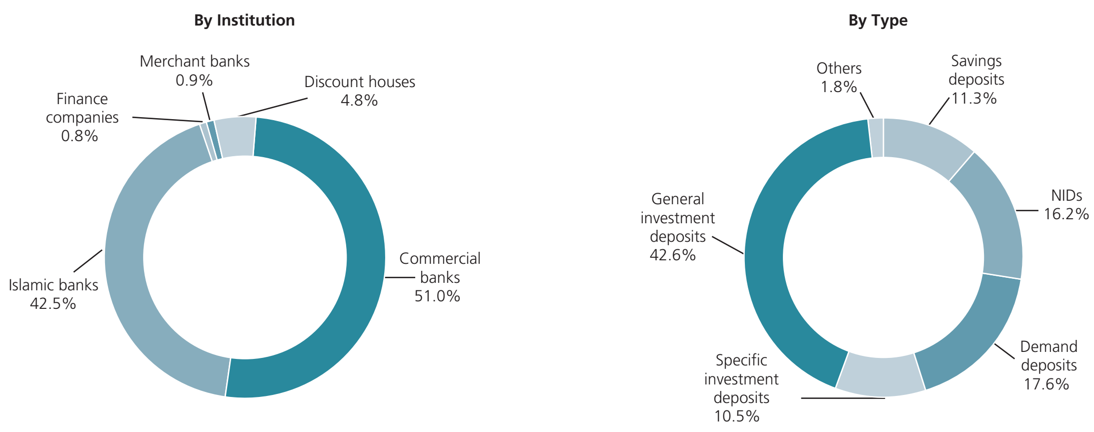
Investment deposits (general and specific) continued to capture a major portion of the Islamic banking deposits, contributing 53.2% (2004: 57.6%) of the Islamic banking deposits. However, investment deposits only grew by 6.2%, while savings and demand deposits grew by 12.7% and 14.5% respectively mainly due to the increase in the retail customer base in Islamic banking. In terms of the maturity profile of general investment deposits, 96.2% continued to be concentrated at the shorter end of the yield curve, mainly in the one to three-month maturity tenure as the incremental return between the shorter and longer placement tenures continued to remain small. The average rates for deposits remained stable in 2005.

Financing to deposits (FD) ratio of the Islamic banking institutions showed a favourable trend. The FD ratio increased from 79.4% as at end-2004 to 80.3% as at end-2005 due to higher percentage increase in the total financing base (16.5%) compared to deposits (15.1%) during the period.

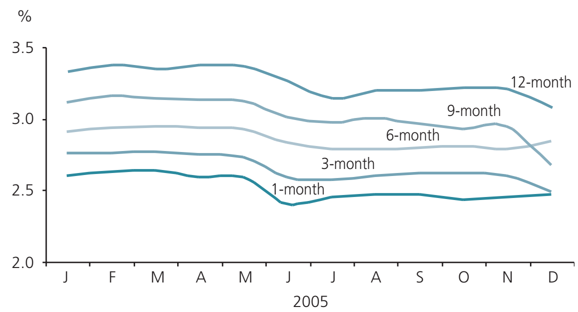
Rates of Return

The rates of return distributed to the various tenures of the *mudharabah* general investment deposits (GID) by the Islamic banking institutions continued to decline in 2005. The average rate of return of 1-month ranged from 2.40% to 2.63% (2004: 2.63% to 2.87%) and 3-month GID ranged from 2.57% to 2.76% (2004: 2.73% to 2.93%) respectively. The declining trend in the rates of return was attributed to the marginal increase in the average monthly net distributable income, which was not proportionate to a higher growth in the average monthly GID. During the year, the average monthly net distributable income grew by RM30 million that contributed to a marginal increase of 0.01 times of profit payable to outstanding GID across all tenures. However, the corresponding outstanding monthly average of GID increased by 13.6% or RM34.5 billion in 2005.

Graph 6.4
Islamic Banking System: Deposits by Institution and Type as at end-2005



Graph 6.5
Islamic Banking System:
Average Rates of Return to General Investment Deposits in 2005



During the year, the Islamic banking institutions allocated an additional RM12.4 million from the gross income to the profit equalisation reserve (PER) account. As at end-2005, the outstanding PER stood at RM481.1 million as compared with RM468.7 million in 2004. The increase in PER provides the additional buffer for Islamic banking institutions to sustain competitive rate of return and smoothen the potential negative impact while operating in an increasing interest rate environment in the dual banking system.

Capital Strength

The Islamic banking sector remained well capitalised thus enabling the sector to sustain the RWCR and core capital ratio above 12% and 10% respectively throughout the year. The total capital base of the Islamic banking institutions increased from RM7.9 billion as at end-2004 to RM10.2 billion as at end-2005, mainly due to new capital brought in with the setting up of three new Islamic subsidiaries and a new foreign Islamic bank, as well as new capital injections and audited profits. Total risk-weighted assets of the Islamic banking system grew by 16.2% or RM10.1 billion in the past 12 months. The growth was apparent in the 0% and 100% risk categories (RM1 billion and RM8.5 billion respectively). As at end-2005, the Islamic banking system recorded a strong RWCR of 14.1% and core capital ratio of 11.3%.

The RWCR of the Islamic banks and IBS commercial banks stood at 14.3% and 14.2% respectively. The RWCR of the IBS merchant banks increased from 14.8% to 22.2% mainly due to the increase in the capital base and decrease in the risk-weighted assets. The RWCR of the IBS finance companies was 10.2% with the capital base declining significantly by 82.1% or RM700.9 million to RM152.9 million as at end-2005 mainly due to the rationalisation of capital arising from the merging of operations of four IBS finance companies into their IBS commercial banks within the same group. The risk-weighted assets of IBS finance companies also decreased by 80.5% or RM6.2 billion.

Table 6.6
Islamic Banking System: Constituents of Capital

	As at end-		Annual change	
	2004	2005*p*		
	RM million			(%)
Tier-1 capital	6,618.1	8,207.5	1,589.4	24.0
Tier-2 capital	1,324.8	2,012.7	687.9	51.9
Total capital	7,942.9	10,220.2	2,277.3	28.7
Less:				
Investment in subsidiaries	12.8	13.5	0.7	5.5
Capital base	7,930.0	10,196.5	2,266.5	28.6
Risk assets:				
0%	*22,349.5*	*23,396.6*	*1,047.1*	*4.7*
10%	*825.3*	*1,419.9*	*594.6*	*72.1*
20%	*7,422.9*	*6,258.4*	*-1,164.5*	*-15.7*
50%	*14,706.2*	*13,588.0*	*-1,118.2*	*-7.6*
100%	*47,234.5*	*55,707.0*	*8,472.5*	*17.9*
Total risk-weighted assets	62,239.0	72,314.0	10,075.0	16.2
Risk-weighted capital ratio (%)				
Islamic banking system	12.7	14.1		
Islamic banks	*12.4*	*14.3*		
Commercial banks	*13.1*	*14.2*		
Finance companies	*11.1*	*10.2*		
Merchant banks	*14.8*	*22.2*		

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ISLAMIC INTERBANK MARKET

The value of trading in Islamic interbank market declined by 36.6% during the year with the decrease in *mudharabah* interbank investment transactions, which constituted more than 70% of the total turnover volume in the Islamic interbank market. The decline in *mudharabah* transactions was also attributed to the stable liquidity condition coupled with the lower average rate of return offered in the *mudharabah* interbank investment transactions. In addition, the increased issuance of Government Investment Issues (GII), Islamic Treasury Bills (ITB) and Bank Negara Negotiable Notes (BNNN) also influenced the turnover volume of the *mudharabah* interbank investments following the relatively active trading in the Government and Bank Negara Malaysia Islamic securities. The increased supply of the Shariah compliant securities in the Islamic money market has contributed towards strengthening the Islamic interbank market position in meeting the increasing market demand for liquid Islamic financial assets.

Table 6.7
Islamic Interbank Market: Turnover Volume

	2004	2005*p*	Annual change	
	RM billion			%
Total	**562.5**	**356.5**	**-206.0**	**-36.6**
Mudharabah* Interbank Investment	**485.7**	**254.7**	**-231.0**	**-47.6**
Financial Instruments	**76.8**	**101.8**	**25.0**	**32.6**
Islamic Accepted Bills*	10.3	9.4	-0.9	-8.7
Negotiable Islamic Debt Certificate*	8.2	8.6	0.4	4.9
Bank Negara Negotiable Notes	21.2	36.1	14.9	70.3
Islamic Treasury Bills	1.2	4.5	3.3	275.0
Government Investment Issues	35.9	43.2	7.3	20.3

* Volume transacted through brokers
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Table 6.8
Outstanding Islamic Securities

	2004	2005*p*	Annual change	
	RM billion			%
Total	**106.8**	**131.3**	**24.5**	**22.9**
Government Securities	**15.1**	**19.1**	**4.0**	**26.5**
Government Investment Issues	9.1	10.1	1.0	11.0
Islamic Treasury Bills	1.0	2.0	1.0	100.0
Bank Negara Negotiable Notes	5.0	7.0	2.0	40.0
Private Debt Securities	**91.7**	**112.2**	**20.5**	**22.3**
Khazanah bonds	9.0	10.0	1.0	11.1
Corporate bonds	66.0	75.4	9.4	14.2
Commercial papers	3.6	4.4	0.8	22.2
Medium-term notes	10.0	16.7	6.7	67.0
Cagamas bonds	2.5	2.5	0.0	0.0
Asset backed securities	0.6	3.2	2.6	433.3

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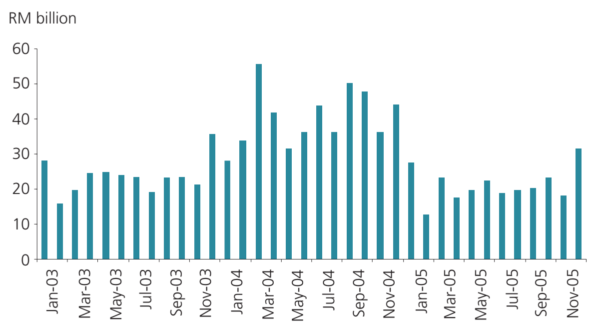
In 2005, the Government of Malaysia issued additional Islamic securities amounting to RM2 billion, consisting of GII and ITB of RM1 billion each. Similarly, Bank Negara Malaysia also increased the issuance of BNNN by RM2 billion during the same period. Overall, the increase in the issuance of Government and Bank Negara Malaysia Islamic securities by RM4 billion or 26.5% during the year has not only stabilised the liquidity condition in the Islamic interbank market but also improved the supply of class one Shariah compliant liquefiable assets in the secondary market. In the case of GII, the new issuance of a 10-year maturity tenure has effectively lengthened the benchmark yield curve of Islamic securities.

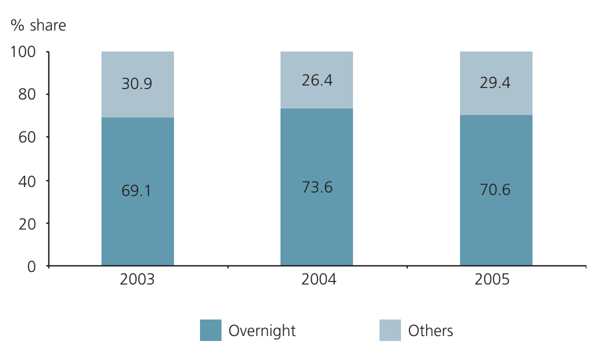
During the year, the total amount of liquidity surplus absorbed through the conduct of *wadiah* interbank acceptance mechanism has reduced as a consequence of the increase in the issuance of Islamic securities. The daily average outstanding amount of liquidity absorbed under this mechanism decreased by 15% from RM3 billion in 2004 to RM2.6 billion in 2005. The stable liquidity position in the Islamic interbank market has led to a steady turnover volume of an average of RM21 billion monthly as well as stabilised the rate of return in the *mudharabah* interbank investment transactions, which registered an average indicative overnight rate of return of 2.6%.

During the year, the trading of Islamic money market papers recorded moderate growth in terms of turnover volume and largely centred on the Islamic securities issued by the Government and Bank Negara Malaysia. The trading of the Islamic Accepted Bills (AB-i) in the secondary market continued to be captive as the issuers prefer to hold the short-term paper until maturity due to the relatively attractive earnings offered by this paper. Similarly, the trading of Negotiable Islamic Debt Certificate (NIDC-i) also recorded moderate growth of 4.9% corresponding with the increase in the creation of this instrument in the

Graph 6.6
***Mudharabah* Interbank Investment - Turnover Volume**



Graph 6.7
***Mudharabah* Interbank Investment - Share of Turnover Volume**



primary market. In 2005, NIDC-i issues increased to RM13.6 billion or 51.1% compared with RM9 billion in 2004. In terms of maturity tenure, more than 45% or RM6.1 billion of NIDC-i is of the maturity of more than one year.

The improvement in the supply of short-term Islamic government securities through BNNN and ITB has contributed to a higher trading volume of these instruments in the secondary market. During the year, the turnover volume of BNNN and ITB grew substantially by RM14.9 billion and RM3.3 billion or an increase of 70.3% and 275% respectively as compared with 2004. In terms of GII, trading in the longer term government securities recorded a growth of 20.3% or RM7.3 billion as compared with 2004. The availability of a continuous and an enlarged supply of these instruments with varying maturity tenure has effectively widened the range of tradable Islamic instruments in the Islamic interbank market.

In terms of total outstanding securities, the Islamic bond market continued to chart a positive growth of 22.9% or RM24.5 billion. The outstanding Islamic private debt securities amounted to RM112.2 billion as at end of 2005 accounted for 40% of the total outstanding private debt securities in the debt market. Corporations have actively sourced funding under the Islamic principles to lock their funding cost through the issuance of longer term Islamic private debt securities with the anticipation of a possible increase in interest rate in the later part of the year. An encouraging development in the Malaysian Islamic bond market, following the liberalisation of the foreign exchange administration rules, was the issuance of a RM700 million ringgit-denominated Islamic debt securities by an international multilateral development financial institution.

In the mortgage securities segment, Cagamas MBS Berhad issued the inaugural Islamic residential mortgage-backed securities (IRMBS) represented by receivables of the Islamic house financing provided by the Government of Malaysia. The RM2.05 billion IRMBS issue is with a maturity tenure ranging from 3 to 15 years and structured based on the concept of *musyarakah*. This landmark issuance, which was oversubscribed by 5.4 times, has attracted wide participation from the domestic as well as the regional investors.