The Islamic Financial System

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OVERVIEW

The year 2004 marked another significant milestone in the progress of Islamic banking and finance in the Malaysian banking system in its two decades of development. The financial liberalisation of the Islamic banking sector was brought forward from 2007 to 2004 with the issuance of three new Islamic bank licences under the Islamic Banking Act 1983 (IBA) to Islamic financial institutions from the Middle East.

The move to bring forward the liberalisation programme emanated from the rapid development and steady performance of the Islamic banking industry over the years. Since 2000, the Islamic banking industry has been growing at an average rate of 19% per annum in terms of assets. At end-2004, total assets of the Islamic banking sector increased to RM94.6 billion, which accounted for 10.5% of the total assets in the banking system. The market share of Islamic deposits and financing also increased to 11.2% and 11.3% of total banking sector deposits and financing respectively.

The entry of the new foreign Islamic banking licensees is in line with the recommendations of the Financial Sector Masterplan (FSMP) to position Malaysia as an international Islamic financial hub. The new entrants, each with distinctive capabilities and strengths, will have the opportunity to participate in the growing Islamic banking industry and tap new markets in Malaysia and the region, as well as promote healthy competition which is necessary to elevate the industry to new levels of dynamism.

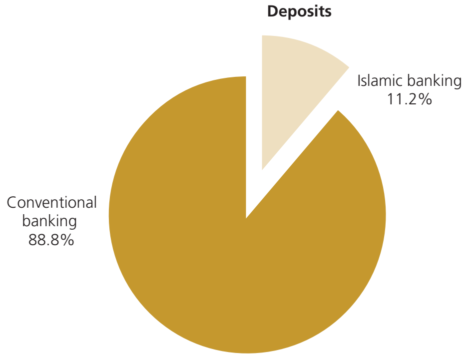
The presence of the foreign players will also accelerate the global integration of the domestic Islamic banking system. The exchange of knowledge and expertise will promote greater economic and financial linkages between Malaysia and the Middle Eastern region, and foster greater harmonisation in terms of Shariah interpretation and understanding. Greater international trade and investment flows would also be facilitated.

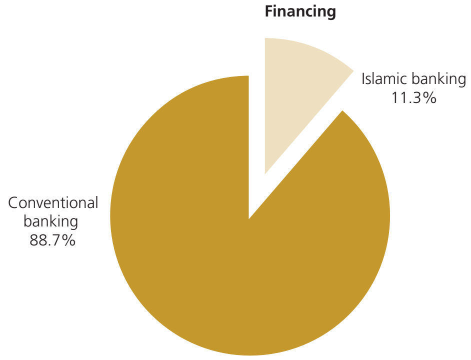
The move to bring forward the liberalisation programme emanated from the rapid development and steady performance of the Islamic banking industry over the years.

Bank Negara Malaysia also continued in 2004 to further strengthen the overall infrastructure development of the Islamic banking system, including enhancing the institutional structure and human capital development.

- As the Islamic banking industry entered a more advanced stage of development, the 'window-based' institutional structure was reviewed to further strengthen and elevate the development of the domestic Islamic banking industry through a new enabling institutional structure. The domestic banking groups and foreign Islamic Banking Scheme (IBS) banks were encouraged to set up Islamic subsidiaries (IS), which will be licensed as an Islamic

Graph 6.1
Market Share of Deposits and Financing as at end-2004





bank under the IBA. The underlying principle of the incorporation of IS is primarily aimed at further strengthening the institutional structure of Islamic banking business operations for greater strategic focus, while continuing to leverage on the synergies of the conventional banking operating infrastructures, which include the availability of Islamic banking products and services at the existing branches of the conventional commercial banks. Towards this end, Bank Negara Malaysia has approved the application of five domestic banking groups, namely four IBS banking groups and a non-IBS bank, to establish IS under the IBA to carry out Islamic banking business. To date, one of the banking groups has launched its IS.

- In terms of regulatory and prudential structure, efforts were directed at improving the corporate governance of Islamic banks via the issuance of guidelines to enhance the effectiveness of their board of directors. The financial disclosure requirements were also enhanced, in line with international accounting standards, to meet a higher degree of transparency. Additionally, the rate of return framework was further strengthened to provide flexibility to the banks in managing their portfolios to compete and to align their business operations with market trends and outlook.

- In line with the developments in the conventional banking system, the Islamic banking institutions were also required to prepare to embrace the Basel II implementation approach. In adopting either the Standardised Approach for credit risks or the Internal Ratings Based Approach under the new capital accord, sound and robust risk management framework and practices would be continuously upgraded and benchmarked against the best industry practices. This would facilitate the efforts of the Islamic banking institutions to optimally apply their economic and regulatory capital.

- Significant enhancement to the Shariah governance in the Islamic banking system was attained following the enlargement of the role and functions of the Shariah Advisory Council of Bank Negara Malaysia. In addition, the introduction of the new Shariah committee framework, where the functions and duties of the Shariah committees have been clearly outlined and streamlined, has reinforced the central Shariah advisory body at the Central Bank.

- The amendments to the tax legislation that accord neutrality to tax treatment between Islamic and conventional banking products and services will create a more conducive tax regime for the Islamic banking industry.

- Product innovation continued to thrive within the boundaries of the Shariah framework. A more diversified product range that includes variable rate and equity-based mechanisms is being more widely introduced. To mitigate liquidity risk due to market volatility, the Islamic banking institutions are beginning to introduce long-term variable rate financing. Through the usage of periodic rebate mechanism, the effective profit rate on the financing can vary to closely track the benchmark rate currently used in the market, thus alleviating any funding mismatch. To further strengthen the risk management framework, a profit rate swap mechanism that applies Islamic principles will also be introduced, allowing the fixed rate commitment of a financing contract to be exchanged with the variable rate commitment of another contract, and vice versa.

- In terms of human capital development and consumer awareness, continuous efforts were carried out throughout the year through various seminars, workshops, exhibitions and other promotional activities. As the Islamic banking industry progresses, a human capital development programme is being structured collectively by the public and private sectors to create a larger pool of experts and professionals in Islamic banking and finance to meet the increasing manpower requirements arising from the rapid institutional development.

In view of these significant developments, the Islamic financial landscape in Malaysia has been set on a course that is filled with vast potential and prospects for future growth, specifically in positioning Malaysia as a leading Islamic financial hub to the international financial community.

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POLICY DIRECTION IN 2004

The key focus of policy in 2004 for the Islamic banking sector continued to be on the efforts to further strengthen the Islamic banking system as an integral component of the Malaysian financial system. The policy thrust centred on enhancing the institutional structure, regulatory and prudential framework, Shariah and legal infrastructure, product and market development, as well as human capital development and consumer education.

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Strengthening Institutional Financial Infrastructure
Institutional Development
Strengthening the financial infrastructure is a key prerequisite for the development of a dynamic and progressive Islamic banking system. In 2004, significant initiatives were carried out in the development of the institutional financial infrastructure of the Islamic banking system.

- Bank Negara Malaysia approved the issuance of new Islamic banking licences under the Islamic Banking Act 1983 (IBA) to three leading foreign Islamic financial institutions from the Middle East, namely, Kuwait Finance House, Al-Rajhi Banking & Investment Corporation and a consortium of Islamic financial institutions represented by Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House. The issuance of the Islamic banking licences to foreign players is part of the strategy to enhance the diversity and depth of players in the Islamic financial landscape. The presence of full-fledged foreign Islamic banks in Malaysia would increase the potential to tap new growth opportunities as well as raise the performance and development of the overall Islamic financial system.

- An important strategic measure undertaken in 2004 was the move by several conventional banking groups participating in the Islamic Banking Scheme (IBS) to transform the current 'Islamic window' institutional structure into an 'Islamic subsidiary' (IS) within their respective banking groups. This strategic move is in tandem with the recommendations of the Financial Sector Masterplan (FSMP) to further strengthen the institutional structure of the banking institutions participating in the IBS. From the legal perspective, this exercise will accord licensing of the Islamic banking business of conventional banking groups under Islamic banking law. In this regard, Bank Negara Malaysia has approved the applications of five domestic banking groups to establish an IS under their commercial banking arm to undertake Islamic banking business under the IBA. The incorporation of the IS by the domestic banking groups will involve the detachment and migration of the existing Islamic banking portfolios in the conventional banking institutions to the newly incorporated IS. The IS will be incorporated as a wholly owned subsidiary of the commercial bank and any divestment of shares in the IS to either domestic investors or foreign investors is subject to the condition that the IS will remain as a subsidiary of the commercial bank with a minimum equity interest of 51%.

The incorporation of IS will provide an institutional structure that can assimilate future developments in the Islamic financial regulatory infrastructure over the longer term and thus strengthen the overall prudential and supervisory regime of the Islamic banking system. This will preserve the integrity of the Islamic banking system and operations in line with the dictates of the Shariah. Developments include the drafting of a different set of prudential regulatory and supervisory standards for Islamic banking operations to be issued by the Islamic Financial Services Board (IFSB), a different set of accounting standards for Islamic financial business to be issued by the Malaysian Accounting Standards Board (MASB) and the forthcoming introduction of the Deposit Insurance Scheme. Compared to the window arrangement, the incorporation of IS will further strengthen the commitment and provide greater strategic focus by the Islamic banking institutions to promote the development of an efficient Islamic banking system.

The distinctive features of the IS, among others, include:

o A minimum capital fund of RM50 million or the current amount of Islamic banking capital funds of the conventional banking institution that comply with the minimum risk-weighted capital ratio requirement of 8%, whichever is higher;

- o An independent board of directors, a dedicated chief executive officer and management team; and

- o Flexibility to leverage on the existing infrastructure of the conventional banking institutions within the banking group, including the branch network and support functions. This would further strengthen the institutional structure for Islamic banking business while retaining the synergies available within the banking group, consistent with the objective of strengthening the competitiveness of the Islamic banking institutions through the maximisation of group synergy and cost efficiency.

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Risk Management

The Islamic banking institutions also continued to focus on enhancing their risk management framework, an important prerequisite in the development of a sound and robust institutional financial infrastructure.

- In November 2004, a review on the *bai' bithaman ajil* (deferred payment sale) variable rate financing mechanism was conducted to promote efficiency in the pricing of this mode of financing. Under the revised policy, the maximum financing spread of 2.5 percentage points above Base Lending Rate (BLR), which is used to determine the effective profit rate, has now been removed. In addition, the requirement to seek Bank Negara Malaysia's approval for the ceiling profit rate to be more than four percentage points above the benchmarked BLR has been lifted. Accordingly, Islamic banking institutions are now allowed to determine a reasonable ceiling profit rate taking into account the institution's risk management capabilities, business strategies and market outlook. The Islamic banking institutions are also required to include in their financing agreements, and in their letter of offer, the mechanism and benchmark used in deriving the effective profit rate.

Enhancing Regulatory, Prudential and Operational Framework

To ensure effective functioning of the Islamic banking system, various initiatives to enhance the regulatory, prudential and operational framework were taken.

Regulatory

- As part of the effort to enhance corporate governance in Islamic banks, the Guidelines on Directorship in the Islamic Banks or GP1-i (the Guidelines) were issued in March 2004. The purpose of the Guidelines is to strengthen the effectiveness of the board of directors, who would assume full responsibility for the overall management of an Islamic bank. The Guidelines set out the requirements on duties and responsibilities of the board, appointment and reappointment of directors and chief executives, directorship in other corporations and composition of the board of directors as well as the requirement for the Islamic banks to establish an Audit Committee and other board committees consisting of Nominating Committee, Remuneration Committee and Risk Management Committee.

- The Guidelines on Financial Reporting for Licensed Institutions or BNM/GP8 issued in October 2004 to the financial institutions also incorporated several enhancements to the financial reporting requirements for the Islamic banking operations of the IBS institutions. The enhancements, amongst others, included the requirement for the IBS institutions to disclose their cash flow statement and statement of changes in equity, in addition to the balance sheet and income statement. It also specified the requirements for disclosure of the functions and duties of the Shariah advisory committee and responsibility towards *zakat* obligations, policy on profit equalisation reserves disclosure and classification of deposits accepted into *mudharabah* and non-*mudharabah* categories. These requirements were introduced to reflect the nature of and risk associated with Islamic banking operations. The above minimum disclosure requirements are to be adopted for the financial year beginning January 2005.

Prudential

- The revised Framework of Rate of Return was issued to the Islamic banking industry in August 2004 to provide it with greater flexibility in managing its rates of return and to enhance the operational efficiency and capacity among Islamic banking institutions in managing their business portfolios. Among the revisions made to the framework are the flexibility to offer different profit sharing ratios, requirement to segregate between *mudharabah* and non-*mudharabah* deposits, classification of funds under restricted or unrestricted funds and discretion to assign flexible weightage to each type of deposits. With regard to board rates, the Islamic banking institutions are required to display the profit sharing ratio and rate of return for each type of deposits as well as the effective period of the rate. The revised framework was implemented beginning 1 October 2004.

- In tandem with the implementation of the Market Risk Capital Adequacy Framework for conventional banking institutions, a similar framework for Islamic banks was issued in September 2004. The framework sets out the approach prescribed by Bank Negara Malaysia in determining the level of capital to be held by the Islamic banks against their market risk, which is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The framework was implemented on a trial basis beginning September 2004 with full compliance from 1 April 2005.

- Following the issuance of the two-phase implementation approach of Basel II for the conventional banks, Bank Negara Malaysia also issued a two-phase implementation approach for the Islamic banks in September 2004. Under this approach, the Islamic banks are given the option to either comply with the Standardised Approach for credit risks in 2008 or to move directly to the Internal Ratings Based Approach in 2010. With regard to the Basel II implementation, the Islamic banks are also required to conduct gap, impact and cost-benefit analyses, develop implementation roadmap, timeline and budget, undertake research and analytical work as well as ensure the roles and responsibilities of the Board and senior management are taken on. These requirements will provide Bank Negara Malaysia with the basis for monitoring the progress made by the Islamic banks in observing the Basel II requirements and, at the same time, serve as a platform for the Islamic banks in complying with the capital adequacy standard for the Islamic banking institutions scheduled to be issued by the IFSB in 2005.

Operational

- With effect from 12 October 2004, acceptance of investment deposits of less than one-month tenure can only be carried out by Islamic banks and discount houses. Following this policy, banking institutions participating in the Islamic Banking Scheme (commercial banks, finance companies and merchant banks) are no longer allowed to accept deposits of this tenure except by way of sell and buy back arrangements.

- In line with the efforts to strengthen Islamic banking operations and streamline industry practices, Bank Negara Malaysia introduced a policy on takaful coverage for financing-i (Islamic financing) in October 2004. Islamic banking institutions are required to offer takaful plans as the first choice to their customers in the offering of protection for Islamic financing that needs coverage. However, if the cost of coverage, i.e. contribution or premium, is to constitute part of the financing package, it is mandatory that the Islamic banking institutions only offer takaful plans.

- To facilitate submission of applications of new products for approval and maintenance of a repository of all Islamic banking products available in Islamic banking institutions, Bank Negara Malaysia is developing an on-line system known as Product Approval & Repository System (PARS). PARS will expedite the processing of applications to introduce new products as it provides on-line application and submission of documents. The system will also facilitate easy monitoring of the flow of processing work on applications, and prompt retrieval of up-to-date product information stored in the system. The project is due for completion in 2005.

Strengthening Shariah and Legal Infrastructure

An effective and conducive Shariah framework combined with a sound legal system is an essential element for a comprehensive Islamic banking system. The Bank has continuously enhanced and fine-tuned the Shariah framework and legal system to keep abreast with developments in the Islamic banking industry.

- Bank Negara Malaysia has issued the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions in December 2004 to rationalise and streamline the functions and duties of Shariah committees of the financial institutions.

Shariah Governance Framework for Islamic Financial Institutions

The Financial Sector Masterplan on Islamic banking and takaful emphasised the importance of establishing an effective Shariah framework in the development of Islamic banking and takaful. An effective Shariah framework would serve to ensure uniformity and harmonisation of Shariah interpretations that will strengthen the regulatory framework and governance practices for the Islamic financial industry. Bank Negara Malaysia issued the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions in December 2004, aimed at achieving uniformity of Shariah decisions, in addition to creating and expanding the pool of competent Shariah personnel in Islamic banking and takaful.

Prior to the issuance of the guidelines, various Shariah bodies co-existed and were governed under separate legal framework. An Islamic bank was required under the Islamic Banking Act 1983 to establish a 'Shariah advisory body', while a takaful operator needed to set up a 'Shariah Supervisory Council' as stipulated under the Takaful Act 1984. The Islamic Banking Scheme (IBS) banks under the Banking and Financial Institutions Act 1989 were required to appoint a Shariah consultant, while financial institutions under the Development Financial Institutions Act 2002 appointed Shariah bodies on their own initiatives. These Shariah bodies were not adequately regulated, and were operating independently of one another, and were also independent of the Shariah Advisory Council (SAC) established by Bank Negara Malaysia. Therefore, these Shariah bodies needed to be regulated in order to avoid divergence of Shariah interpretations on similar matters and eliminate confusion among the public. Current practice of allowing similar members in the various Shariah bodies of Islamic financial institutions was also reviewed from the perspective of corporate governance especially in terms of confidentiality and secrecy provisions.

To address these emerging issues, the Bank amended the Central Bank of Malaysia Act 1958 in 2003 to enhance the role and functions of the SAC of Bank Negara Malaysia. The SAC was accorded the sole authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. The jurisdiction covers all financial institutions regulated and supervised by the Bank. An important development is that the Judiciary has agreed to refer to the SAC dispute cases involving Shariah issues on Islamic banking and finance. To preserve its independence, members of the SAC of Bank Negara Malaysia are not allowed to participate in any Shariah committee of financial institutions.

Following the establishment of the SAC at the Bank, the guidelines to strengthen the Shariah committees at the Islamic financial institutions were issued in December 2004. The guidelines, which will take effect on 1 April 2005, set out the rules, regulations and procedures in the establishment of a Shariah Committee (the Committee), the role, scope of duties and responsibilities of a Committee as well as the relationship and working arrangement between the Committee and the SAC of Bank Negara Malaysia. The requirement to establish the Committee covers the Islamic banks, banking institutions that participate in the IBS, takaful operators and development financial institutions that provide Islamic banking facilities. IBS banks may establish a Committee for the banking group, while takaful operators must have their own Committee as required by law.

Among the duties and responsibilities of the Committee are to advise the board of directors on Shariah matters on the bank's business operations to ensure that they comply with Shariah principles at all times, to endorse the Shariah Compliance Manuals, and to endorse and validate relevant documentations. To ensure the proper record for easy reference, the Committee is required to provide written Shariah opinions or decisions.

To ensure the smooth running of the Committee, every Islamic financial institution is responsible to provide the necessary assistance to the Committee in all its undertakings. The Islamic financial institution is required to refer all Shariah issues to the Committee for advice for adoption. It is also required to ensure that product documents containing Shariah matters be endorsed and validated by the Committee, provide access to relevant records, transactions, manuals or other relevant information for the Committee members to enable them to perform their duties, and provide sufficient resources, independent expert consultation, reference materials and training.

An individual person is only allowed to be a member of one Committee for each industry. In other words, if the person sits on the Committee of an Islamic banking institution, he cannot sit on another Committee of an institution of the same industry. However, he is allowed to sit on a Committee of a takaful company. A company or an institution is no longer allowed to be a Committee member as the guidelines restrict the members of the Committee to individuals only. The Committee member must be at least qualified in the field of Islamic jurisprudence (*Usul Fiqh*) or Islamic transaction/commercial law (*Fiqh Mu'amalat*) or possess the necessary knowledge, expertise or experience in the related field.

The composition of the Committee shall be a minimum of three members. In addition to the Shariah Committee, an Islamic financial institution is required to designate at least one officer, preferably with knowledge in Shariah, to serve as the secretariat to the Committee. The Committee will report to the board of directors of the financial institution. This reporting structure reflects the status of the Committee as an independent body of the Islamic financial institution.

The guidelines are expected to improve and strengthen the Shariah governance of the financial institutions and contribute towards creating a larger pool of highly qualified, conversant and experienced Shariah advisors.

- Following the establishment of the Shariah Advisory Council (SAC) at Bank Negara Malaysia under the Central Bank of Malaysia Act 1958, the Malaysian Judiciary and the Regional Centre for Arbitration Kuala Lumpur will use the SAC as the reference point in the event of a dispute that involves Shariah issues on Islamic banking and finance. As the reference body and advisor to Bank Negara Malaysia on Shariah matters, the SAC is also responsible for validating all Islamic banking and takaful products to ensure their compatibility with the Shariah principles.

- The SAC has convened six meetings during 2004. Among the main decisions made by the SAC were as follows:-

  - Approval on the mechanism of Islamic bond based on *bai' bithaman ajil* to be used by the national mortgage corporation in purchasing the financing assets from the Islamic financial institutions. The new instrument will be an alternative investment instrument offered to the investors and players that prefer fixed and pre-determined return on their investment. The SAC has also approved the bidding methods for this instrument to be based either on price or rate of return. Methods to determine the rate of return to successful investors can also be based either on bid price or bid profit rate or weighted average of bid profit rates.

  - An Islamic financing that includes cost of coverage as part of its financing package must be covered by takaful. This is to avoid the involvement of Islamic financial institutions in any transaction that is not Shariah compliant. However, the SAC viewed that if the cost of coverage does not form part of the financing package, the Islamic financial institutions should offer takaful as a first choice to the customers.

  - Approval in principle on the profit rate swap transaction based on sell and buy back arrangement was given to an IBS merchant bank. The proposed profit rate swap is an arrangement where one party exchanges the fixed profit rate obligation of its asset with the variable profit rate obligation of the counterparty's asset, or vice versa. One rationale for this mechanism is for the Islamic financial institutions to match their long-term investment or fixed rate financing with their shorter-term variable funding rates in order to mitigate their market risk exposure.

- The Law Review Committee that was formed in June 2003 by Bank Negara Malaysia focused its task in 2004 in reviewing the relevant tax laws governing the Islamic banking and finance transactions, namely the stamp duty and tax law, and has made some recommendations to the Government. Towards this end, the Government has announced the tax neutrality policy for Islamic banking and finance in the 2005 Budget to create an equitable tax treatment of Islamic banking and financial transactions *vis-à-vis* similar conventional banking transactions. Under the tax neutrality framework, the Inland Revenue Board (IRB) will exempt additional instruments and transactions executed to fulfil Shariah requirement, from additional stamp duty and tax payment. Subsequent amendments were made to the Income Tax Act 1967, Real Property Gains Tax Act 1976 and Stamp Act 1949. To facilitate this arrangement, Bank Negara Malaysia has been empowered under these laws as the authority to recommend to the IRB to exempt such additional instruments and transactions from stamp duty.

Enhancing Human Capital Development and Consumer Education

During the year, efforts continued to focus on developing human capital and expertise to enhance the effectiveness and competitiveness of the Islamic banking business. The purpose was to enhance the intellectual capital development with the objective of creating a larger pool of experts and high calibre professionals in Islamic banking and finance.

- To achieve this objective, the Islamic Banking and Finance Institute Malaysia (IBFIM) organised several courses on Islamic banking and finance, covering the management, operation, Shariah and legal aspects. It undertook joint efforts, local as well as international, with Islamic financial institutions and other institutions in the development of a comprehensive and complete range of Islamic financial products and services. IBFIM also assisted financial institutions in designing training programmes to meet their specific training requirements. In addition, IBFIM provided advisory and consultancy services to domestic and foreign institutions.

- Two workshops on Risk Management and Capital Adequacy, and on Implementing Islamic Money Market for Islamic banking and finance were organised by the Bank on 23 September 2004. The Workshop on Risk Management and Capital Adequacy provided insights on the standard setting process and the challenges faced by the Islamic financial institutions in implementing risk management and in meeting the requirements of the IFSB's capital adequacy standards. The Workshop on Implementing Islamic Money Market focused on the development and importance of an Islamic money market as an integral component of a comprehensive Islamic financial system.

- To boost customer awareness and education, a survey was conducted on the customer requirements and the extent to which these were met by the products and services provided by the Islamic banking industry. The results revealed the need to enhance customer relationship as customers place importance on the quality of interface with banking institutions. Enhancing human capital is therefore vital. Customers are becoming increasingly discerning and demanding greater product differentiation and value added services that meet their financial requirements.

- Bank Negara Malaysia also participated in the 1st Malaysia International Halal Showcase, organised by the Islamic Da'awah Foundation, which was held from 14 to 18 August 2004, and the Islamic Banking and Takaful Expo, organised by the Association of Islamic Banking Institutions Malaysia held from 8 to 10 October 2004.

- Bank Negara Malaysia launched the Islamic money market website in October 2004 as part of the initiative to effectively and efficiently disseminate information on domestic Islamic financial instruments. It provides greater transparency of the Islamic money market operations, thus facilitating investment decisions and enhancing public confidence in their investments. The website also provides an analysis facility to chart historical data, in addition to the rules and regulations in the conduct of Islamic money market transactions. The website at *http://iimm.bnm.gov.my* will be linked to the website of markets in other jurisdictions to serve as a platform for exchanging information and knowledge beyond Malaysian borders.

- In promoting Malaysia as a centre for education excellence and training in Islamic banking and finance, an initiative is underway to establish a structured financial training and education institute. This is to meet the increasing manpower requirements arising from the current institutional development. This will effectively develop a human capital framework where Islamic banking industry requirements for skilled staff and experts would be adequately met by the supply of human resources.

SUPERVISION OF THE ISLAMIC BANKING SYSTEM

An important component in the development of a sound and viable Islamic banking system is the establishment of a strong supervisory framework, which has the capacity to specifically address the unique peculiarities inherent in Islamic banking activities. As Islamic banking and finance has become an integral component of the banking system, strains experienced in the Islamic banking system would have repercussions on the overall financial system.

Islamic banks are supervised premised on the same risk based supervision framework as in conventional banking. The financial and operating condition of the Islamic banking operations are assessed using the CAMELS-*i* rating framework. This framework assesses capital, asset quality, management quality, earnings performance, liquidity and sensitivity to market risk. However, the rating criteria has been adapted to cater for the specific characteristics inherent in Islamic banking operations. The CAMELS-*i* rating also includes an assessment on the adequacy of the financial institutions' risk management systems. An important facet of the supervision of the Islamic banking operations is the review of the financial institution's compliance with Shariah principles. For this purpose, 'Shariah compliance checklists' have been developed as a tool for bank supervisors to carry out their supervisory functions.

An important component in the development of a sound and viable Islamic banking system is the establishment of a strong supervisory framework, which has the capacity to specifically address the unique peculiarities inherent in Islamic banking activities.

In line with the FSMP, Islamic banking institutions invested more resources in enhancing their risk management systems during 2004, to build resilience while operating successfully in a highly competitive environment. New product development and innovations were also intensified in creating a wide range of Islamic financial products capable of meeting customers' requirements. The Islamic banking institutions also developed and enhanced their operational processes in improving their efficiency and effectiveness to operate in a more dynamic and competitive environment. The stress-test analysis on the Islamic banking institutions showed that there was adequate capital to withstand economic shocks as well as to meet planned business expansion.

In 2004, Bank Negara Malaysia conducted on-site examinations of full-fledged Islamic banks, covering both head offices and branches, as well as the conventional financial institutions (commercial banks, finance companies, merchant banks and discount houses) offering Islamic banking products and services, under the IBS. These examinations were conducted as part of the overall examination of the conventional financial institutions. In reviewing the overall financial and operating conditions of the Islamic banking operations of the conventional financial institutions, particular attention was given to ensure that there were proper internal controls and procedures in place to prevent commingling of conventional and Islamic banking funds. These on-site examinations were complemented with off-site surveillance to ensure that there was continuous monitoring of these financial institutions. The two-pronged approach to supervision enabled the Bank to detect emerging problems and thus take necessary pre-emptive supervisory actions on a timely manner.

The entry of the new foreign Islamic banking players and the establishment of Islamic subsidiaries by domestic banking institutions are expected to foster the development of more innovative Islamic financial products and services into the market. Whilst this development will broaden and deepen the Islamic financial markets, supervisors will need to ensure that financial institutions have in place adequate risk management systems to identify, measure, monitor and control all associated risks and that adequate capital is held against the risks.

The existing supervisory processes and procedures will continue to evolve in line with best international standards. Regulatory and supervisory standards, which can specifically address the unique peculiarities of their operations, are necessary to promote resilience and competitiveness of the Islamic banking sector. In this regard, the work of the IFSB, the body established to issue prudential and supervisory standards for the Islamic banking and finance industry would act as a catalyst to the development of a stronger supervision framework in Malaysia. Concurrently, a group of specialised supervisors has been established to act as a reference point for its peers by keeping abreast with new developments in the area of Islamic banking.

The challenges facing the bank supervisors going forward will be more demanding as the system becomes more complex and liberalised. To meet the increasing supervisory needs in a rapidly changing environment, resources will continue to be invested towards strengthening the Bank's supervisory capacity.

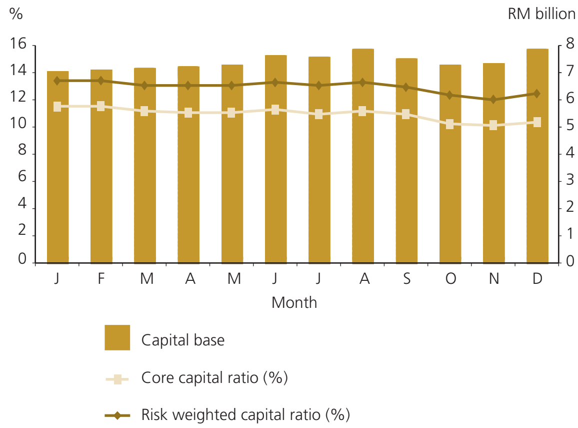
PERFORMANCE OF THE ISLAMIC BANKING SYSTEM

The Islamic banking industry continued to show strong growth in 2004 in tandem with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system. The industry was able to sustain its performance, and its strong capitalisation levels were attributed to increases in capital and profits as well as higher financing activities. In addition, asset quality recorded further improvement with a declining trend in net non-performing financing ratio and high financing loss provisions.

Capital Strength

The Islamic banking sector remained well capitalised. The risk-weighted capital ratio (RWCR) and core capital ratio were sustained above 12% and 10% respectively throughout the year. The total capital base of the Islamic banking institutions increased from RM6.8 billion as at end-2003 to RM7.8 billion as at end-2004, mainly due to new capital injections and audited profits. Total risk-weighted assets of the Islamic banking system grew by 20.4% or RM10.6 billion to RM62.5 billion in the past 12 months. The growth was apparent in all risk categories except for the 20% category where there was a decline in Islamic Acceptances held and placement with domestic banking institutions. A large increase was recorded in the 100% and 0% risk categories (RM10 billion and RM8 billion respectively) due to hikes in other financing and placement with Bank Negara Malaysia. As at end-2004, the Islamic banking system recorded a strong RWCR of 12.5% and core capital ratio of 10.4%.

Graph 6.2
Islamic Banking System: Capital Adequacy in 2004



The Islamic banking industry continued to show strong growth in 2004 in tandem with the growth in the economy.

Table 6.1
Islamic Banking System: Sources and Uses of Funds

	Annual change		As at end-2004*p*
	2003	2004*p*	
	RM million		
Sources			
Capital and reserves	2,081	725	7,509
Deposits	6,906	12,647	72,859
Funds from other financial institutions	2,541	-2,958	4,027
Other liabilities	2,598	1,925	10,185
Total	**14,126**	**12,339**	**94,580**
Uses			
Cash	15	16	271
Reserve with Bank Negara Malaysia	321	-159	1,358
Deposits with other financial institutions	1,247	9,670	18,652
Financing	11,897	9,223	57,883
Securities	3,277	-3,510	19,044
Other assets	-2,631	-2,901	-2,628[1]

[1] Denotes the interbranch balances pending settlement.
p Preliminary

The RWCR of Islamic banks and IBS commercial banks stood at 12.5% and 12.7% respectively. The RWCR of IBS merchant banks as a group increased from 13.5% to 14.5% mainly due to the higher increase in the capital base compared with the increase in the risk-weighted assets. The RWCR of IBS finance companies was 10.8% with the capital base declining significantly by 58.4% or RM1,170 million to RM832 million as at end-2004 mainly due to the rationalisation of capital arising from the merging of operations of four IBS finance companies with their IBS commercial banks of the same group. Accordingly, the risk-weighted assets also decreased by 49% or RM7.4 billion.

Assets

As at end-2004, the total assets of Islamic banking sector increased by RM12.3 billion or 15% to RM94.6 billion. A significant portion of the increase in total assets was attributable to the high growth in total financing. As at end-2004, total financing amounted to RM57.9 billion or 61.2% of the total Islamic banking assets. Meanwhile, investment in securities decreased by 15.6% (RM3.5 billion) during the year to account for RM19 billion or 20.1% of total assets. In terms of market share, the largest portion of Islamic banking assets remained with the IBS commercial banks with a share of 57%, followed by Islamic banks (26.3%) and the IBS finance companies (8.2%). In terms of the growth in assets, IBS merchant banks recorded the highest growth of 47.1%, followed by IBS commercial banks (46.5%) and Islamic banks (18.4%).

Financing Activities

The financing activities of the Islamic banking system grew further in 2004. During the year, there was increased demand for financing, resulting in a higher number of financing applications received by the Islamic banking institutions. Evidently, there were increases in financing approvals and financing disbursements of 0.6% and 14% respectively. In addition, financing repayments increased by 28.6% as many customers repaid and refinanced their financing to take advantage of the environment of low cost of funds.

Table 6.2
Islamic Banking System: Financing Activities

	For the year		Annual change (%)
	2003	2004*p*	
	RM million		
Financing approvals	16,168	16,260	0.6
Financing disbursements	36,049	41,089	14.0
Financing repayments	26,157	33,639	28.6
	As at end-		Annual change (%)
	2003	2004*p*	
	RM million		
Outstanding financing	48,660	57,883	19.0

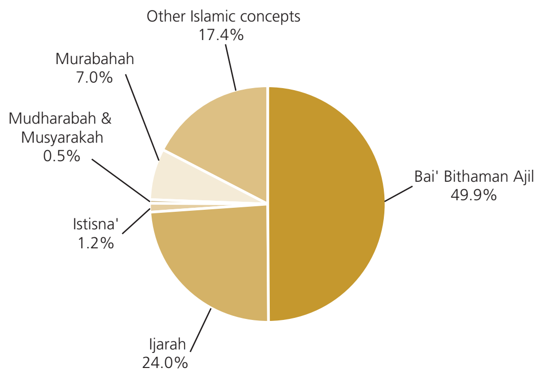
p Preliminary

Table 6.3
Islamic Banking System: Direction of Financing

	Annual change		As at end-2004*p*
	2003	2004*p*	
	RM million		
Agriculture, hunting, forestry and fishing	267.6	467.0	2,328.6
Mining and quarrying	-11.0	13.1	76.6
Manufacturing	505.6	1,725.8	6,112.6
Electricity, gas and water supply	-284.8	470.3	719.2
Community, social and personal services	89.4	115.2	418.5
Broad property sector	4,747.0	1,923.6	22,451.0
Real estate	*142.6*	*94.5*	*906.4*
Construction	*655.3*	*597.4*	*3,530.9*
Purchase of residential property	*3,581.4*	*1,044.4*	*15,433.3*
Purchase of non-residential property	*367.7*	*187.3*	*2,580.4*
Wholesale and retail trade, restaurants and hotels	410.6	1,273.9	3,070.9
Transport, storage and communication	199.5	152.2	1,176.5
Finance, insurance and business services	661.6	156.8	2,090.1
Purchase of securities	-14.1	-42.7	878.1
Consumption credit	5,584.9	2,931.2	17,803.4
Credit cards	*95.7*	*155.8*	*312.0*
Personal use	*575.5*	*812.2*	*2,449.3*
Purchase of consumer durable goods	*-9.2*	*-10.5*	*43.6*
Purchase of transport vehicles	*4,922.9*	*1,973.7*	*14,998.5*
Others	-258.7	36.1	757.0
Total	**11,897.6**	**9,222.5**	**57,882.5**

p Preliminary

Graph 6.3
Islamic Banking System: Major Financing Concepts



In 2004, total financing expanded by 19% or RM9.2 billion (2003: 32.4% or RM11.9 billion). Consumer financing extended by Islamic banking institutions, which had risen by 19.7%, was supported by strong consumer spending. Similarly, financing for purchase of transport vehicles (primarily for purchase of passenger cars) recorded a growth of 15.2%, while financing for purchase of residential properties expanded by 7.3%. The expansion in consumer demand was further supported by the attractive and competitive financing packages offered by the Islamic banking institutions. Financing extended to the manufacturing sector continued to be significant in 2004, accounting for 10.6% of total financing as at end-2004 (end-2003: 9%). Financing based on *bai' bithaman ajil* (deferred payment sale) concept remained dominant, constituting 49.9% of total financing while *ijarah* (leasing) constituted 24%.

The Islamic banking sector continued to focus on providing financing to small and medium enterprises (SMEs). Total financing provided by the Islamic banking institutions to the SMEs increased by 29.6% from RM6.2 billion as at end-2003 to reach RM8 billion as at end-2004. Islamic financing contributed 13.8% of the total financing extended by the banking system to the SMEs as at end-2004 as compared with 7.5% as at end-2003.

Asset Quality

The asset quality of the Islamic banking industry improved further during the year. As at end-2004, the gross and net non-performing financing (NPF) ratios stood at 8.1% (2003: 8.5%) and 5.3% (2003: 5.5%) respectively, based on a 6-month classification. The net NPF ratio of the Islamic banking institutions was sustained within the range of 4.8% to 5.7% throughout the year. Financing loss coverage remained high at 60.5% of total NPF as at end-2004. In terms of absolute amount, financing loss coverage increased to RM3 billion from RM2.4 billion in 2003.

The income-in-suspense, general provision and specific provision set aside by Islamic banking institutions increased by 16.1%, 36.6% and 15.8% respectively during the year. The general provision of total net financing for the Islamic banking industry increased to 2.1% from 1.8% as at end-2003 reflecting the prudent stance of a number of Islamic banking institutions in setting aside higher provisions for financing.

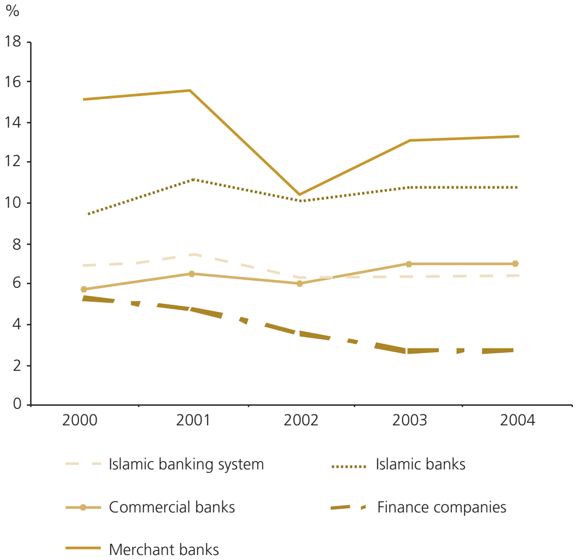
The broad property sector continued to account for the largest share, at 66.7% of the total NPF (2003: 62.4%). The high NPF in the broad property sector

Table 6.4
Islamic Banking System: Non-performing Financing and Financing Loss Provisions

	As at end-					
	2003			2004*p*		
	Actual[1]	Classification 3-month	Classification 6-month	Actual[1]	Classification 3-month	Classification 6-month
	RM million					
Islamic banks						
Total financing	9,809.2			11,463.3		
General provisions	174.7	174.7	174.7	163.9	163.9	163.9
Income-in-suspense	178.2	186.9	178.2	204.1	215.3	204.1
Specific provisions	405.5	433.7	405.5	424.0	457.7	424.0
Non-performing financing	1,575.6	2,002.3	1,575.6	1,668.7	2,152.7	1,668.7
Net NPF ratio (%)[3]	10.8	15.0	10.8	9.6	13.7	9.6
Total provisions/NPF (%)	48.1	39.7	48.1	47.5	38.9	47.5
Commercial banks[2]						
Total financing	22,323.8			38,803.0		
General provisions	400.9	379.7	300.8	923.2	922.9	545.5
Income-in-suspense	213.3	130.1	207.1	341.5	343.6	334.8
Specific provisions	280.3	284.4	309.3	544.8	552.5	532.3
Non-performing financing	1,991.7	2,274.4	1,653.7	2,798.6	3,411.7	2,542.4
Net NPF ratio (%)[3]	6.9	8.5	5.2	5.0	6.6	4.4
Total provisions/NPF (%)	44.9	34.9	49.4	64.7	53.3	55.6
Finance companies[2]						
Total financing	15,746.0			6,823.5		
General provisions	316.7	316.6	318.7	130.0	130.0	130.0
Income-in-suspense	150.8	155.8	149.8	100.5	107.9	100.5
Specific provisions	274.9	296.7	274.5	136.4	151.4	136.4
Non-performing financing	832.3	1,058.7	805.1	389.5	639.2	389.5
Net NPF ratio (%)[3]	2.7	4.0	2.5	2.3	5.8	2.3
Total provisions/NPF (%)	89.2	72.6	92.3	94.2	60.9	94.2
Merchant banks[2]						
Total financing	781.0			792.7		
General provisions	12.1	12.1	12.1	12.9	12.9	12.9
Income-in-suspense	20.6	20.7	20.6	7.6	7.6	7.6
Specific provisions	5.4	5.4	5.4	14.9	14.9	14.9
Non-performing financing	125.6	128.3	125.6	109.8	109.8	109.8
Net NPF ratio (%)[3]	13.2	13.5	13.2	11.3	11.3	11.3
Total provisions/NPF (%)	30.3	29.8	30.3	32.2	32.2	32.2
Islamic banking system						
Total financing	48,660.0			57,882.5		
General provisions	904.4	883.2	806.2	1,230.0	1,229.7	852.3
Income-in-suspense	562.9	493.5	555.6	653.7	674.4	647.0
Specific provisions	966.0	1,020.2	994.6	1,120.1	1,176.5	1,107.6
Non-performing financing	4,525.2	5,463.7	4,160.0	4,966.7	6,313.4	4,710.5
Net NPF ratio (%)[3]	6.4	8.4	5.5	5.7	8.0	5.3
Total provisions/NPF (%)	53.8	43.9	56.6	60.5	48.8	55.3

[1] Financing classified as NPF based on individual banking institution's NPF classification policy i.e. 3-month or 6-month classification.
[2] 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, finance companies and merchant banks.
[3] Net NPF ratio = (NPF less IIS less SP) / (Gross financing less IIS less SP) x 100%.
p Preliminary

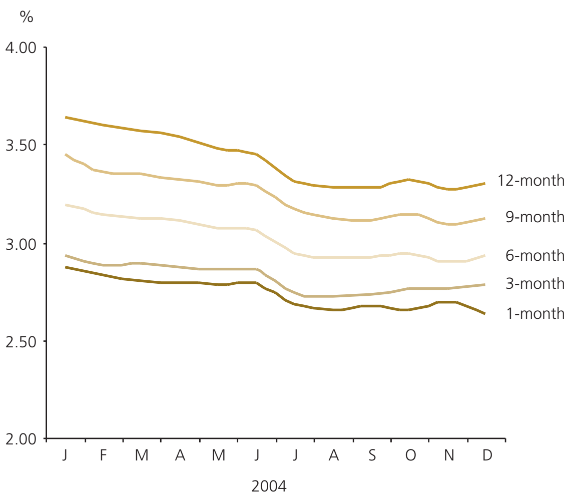
Graph 6.4
Islamic Banking System:
Net Non-Performing Financing Ratio[1]



[1] Based on actual classification.

was recorded in the residential property and construction sub-sectors, which increased by RM345.9 million (24%) and RM176.9 million (29.8%) respectively. The NPF level of the residential property to total financing for this sub-sector increased from 10% as at end-2003 to 11.6% as at end-2004. Apart from the broad property sector, there was also an increase in NPF in the purchase of transport vehicles sub-sector, primarily for purchase of passenger vehicles of RM116.1 million.

Graph 6.5
Islamic Banking System:
Average Rates of Return to General Investment Depositors



Rates of Return

During the year, the rates of return to general investment depositors showed a declining trend across the different tenures. The 1-month and 3-month rates ranged between 2.63% to 2.87% and 2.73% to 2.93% respectively. The declining trend was partly due to the proportionately larger increase in the general investment deposit base than the increase in the net distributable income. The general investment deposits recorded an average monthly growth of 1.5% while the net distributable income registered an average monthly growth of 1.3%.

Profitability

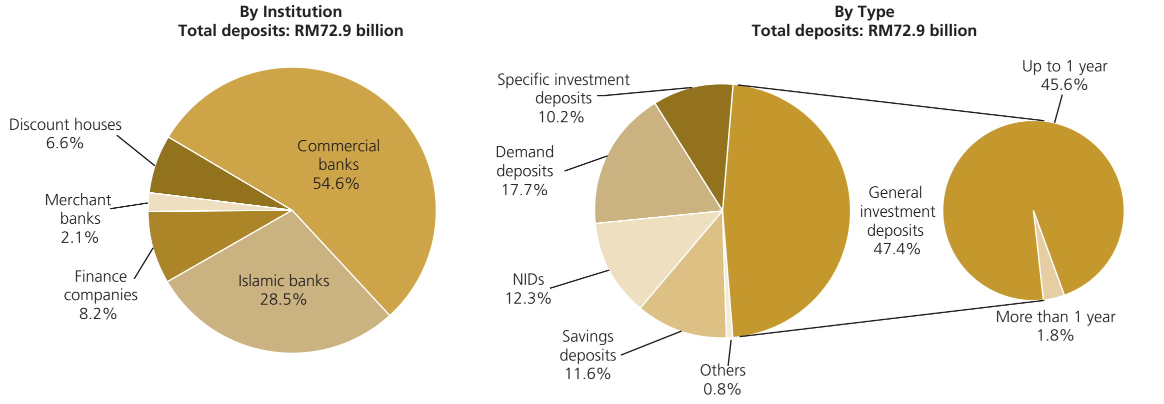
In 2004, the Islamic banking sector recorded an increase of 14.1% in net income (from financing activities and securities) of RM306.6 million at the operating level. Notably, other income of the Islamic banking sector registered an increase of RM87.5 million or 11.8%. The Islamic banking sector posted higher profit before provision of RM2.6 billion (2003: RM2.3 billion). After allocating financing loss provisions, the Islamic banking sector recorded profit before tax of RM986.3 million for the calendar year 2004 (2003: RM960.4 million). Despite the higher provision for financing losses of RM1.6 billion, a higher profit before tax was recorded as the increase in total income was more than offset the increase in provisions. The higher financing loss provisions charged by the Islamic banking institutions were partly due to the increase in NPF and Profit Equalisation Reserve. The return

Table 6.5
Islamic Banking System: Income and Expenditure

	For the calendar year		Annual change	
	2003	2004*p*		
	RM million			%
Income[1] net of income-in-suspense	3,864	4,296	432	11.2
(Income-in-suspense)	*307*	*310*	*3*	*1.0*
Less: Expense[1]	1,689	1,814	125	7.4
Net income	2,175	2,482	307	14.1
Add: Other income	748	836	88	11.8
Less: Staff cost	232	267	35	15.1
Overheads	384	422	38	9.9
Profit before provisions	2,307	2,629	322	14.0
Less: Financing loss & other provisions	1,347	1,643	296	22.0
Pre-tax profit	960	986	26	2.7
Return on assets (%)	1.2	1.0		
Return on equity (%)	14.2	13.1		

[1] From financing activities and securities.
p Preliminary

Graph 6.6
Islamic Banking System: Deposits by Institution and Type



on assets and return on equity, however, declined to 1% and 13.1% respectively due to the increase in asset size and capital funds.

Liquidity

There was ample liquidity in the Islamic banking system throughout 2004. Total deposits recorded a moderate growth of 21% or RM12.7 billion to reach RM72.9 billion as at end-2004. The IBS commercial banks and Islamic banks accounted for the major share of 83.1% of the total deposits in the Islamic banking sector (2003: 73.3%). Among the Islamic banking players, the IBS merchant banks recorded the highest growth rate in deposits of 79.2% followed by the IBS commercial banks, which registered a growth of 50%.

Investment deposits (general and specific) continued to capture a major portion of the Islamic banking deposits, amounting to 57.6% of Islamic banking deposits. During the year, savings and demand deposits recorded a growth of 22.8% and 17.6% respectively mainly due to increase in the retail customer base in Islamic banking. In terms of the maturity profile of general investment deposits, 96.2% of the general investment deposits 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 earned on deposits remained stable in 2004.

In terms of short-term liquidity for the period of up to one month, the two Islamic banks had sufficient liquidity to meet any unexpected withdrawals. There was surplus liquidity above the minimum requirement of 3% for the up to one-week time bucket and 5% for the one-week to one-month time bucket. The financing to deposits ratio decreased from 80.8% as at end-2003 to 79.4% as at end-2004 due to higher percentage increase in total deposit base compared with that in total financing during the period.

Islamic Interbank Market

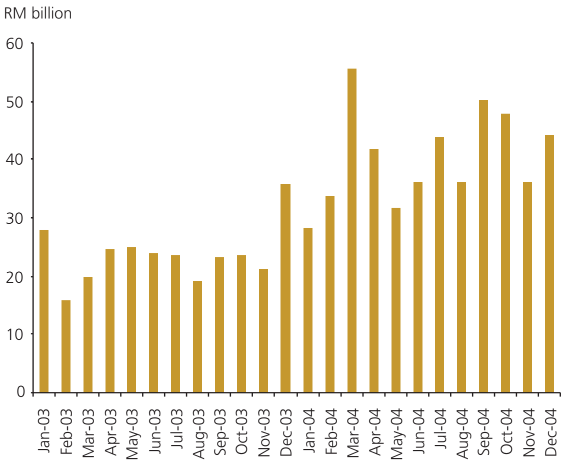
During the year, the Islamic interbank market registered significant growth of 64.8% in terms of turnover volumes against a backdrop of ample liquidity. The *mudharabah* interbank investment transactions continued to dominate more than 70% market share of the total turnover volumes in the Islamic interbank market. Stable rate of return on the *mudharabah* interbank investment coupled with the enlarged issuance of Government and Central Bank securities had contributed to strengthen the Islamic interbank market position to meet increasing market demand for short-term investments.

Table 6.6
Islamic Interbank Market - Turnover Volume

	2003	2004*p*	Annual change	
	RM billion			%
Total	**341.4**	**562.4**	**221.1**	**64.8**
***Mudharabah* Interbank Investment**[1]	**283.8**	**485.7**	**201.9**	**71.1**
Financial Instruments	**57.6**	**76.8**	**19.2**	**33.3**
Islamic Accepted Bills[1]	10.0	10.3	0.3	3.5
Negotiable Islamic Debt Certificate[1]	4.2	8.2	4.0	94.0
Bank Negara Negotiable Notes	8.9	21.2	12.3	137.6
Islamic Treasury Bills[2]	–	1.2	1.2	–
Government Investment Issues	34.5	35.9	1.4	4.0

[1] Volume transacted through brokers.
[2] Inaugural issuance.
p Preliminary

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



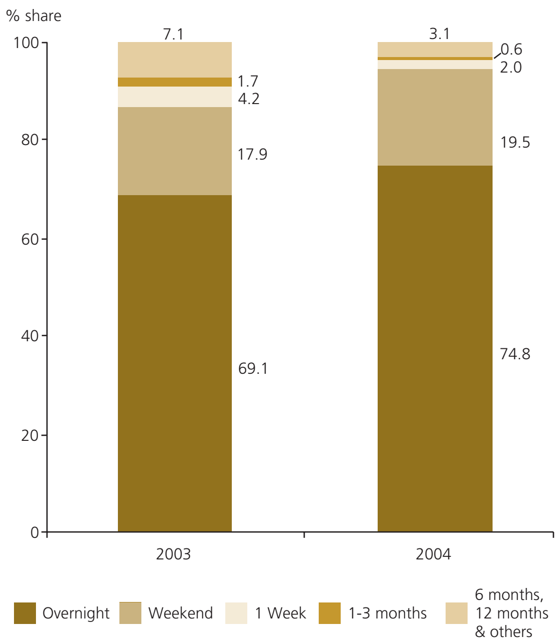
The Islamic interbank market sustained ample liquidity during the year. The excess liquidity condition, however, was effectively maintained at an appropriate level through Bank Negara Malaysia's liquidity operation. Under the liquidity operation, the excess liquidity was absorbed through the issuance of Government and Bank Negara Malaysia Islamic papers as well as through the direct acceptance of *wadiah* interbank deposits. During the year, the Government of Malaysia issued the inaugural Islamic Treasury Bills (ITB) amounting to RM1 billion based on the Shariah concept of sell and buy back arrangement. The one-year Government paper was issued in eight series and attracted broad investor participation, with the issue being over-subscribed by 3.6 times. Apart from the ITB, the Government also issued an additional RM2.1 billion of Government Investment Issues (GII), of which RM1 billion was issued for a seven-year tenor as part of the effort to lengthen the benchmark yield curve for Islamic securities. Bank Negara Malaysia issued an additional RM2 billion of Bank Negara Negotiable Notes (BNNN). Following the issuance of the three Government and Bank Negara Malaysia papers, the net issuance of Islamic securities by the Government increased by 51% or RM5.1 billion.

The continuous liquidity surplus in the Islamic banking system was further absorbed through the *wadiah* interbank deposits transaction whereby the average daily amount absorbed by Bank Negara Malaysia under this mechanism increased from RM2.4 billion in 2003 to RM6.8 billion in 2004. The bulk of the *wadiah* transactions, however, was concentrated on the overnight tenor. Following the liquidity operations carried out by the Bank, the *mudharabah* interbank investment overnight rate that was used as an indicator by Bank Negara Malaysia for the day-to-day liquidity operation in the Islamic interbank market remained stable at an average of 2.70% throughout the year.

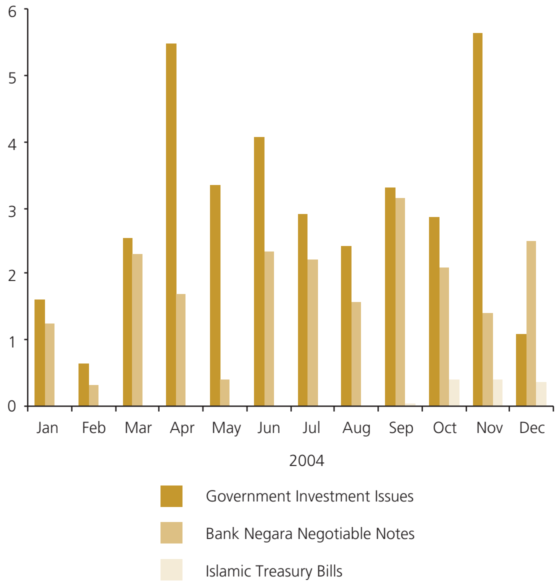
Trading volume in the *mudharabah* interbank investment transactions continued to record favourable growth of 71.1%, at an average monthly turnover of RM40 billion. Similar to the *wadiah* interbank acceptance deposits, more than 70% of the *mudharabah* interbank investment transactions were mainly concentrated on the overnight tenor, primarily due to the limited supply of Shariah compliant short-term papers. The stable rate of return which averaged 2.70% for the overnight investment in *mudharabah* interbank investment was also the contributing factor given that the rate was more favourable to market participants compared to the declining yields in the Government Islamic securities.

With the exception of Islamic Accepted Bills (AB-i), there was continuous demand for short-term liquid assets arising from the surplus liquidity position. Due to the limited supply of instruments in the secondary market, the majority of the AB-i issuers preferred to hold the short-term paper until maturity. In addition, the AB-i provided higher return on investment as it was priced above the *mudharabah* interbank investment rate.

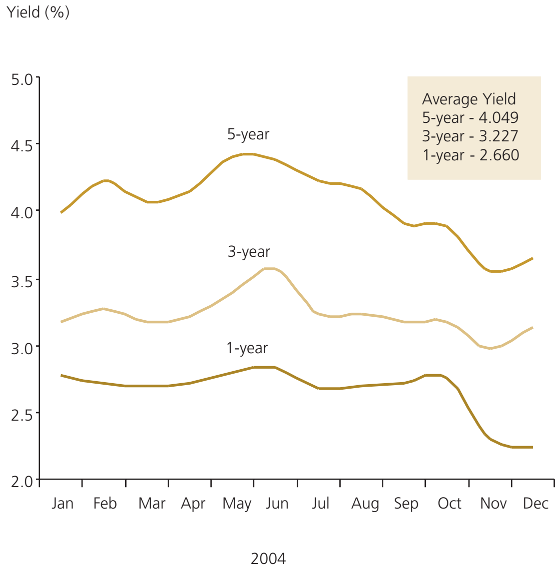
Graph 6.8
***Mudharabah* Interbank Investment - Share of Turnover Volume**



Graph 6.9
Islamic Securities - Turnover Volume



Graph 6.10
Government Investment Issues - Average Yield to Maturity



Notwithstanding the limited supply, the moderate increase in AB-i was offset by a higher increase in the supply of Negotiable Islamic Debt Certificate (NIDC-i). The ample liquidity situation in the banking system provided the environment for the Islamic banking institutions to increase the creation of NIDC-i to mobilise medium and long-term deposits. This exercise has consequently improved the supply of NIDC-i in the secondary market. As at the end of 2004, total outstanding NIDC-i amounted to RM8.8 billion as compared to RM5.7 billion as at end-2003, representing an increase of 54%. In terms of maturity tenor, 62% or RM5.7 billion of the outstanding NIDC-i ranged from nine months to five years.

The increase in supply of BNNN and the new issuance of ITB contributed significantly to higher trading of these instruments in the secondary market. During the year, the turnover volume of BNNN grew by 137.6% or RM12.3 billion. The trading of ITB also showed an encouraging growth where the turnover ratio in the new Government paper recorded 1.2 times in terms of trading volume to the total outstanding securities. Meanwhile, the trading volume of GII recorded a marginal increase of 4% or RM1.4 billion as compared to that of the previous year due to the relatively lower average yield-to-maturity.

The Islamic bond market charted a positive growth of 13.4% or RM11.6 billion in 2004. Total outstanding Islamic securities amounted to RM97.8 billion, accounting for 25.7% of the total outstanding bonds in the capital market. In the private debt securities market, a total of RM82.7 billion Islamic securities remained outstanding as at end-2004, which accounted for 42% of the total outstanding private debt securities in the market or an increase of 8.5% from 2003. The continued low interest rate environment and ample liquidity situation influenced corporations to raise funds in the capital market via the issuance of long-term private debt securities.

A significant development in the domestic Islamic bond market was the inaugural issuance of ringgit-denominated Islamic debt securities based on *bai bithaman ajil* (BBA) by a multilateral financial

Table 6.7
Outstanding Islamic Securities

	2003	2004*p*	Annual change	
	RM billion			%
Total	**86.2**	**97.8**	**11.6**	**13.4**
Government Securities	**10.0**	**15.1**	**5.1**	**51.0**
Government Investment Issues	7.0	9.1	2.1	30.0
Islamic Treasury Bills	0.0	1.0	1.0	-
Bank Negara Negotiable Notes	3.0	5.0	2.0	66.7
Private Debt Securities	**76.2**	**82.7**	**6.5**	**8.5**
Khazanah bonds	10.0	9.0	-1.0	-10.0
Corporate bonds	52.5	57.0	4.5	8.5
Commercial papers	6.2	3.6	-2.6	-41.7
Medium-term notes	5.4	10.0	4.5	83.6
Cagamas bonds	1.1	2.5	1.5	135.6
Asset backed securities	1.0	0.6	-0.4	-39.4

p Preliminary

institution. The issuance was made possible following the liberalisation to the Foreign Exchange Administration Rules to facilitate multilateral development banks, multilateral financial institutions and multinational corporations to raise ringgit-denominated bonds in the Malaysian capital market.

In the mortgage securities segment, Cagamas Berhad (Cagamas) introduced a new Islamic mortgage securities based on the concept of BBA in addition to the existing *mudharabah* Cagamas bond. Under this concept, Cagamas undertakes a sell and buy back arrangement transaction with market participants for the purpose of raising funds from the capital market. Funds raised from these issuances were utilised by Cagamas to purchase the house financing and hire and purchase facilities from the Islamic banking institutions. In 2004, Cagamas issued a total of RM1.6 billion of the new BBA Cagamas with maturities ranging from two to five years. The increase in the supply of the Cagamas bond promoted active secondary market trading activities of this instrument, which registered a growth of 84% or RM2.1 billion in terms of turnover volume.