

Islamic Finance *news*

October 2013

Supplements

Asia: Positivity abounds

Feature

An intriguing
proposition

Chapters

- Islamic banking product development
- Global perspective in Shariah investing

Analytical research

Sun rises
in the east

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The Asian Sensation

Asia's Islamic capital markets are thriving on the back of issuances in Malaysia and the government of Indonesia's repeated efforts in tapping the domestic and global market. Other countries such as Hong Kong has also recently amended its securitization laws to accommodate Sukuk, in recognition of the potential business Islamic finance could bring to the republic, while the Shariah compliant funds industry in Asia Pacific is currently dominated by Malaysia-based fund managers such as UOB Asset Management and Apex Investment Services.

Bankers from the top Islamic banks in Malaysia are also being kept busy with the spate of issuances expected to be rolled out in the domestic market before the end of the year, while it has been mentioned that major corporates are expected to come to the fore with issuances of significant volumes this quarter.

In the last year, foreign issuers have begun to test the waters of Malaysia's Islamic capital markets through ringgit-denominated issuances in an effort to tap into its well-developed trading market for Islamic securities. In April this year, major Saudi Arabian conglomerate Al Bayan Holdings issued a RM200 million (US\$65 million) Sukuk in Malaysia; making it the first Saudi Arabian-based company to do so.

In this issue of Islamic Finance *news* Supplements, we focus on the thriving Asian markets and the opportunities that beckon to issuers and investors alike. ☺



**Nazneen Halim,
Editor**

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Positivity abounds in Asia

Despite a cautious outlook by Asian corporates and a drop in the region's business sentiment index due to volatility across emerging economies, NAZNEEN HALIM believes that Asia remains as a beacon of hope for conventional and Islamic businesses alike.

Continued deleveraging in Europe and an almost palpable unwillingness amongst investors to park their money and investments in the continent has created a myriad of business opportunities in Asia and other markets outside of the Eurozone. However, recent announcements by the US Federal Reserve to taper down its investments in emerging markets has without a doubt had an impact on Asian currencies, bonds and equities over the last few months.

As illustrated in the Thomson Reuters/ INSEAD Asia Business Sentiment Index, readings in Q3 fell to 66 from 71 in the second quarter of the year. According to market commentators, this was mainly driven by declines in the shipping and corporate sectors, with Asian corporates are still assessing their global growth outlook. Rating agency Moody's expects industrialized and developing countries to experience economic volatility in light of tightening monetary policies in the US, but the impact is likely to be limited and temporary at the sovereign level.

In terms of Islamic finance, however, Asia is still seen as the global destination of choice for endless opportunities. A rare and interesting mix, countries in Asia with Islamic finance capabilities already have sound regulations and structures in place, but are also open to new business and development opportunities. One of the more prominent markets in Asia and the world for Islamic finance, Malaysia has suffered quite a blow this year, following a sovereign ratings downgrade coupled with a negative outlook and a weakening currency, as fears of a possible recession have begun to seep into the market. Nonetheless, a senior banker in Malaysia told *Islamic Finance news*: "We are looking forward to some major deals which are expected to close before the end of this quarter, and although mostly domestic, things are looking up for the corporate Sukuk market and there are also some global deals in the pipeline."

Ahsan Ali, managing director and head of Islamic origination at Standard Chartered in Dubai says that Asia is an interesting

prospect for issuers in particular, due to its active trading market. Compared to other countries, he says, Malaysia is attractive to issuers who are looking to list due to an investor base who are familiar with investing in Islamic securities and are less likely to have a buy-to-hold mindset. Testament to this, Al Bayan Holding, a major Saudi Arabian conglomerate this year, chose to issue a ringgit-denominated Sukuk; and although the amount was not massive – issued at RM200 million (US\$65 million) – market players believe that this bodes well for future international issuers to tap into the Malaysian market.

Recently, one of the largest banks in the Eurozone, Societe Generale (Soc Gen) came to market stating plans to launch a RM1 billion (US\$302.69 million) Sukuk in Malaysia with the first tranche due before the end of this year. The planned issuance, which is still pending regulatory approval from the Securities Commission of Malaysia is expected to open up the bank's distribution base and create diversity of its funding sources.

Commenting on the issuance, an industry analyst said: "Being the largest Sukuk market in the world, Soc Gen's decision to issue in Malaysia was driven by liquidity woes arising in Europe. It is also buoyed by the depth and pricing of the country's Sukuk market."

Out of the 20 most recently issued global Sukuk since April 2013, 16 issuances have originated from Asia, with Malaysia commanding the lion's share at 12, totaling at US\$2.92 billion, followed by Indonesia with two issuances worth US\$1.69 billion and Singapore with two domestic public issuances worth US\$275 million.

Beyond Sukuk

According to data from the Malaysia International Islamic Financial Center (MIFC), the total market for Islamic funds globally reached US\$65.1 billion in 2012, growing at an average of 11.2% a year. The report further elucidated that this growth has been driven by the steady economic performance and rising wealth of high net-worth individuals in Asia and the GCC, as more than 70% of Islamic funds are centered around these two regions.

In a recent interview, Noripah Kamso, industry maven and advisor at CIMB Islamic shared her experience through her dealings with sovereign wealth funds and what appeals to them when it comes to choosing an investment vehicle: "When I met with one of the top three sovereign wealth funds based in the Middle East, it was clear that their holy grail is performance – not faith or anything Islamic, although they do invest in ethical funds. It has to be mentioned that Islamic funds have been outperforming some conventional funds, and it is important to know the characteristics in these stocks that leads to this outperformance. Islamic funds typically cover technology, healthcare, oil and gas; whereas conventional funds cover financials, industrials and consumer goods."

In Asia, Pakistan and Malaysia are perceived as the strongholds for Islamic funds. Two out of the top five best performing Shariah compliant funds in the world are domiciled in Pakistan and managed by Atlas Asset Management and Al Meezan Investment Management, while Malaysia's Public Mutual

ranks fourth, followed by Jadwa Investment's Saudi Equity Fund in fifth place. According to data from Bloomberg, there are currently 46 Islamic funds domiciled in Pakistan; making up almost a quarter of the total funds listed in the country. Further data has suggested that the Islamic funds industry constitutes 12% of the entire asset management industry in Pakistan; with industry players constantly pushing for more uptake of Islamic products to create growth beyond the current levels.

Recently, the Securities and Exchange Commission of Pakistan established a Shariah advisory board to oversee transactions by Islamic financial institutions and those which fall under the Islamic capital markets. The move is also expected to boost awareness of Islamic financial products within the republic as the Shariah advisory board will also take on educational activities pertaining to the understanding of Shariah principles and the introduction and implementation of new Shariah compliant models and products. Commenting on the prospects for Islamic funds in Asia, the governor of the Central Bank of Kuwait, Dr Mohammad Y. Al-Hashel said: "Estimates suggest that as of 2010, around 12% of the US\$25.2 trillion in total assets under management in the US is invested in socially responsible investing. Since developing countries in Asia have far more opportunities for high return investments than in advanced economies, it will be beneficial to achieve future growth by promoting investments that are community-oriented and socially beneficial."

“ Being the largest Sukuk market in the world, Soc Gen's decision to issue in Malaysia was driven by liquidity woes arising in Europe ”

Real estate funds have been touted to be the next big thing within the Islamic funds industry in Asia. In May this year, HSBC predicted urban infrastructure requirements in Asia to reach levels of US\$11 trillion, or 80% of the region's entire GDP between 2010-2030. Malaysia and China are currently ranked highest amongst the 'Take-off economies', recording the largest growth in urbanization since 2000, and this sector is expected to be a key driver of infrastructure investment over the medium-term. Real estate funds are also moving towards Europe and Asia, as these markets become hotbeds for real estate investments and as a means for fund managers to diversify their investments beyond North America, following the credit crisis.

The Takaful industry, despite its growth challenges on a global scale, continues to thrive in Asia due to encouraging growth in Malaysia and Indonesia in particular. However, Takaful penetration in these countries are still low, with Family Takaful in Malaysia commanding an 11% market share and charting a compound annual growth rate of 27% between 2005 and 2010,



and overall insurance penetration in Indonesia at levels below 2%. According to the Ernst & Young World Takaful Report 2012, Brunei, Indonesia and Malaysia are expected to be the main markets for Takaful growth in Asia moving forward, with gross Takaful contributions from these three countries reaching US\$2 billion last year. Although Indonesia, with its high Muslim population, has been identified as a market with great potential in this sector, profitable growth for Takaful is still said to be a main concern in the republic.

Canadian Insurance company Sun Life Financial recently made its foray into the Asian Takaful market via its acquisition of CIMB Aviva Takaful. The new entity, Sun Life Malaysia Takaful will focus on both the Malaysian and Indonesian market despite being based in Malaysia. Kevin Strain, president of Sun Life Asia commented: "There's a lot of sharing we can do between Indonesia and Malaysia based on the Takaful business. And as we expand across the region, I think there would be pockets where Takaful would also be important. So primarily, it's Malaysia and Indonesia but I can see it being important for us in the broader sense of the word."

Regulations for Takaful on a global scale are said to still be lacking in most countries, particularly in the GCC. In Asia, Malaysia has taken the lead in terms of regulatory advancements, with the upcoming risk-based capital framework in 2014 seen as a boost to the Malaysian Takaful

industry. Commenting on this, Ahmad Rizlan Azman, CEO of Etiqa said: "This framework will strengthen and align individual operators' solvency and capital position according to their respective risk profiles. The introduction of the RBC for Takaful will mitigate issues of capital insolvency to create a financial buffer for Takaful operators against any exposure to risks."

Let the good times roll

Regional tie-ups through initiatives such as the ASEAN Free Trade Area (AFTA) agreement are also expected to further boost Islamic banking initiatives, especially in countries such as Indonesia. It has been reported that following the establishment of the AFTA Council, the minister of state-owned enterprises, Dahlan Iskan said that the government will look to establish a state-owned Shariah bank either through the merger of several Shariah compliant entities, or through the conversion of a government-owned bank.

With all eyes now on Asia especially in terms of infrastructure development, SME financing, microfinancing, Takaful and capital markets growth, Islamic banking and finance in the continent is on an upward growth trajectory. Strong government support and regulatory progress, as well as increased focus from international financial institutions, all bode well in guaranteeing that the Asian continent sees a continuous flow of liquidity, particularly from the Middle East and Europe. ☺

Asia focus: Sun rises in the east

Islamic finance has seen considerable growth in markets with dominant Islamic populations like Southeast Asia and the Middle East. However, can the same be said for non-Muslim jurisdictions which have taken proactive initiatives to facilitate Islamic finance in the recent years? SYED SIDDIQ AHMED explores a few of the emerging Asian markets where Islamic finance has made inroads.

After the global financial crisis, countries were in desperate need to look for alternate avenues where value of their investments and market stability are ensured. With its strong principles and practical applications, Islamic finance has come close to meeting the expectations of many including a host of non-Muslim jurisdictions.

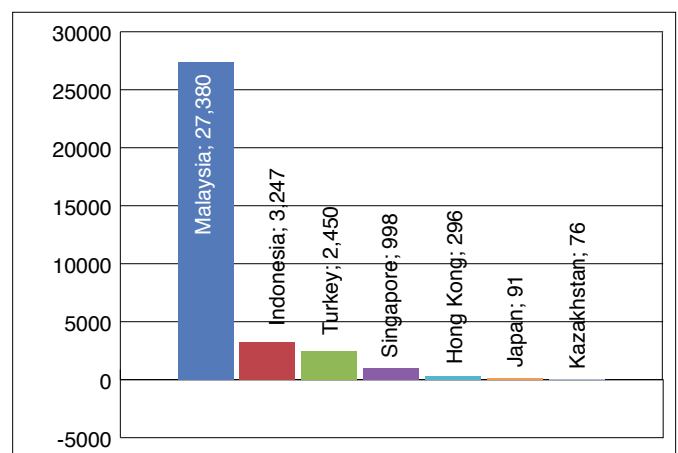
However as the world economy recovers, this notion doesn't seem to hold as a majority of Muslim-minority nations showed a lukewarm response towards this mode of finance. Advocates of Islamic finance are nonetheless as ever, continually optimistic, and this optimism is proved and turned into positive results as the industry surges towards robust growth.

There have been advancements in regulatory approaches in varying degrees in many Asian countries such as Turkey, Brunei Darussalam, India and Hong Kong to facilitate Islamic finance in their jurisdictions, and while other countries have shown a status quo in their approaches such as Australia, Japan and Korea; countries like Malaysia, Pakistan and Bangladesh continue to show great progress in their Islamic finance markets.

Afghanistan

Holding more than 24.2% of the country's GDP, the Afghan banking sector has made substantial progress. Out of 16 licensed financial institutions, six institutions provide Islamic financial services. Takaful and Sukuk are however non-existent but the central bank has announced that it will issue Islamic treasury bills by early 2014. There have been recent amendments to the Banking Law by the Afghan parliament, and the Supreme Council of Da Afghanistan Bank has submitted the final draft of the Islamic Banking Law to the Ministry of Justice. A draft law on Afghan Deposit Insurance Corporation (ADIC) has also been sent to the Ministry of Justice for their comments and approval. As at June this year, Islamic banking assets in Afghanistan grew by 10.1% to AFN9.55 billion (US\$170.6 million) from AFN8.21 billion (US\$154.9 million) in December 2012..

The republic has shown significant progress in terms of spreading awareness on Islamic banking within its market and enhancing Islamic finance infrastructure at the central bank level.



Hong Kong

Hong Kong is one of the most vibrant and open financial marketplaces which has shown great progress in facilitating Islamic finance structures in recent times. In July 2013, its regulator the Hong Kong Monetary Authority (HKMA) announced amendments to its Inland Revenue Ordinance and Stamp Duty Ordinance to provide a comparable taxation framework for common types of Sukuk. Before the amendments, the issuance of Sukuk was subject to substantial tax disincentives because of multiple transfers to assets. HKMA in June 2013 hosted a seminar on strategies for the development of Islamic capital markets in Hong Kong to promote discussions, understanding and experience-sharing in the area of Islamic capital markets in collaboration with Islamic Financial Services Board (IFSB).

Hong Kong shares good working relations with the pioneer in the field, Malaysia. In August this year at a bilateral meeting between the CEO of HKMA and the governor of the Malaysian central bank, Hong Kong reaffirmed its commitment in advancing the Islamic finance proposition in the island. With Sukuk guidelines expected to be published by HKMA soon, the market is all set to embrace Islamic finance in a big way.

India

The Reserve Bank of India (RBI)'s much-awaited move allowing Islamic finance to be practiced in the republic has been well-received by the global Islamic finance industry. Although authorized under the Non-Banking Financial Companies

(NBFCs) provisions of the Reserve Bank of India Act 1934, financial transactions are nonetheless allowed to be made in accordance with Shariah principles. NBFCs are registered under the Companies Act 1956 but need to comply with the RBI guidelines. NBFC definition includes asset finance companies, investment companies, loan companies, infrastructure finance companies, systemically important core investment companies, infrastructure debt funds, non-banking financial company - micro finance institutions and non-banking financial company - factors. Institutions must have a minimum of INR20 million (US\$316,200) in net-owned funds to register with the RBI. The amount may vary depending upon the class of the NBFC.

The appointment of the much-celebrated 'rock star' economist who predicted the global financial crisis, Dr Raghuram Rajan, as the new governor of RBI in September this year is expected to breathe a new life in efforts to advance Islamic finance in the republic.

Japan

While regulators have allowed Japanese banks to operate in external markets and to structure and place Islamic deals offshore, Japan's domestic banking rules still do not permit Islamic finance transactions. Japan has however maintained a status quo in offering tax exemptions by extending them till March 2016. This exemption for interest on book-entry transfers of Islamic bonds expired in March 2013. The regulation to permit subsidiaries of Japanese banks to engage in Islamic financial transactions by the Japanese Financial Services Agency (FSA) in December 2008 also continues to be in force. Japanese banks operating in offshore markets have reached new heights and made ground-breaking progress in areas such as establishing in-house Shariah committees and launching their Islamic financing products. Japanese insurance player, Mitsui Sumitomo acquired a 35% stake in Hong Leong Takaful, formerly known as Hong Leong Tokyo Marine Takaful. Japan has taken initiatives and has maintained friendly regulations for the development of Islamic finance but has slowed down the pace with increasing self-sufficiency of funds from its domestic resources. With the Middle Eastern and Asian economies booming, Japan might step up its efforts in formulating laws to facilitate Islamic financial transactions in the future.

Japan's lack of Shariah expertise may hinder the development and issuance of Sukuk and other Shariah compliant instruments. There is a call from Japanese players to the global Islamic finance industry players to issue Shariah compliant instruments and set up more support agencies to help facilitate Shariah transactions in the country. This might give a much-needed boost for the development of the industry in Japan and push the authorities to provide more conducive regulatory and tax frameworks.

Kazakhstan

Kazakhstan, which is the first country in the CIS (Commonwealth of Independent States) region to take the initiative to embrace Islamic finance through the enactment of enabling legislations, is one of the emerging marketplaces for Islamic finance in Asia. After the global financial crisis which shaved almost 25% of Kazakhstan's currency tenge's value, the republic has systematically explored Islamic finance to aid recovery. The Development Bank of Kazakhstan (BRKZ) has since issued a

debut US\$75.5 million Sukuk in July 2012 with the assistance of Malaysian regulatory authorities.

The IDB, through its affiliate, Islamic Corporation for the Development of the Private Sector (ICD), has played a significant role in developing Kazakhstan's Islamic finance industry and its private sector along with improving its ties with other Islamic countries. In May 2013, ICD announced its initiative to convert domestic Zaman Bank into an Islamic bank with an investment of up to 35% of its capital. It will be the second Islamic bank in the country. Recently, the IDB also allocated US\$25 million for agriculture funding in Kazakhstan. UAE's Al Hilal Bank is presently the only Islamic bank in the republic and aims to expand its operations into other CIS countries.

With huge oil, metal and natural resources there are opportunities for major industrial projects in Kazakhstan. The government plans to issue Islamic securities for their funding and set up more Islamic banks by 2014 to facilitate Islamic transactions. Aiming to develop the Islamic finance industry, the government has drafted a 41-point road map in March 2012. Kazakhstan has Vision 2020 plan to make its capital Almaty as the regional center for Islamic finance.

South Korea

Having shown great interest in Islamic finance post-financial crisis with a series of conferences and seminars in collaboration with various Islamic finance industry stakeholders, South Korea has tried its best to accommodate Islamic structures. Amendment to the Special Tax Treatment Control Act (STTCA) which will facilitate Sukuk issuance is however, yet to be approved. The bill was introduced in the parliament many times but with the resistance from Christian lobbyists it could not be passed. However, with the industry growing in the past few years, there seems to be a clearer understanding among the South Koreans with regards to the potential and tenets of Islamic finance. The country, which is one of the major exporters to Islamic nations, has explored the Halal market and Islamic finance might just be the natural progression to bring diversity into its markets.

In January 2013, in an effort to understand and move closer to introducing Islamic finance in the country, Korea Federation of Banks (KFB) organized a training suite on Islamic finance in collaboration with Qatar Central Bank. The suite explained the principles and contracts of Islamic finance, the licensing systems and discussed case studies on Islamic financial products.

Outlook

Underpinned by strong and near-stable economies, Asian economies have shown growing resilience towards overcoming the global financial crisis. They will continue to play a major role in the world's financial arena as an increasing number of jurisdictions look to diversify their markets and transform into broad-based and sustainable regional financial and business hubs. Islamic finance has convinced both investors and issuers alike, who look for safer and attractive yields, to benefit from and tap into Islamic finance markets in the burgeoning Asian space. While infrastructure, project, SME and micro-finance remain the active areas; housing, commercial and Takaful are also favored areas of investment. (2)



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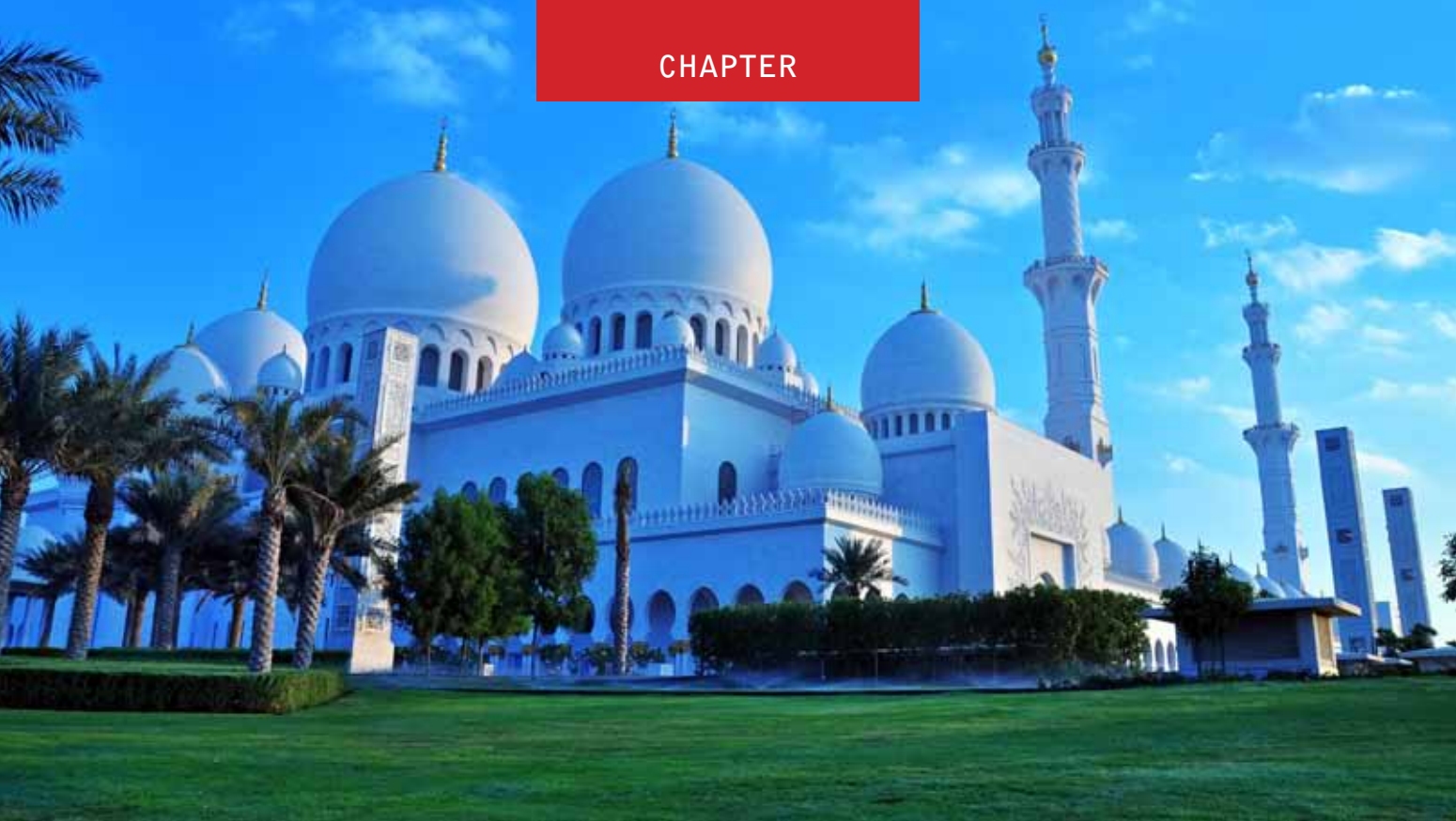
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The changing landscape of Islamic banking product development

The Islamic banking industry is looking better than ever with growth outpacing the overall banking sector by 50% as reported by Ernst & Young, and such exponential growth has opened the landscape to a host of robust Shariah compliant banking solutions. In an exclusive interview with *Islamic Finance news*, KHURRAM HILAL, the global head of Islamic banking products at Standard Chartered Saadiq, sheds light on the emerging trends in Shariah compliant banking product development and shares his thoughts on the industry moving forward.

Evolving products

Over the last decade, the Islamic financial universe has been witnessing the evolution of Islamic products, moving from plain vanilla and basic deposit and financing solutions to more advance products such as hedging, Sukuk, structured investments etc. This is in line with the growing sophistication of customer demand and increasing competition in the market, prompting industry players to be more innovative in their product offerings to stay ahead of the race.

Recognizing the potential in high net worth individuals, the retail segment has begun to see increased emphasis by banks on

the growth areas of private banking and wealth management as more customers are seeking to manage their wealth in a Shariah compliant manner. Commenting that these areas are one of the most underdeveloped areas of Islamic finance with very few providers offering comprehensive wealth management solutions going beyond deposits and local equity funds, Khurram says: "For a Muslim investor his hurdle rate starts at 2.5%, that's the Zakat that he has to pay on his savings. You can't get these returns from deposits (inflation adjusted). Hence we need to offer our clients a holistic offering which not only helps them achieve their investment objectives but also provides sufficient diversification to keep the risks under

control. At Standard Chartered Saadiq we see huge potential in this space and have already rolled out our comprehensive Shariah compliant private banking proposition last year. The response has been great and based on customer feedback we are now expanding our product suite.”

In the wholesale banking arena, providers are observably putting more focus on structured trade finance products as Islamic finance fast becomes the vehicle of choice for trade due to the complementary nature of the two sectors.

“Islamic finance and trade are a natural fit as Islamic finance has to be asset-backed, and the buying and selling of goods is a reality of life,” explains Khurram. “The industry is now focusing on the more complex trade needs of clients looking at cross-border trade flows; from Africa to the Middle East and across Asia – this is a burgeoning area. Islamic finance offers a natural advantage over conventional banking which is its ability to take ownership of assets. This on one hand provides the clients a fit for purpose financing solution and on the other hand offers great risk mitigation for the bank as it has recourse to the underlying goods in case of a credit event.”

In addition to that, the wholesale banking sector is also experiencing an increased effort on the part of players and regulators alike to develop acceptable common standards across Shariah boards to further boost the growth of the industry.

Moving on to the institutional space, the Shariah compliant financial stage is exhibiting considerable focus on interbank markets over Islamic securitization instruments on banks’ balance sheets. “We are seeing an emergence of Islamic repo products, which are in essence collateralized Murabahah,” Khurram elucidates. “This opens new doors for Islamic banks as it improves their ability to unlock the liquidity tied up in long-term Sukuk holdings.”

Mirroring the conventional?

The Islamic finance industry has been slapped with accusations by certain market participants and non-participants alike alleging that Shariah compliant products lack originality and are merely conventional products repackaged under a thin Islamic compliancy veil. This lack of innovation, some players assert, would inhibit the growth of the industry. However Khurram offers a different perspective: “While it is true to some extent that Islamic finance products do mirror the conventional, conventional banking has more than 400 years of experience and knowledge that Islamic banking, as a relatively young industry, can learn from and adapt to where appropriate.”

Having said that, Khuram nonetheless affirms that: “It is important for Islamic banks and practitioners to ensure that we live up to the promise which Islamic finance brings with it; the notion of fair, equitable and wholesome banking practices that contributes to the socio-economic development of the society.”

This goes in tandem with shifting market sentiments following the recent global financial crisis, where the social role of banks has been brought to the fore and the general consensus is that there should be more emphasis on ethical banking practices.

Survival tips

As the industry continues to grow at an unprecedented rate, the nascent industry still struggles with the issue of human capital scarcity, technological disadvantages and less-than-comprehensive regulatory frameworks.

So how does one survive in this seemingly non-conductive environment? Apart from boosting efforts in developing competent human resource, increasing investment in upgrading banking technology and working together with regulators to design a conducive regulatory framework for the Islamic financial industry, Khurram shares that Standard Chartered stays ahead of the curve by offering innovative Shariah compliant end-to-end solutions, capitalizing on the bank’s strong 150-year old history and expertise, and more significantly by adopting a ‘one bank collaborative structure’.

“We have over the years built a pool of resource and industry knowledge through the experience of working with our clients and being at the forefront of product innovation, with a clear view of Islamic principles,” says Khurram. “Our strategy is driven by a strong client focus and we work in close partnership with the bank’s transaction banking, financial markets and corporate finance teams to ensure we are aligned to the evolving needs of our clients.”

“Islamic finance and trade are a natural fit as Islamic finance has to be asset-backed, and the buying and selling of goods is a reality of life”

Healthy but not immune

With growth in most markets, from majority Muslim countries across the Middle East and Asia, to growing acceptance in Muslim minority jurisdictions like Kenya, the market outlook for the industry is looking positive, especially with increasing customer demand and support from regulators.

“Islamic institutions are a part of the larger financial system. It is in this relationship that the Islamic banking system cannot be looked at in isolation. Challenges faced by conventional financial institutions will have implications on the larger financial system, and in turn Islamic financial institutions.

Though healthy, Islamic banking is not immune to shocks in the economic system so we need to stay alert and be quick to respond,” cautions Khurram.

With good banking practices, healthy competition to steer product diversification and innovation, and a commitment to the value proposition behind Islamic finance, the industry is bound to continue its upward trajectory. (2)

A global perspective in Shariah investing

Franklin Templeton Investments has been managing assets globally for over 65 years with investments in Asia dating back to the 1950s. Now, the firm has grown to more than 590 investment professionals located across the world, including asset managers with expertise in Shariah compliant strategies in Malaysia, Singapore, Hong Kong, and the UAE. The company was also recently ranked as the 15th largest Islamic fund house in the world.^[1]

Malaysia is set to be the strategic Shariah investment hub for Franklin Templeton globally. At the time when most global financial institutions were downsizing their operations after the global financial crisis in 2008, Franklin Templeton took the contrarian route and established its office in Kuala Lumpur in March 2009. By January 2010, the Islamic investment management arm of Franklin Templeton obtained the coveted Islamic fund management license from the Securities Commission, Malaysia. It has since been growing its presence in the Malaysian investment industry and has developed to become a key player in the Islamic institutional space.

Investment process: A rational approach in an irrational market

One of the pillars within Franklin Templeton's Shariah strategy lies in its collaboration among the investment teams globally, which forms part of its investment process. The company pulls and pools the expertise of the portfolio investment teams located in over 30 countries around the world to provide a three-dimensional perspective to the management of its investment portfolios. That differentiates Franklin Templeton's services in the local investment industry. In this context, the following sections highlight the different aspects within Franklin Templeton's global teams with regards the management of our Shariah-compliant investment portfolios.

Global collaboration in local Sukuk investing

By Hanifah Hashim

Executive Director/Head Malaysian Fixed Income & Sukuk of Franklin Templeton GSC Asset Management



Franklin Templeton prides itself on being disciplined long-term investors, known for minimal style drift and for adherence to our investment goals regardless of

market trends. We believe an active portfolio management approach combined with strong research capabilities and investment process can outperform market indexes over time. Our Sukuk investment process involves fundamental bottom-up, top-down analysis and quantitative approaches.

We cover the entire Sukuk market and conduct our own independent research on issuing companies. The focus is to identify credits that will perform on an absolute return basis. In addition to relative value analysis, we also evaluate the potential upside and downside of each credit down to its granular level.

What set us apart is our ability to leverage on the global investment platform of the Franklin Templeton Fixed Income Group, which is one of the largest specialist managers of fixed income assets in the world, with over US\$359 billion (as at the 30th June 2013) in fixed income assets.

The local Sukuk team leverage on the resources available from this unified structure and the diversified expertise within the group, including macroeconomic analysis, sector guidance as well as quantitative analysis. The close working collaboration provides us with better access to information, contact with global decision makers, and the edge needed to potentially achieve superior performance.

We also work with our global risk management team to draw on their expertise in managing portfolio risk. That includes harnessing the Performance Analysis and Investment Risk (PAIR) team to provide their evaluation on our portfolios.

In addition, some of our Sukuk are put under additional scrutiny to ensure the screening goes beyond the breadth of investable Shariah universe, but also the Shariah structures of each security. This is done via our partnership with world-class Shariah scholars that provide us with valuable insights and perspectives for analyzing different Sukuk structures. Moving forward, we will continue to adopt this process, while fine tuning those that we believe can be improved, and adapt with the ever-advancing market to remain ahead of the curve.

Team-based decision process unearths hidden gems in Shariah equities

By Dennis Lim

*Senior Executive Vice-President
& Senior Managing Director of
Templeton Emerging Markets Group*



We believe that the principles of Shariah investing do not necessarily prevent a company from operating efficiently or profitably. Some even believe the added discipline may be an advantage. In our case, we are finding a lot of good companies in many areas of the world that fit within the parameters. In India, for example, there are hundreds of listed companies and we regularly unearth what we believe could be potential Shariah gems there.

For all our potential investments, the first step in the screening process is to identify companies that appear to be trading at a discount, based on our estimated projections for future intrinsic value. We then narrow down our potential investments through comprehensive fundamental and quantitative analysis on a company-by-company basis to assess long-term value.

“For all our potential investments, the first step in the screening process is to identify companies that appear to be trading at a discount, based on our estimated projections for future intrinsic value”

An important part of the process is to really understand the business, its management quality, ownership structure, corporate governance and commitment to creating shareholder value. Company visits are a key part of the process, where we tour facilities and interview management. The decision-making process is team-driven. One thing we have noticed is that Shariah companies tend to have very efficient balance sheets. While other companies may have too much or too little capital, such companies would be screened out under Shariah investing rules.

Once we have built a portfolio, we continually examine performance contributors/detractors. Our disciplined sell methodology may kick in when a stock price exceeds our estimation of fair value, when we think greater value potential exists in another security, or when a fundamental change occurs at a company that alters our forecasts and the deem the asset no longer Shariah compliant. Our team regularly reviews portfolios for adherence to investment objectives and principles. Through this process, we believe our Shariah portfolios continually reflect Templeton Emerging Markets Group's best investment ideas.

The 3Rs of risk management: Risk should be recognized, rational and rewarded

By Wylie Tollette

*Senior Vice-President and Director,
Performance Analysis and Investment
Risk, Franklin Templeton*



The basic foundations of our integrated approach to risk management apply across virtually all investment strategies, including our Shariah portfolios. Central is the idea that risk management is not about avoiding risk entirely, but instead, seeking to determine whether investment risks are:

1. Recognized – Risks should be understood at the security, portfolio and operational levels;
2. Rational – Risk decisions should be an intended and a rational part of each portfolio's strategy; and
3. Rewarded – Every risk should have commensurate long-term reward potential.

The decision to enter new markets, particularly where many others fear to tread, carries considerable risks. We address these by considering risk at the step of the investment process. We also support our Shariah portfolios with independent portfolio risk evaluation, led by Franklin Templeton's global investment risk management team, called the Performance Analysis and Investment Risk (PAIR) group. This group consists of over 90 experienced professionals spread globally across the firm, who work consultatively with the portfolio managers to provide an independent perspective on the absolute and relative risks and seek to align those risks with the portfolio managers' investment research and convictions.

Strong fundamental research

Our first step in terms of risk management is conducting on-the-ground fundamental research such as country visits, meeting with the central banks and treasury officials, as well as people in the business community. "On-the-ground" research is particularly important in newer markets where there is less market data and research about the market, such as the case of Sukuk. Each Sukuk has a unique underlying agreement with the issuing firm, so our research includes examining the underlying agreements to help determine the credit support for the instrument.

By analyzing the fundamentals, our investment teams may be able to see the potential for improvements on the macroeconomic front before market indicators turn bullish. Our analysts' research is then used by the portfolio managers during portfolio construction. This includes deciding which Sukuk or stock to buy, at what margin of safety, the likelihood of repayment and risk of default. The portfolio manager also seeks to manage risk by sizing positions and diversifying the portfolio across sectors and risk factors, taking into account risk and reward considerations while staying true to the portfolio's mandate and investment goals and objectives.

Critical to understanding Franklin Templeton's approach to investment risk is the research team's independent opinion of

the country's credit ratings. In general, the research team views the ratings assigned by ratings agencies as a "lagging" indicator, rather than as a prediction of investment opportunity or risk.

Spreads in the bond market — which the investment team and PAIR monitor closely — can be a better reflection of credit risk and are valuable as an additional input into the research process. Changes in a security's stated credit rating, especially a downgrade, can affect the portfolio's composition versus mandated investment restrictions. However, this does not mean that the portfolio managers necessarily have to redeem following a downgrade, as every portfolio has an overall risk budget. Downgrades and short-term market volatility can actually present investment opportunities if the fundamentals remain consistent with our long-term convictions and research.

“ ‘On-the-ground’ research is particularly important in newer markets where there is less market data and research about the market ”

Taking a top-down perspective

Complementing the bottom-up research conducted by the investment team, PAIR completes a top-down risk review, assessing the risk of each security in the context of the overall portfolio. This is a key component of our investment risk process for all our Shariah strategies, including sovereign debt and Sukuk. In these markets the PAIR team calculates exposure to several major risk factors such as credit, duration, currency and liquidity risk, adding the contributing and diversifying effect of each security into a comprehensive picture at the portfolio level.

Essentially, PAIR's evaluation process relies on a 'three-legged stool' of key analytics as follows:

- **Exposure and attribution analysis:** This analysis examines relative and absolute portfolio weightings and how past investment decisions have impacted portfolio returns. It helps determine the success of the investment research process at generating returns over the long-term;
- **Risk modelling:** These analytics use risk models to measure the sensitivity of the portfolio to key risk factors, like currency fluctuations, credit risks and interest rates. Our risk models seek to capture the volatility and inter-relationships between individual issuers and securities that simple exposure analysis alone cannot capture. This helps identify areas of hidden concentration and risk exposure; and
- **Downside risk decomposition and scenario analysis:** This third analytic component uses the risk model to run the portfolio through thousands of potential market scenarios to analyze the worst 1% of these scenarios and determine which positions in the portfolio contributed to the worst outcome. It helps reduce the probability of surprise losses.

One of the key challenges in the global Sukuk market is access



to historical data. Statistical risk modelling is highly dependent on the underlying data used to calculate and predict risks and exposures. To build a more rigorous risk model for a Sukuk portfolio, PAIR "proxies" the Sukuk by finding data from other analogous securities that have similar characteristics but have a more complete history available.

In closing, we believe the basic job of risk management is not to eliminate all risk but to ensure that the risks we take are recognized, rational and rewarded over the long-term. To this end, PAIR risk managers seek to work consultatively with the portfolio managers and analysts as trusted risk advisers. We believe the best way to manage risk is through this integrated approach, where investment managers and independent risk managers work in close partnership for the benefit of our clients. ⁽²⁾

^[1] Source: Ranked by Asian Investor, as at March 2013

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Every day, the world of Islamic finance is evolving.

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INCEIF, The Global University of Islamic Finance, is fully committed to bridging this need through its Executive Programmes (EPs). These customised EPs seek to keep participants abreast with real challenges and opportunities in the industry by harnessing the experiences of a distinguished pool of global experts, academics and practitioners.

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Asia: An intriguing proposition

Markets move according to sentiment. Wherever investor confidence is high, the money is sure to flow. NAZNEEN HALIM discovers how Asia has become a source of comfort to GCC investors particularly in the Shariah compliant space.

According to a study by the Economist Intelligence Unit, Asia will become the most important emerging market region for the GCC in the coming years. The total trade between ASEAN and the Gulf was valued at \$83.25 billion in 2010, up from \$67.3 billion in 2009, marking a 24% growth. In the ASEAN region alone, exports reached US\$20.1 billion in 2010, while imports reached US\$63.1 billion. This, coupled with an intense push for Islamic investments and Shariah compliant products in Asia, particularly in Malaysia, Indonesia, Central Asia and Hong Kong, is expected to further boost the presence of GCC investors in the continent.

Infrastructure, real estate, technology, oil and gas and agriculture investments have been ear-marked as Asia's hottest selling points to the GCC, with a handful of sovereign funds from Qatar and Abu Dhabi already pledging billions of dollars-

worth of projects in these areas. Sheikh Hamad bin Faisal bin Thani al-Thani, chairman and managing director of Al Khaliji Bank said: "Economic power has shifted eastwards to the GCC region and ASEAN countries; we are the focus of global investments now." Asia's growing population has also laid the grounds for a boom in consumer banking, and it is evident from the spate of products being offered by Islamic banks that there are numerous opportunities in this area.

A report by the Gulf Research Center has also highlighted the need for GCC countries to step up ties with Asian countries, particularly in the agriculture sector. By the year 2030, the population of the GCC is expected to double to 60 million, raising concerns in terms of food supply. In Saudi Arabia alone, 15% of the kingdom's expenditure is allocated to food import and these numbers are no doubt expected to rise. Several

countries within Central Asia and South Asia have been identified as potential sources of raw products such as wheat and rice, and governments within the GCC are keen to tap into these markets through strengthened business relations and investments.

“ The increasing strength of trade and investment ties between the GCC and Asian economies offers GCC investors attractive investment opportunities in sectors such as energy, financial services, real estate, technology and healthcare ”

Another key area worth elucidating is trade and Islamic trade finance, which facilitates investment flows between countries. The understanding between Asia's most powerful economies; which also happen to be heavily invested in Islamic finance, and the GCC region through alliances within the OIC are not to be ignored, say market experts.

Capitalizing on this, Asiya Investments which has a presence

in Hong Kong and is owned by the Kuwait China Investment Company, launched an Asia Trade Finance Fund in May this year, worth US\$20 million in an effort to facilitate cross-border trade flows between Asia and the Middle East. The fund aims to play on the shortage of opportunities for GCC Islamic investors who are seeking an attractive income stream and lower risk profiles.

Sulaiman Alireza, executive director of Asiya Investments Hong Kong said: “GCC investors are eager to step up their exposure to the growing Asian Economies as many of them are currently under-allocated to the region. At the same time, they are seeking lower risk strategies.” He added that annual intra-Asia trade is expected to quadruple by 2020 to US\$20 trillion, while GCC trade with Asia is growing at a rate of 25% a year. Medium-sized companies especially are said to be missing out of US dollar funding, following the ongoing shortage.

Other market players also share Sulaiman's sentiments, on Asia being an under-allocated sector by global investors at present. Ahmad Al-Hamad, group managing director of Asiya Investments commented: “The increasing strength of trade and investment ties between the GCC and Asian economies offers GCC investors attractive investment opportunities in sectors such as energy, financial services, real estate, technology and healthcare, while at the same time providing solutions for the financing of Asia's much-needed infrastructure.” He also added that Chinese companies have been actively boosting Asian investments into the GCC through the commitment of capital into Gulf-based construction projects. “The GCC is also an important consumer of Asian goods, with imports doubling in the last two decades, helping to cement this strategic alliance for the 21st century,” Ahmad said. ☺



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Late to the table: Which Asian nations are going hungry at the feast?

Islamic finance is a booming industry with a strong growth rate that is attracting participants from all over the world as the flaws in the conventional industry are increasingly exposed and countries seek alternative means of diversifying their financial bases. LAUREN MCAUGHTRY takes a look at the line-up.

However although the industry has a number of strong leaders who have pioneered its development and are now reaping the rewards, countries who have been less proactive are finding that joining the party might not be quite as easy as just knocking on the door.

A new world order

Asia Pacific is one of the economic boom areas that is contributing to a global shift in power from west to east. A new report from Business Monitor International released last month highlights 15 developing markets which are currently seeing growth rates exceeding both China and India, and five of these are Asian nations. By 2020 the report predicts that the balance of economic power will have shifted to the east, with emerging markets holding a greater share of total global GDP for the first time ever: at 52.5% (US\$59.78 trillion) compared to 47.5% (US\$54.19 trillion) for developed markets. Currently the balance stands at 56.6% or US\$42.62 trillion for developed markets compared to 43.4% or US\$32.69 trillion for the developing world.

With this massive economic opportunity, countries in Asia Pacific are also developing their financial systems. The data

highlights a key turning point for the global economy as the balance of power gradually swings from the struggling west to the booming east. Along with this shift in economic influence comes an accompanying movement in the weighting of the global financial sector. In 1990, banks from western economies accounted for around 80% of the top 1,000 global banks (778 from the western bloc, 112 from Japan and just 93 from the rest of Asia). By 2010 this had shifted to just 586 from the west, compared to 224 from Asia ex Japan, and the trend is set to continue – by 2032 Asia will account for 60% of the global population and Asian banks (excluding Japan and China) will account for 30% of the industry.

Opportunity knocks

Building on and leveraging this optimistic forecast, countries in the region continue to seek diversification opportunities and Islamic finance represents one of the most tempting tables to join: with a growing global Muslim population that is seeing its purchasing power rapidly increase, along with a financial system that is constantly developing in terms of sophistication and product offering so that it now represents a viable alternative to the conventional in many areas. The Islamic finance sector has reached a point in its global development where standards

are being settled, dispute resolution has developed and international players are increasingly comfortable participating in the industry.

Investment flows

A driving factor behind the importance of Islamic finance is the indisputable economic advantage it brings to the increasing trade flows between Asia and the Middle East. The economic relationship between the two regions is rapidly developing beyond the energy sector – about 40% of the GCC's non-oil exports are now to Asia, while China's exports to the GCC are estimated to be growing by 30% per year. Financial flows between the two regions are also increasing significantly. With rising oil prices in recent years resulting in significant foreign reserves, GCC countries have been rebalancing their foreign investments with a greater allocation towards Asia as wealth is redistributed according to economic growth. Leading global consultants McKinsey have noted that between 2002-06, around 11% of GCC's capital outflows were to Asia – and that this share could double to up to 20% by 2020. And Asia in turn is also investing into the Middle East region, particularly in infrastructure projects in the GCC. With growing fund flows in both directions, Islamic finance is increasing in importance and countries on both sides of the world are recognizing the economic power its clients can wield.

Leading lights

Yet while the countries that have pioneered this development, such as Malaysia, are now reaping the rewards; others are finding that it is not as easy as just jumping on the back of the bandwagon. Islamic finance is a moving target that is constantly evolving and without the necessary expertise, experience and investment it can be difficult to set up a viable industry. While involvement may provide substantial rewards nothing comes for free and investment is needed – both at a national, regulatory and institutional level – in order to enter the game.

The role of the state

It comes as no surprise that Malaysia is the leading pioneer of Islamic finance in Asia. With a sector that now accounts for over 25% of the overall banking system and a government that has constantly supported and promoted the industry through investment and regulation, the country is not just a regional but a global powerhouse. But what is the driving force behind this success? Speaking to Islamic Finance news Bobby Tay, the CEO of Sabana REIT, the world's largest Shariah compliant real estate investment trust, explained the significance of the state's role in developing a viable industry and suggested why other nations in the region may not have been so successful.

"Government support is of paramount importance. If governments – especially central banks – do not believe in Islamic finance and to make special arrangements such as giving incentives and promoting these incentives widely, then these countries will never succeed [in the industry]."

In Malaysia, Islamic finance is a huge success as Bank Negara Malaysia (the central bank) promotes it through education by setting up INCEIF university, and promotes the use of Islamic finance products through tax incentives."

Upcoming star

Malaysia does not stand alone – Tay also points out that as the world's most populous Muslim nation: "Indonesia is following Malaysia and will reap the same success too." The country has seen a wide-reaching range of new regulations and central bank support; designed to promote and develop the Islamic finance industry and increase its market share. Just last month new central bank regulations were released concerning the loan-to-value ratio and financing-to-value ratio for property credit and property-backed consumer loans to provide equal treatment for Islamic banks, and the results are encouraging. In 2012 Indonesia's Islamic banking assets grew by 50% to US\$17 billion, and are expected to continue their upward trajectory as the number of Islamic institutions grows and foreign investors flock to the country's burgeoning capital market. The country also recently established a new financial services authority, Otoritas Jasa Keuangan, which in creating a more regulated and transparent environment for the Islamic capital market should also go a long way towards encouraging growth.

A muted roar

Yet while Indonesia demonstrates what can be achieved with investment and staunch government support, other nations have not been so lucky in achieving success. Singapore, for example, despite repeated efforts, has so far failed to achieve a scale market in Islamic finance and the lion state is facing an uphill struggle in developing the sector despite its reputation as a global financial hub for the conventional industry.

As Asia's leading fund management center Singapore represents an important potential market for the Islamic finance industry, and the Monetary Authority of Singapore (MAS) has since 2004 been attempting to improve legislation to encourage its development. For a long time Sabana REIT has been not only the biggest but almost the only visible player on the Singaporean skyline – but gradually the Sukuk market in the city has started to show signs of progress. In 2010 Malaysia's state investment vehicle Khazanah issued a successful SG\$1.5 billion Sukuk in Singapore while homegrown firm City Development also launched a SG\$1 billion program; encouraging other players to follow suit both in Singapore and abroad. Sabana REIT subsequently issued the first convertible Sukuk in Singapore in 2012 which met with such a strong response that the firm launched a SG\$500 million multi-currency Sukuk program in April this year. Also last year, taking advantage of favorable currency swap rates, Singapore-listed companies First Resources and Golden Agri for example tapped the Malaysian ringgit Sukuk market.

Middle East banks based in Singapore have subsequently started offering Islamic window facilities for their corporate clients – this year, Singapore-listed shipping firm Atlantic Navigation, which has operations in GCC and India, signed an Islamic financing facility with a Singapore-based bank for example. Another Singapore firm, Mustafa Group, is also believed to be considering an Islamic financing facility to fund regional expansion, while Securus Fund, the world's first Shariah compliant data center fund (managed by AEP Investment Management, a subsidiary of Saudi Al-Rajhi Group, one of the largest Islamic banks in the world), successfully completed its second round of fund raising earlier this year to

double its capital to US\$200 million. Most recently in August this year marine offshore services company Swiber took advantage of the competitive Sukuk pricing to launch a S\$150 million five-year deal which saw strong local demand especially from Brunei and domestic Singaporean buyers. Only the second Singaporean corporate firm to enter the Islamic capital market in Singapore (rather than crossing into Malaysia) the release nevertheless bodes well for the island's hopes of developing into a valid market in its own right.

According to Lim Hng Kiang, the minister for trade and industry and the deputy chairman of MAS, we can also expect further regulatory and tax developments as Singapore continues to work towards encouraging its nascent Islamic industry: "These developments suggest that the growth potential for Islamic finance in Singapore has yet to be fully realized, and that Singapore can play a role in giving growth of cross-border Islamic financing an even greater push. Towards this end, MAS is presently working with other government agencies and the industry to identify and address time-to market issues to further facilitate Islamic finance activities in Singapore. This includes looking into providing greater clarity and certainty in the regulatory and tax treatment to expedite the issuance of Sukuk and other Islamic capital market instruments."

Dim sum Sukuk

Often compared in the same breath as Singapore, Hong Kong is another island state which has recently made strides in accessing the Islamic dollar despite a slow start and a long wait for regulatory approval. Yet compared to Singapore, there are doubts over how far Shariah compliant finance can really progress in the city. Despite being, like Singapore, an international financial hub with a deep pool of expertise and a strong background in funds and capital markets, Hong Kong lacks the relationship that Singapore has with its neighbor Malaysia as well as the proximity to the enormous potential of Indonesia. While it does have potential in terms of investment flows with the Middle East, where the real interest lies is in its position as a gateway for Islamic investors to access the vast market of mainland China.

Hong Kong has been looking to develop its Sukuk market since 2007 but it was only in July 2013 that the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance was gazetted, essentially allowing Sukuk transactions by making changes in the tax treatment to classify the deals as debt arrangements, and thus removing the tax impediments which had previously inhibited the market.

The initial response has been positive and Florence Yip, the financial services tax leader for China and Hong Kong at PwC, told Islamic Finance news that: "It will pave the way for Hong Kong to further develop as a major international financial center, catering to Chinese, Asians and western customers. We are developing a platform that will be a good conduit for Islamic finance products which it is hoped will attract Islamic investors."

However, not everyone is so enthusiastic. While recognizing the value of the move, many experts in the region believe that it will have only a limited effect on a market that will always be only a minor part of the overall financial landscape of Hong



Kong. Since 2006 just six Sukuk totalling US\$5.8 billion have been listed on the Hong Kong stock exchange. Compare this to London which, although also trailing behind in terms of developing an Islamic finance market, has seen over 40 Sukuk listed with a total value of more than US\$35 billion.

Hong Kong has a limited domestic Muslim investor pool and is facing intense competition from other countries in the region who are both more advanced and more appropriately positioned. Davide Barzilai, a partner and the head of the Islamic finance practice at Norton Rose Fulbright in Hong Kong, confirmed that: "I think it's a very positive move, but I don't think it's going to lead to an overnight rush of new Islamic finance business in the Sukuk market in Hong Kong."

Australian over-optimism

In comparison, high hopes have long been held for Australia which despite a tiny Muslim population has seen a growing interest in Islamic finance over the past few years. The current regulatory environment already allows Shariah compliant funds and several have already been launched: most notably by leading Australian fund manager Crescent Wealth, which recently launched the first Islamic pension fund in the country which it predicts could grow to US\$22 billion by 2020.

In addition, the 2010 Johnson Report recommending policy options to improve Australia's position as a global financial center made several specific notes regarding Islamic finance: including a recommendation that the Board of Taxation updated the tax treatment for Shariah compliant products, and a recommendation for the identification and removal of regulatory barriers which may be preventing the development of Islamic finance in the country.

However, with less than 500,000 Muslims in Australia making up just 2.2% of the population, as with Hong Kong, opportunities will always be limited. While Australia might be keen to tap the Islamic finance market as a means of furthering its relationship with strong Asian economies and encouraging the entrance of

attractive Islamic liquidity into its investment channels, like Hong Kong it will struggle to compete with other, better-suited and more attractive jurisdictions. As Tay warned: "If it is as simple as opening a bank and giving [it] an Islamic branding and [that is how you] hope to be successful in the world of Islamic finance, then these regulators really do not know the industry."

Thai horizons

Thailand is a more optimistic prospect for the industry, and both the state regulators and the country's financial institutions have been looking into Islamic finance for some time, especially regarding the prospect of attracting Islamic funding for major upcoming infrastructure projects including an upgrade of Bangkok's public transport system and an airport expansion. Islamic banking assets in Thailand currently stand at around US\$4.5 billion.

The country only has fully-fledged Islamic banks including the state-owned Islamic Bank of Thailand (iBank). However, concerns have been raised over its financial stability, with iBank reporting non-performing financing of THB39 billion (US\$1.24 billion) in earlier this year – or 20% of its total lending – while in May the government had to extend a THB6 billion (US\$191.1 million) loan to shore up the bank's shaky finances.

Nevertheless Thailand represents a much more positive market for Islamic finance, with a Muslim population of around 9.5 million many of whom are underbanked. Its close proximity and cultural links with Malaysia also lend themselves to encouraging the development of the industry, and the country in May 2011 passed legislation to level the playing field in order to facilitate Sukuk. However so far little has been forthcoming, with only a handful of foreign-currency issuances from Thai companies (including a small Sukuk launch from leading energy firm PTT in Malaysia in 2010).

No sovereign Sukuk has yet been forthcoming despite longstanding rumours, but in June this year iBank announced that it would issue a THB5 billion (US\$159.25 million) Sukuk in order to increase its capital – the first Sukuk launch in the country. The bank also plans to establish a presence in the Middle East over the next three years, as well as increasing its number of domestic branches. According to Dr Rak Vorrakitpokatorn, its senior executive vice-president, iBank has seen a 90% growth rate since its establishment, and is hopeful of further growth in other areas – for example it last year launched an Islamic leasing subsidiary, Amanah Leasing. However with just one player in the market and a low level of awareness of the opportunities available, it looks as if it will take some time before Thailand manages – if ever – to find its footing as a viable player in the Asian Islamic landscape.

Land of the rising sun

Like Thailand, Japan is another pretender which has long trumpeted its commitment to Islamic finance without actually making any real investment or commitment to the industry – and, consequently, seeing little in return. Although the Japan Bank for International Cooperation has pioneered local research into the sector, the banking laws were only updated in 2008 to allow Japanese banks to engage in Islamic finance transactions. And although banks such as Bank of Tokyo-Mitsubishi UFJ have

been active in markets such as Malaysia and the Middle East, domestic activity has remained very limited.

Until 2010 only a handful of deals were seen in the market. In June 2010 despite an unfavourable tax and regulatory environment Japanese bank Nomura issued a US\$100 million Sukuk Ijarah on the Malaysian exchange, along with the launch of a US\$70 million commodity Murabahah facility, demonstrating that despite the difficulties in the domestic market, firms could still tap Islamic opportunities abroad. Corporates such as AEON and Toyota have already tapped foreign markets for Sukuk, and Japan has finally recognized this. The recent Asset Liquidation Amendment Act took the first step in opening up Japan to non-resident Islamic investors and it is hoped will provide not only the much-needed push for Islamic finance in Japan but also provide the country's own stagnant economy with a shot in the arm from Islamic investment.

Philippines: The new frontier

However the country that is currently showing the biggest push in the region is undoubtedly the Philippines, and it is here that the industry is looking for the next big thing. It was reported in September that the central bank has launched a number of key initiatives to drive Islamic finance forward: including a new draft Islamic banking law and a request to amend its charter. The move follows a spate of violence last year between Muslim separatists and the ethnic majority which killed over 100,000, and was just the latest bout in a 40-year conflict. However following the signature of a peace deal in October 2012 the Philippine government has made inclusion of the Muslim minority a major priority, meaning that we might soon be seeing big things come from this small country.

Currently only one Islamic bank, Al Amanah, is currently active; which is in the process of being privatized by the Development Bank of the Philippines after years of financial struggles. However the central bank plans to encourage foreign investment and participation as well as to develop its own Sukuk market through legislative changes to encourage issuance. The central bank is also working with supranational agencies such as the IFSB (of which it is an associate member) and the ADB to develop its domestic industry.

The Philippine economy is currently one of the region's top performers, with a growth rate topping 7% for four straight quarters and beating almost every other country in the region despite the slight regional slowdown in Southeast Asia. The country was upgraded to investment grade this year by both Fitch Ratings and S&P, and is predicted to be among the top five fastest-growing global economies of 2014 by Bloomberg with expected growth rates continuing at around 6-7%. In addition, the bulk of this stimulus comes from the domestic economy, in which the 9% Muslim population plays a significant part.

A senior banker based in Singapore confirmed that: "The Philippines will be the most likely to enter the Islamic finance industry over the next few years as the regulators are pushing them as a part of their nation's peace program," and suggested that "if they can continue to nurture and cultivate the sector, they could be the next break-out country in terms of Islamic finance in the region." (2)

Islamic finance in the global commercial arena

Commercial arbitration has long been an effective and efficient means of resolving disputes both domestic and international, providing speed, autonomy and most importantly reliable enforcement. As Islamic finance spreads outside its conventional borders, the need for such dispute resolution avenues has grown in parallel.

This paper, the first in a three-part series, will look at the problems faced by Islamic finance users across Asia and internationally when looking to resolve disputes in a commercially viable manner, and highlight the role that the Kuala Lumpur Regional Centre for Arbitration (KLRCA) and its award winning i-Arbitration Rules (the Rules) will play moving forward.

The second paper in this series, to be published in the upcoming Islamic Finance *news* Capital Markets Supplements, will examine how parties to contracts utilizing Islamic finance are able to select the appropriate Shariah laws to govern their transaction, particularly in a cross-border context. The third and final paper, due to be published in the Islamic Finance *news* Middle East Supplements will compare dispute resolution under the i-Arbitration Rules with traditional Islamic arbitration and some of the existing forums available.

Islamic banking in Asia

The Islamic banking industry in Malaysia is one of, if not the, most developed in the world. As of May 2013, total Islamic banking assets in Malaysia stood at RM525.63 billion (US\$161.97 billion), comprising 24.24% of the country's total banking assets. At the same time, Malaysia was responsible for 17% of global Takaful contributions and 68% of total global Sukuk issued, according to Malaysia International Islamic Financial Center (MIFC), with similar trends visible in the equities market, foreign currency market and total Islamic funds market share. The launch of MIFC, aiming to cement Malaysia as the 'World's Islamic Finance Marketplace', signals a move to develop Islamic finance in Malaysia beyond economic terms. Education, communication and cooperation are among the areas that are being developed, most relevantly through various joint ventures and a robust legal regime.

Hong Kong, in addition to restructuring its tax framework to support Islamic finance, has engaged with Malaysia by way of an MoU as well as a recent meeting in Kuala Lumpur for the exchange of ideas. Hong Kong is seen as the gateway for Islamic finance into China. Japan, likewise, has engaged with Malaysia on discussions relating to a bilateral swap agreement with the intention of facilitating Japanese investment into the Malaysian Islamic finance sector. South Korea and Singapore

are both expected to amend their taxation structures pertaining to Islamic finance, with Singapore having also established its first Islamic bank. All of these measures represent an extension of growing Islamic financial activity across the continent.

Supporting its Islamic banking sector, Malaysia boasts a strong and reliable regulatory and legal framework. Malaysia maintains its own Shariah Advisory Councils; one attached to Bank Negara (the central bank of Malaysia) and established under the Central Bank Act 2009, and one to the Securities Commission pursuant to the Securities Commission Act 1993. Together with the special Muamalat Division of the High Court of Kuala Lumpur – designed specifically to hear Islamic banking cases and created in 2003 – this approach recognizes the need in the Islamic banking industry for consistent, just and knowledgeable rulings in relation to Shariah points of law.

“ Malaysia was responsible for 17% of global Takaful contributions and 68% of total global Sukuk issued ”

Given the relatively early stage of development of Islamic finance across the rest of Asia, it is imperative that a country like Malaysia is able to offer the strength and expertise of its own legal structure to the international Islamic banking industry. The introduction of the KLRCA's i-Arbitration Rules goes a long way to achieving this goal.

How the i-Arbitration Rules function

In 2012 the KLRCA at the Global Islamic Finance Forum launched the i-Arbitration Rules, a remodelled set of its Arbitration Rules designed for Islamic arbitration. The new rules aim to provide a tool for the resolution of disputes arising from any contract that contains Shariah transactions and issues, suitable for international commercial agreements and providing international recognition and enforcement.

Provisions under the Rules

Previously, the 2007 KLRCA Rules for Islamic Banking and Financial Services Arbitration only applied domestically. Originally their use was restricted to transactions and business arrangements specifically involving financial instruments and commodities as defined under the Central Banking Act and Capital Market and Services Act 2007.

The Rules in their current incarnation bring in amendments to the 2012 revision of the conventional KLRCA Arbitration Rules which incorporate the 2010 UNCITRAL Arbitration Rules. The i-Arbitration Rules Model Arbitration Clause provides “[A]ny dispute, controversy or claim arising out of a commercial agreement which is based on Shariah principle or the breach, termination or invalidity thereof shall be settled by arbitration in accordance with the KLRCA i-Arbitration Rules”.

The Rules are presented in two parts:

- Part 1 is based on Part 1 of the current KLRCA Arbitration Rules (Second edition, 2012) with a modification to provide for a specific procedure for reference to the Shariah Advisory Council or a Shariah expert including necessary changes to provide for clarity and definitions of Shariah-related terminologies;
- Part 2 adopts the most current UNCITRAL Arbitration Rules 2010 (when conflicted, provisions under Part 1 will supersede those of part 2).

Salient provisions under the KLRCA i-Arbitration Rules include:

- Specification of information, documents and fee required for registration of a matter with the KLRCA;
- Provisions relating to the appointment of arbitrators, including provisions ensuring their independence and impartiality;
- Provisions relating to rendering of the award are clearly set out, whereby the arbitrator shall be required to render its award within a period of three months from closing of pleadings;
- The KLRCA’s schedule of costs applies immediately unless parties agree otherwise; and
- To encourage the due payment of fees and costs by parties, the parties are required to pay deposits at the beginning and during the course of the arbitral proceeding.

Dealing with points of Shariah law – reference to the Shariah Advisory Council

Rule 8 of the current Rules provides that where the arbitral tribunal has to “[f]orm an opinion on a point related to Shariah principles; and [d]ecide on a dispute arising from the Shariah aspect of any agreement which is based on Shariah principles”, the tribunal must refer the matter to one of the two Shariah Advisory Councils in Malaysia. If the issue is beyond the purview of the councils, the parties may agree on an alternative Shariah council or expert to which the issue will be referred. Purview of the Shariah Advisory Councils, puts simply, refers to those matters falling within the scope or jurisdiction of the Advisory Councils under the relevant legislation establishing the Advisory Councils.

The new edition of the Rules, due to be launched in October 2013, seeks to remove any ties to a specific jurisdiction and create a tool suitable to parties of any nationality equally. There

is no reference to a specific Shariah council or expert; rather, the appropriate council or expert will be determined according to the characteristics of the transaction.

A transaction regulated by Malaysian legislation, for example, will fall under the purview of the relevant Shariah Advisory Council, and will necessitate a referral to that authority. A transaction with the Bahrain Islamic Bank, conversely, may come under that bank’s own Shariah board. In this way the Rules are capable of handling any Shariah issues that may arise in any transaction, irrespective of the appropriate Shariah authority.

“ KLRCA has leveraged Malaysia’s expertise and status as a global Islamic finance hub to provide a truly commercial avenue of dispute resolution taking advantage of all the benefits offered by international commercial arbitration ”

Upon referral to the relevant advisory council or expert, the tribunal will adjourn the arbitration proceedings until a ruling has been given. In the meantime, proceedings will continue regarding areas of the dispute independent of the Shariah issues referred. The relevant advisory council or expert will deliver the ruling within 30 days from the date of the reference and the tribunal must then apply it within 15 days (These timelines have been reviewed for the new edition of the i-Arbitration Rules). The costs of the reference incurred by the tribunal form part of the “arbitration costs” as defined under the Rules.

Through the i-Arbitration Rules, the KLRCA has leveraged Malaysia’s expertise and status as a global Islamic finance hub to provide a truly commercial avenue of dispute resolution taking advantage of all the benefits offered by international commercial arbitration, providing access to industry and commercial expertise, a wide panel of international arbitrators and the most up to date processes and standards of international commercial dispute resolution. By utilizing the i-Arbitration Rules, parties can be confident in exploring Islamic finance opportunities across the globe with the certainty and support of a strong legal regime. (2)



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Impact of the new Malaysian IFSA 2013 regulation on Takaful and reTakaful operators

The new Malaysian IFSA (Islamic Financial Services Act) came into force on the 30th June 2013. Its main objectives are to promote financial stability and compliance to Shariah and further strengthen the regulation of Islamic financial institutions. By this, the new Act aims to strengthen consumer protection and further increase the confidence of the public in Takaful.

At the same time, it remains to be seen if the IFSA will also encourage Takaful operators to take their social and religious responsibility more into consideration, which is fundamental behind the concept of Takaful.

The following discusses the key changes of the IFSA and highlights the impact of the new Act on Takaful and reTakaful operators:

Single licensed Takaful business

The Act requires a Takaful operator (other than a professional reTakaful operator) with a composite license to separate its Family business from its General Takaful business. The firm is given a grace period of five years to split its business into separate entities.

The intention of the regulator is to expand the growth of General Takaful business. Most of the composite Takaful operators are currently focusing their activities on Family Takaful and the growth on the General side is lagging behind.

As a result of this, several existing composite operators may consider giving up their General license and new players will enter the market. Will this really lead to an increased growth on the General side? Takaful operators currently write little commercial and industrial risks, and it is expected that some of the new players may focus on such business.

However, question remains if such risks are really suited for the principle of risk-sharing under Takaful given their inherent volatile nature. Will Takaful and reTakaful operators find a way to write such business in a sustainable manner?

Another challenge for the new separated entities is to find the necessary personnel given the fact that there is only a limited number of people who are experienced in Takaful in the industry.

Establishment as public company

The IFSA requires Takaful operators to be established as public companies. However, given the nature of mutual assistance in Takaful, it will be more appropriate for the firm to be set up as co-operatives or mutuals. By being a public company, Takaful firms will become a wholly commercial venture. Whilst this is not prohibited under Shariah, it will be better if the Takaful companies have also the option to set themselves up as co-operatives or mutuals.

Shariah governance

The new Act emphasizes on Shariah governance and henceforth, it is much more comprehensive in this respect compared to previous regulation. It gives Bank Negara Malaysia (BNM) and the national Shariah Council (SAC) certain power in case of non-compliance by the companies. BNM also has the possibility to specify standards based on Shariah.

“With the requirement of a compulsory Qard, Takaful becomes a risk transfer mechanism between participants and operators just like conventional insurance”

It is laudable that the regulator has incorporated stricter Shariah requirements as they are the foundation of Takaful. At the same time, these requirements will add more strain on Takaful and reTakaful operators.

All the efforts in ensuring Shariah compliance increase the firm's operational costs. Therefore, in principle, Takaful and reTakaful firms should be able to charge higher prices than their conventional counterparts. However, in reality this is often not possible, and by this, it makes it more difficult for the firms to achieve the same returns as conventional insurers.

New prudential requirements

The IFSA has also implemented additional prudential requirements on Takaful operators with regards to maintenance of various funds, assets and risk management among others.

It also makes the provision of a Qard (interest-free loan) compulsory in case of a deficit in the risk fund. This is important to Takaful and reTakaful operators because it has an effect on their reserves requirements. In principle, Takaful is meant to be a program of mutual assistance between participants. With the requirement of a compulsory Qard, Takaful becomes a risk transfer mechanism between participants and operators just like conventional insurance.

Expanded power in supervision

The role, function and power of BNM have been expanded under the new Act. BNM now has the power to issue directions to institutions. It can carry out intervention and remedial actions

to avert or reduce any risk to the country's financial stability. However, is BNM ready to take on this additional role and will there be sufficient checks and balances in place?

Consumer protection

One main goal of the IFSA is to provide greater certainty and build public confidence in the system. With the new Act, there is now more emphasis on ethical business conduct and consumer protection. There is also a plan to set up a financial ombudsman scheme to ensure fair and effective handling of complaints and resolution of disputes.

Conclusion

As it can be seen from the key changes above, the new IFSA has a significant impact on Takaful and reTakaful operators in Malaysia. These will lead to considerable changes in the industry. It will also set a new benchmark for Takaful regulations in other countries.

Majority of the industry practitioners seem to embrace the new Act as they believe that it will help the Takaful sector to expand. Nevertheless, there are still many open questions concerning the actual implementation of the IFSA as many regulations are yet to be finalized.

For reTakaful companies, the changes are of concern as they tend to have a small operation and will find it difficult to fulfill all requirements of the new Act.

It will be interesting to see how the regulator is considering the feedback from market players and together with the industry, make the transition as smooth as possible for Takaful and reTakaful companies.

With these changes, will consumers also conclude that Takaful is to a big extent akin to conventional insurance, and in this case, will they still be enticed to buy Takaful if it becomes more similar to conventional insurance?

It is also yet to be seen if the IFSA will encourage Takaful operators to continue and take on more social and religious responsibilities despite the higher operating costs due to the new regulation. Will they promote the idea of social welfare of Islam more for example by providing cover for lower income groups which are currently underserved by the Takaful and insurance industry? The (re)Takaful industry will need to look at the full breadth of these changes and decide what will work best for them going forward, and towards the sustainable growth of the (re)Takaful industry in Malaysia. ☺

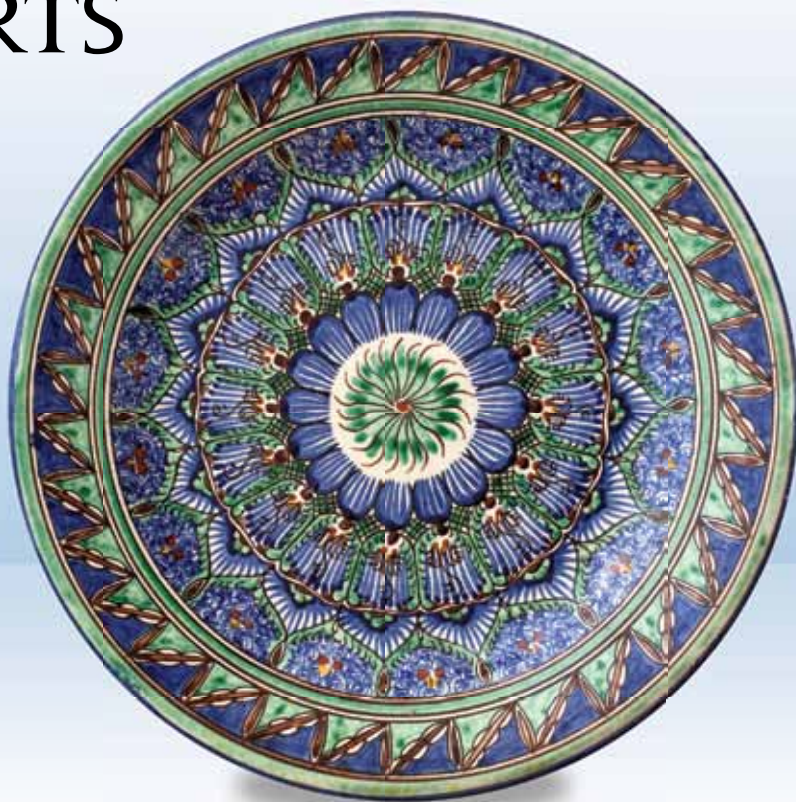
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