

Borrowed Ideas: Malaysia Transforms Rules For Finance Under Islam — In a Lesson to Arabs, Asian Bankers Mix Religion, Modernity

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KUALA LUMPUR, Malaysia -- Six years ago, a Malaysian bank asked 80 financial institutions in the Persian Gulf for help in selling a corporate bond that complied with Islamic prohibitions on interest.

All but one declined to participate, branding the novel security "haram," or banned by Islam. Just a few months after the \$150 million offering proved a success, however, many of these doubters shelved their theological qualms and came up with similar Islamic bonds of their own.

The global Islamic bond market that has developed since then is now worth an estimated \$50 billion in securities outstanding, part of a burgeoning Islamic financial industry that's fast approaching \$1 trillion in assets. The torrents of cash that fuel this boom mostly come from the Persian Gulf's oil bonanza. But it is distant Malaysia, thousands of miles to the east, that has emerged as the industry's unlikely trailblazer.

"Malaysia is the catalyst for change," says Faiz Azmi, Kuala Lumpur-based global head of Islamic finance at PricewaterhouseCoopers, the accounting and consulting firm. Much of what is now considered conventional in the industry, he explains, was test-driven here first -- often against the objections of conservative clerics in places like Saudi Arabia. Now such innovations are not just commonplace in the Gulf, but also have become an important revenue source for Western financial giants with Islamic-banking divisions, such as Citigroup Inc. and HSBC Holdings PLC.

Malaysia's impact on the financial industry showcases a shift in the Muslim world's balance of power. For centuries, religious and cultural knowledge streamed from the Middle Eastern core to the Muslim periphery, as converted peoples in South and Southeast Asia adopted the Arabic script, traditions and mores.

But now, increasingly sophisticated Muslim communities in fast-growing Asian countries such as Malaysia are beginning to influence the Arab heartland, offering a vivid example that an embrace of the global economy can coexist with Islam.

Malaysia's cosmopolitan capital of Kuala Lumpur, a metropolis of glittering skyscrapers connected by futuristic monorail trains, is teeming these days with Arab tourists who gawk at the Petronas Towers, until recently the world's tallest buildings. (They were eclipsed by the Taipei 101 tower in Taiwan.) Unlike oil-rich Gulf monarchies that rely on guest labor, Malaysia derives its prosperity from an educated work force and cutting-edge

manufacturing. Electric and electronic goods such as mobile phones, semiconductors and computer parts account for about half of its exports.

Peaceful Malaysia, so far spared the terrorist attacks that have rocked neighboring Indonesia, Thailand and the Philippines, also boasts a relatively liberal political system. The latest ranking of political rights and civil liberties by Freedom House, a New York think tank, puts it ahead of all Arab nations. At home and abroad, Malaysia's prime minister, Abdullah Ahmad Badawi, promotes his vision of "Islam Hadhari," or civilizational Islam -- stressing economic development, mastery of sciences, and respect for diversity as core values of the faith.

Reconciling modern finance with Islam is a key part of that vision. "Islamic finance is not just for the benefit of the Muslims," Prime Minister Abdullah told a conference of Islamic bankers in Kuala Lumpur last month. "Its significance is far wider, and needs to be seen in the context of global peace and prosperity."

The barrier that Islamic financial modernizers are trying to overcome is the Quranic prohibition on receiving or paying interest: "Allah permitted trading and forbade interest." While ignored by many secular Muslims and the conventional banks that operate in most Muslim nations today, this ban has long denied the benefits of modern banking to strict believers -- contributing, some say, to the Muslim world's relative decline after interest-based bonds and loans powered the West's Industrial Revolution. In Malaysia, Muslim distrust of conventional finance has also helped cement the historic domination of the country's economy by non-Muslim ethnic Chinese.

As Malaysia's government sought to lift the Malay majority out of poverty and promote native entrepreneurship, it focused on creating an Islamic financial alternative. Initial ideas came from Muslim revivalists in places like Egypt or Pakistan, who began Islamic banking experiments in the 1960s, often meeting opposition from secularist regimes. Malaysia's government, by contrast, encouraged banks to replace interest-based transactions with arrangements that, while benchmarked to interest rates, are technically based on profit-sharing, leasing or trading -- all activities permissible in Islam because they involve entrepreneurial work rather than simply moneylending.

The first step, in 1983, was to pass an Islamic banking law and set up Bank Islam, which gave out the nation's first Islamic loans. An Islamic insurance company, Takaful Malaysia, was created the following year, and the country's religious scholars issued a fatwa to spur stock-market investment -- more than a decade before Saudi clerics followed suit.

In the 1990s, as Malaysia's conventional banks were encouraged to open "Islamic windows," the industry became a testing ground for big Western lenders. HSBC began Islamic banking in Malaysia in 1994, years before establishing its international Islamic franchise. Malaysia also introduced the first sukuk, or Islamic bonds, years before Middle Eastern clerics accepted the practice.

Though rival Islamic banking and capital-markets centers have since sprung up in Dubai, Bahrain and London, Malaysia still accounts for two-thirds of the world's Islamic bond issuance. The country has achieved "the closest possible replication of conventional finance while giving it an Islamic label," says Mahmoud El-Gamal, Egyptian-born chair of Islamic finance and economics at Rice University in Texas.

Some 80% of shares traded on Bursa Malaysia, the country's stock exchange, are designated as compliant with Islam, while 12 Islamic banks and six Islamic units of conventional banks operate in Malaysia today, accounting for about 12% of total banking assets. The government expects the Islamic sector's share to reach 20% of assets by 2010.

One beneficiary is Azrulhakim Suradi, the 31-year-old owner of a herbal-medicine business in the town of Shah Alam outside Kuala Lumpur. Mr. Azrulhakim, who sports a shaggy beard and whose wife is shrouded in a black abaya, is a fervent Muslim believer and considers paying or receiving interest a grave sin.

Thanks to the availability of Islamic finance, Mr. Azrulhakim became the first in his family to accept a bank loan. He has borrowed \$43,000 from one Islamic bank to buy his dream car, a Mercedes-Benz C 200. He owes another Islamic bank \$27,000 on a mortgage, and has just arranged financing for a second home. "I can sleep well at night," Mr. Azrulhakim beams, "because I can be sure that everything my bank is doing conforms with the way of Islam."

Not every Muslim scholar would agree. One of the biggest issues in the industry is what exactly can be called Islamic. In the Middle East, the final answer usually lies with advisers on Shariah, or Islamic law, that every Islamic bank keeps on payroll. A few of the most senior clerics counsel dozens of institutions, and they often compete against each other in theological purity. By contrast, Malaysia is promoting its vision through a centralized religious regulator, the Shariah Advisory Council of the central bank, Bank Negara.

Last year, this clerical body -- which must approve all Islamic financial products -- bestowed its blessing on Islamic real-estate investment trusts, structured dual-currency derivatives, Islamic stock index funds and Shariah-compliant single-stock futures.

More innovation is in the pipeline. "The nomenclature may be suspicious -- hedge funds, derivatives -- and sounds very Western, but we have to make these products Islamic," says the Shariah Advisory Council's chairman, Mohamad Daud Bakar, 43, who wears a dark suit and a tie and holds a doctorate from the University of St. Andrews in Scotland. "We need to be able to protect from risk."

Dr. Daud is unapologetic about the fact that many recent Islamic financial products, while technically based on lease or trade contracts, have become virtually indistinguishable from those offered by interest-driven Western finance.

"It's all about the journey you take to that destination," he says, drawing a parallel between financial gain and sex. A seeker of sexual pleasure, he explains, can get married or fornicate on the side -- just as a seeker of financial gain can profit from an Islamic sukuk or a conventional bond. "You'll have enjoyment in both cases," Dr. Daud chuckles, "but one is halal [permissible] and the other is not."

Malaysia's comparatively liberal approach, as championed by Dr. Daud's council, has often earned the country criticism from Islamic clerics in the Middle East and Pakistan. Dr. Daud, who also studied in Kuwait and speaks fluent Arabic, says he frequently engages in "heated" discussions with Arab scholars when traveling to the Gulf.

This continuing doctrinal discord means that most sukuk denominated in Malaysia's currency, the ringgit, are still considered unacceptable in the Middle East, as are some lending practices widely used by Malaysian banks. The Arabs "are treating us as small brothers," complains Mohamad Bakir Mansor, a Malaysian scholar of Islamic finance who advises Bank Islam and Takaful Malaysia on Shariah. "They consider themselves senior and have an attitude."

Aware of this attitude, Malaysian banks in recent years have concentrated on crafting new structures based on leasing contracts, known as ijara, for global dollar-denominated sukuk marketed to Arab investors. The issuer of ijara sukuk places certain assets, such as a palm plantation or a building, in a special-purpose vehicle. In exchange for their cash, investors receive the right to the lease payments that the issuer makes to the special-purpose vehicle. The lease payments are usually set in advance and benchmarked to interest rates, making the investors' return comparable to interest from a bond.

The ijara principle was pioneered in corporate bonds in 2001, when Malaysian plantation company Kumpulan Guthrie issued the \$150 million sukuk that were so controversial at the time. These days, almost identical ijara sukuk are commonplace in the Gulf. "If we persevere in educating the markets, eventually the markets will understand," says Badlisyah Abdul Ghani, the chief executive of CIMB Islamic Bank, one of Malaysia's largest. Mr. Badlisyah helped arrange the pathbreaking bond as an investment banker at Bank Islam.

Eager to educate oil-rich Gulf investors about such financial novelties, Malaysia's central bank, Bank Negara, is spending \$57 million to invite Islamic scholars from around the world to Kuala Lumpur for a "Shariah dialogue" program. "To be an international financial center, you must allow a diversity of interpretations," says Bank Negara Deputy Governor Razif Abdul Kadir. "This is our strength."

As part of its drive for diversity, Bank Negara has also issued Malaysian banking licenses to three Islamic banks from the Gulf, including Saudi Arabia's Al Rajhi, which labels itself as the world's largest Islamic financial institution. For Al Rajhi, this was the first venture overseas -- and the Saudi giant spared no effort as it rolled out a Malaysian network of 12 glass-and-marble branches, with 38 more on the way. Plastering Kuala

Lumpur with blue advertising billboards, Al Rajhi stressed its pristine Islamic credentials and promised to deliver the Saudis'"Just Values" to faithful Malaysians.

Since beginning operations here last October, however, Al Rajhi has had to adapt to Malaysian reality. "In Saudi Arabia, those religiously inclined would keep their funds with Al Rajhi and expect nothing in return," says Al Rajhi Bank Malaysia's chief executive, Ahmed Rehman, a Pakistani citizen who came to Kuala Lumpur after a career with Britain's Standard Chartered Bank in Dubai.

Customers in Al Rajhi's Saudi operation have stashed some \$18 billion in no-return checking accounts; because of concerns about illicit interest, savings accounts do not exist there, says Mr. Rehman. In Malaysia, this was clearly a nonstarter, he realized. "At the end of the day you have to have deposits, which means you have to come up with the products...and give an element of return," he says.

After much soul-searching, Al Rajhi decided to introduce a Malaysian savings account of its own. As the bank's local Shariah board -- composed of two Saudi clerics dispatched from headquarters and two Malaysians -- discussed the product, theological complications arose. Technically, the return on savings accounts in Malaysia's Islamic banks comes from a profit-sharing contract with the bank. That, however, could cause big fluctuations if the bank posts a loss or higher-than-expected profits. Mitigating the risk for account-holders, the Malaysian banks use a special profit reserve that allows them to keep these payouts relatively steady and similar to conventional interest rates.

Though Mr. Rehman and Al Rajhi's Shariah experts entertained grave reservations about such arrangements, they went ahead nevertheless, citing the need to comply with Malaysian regulations. Customers flocked in response, and the bank now boasts some 8,000 Malaysian accounts. The savings account, as plasma-screen displays advertise in Al Rajhi's branches, was last offering a "profit" of an annualized 3.1% on one-month deposits, in line with interest rates in the industry.

Now, Al Rajhi is thinking of bringing such savings accounts, and other financial novelties it's testing in Malaysia, to consumers back home in the Saudi kingdom, Mr. Rehman says. "In terms of products, the market is much more sophisticated here than in the Middle East," he says. "Here, you have to work for your money. And it brings out innovation."

Bonds for Muslims?

How conventional fixed-rate bonds differ from fixed-rate, leasing-contract Islamic bonds known as ijara sukuk:

Conventional bond:

-- A company needs to raise \$100 million.

-- It borrows the money by selling investors a 10-year bond that pays a 6% coupon every year.

-- Result: Bondholders receive \$6 million in annual interest payments during the life of the bond, and \$100 million is returned to them at maturity.

Ijara sukuk:

-- A company needs to raise \$100 million.

-- It transfers assets, such as buildings, mines or plantations, to a special-purpose vehicle.

-- It signs a 10-year lease agreement with that vehicle, promising lease payments of \$6 million a year for these properties.

-- Sukuk investors purchase the right to the vehicle's assets, which the company pledges to buy back for \$100 million in 10 years, and to the lease payments.

-- Result: Sukuk holders receive \$6 million in annual lease payments during the life of the sukuk, and \$100 million is returned to them at maturity.

Source: WSJ research