Malaysia's Importance to the *Sukuk* Market: March 2007 Report

By Abdulkader Thomas

Introduction: In closing 2007, the *sukuk* markets closed the year as the opened with another record setting issuance by a Dubai issuer – Nakheel's $3.52 billion *sukuk al ijara*. As a result of the strong finish, 2006 issuances were 2.36 times greater than the 2005 new issuance volume. And, the gross market size doubled from $25.9 billion to $52.6. billion. Assuming that the Arabian Gulf region is not subjected to any new conflicts, one may expect that the *sukuk* market will enjoy another record year in 2007.

The Nakheel transaction is a tribute, albeit unintentionally to the role played by Malaysia in pioneering the *sukuk* market. Albeit an adaptation of the *ijara* concept, Nakheel harkens back to the landmark Guthrie and Malaysian sovereign issues of 2002, both of which applied the basic *ijara* contract as the underlying Islamic means to achieve a profit. The application of the forward lease is an innovation developed elsewhere, but made possible in the *sukuk* space thanks to Malaysia's progressive steps to define the broad *sukuk* space, and grow it with new concepts. In this report, we will examine the important regulatory and legislative philosophies and steps that have caused Malaysia to achieve its importance in the definition of the Islamic capital market.

Prior to focusing on Malaysia, AJIF reports on the main trends in the market which are largely unchanged from the prior quarter:

1. The awakening of more GCC underwriters and issuers to the *sukuk* opportunity, and with this awakening, the fact that the GCC may now overtake Malaysia in terms of issuance volume during the coming years.
2. Continuing market experimentation in the absence of both firm regulation in some markets and the specific adoption of AAOIFI and IFSB standards by underwriters and issuers.

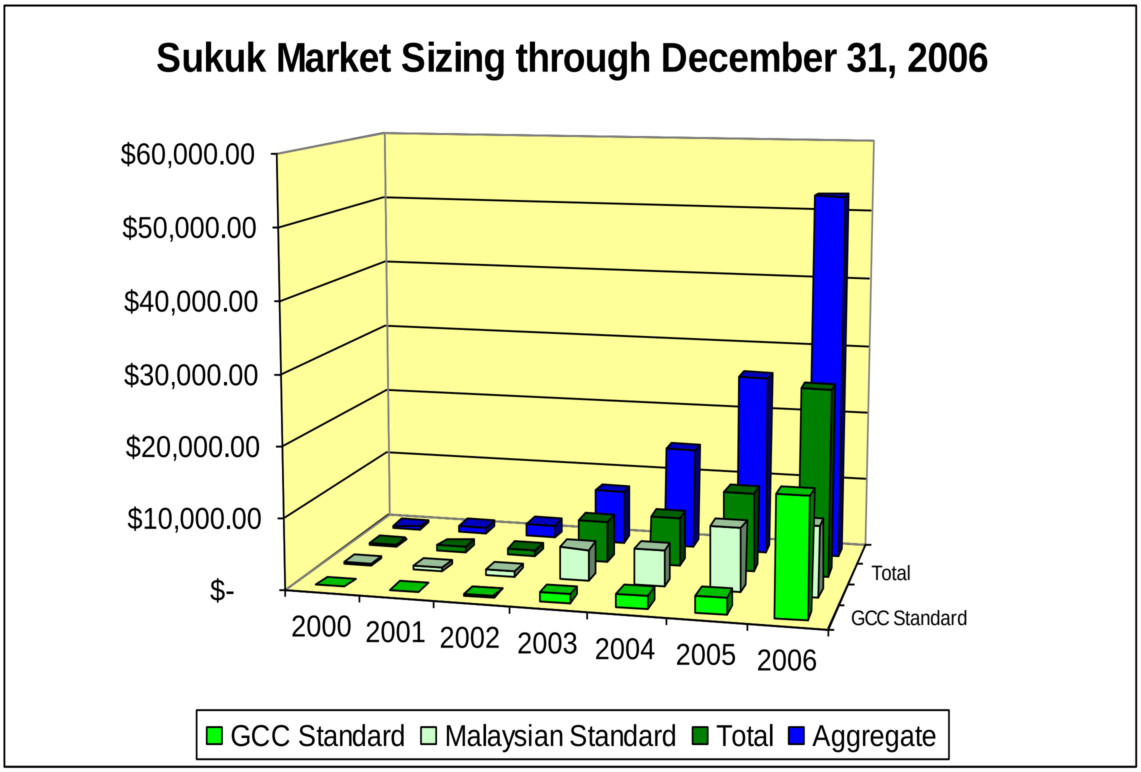
Sukuk Markets as of December 31, 2006

	2000	2001	2002	2003	2004	2005	2006
GCC Standard	$ -	$ 100.00	$ 200.00	$1,180.00	$ 1,893.08	$ 2,305.79	$14,787.41
Malaysian Standard	$ 336.30	$ 530.00	$ 719.40	$4,576.50	$ 5,054.30	$ 9,002.65	$11,910.51
Total	$ 336.30	$ 630.00	$ 919.40	$5,756.50	$ 6,947.38	$11,308.44	$26,697.92
Aggregate	$ 336.30	$ 966.30	$1,885.70	$7,642.20	$14,589.58	$25,898.02	$52,595.94
Aggregate GCC	$ -	$ 100.00	$ 300.00	$1,480.00	$ 3,373.08	$ 5,678.87	$20,466.28
Aggregate MS	$ 336.30	$ 866.30	$1,585.70	$6,162.20	$11,216.50	$20,219.15	$32,129.66

disaggregated from Islamic Finance Information Service at www.securities.com

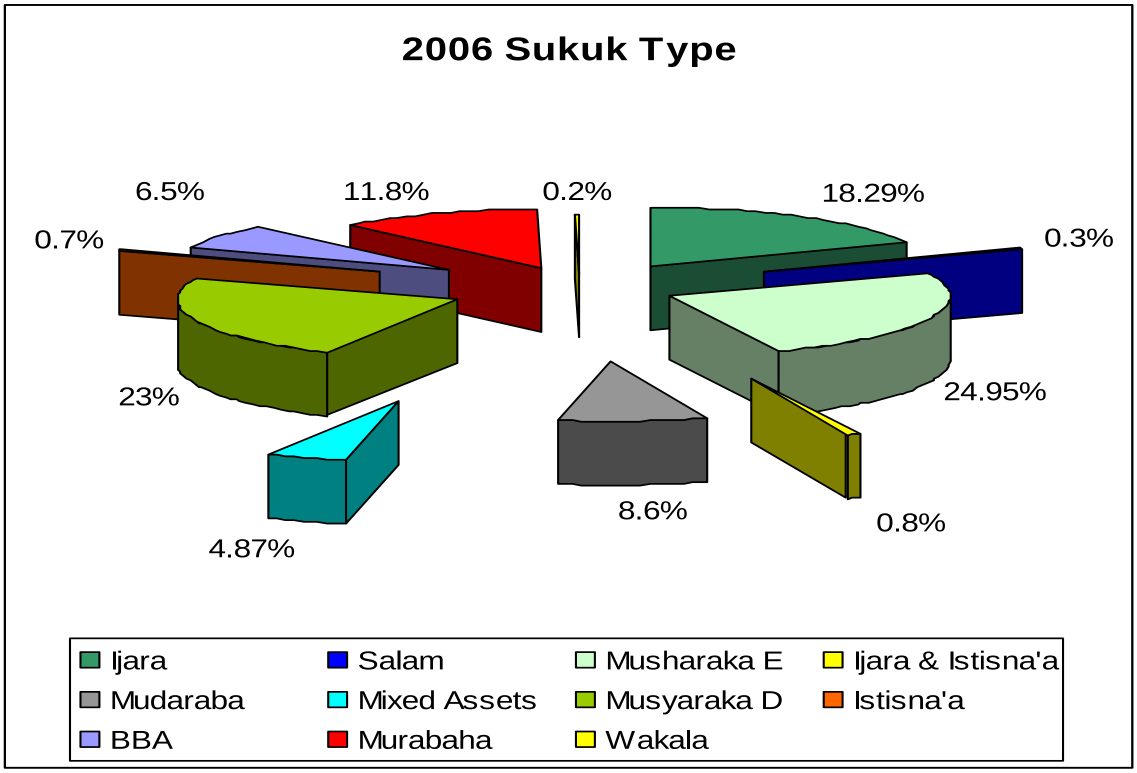
How Much and Where: In the end, the mega Nakheel deal put the GCC ahead of Malaysian standard instruments instead of the two forms achieving parity. Please note that we indicate standards due to prevailing trends in the GCC in Malaysia and the discomfort with some Malaysian instruments by many in the GCC. These points of difference will be discussed below.

Malaysia will maintain a steady pace of production in 2007 because the engine is in place and well oiled: rules, regulations, underwriters and market makers are defined, tested, and capable of meeting new demand with ease. The UAE, less well oiled, is also promising a strong 2007. But, following the establishment of new rules and clear regulation, Qatar and Bahrain should provide strong competition to Dubai for new issuances. The important markets that require specific regulatory adaptation for *sukuk* are Saudi Arabia and Kuwait. As *sukuk* friendly regulation takes root in the GCC, it is sure to expand in the other Arabian countries, just as Malaysia is influencing these countries as well as the ASEAN region.



This data is dis-aggregated from Islamic Finance Information Service at www.securities.com and is based on the author's best efforts to clearly segregate concept origin. Future reports will show issuances from 2006 onwards. AJIF looks at the data in the above bar chart. The front row in bright green represents new GCC issuances for the period; the light green second row represents the new Malaysian issuances; and the third row, in dark green is the total GCC and Malaysian new issuances for the period. The back row in blue is gross production of *sukuk* since the advent of the current *sukuk* market. The only element that the available data does not facilitate tracking is the retirement or redemption of issues. There is also limited public data on defaults or failures of *sukuk* issuances. Although no GCC issues are known to have failed, some Malaysian issues are rumored to have defaulted or otherwise struggled.

Perhaps the single most significant fact that is not captured in current data sets is the assertion that up to forty percent of the GCC issuances are sold to non-Islamic investors in Europe; and a similar percent is sold from Malaysia to North Asian institutional investors. In both cases, Islamic banks are not necessarily the main investors in any specific *sukuk* issuance. As we have noted in our prior reports, Basle II compliance should drive a greater role for Islamic banks as buyers and issuers of *sukuk*.



Experimentation with form: The fourth quarter of 2006 showed no end to experimentation in the *sukuk* markets. But, the mega Nakheel *ijara* deal and the continued application, directly and indirectly of the *bai al dayn* and BBA securities in Malaysia have maintained the basic market balance as seen in the third quarter. below, the elements on the left are predominately Malaysian Standard, and the elements on the right are predominately GCC Standard.

Although there is an apparent decline in Malaysian style BBA or *bai bi thamin al ajil* bonds from 6.5% at year end, up from 4.63% as of the quarter ending September 30, 2006. *Musyaraka D* bonds 23% were down from 28.17% of the third quarter figures. *Murabaha* bonds 11.8% down from 15.6%. The proportion of debt sales based securities has decreased by the end of the year, but this is a fact that is influenced by Nakheel.

At the end of the third quarter, *ijara sukuk* were only 7.5% of gross issuances: Thanks mostly to Nakheel, *ijara* issuances were up to 18.29% for the 2007 issuances.

Musharaka E bonds, a collection of experimental forms being tested in the GCC, dropped from 35.22% as of the end of 3Q06 to 24.95% of the total issuances in 2007. This method will be subjected to more innovative concept testing, and should continue to form an important part of the market. Curiously, there may be more attempts to solve the same problems with *mudaraba* and *wakala sukuk*. Watch this space in 2007.

***Sukuk* and the Malaysian Approach**[1]: Since the start in the early 1980's, Malaysia has constructed a detailed plan to take Islamic banking from an idea to a full fledged parallel system by 2020. The Islamic Banking Act of 1983 was based on an acknowledgement of the aspirations of Muslims to have *riba*-free banking and investment services as well as the government's goal of establishing a modern financial system in every aspect to Malaysia's socio-economic goals for the 21st century economy. On a continuous basis, the Malaysian government has been revising and adapting its Interest Free Banking Scheme and securities programs to meet market and economic changes. The progressive changes included three main primary pillars which were brought into place progressively during the early 1990's: Islamic Inter-Bank Money Market ("IIMM"), Mudaraba Inter-Bank Investment ("MII"), and Islamic Inter-Bank Checque Clearing System ("IICCS")[2]. The most recent developments and the establishment of the Malaysian International Islamic Financial Centre ("MIFC").

MIFC changes to existing regulations and procedures were announced in August 2006 and these break down prior onshore/offshore distinctions; allows greater mobility of capital. The reforms include Bank Negara allowing the operation of foreign currency business through establishment of an international currency unit / business). In addition, the Securities Commission and Bank Negara have introduced frameworks to allow the issuance on non-Ringgit *sukuk* in Malaysia with an incentive exempting foreign investors from withholding tax). The MIFC reforms must be seen in tandem with the endeavor of Malaysia to build its Islamic finance educational infrastructure in the Bank Negara funded International Center for Education in Islamic Finance ("INCEIF") program.

In the Malaysian approach, the Malaysian scholars have applied the concept of *bai al-dayn* or the *sale of debts*. The formal definition is:

> "…the sale of debt as a type of contract in which the creditor sells his payable right upon the debtor either to the debtor either to the debtor… or to a third party. This sale [sic] contract between two parties may be either on the spot or forward basis. It may also be either at a discount price or at the cost price."[3]

Although controversial elsewhere, this approach has allowed the stepped transition to Islamic principles from traditional banking. In the first step, the move is from a *renting of money* or *sale of credit*, to the *sale of a non-monetary asset* as a means to create credit. For inclusion in the Islamic debt scheme, the underlying debts must arise from a permissible Islamic contract of sale, which could be *murabaha* or *istisna'a*. The sale of debt allows the issuance of an Islamic promissory note affirming the payment obligation under the original sale, and itself a negotiable or tradable instrument. As of this writing,

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[1] This section draws, partially, upon material previously published in Adam, Nathif and Abdulkader Thomas, Islamic Bonds (London: Euromoney, 2004). The content is significantly changed and updated, reflecting the latest developments in the market.

[2] In addition to Bank Negara Malaysia materials which are available, a helpful summary of the Malaysian Islamic markets scheme may be found at www.islamic-world.net/islamic-state/malay_islamoneymakret.htm.

[3] Moustapha, Dr. Sano Koutoub, *The Sale of Debt: As Implemented by Islamic Financial Institutions in Malaysia* accessed on December 9, 2003 at www.drsan.net/papers/malaysia.htm.

the three tangible asset contracts of BBA (medium and long term sales debts), *Murabaha* Note Issuance Facilities (short term sales contracts structure for working capital), *Bai Al Inah* (sale and buy back between the same parties) and *Bai al Dayn* constitute 80% of Malaysian Islamic debt market according to Aseambankers.[4]

When one considers the Malaysian space, it is worth comparing the trading profiles of Malaysian instruments to the AAOIFI Investment Sukuk Standard:

Type	AAOIFI Feature	Tradable?
Murabaha[5]	*Sakk* represents assets purchased and intended for sale. Once the sale is made, the *sakk* represents a debt. In Malaysia, this is a short term debt security.	Such *sukuk* are only tradable under Malaysian rules.
Ijara	*Sakk* must lay title claim to asset. The claim may be direct or beneficial.	Such *sukuk* are universally tradable.
Musharaka	*Sakk* must lay title claim to asset, but this may include participation in business ownership or operations. Frequently an "undertaking" is added to make a *musharaka* operation more debt like.	Depending upon the underlying asset, these *sukuk* are tradable. In Malaysia, the underlying asset may be a permissible debt form like a *murabaha* receivable.
Mudaraba	*Sakk* must lay title claim to asset, but this may include participation in business ownership or operations. Frequently an "undertaking" is added to make a *musharaka* operation more debt like.	Depending upon the underlying asset, these *sukuk* are tradable. In Malaysia, the underlying asset may be a permissible debt form like a *murabaha* receivable.
Declining Balance Partnership	*Sakk* must lay title claim to asset, but this may include participation in business ownership or operations. In this *musharaka* operation one partner promises to buy out the other.	Depending upon the underlying asset, these *sukuk* are tradable. In Malaysia, the underlying asset may be a permissible debt form like a *murabaha* receivable.
Wakala	In this operation, the *sukuk* holders appoint the beneficiary of funds as their agent to perform certain business operations.	Depending upon the underlying asset, these *sukuk* are tradable. In Malaysia, the underlying asset may be a permissible debt form like a *murabaha* receivable.
Istisna'a	*Sakk* must lay title claim to asset.	This operation is a hybrid between an asset (not yet completed) and a debt (the obligation to deliver the completed asset). Therefore, the accepted view is that trading is restricted. In Malaysia, these *sukuk* are freely tradable.
Bai Bithamin Al Ajil	*Sakk* represents assets purchased and intended for sale. Once the sale is made, the *sakk* represents a debt. In Malaysia, this is a long term debt security.	Such *sukuk* are only tradable under Malaysian rules.
Salam	*Sakk* represents a claim on an asset.	This operation is a hybrid between an asset (not yet existing) and a debt (the obligation to deliver the asset). Therefore, the accepted view is that trading is not permitted.

[4] Aseambankers, Malaysia – The Center of Islamic Product Innovation and Global Recognition in Malaysia – the International Islamic Financial Centre, Report 2006, Kuala Lumpur, Malaysia.

[5] Both *Murabaha* and *Bai Bithamin Al Ajil* operations in Malaysia may result from *bai al 'inah* (a sale of the same object between two parties and its repurchase at a different price by one of them), an both may result in a debt "*dayn*" that is traded under rules called *bai al dayn* rules.

Further milestones in 2006 include new products like regulated short selling with no *gharar*, redeemable preference shares on basis of *musharaka mutanaqisa*, and restrictive futures for stocks and palm oil. Perhaps each may prove controversial or subject to further debate among scholars and market participants outside of Malaysia. Yet, each demonstrates the capacity of Malaysian scholars and regulators to probe the frontiers of product development in order to solve the commercial challenges of their public with an answer framed by *Sharia'a*.

The importance of government intervention: tax incentives, required ratings and how these policies help issuers and underwriters to enter the market, improve client and underwriter confidence. One of the important sets of tax incentives in Malaysia is comprised of stamp duty waivers for Islamic securities, bonds and financings. These waivers put the Islamic "debt" sector on an equal footing with the traditional debt sector, and may even create a marginal advantage.

An additional regulation in Malaysia that is supportive of the growth and integrity of the market is that all new securities are issued with a rating from an approved rating agency. The independence of the rating agencies are meant to promote public confidence and to assist in defining the suitability of a security for investors. Even if rating agencies are not perfect, there is no doubt that they shift the public's reliance from assertions made by the underwriter to more provable, independent assessments. This appears to be playing out in Malaysia and helping to create a level playing field for issuers, investors and underwriters.

Let's summarize the Malaysian market space. A broad based coordination of government policies has resulted in a comprehensive public policy that supports growth and innovation in the Islamic financial market serving the Malaysian and international public. Within the investment and securities markets, there is a clear and separate universe of Securities Commission guidelines for Islamic instruments. These are supported and governed by the Securities Commission Shariah Advisory Council which was established in 1996. This Shariah Advisory Council works in parallel with the central bank's, Bank Negara Malaysia, Shariah Council.

The formalized outcome is the routinely updated series of master plan. For instance, since 2001, the country has a Capital Market Master Plan that has allowed expansion to Islamic asset backed securities and Islamic REITs (2005). The updated master plan has allowed a transformation of Islamic securities issuances. Prior to 2004, Islamic securities were issued under the rules relating to debentures (making BBA or long term Islamic debt certificates an easy fit). In July 2004, SC issued Islamic Securities Guidelines, which have created more opportunities for product innovation across Islamic contract and concept types.

There is nothing new in these recent developments. They are consistent with the pattern of benign market intervention that build on the Islamic Banking Act with the Takaful Act of 1984; the periodic amendments to the laws governing banking and financial institutions, such as the opening of Islamic windows in 1993 with amendments to the Banking and Financial Institutions of 1989; the formal regulation of appointed *Sharia'a* advisors; and the coordination of GAAP for *Sharia'a* instruments with Malaysian Accounting Standards Board.

So where has this dynamic regulatory environment gotten Malaysian Islamic Capital Markets? Since 2005 the majority of new Malaysian bond issues are Islamic. The size of the domestic *sukuk* outstanding is MYR 105.2 billion (approximately US$30 billion). This is 47.75% of total outstanding bond issues. New *sukuk* approved by SC were 71.41% of the bond market in 2005 and 55.41% in 2006. In other areas of the capital market, the 2006 *Sharia'a* compliant unit trust universe represented about 7.5% of unit trust industry and 86% of listed equities are deemed *Sharia'a* compliant (up from 2005) representing 64.26% of market capitalization.[6]

This capital markets element integrates well into the basic banking market. For instance, CAGAMAS secondary market for Islamic mortgages was established in March 1994. Although it has relied on the BBA and *bai al dayn* forms with recourse to originators, the process has allowed Malaysian banks to securitize Islamic mortgages. The universe of underlying Islamic mortgage assets were 21.6% of Islamic banking credit extended in the first half of 2006, and 12.3% of total mortgage lending as of 6/2006. The issuance of Islamic mortgage backed securities by CAGAMAS supports the Bank Negara goal of building total Islamic banking assets to 20% of total banking assets by 2010.

And, the benignly dynamic market intervention is not expected to end. In 2007, new tax incentives have expected in order to attract *Sharia'a* compliant managers to base themselves in Malaysia. Currency liberalization has been introduced to allow LOFSA based offshore operations to participate in on shore transactions. And, now international ratings agencies will be allowed to opine on the creditworthiness of domestic Malaysian transactions.[7] The 2007 next steps build on the already robust achievements of the past.

A final feature of the Malaysian approach should be understood as the increasingly holistic view taken by Malaysian regulators and legislators with respect to the Islamic finance industry. Not only have they accommodated inbound investment along with the relevant structures from the GCC, but the Malaysian regulatory framework plays well with others. An important element of this is witnessed in various bilateral agreements between Malaysia and their international peers including the Central Bank of Bahrain, the Dubai International Financial Centre, as well as pan Islamic bodies including the IFSB, AAOIFI and the Islamic Development Bank.

Conclusions: The *sukuk* markets finished 2006 strongly, to some degree mimicking the traditional bond market with its pressure to close deals before the end of the year. Hence, the landmark Nakheel deal closing in December 2006. Impressive growth should be

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[6] Quarterly Bulletin of the Malaysian Islamic Capital Market by the Securities Commission, March 2007, vol. 2, No. 1

[7] Quarterly Bulletin of the Malaysian Islamic Capital Market by the Securities Commission, November 2006, Vol. 1, No. 3.

expected as both the GCC becomes more active, and as Islamic banks become even more important investors in *sukuk*.

With gross issuances of US$52.6 billion through 2006 of which $20.4 billion complied with GCC standards and $32.1 billion met Malaysian standards, the volume of *sukuk* issuances is approximately equal to 10% of the gross assets of the Islamic banks. But, non-Islamic investors in Asia and Europe may represent up to 40% of the buyers according to diverse sources in the market. If true, then Islamic banks, already seeking to replace their short term *metals murabaha* placements with *sukuk* and truly negotiable instruments will become even more active buyers of *sukuk*. This will further sustain the market at current levels, if not higher.

Up until now, Malaysian regulators and ministries have developed a robust Islamic financial regulation framework that is meant to serve the broad public interest. These along with a centralized *Sharia'a* governance and research function have allowed the Malaysian Islamic securities market to be a leader. Now, new liberalizations in Malaysia are meant to create new opportunities, and enhance the leadership role already enjoyed by Malaysia. As noted by Nik Ramlah Mahmood of the Securities Commission at Euromoney's 2nd Annual Asian Islamic Banking and Finance Summit, the focus of the Malaysian regulators is now to shift from policy driven initiatives to market driven initiatives. The regulators' job is to fine tune the framework, and the global industry is now to drive the process of market evolution. The evidence, based on prior success, indicates that Malaysia will continue its leadership role, informing the global *sukuk* markets as to innovation and opportunities.

In our next report we will examine the challenge of *musharaka* and declining balance partnership *sukuk*, equity or not?

Appendix: Web Resources for the Malaysian Market

Bank Negara Malaysia (Malaysian Central Bank) at http://www.bnm.gov.my

Islamic Financial Services Board at http://www.ifsb.org/

Association of Islamic Banks in Malaysia at http://www.aibim.com.my

Securities Commission http://www.seccom.com.my/

Labuan Offshore Financial Services Authority http://www.lofsa.gov.my

Bursa Malaysia http://www.bursamalaysia.com

Malaysian Accounting Standards Board www.masb.org.my

International Centre for Education in Islamic Finance www.inceif.org