



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The Malaysian Islamic Financial Market Report

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PART A OVERVIEW

1. Objective

1.1 This report aims to highlight the current state of the Malaysian Islamic financial market, challenges, prevailing gaps and the way forward for further development and progress. The assessment is vital to validate and to ensure that the progress made thus far is in line with the overall progress of Islamic finance. Previously, development initiatives in this area have been concentrated on the following aspects:

- Infrastructure development
- Enhancing market competitiveness and liberalisation
- Internationalisation of Islamic finance and promotion of cross-border liquidity management

The assessments made in the report would act as a guide for the market and the authorities, indicating the areas that require further development as well as areas of opportunities.

2. The dual financial market system in Malaysia

2.1 Malaysia¹ has established a dual banking system which has become an integral part of the financial system. Malaysia's dual banking system, where the Islamic banking system operates in parallel to the conventional banking system, has continued to develop and evolve over time to a proven mature system it is today. The origins are traceable to the establishment of Lembaga Tabung Haji (Muslim Pilgrimage Fund Board) in 1967, an institution tasked with collecting deposits from pilgrims and provide Shariah compliant savings management and efficient hajj management. The development continues with incorporation of the first Islamic bank in the country, Bank Islam Malaysia Berhad (BIMB)² in 1983 and later the launching of Interest-free Banking Scheme (IFBS) in March 1993 which allowed the conventional banks to offer Islamic banking products and services³. Subsequently, the establishment of the Islamic Interbank Money Market (IIMM) ensued in 1994 as a platform to provide a ready source of short-term investment outlets based on Shariah principles where participants are able to match funding requirements effectively and efficiently⁴.

2.2 The journey continues today with the development of a comprehensive Islamic financial system comprising all the core components of banking, takaful, capital, money, foreign exchange (FX) and derivatives markets, together with a comprehensive legal and regulatory framework to support the expansion and soundness of the system³. This includes the strengthening of the regulatory and

¹ Together with several countries in the Organisation of Islamic Cooperation (OIC) community

² TH is the largest shareholder of BIMB (48.28%)

³ Source: BNM

⁴ Source: Islamic Interbank Money Market website

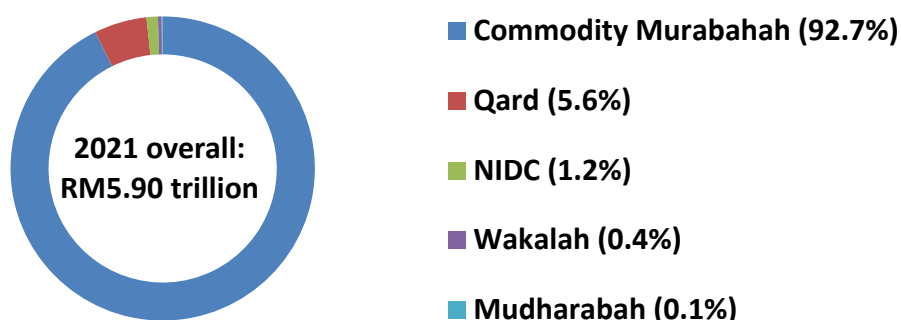
supervisory framework whilst achieving the best practice standards in corporate governance, risk management and financial transparency and disclosure.

- 2.3 The Malaysian Islamic financial market has served the Islamic financial system well that has served the development of the real economy. The Islamic financial system has thus now reinforced its position as a viable and effective means of intermediation which is pivotal to the nation's economic development, resulting in Malaysia as one of the leading Islamic financial centres in the world. However, there remains areas of development that can be addressed to better position Malaysia as a more developed and comprehensive Islamic financial centre.

3. Components of Islamic and conventional financial instruments

Money market

- 3.1 Both components of Islamic and conventional money markets have seen growth in trading volume amid continued effective liquidity intermediation in the financial market. Total trading volume has increased steadily over the years at RM15.5 trillion as of the end of 2021 comprising RM9.6 trillion in conventional money market and RM5.9 trillion in Islamic money market⁵. In comparison with the total Islamic banking asset which stood at 35.5%⁶ of total banking assets of entire banking system and 41%⁷ share of total financing by the Islamic banking system, the percentage of traded instruments in Islamic money market vis-à-vis conventional money market is comparable to the percentage of banking asset and total financing. Islamic money market volume accounted for 38% of the total turnover in the money market and there is still room for growth in the area. Commodity Murabahah has been the predominant instrument in the Islamic money market with a 92.7% composition followed by Qard Acceptance (5.6%), Negotiable Instrument of Deposits (NIDC, 1.2%) and others.



Bond market

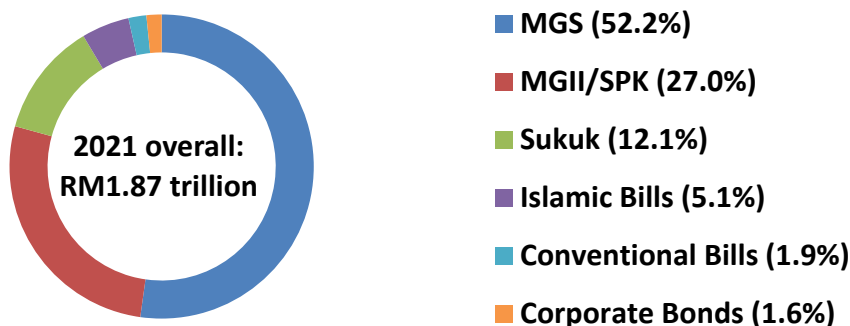
- 3.2 The overall bond market (including sukuk market) continued to grow with bond and sukuk outstanding growing at 8% in 2021 to RM1.7 trillion or 113% of GDP. Turnover of debt securities and sukuk remained robust at RM1.87 trillion as of end-2021 with average daily secondary bond trading volume of RM3.8 billion. Malaysian government bonds, which are MGS and MGII (including SPK) dominated the secondary trading volume in 2021 and accounted for 79% of total volume. This is followed by corporate sukuk, which accounted for 12% of the total

⁵ Source: 2021 League Table, Bond Info Hub

⁶ Source: BNM Financial Stability Review 2021

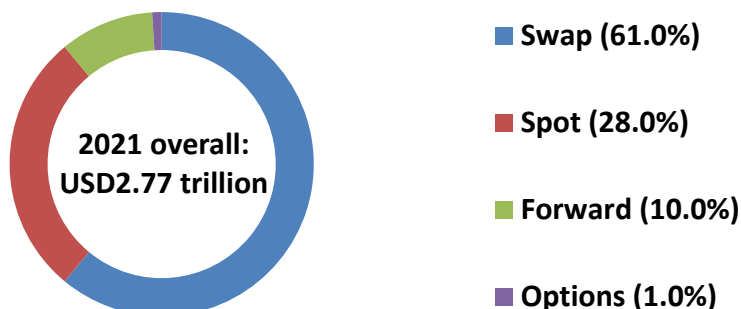
⁷ Source: BNM Financial Sector Blueprint 2022-2026

trading volume. Overall, the breakdown of bond market turnover in 2021 comprised 56% of conventional bonds against 44% of sukuk (MGII/SPK, sukuk and Islamic bills). To-date, Malaysia remains as the biggest global sukuk market with a share of 52% of total sukuk outstanding and 42% share of global sukuk issuances as of end 2021⁸.



Foreign exchange market

3.3 The onshore foreign exchange (FX) market continued to record healthy average daily trading volume of \$11.3 billion in 2021 with a total turnover for the year amounted to \$2.77 trillion⁹. The biggest components of the trades came from swap (61%) followed by spot (28%) and forward (10%). Islamic components only contributed a small fraction of the total FCY trades in the form of spot, swap and forward. At this juncture, only a limited number of Islamic players involved in the FX trades with interbank players and corporate entities.

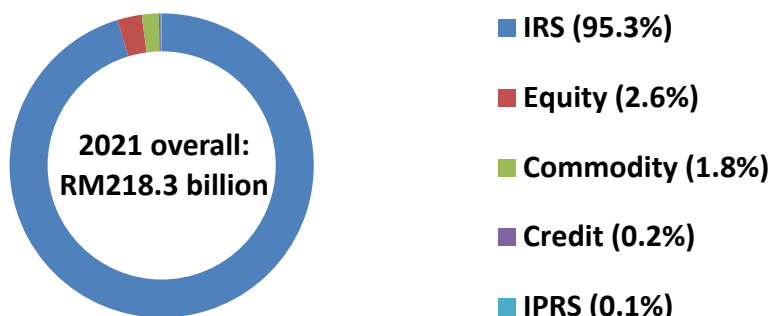


Derivatives market

3.4 The derivatives market is regarded as one of the smallest components in the Malaysian financial market with total turnover of RM218.3 billion in 2021, which is dominated by conventional instruments. A mere fraction of 0.1% consisting Islamic instrument (Islamic profit rate swap) while the rest went to conventional instruments with interest rate swap (IRS) being dominant, contributing 95.3% of the total derivatives volume in 2021⁹. There is a lot of room for development in the derivatives market in Malaysia, especially in Islamic derivatives which requires effort by the industry to develop the market further.

⁸ Source: MIFC

⁹ Source: 2021 League Table, Bond Info Hub
Issued on: 13 April 2023



- 3.5 The position of Islamic money market is considerably strong against the conventional money market while the overall sukuk market fared quite well against the conventional bond market. Even though MGII trading lagged behind MGS, corporate sukuk turnover was much superior compared to corporate bonds in Malaysia, thus resulting in the sukuk turnover comprising almost half of total bond market turnover. Moving forward, the gap between the conventional bond market and sukuk market could be narrowed through better trading and acceptance of the MGII among the investors, especially the foreign players.
- 3.6 On another note, the Islamic FX market is relatively small compared to the mainstream FX market. One of the factors is due to the smaller size of Islamic banking institutions compared to conventional banks as well as the lesser requirement to trade in FCY. Most of the Islamic financial institutions (IFI) only trade in FX market based on requirements by corporate and retail customers. Their focus is domestic centric with no overseas presence and a majority of assets and liabilities denominated in Ringgit. Similarly, Islamic derivatives market is still at the infancy stage compared to conventional market. Though the approved Islamic principles, structure and products have been in the market for quite some time, IFIs hardly trade in the derivatives market. One of the impediments is due to strict, and often divergent, Shariah requirement to have underlying exposure before they can hedge their positions or transact in derivative instruments. Moreover, there is lack of liquidity in Islamic derivatives space and IFIs are only price takers, leaving them with a price disadvantage against conventional peers. The above scenario could be reversed with the allowance of anticipatory hedging (based on historical data) and converging Shariah views, where appropriate, hence providing clarity and increased participation by the IFIs to transact in Islamic derivative instruments.

PART B THE STATE OF THE MALAYSIAN ISLAMIC FINANCIAL MARKET

4. The Islamic financial market in Malaysia

4.1	Market	Islamic	Conventional
	Money Market and Derivatives	<ul style="list-style-type: none"> • Commodity Murabahah • Qard Acceptance • Secured borrowing • Islamic repurchase agreement (repo): <ul style="list-style-type: none"> - Collateralised Commodity Murabahah (CCM) - Sell Buy Back Agreement (SBBA) • Islamic cross currency swap • Islamic FX Swap • Islamic FX Forward • Islamic FX Options • Islamic profit rate swap (IPRS) • Islamic Dual Currency Investment • Islamic Callable Range Accrual 	<ul style="list-style-type: none"> • Clean borrowing • Secured borrowing • Repurchase agreement (repo) • FX swap • Cross currency swap (CCS) • Interest rate swap (IRS) • Cross currency swap • FX Swap • FX Forward • FX Options • Interest rate swap (IPRS) • Dual Currency Investment • Callable Range Accrual
	Debt Securities	<ul style="list-style-type: none"> • Central Bank: Bank Negara Islamic Monetary Notes (BNMNI) & Bank Negara Islamic Interbank Bills (BNIBI) • Government: Malaysian Islamic Treasury Bills (MITB), Malaysian Government Investment Issue (MGII) & Sukuk Perumahan Kerajaan (SPK) • Corporate: Islamic Medium-Term Notes (IMTN), Islamic Asset Backed Securities (IABS), Islamic Commercial Papers (ICP), Islamic Negotiable Instruments of Deposit (INID), Islamic Banker's Acceptances (BAI) 	<ul style="list-style-type: none"> • Central Bank: Bank Negara Monetary Notes (BNMN) & Bank Negara Interbank Bills (BNIB) • Government: Malaysian Treasury Bills (MTB) & Malaysian Government Securities (MGS) • Corporate: Medium-Term Notes (MTN), Asset Backed Securities (ABS), Bonds, Commercial Papers (CP), Negotiable Instruments of Deposit (NID), Banker's Acceptances (BA)

4.2 Apart from the Qard and Murabahah structures, Shariah contracts include sale & purchase, leasing (Ijarah), profit-sharing (Mudharabah), joint-venture (Musharakah), agency (Wakalah) and pledging (Rahnu).

- 4.3 Ensuing the global transition to robust alternative reference rates (ARRs), the Kuala Lumpur Islamic Reference Rate (KLIRR) was discontinued in March 2022 and replaced with a new Islamic benchmark rate, named the Malaysia Islamic Overnight Rate (MYOR-i). MYOR-i is designed based on the International Organisation of Securities Commissions' (IOSCO) Principles for Financial Benchmarks and is derived from overnight unsecured lending transactions in the interbank market based on Commodity Murabahah instrument. Malaysia is the first country to launch an Islamic ARR. The fully Shariah-compliant benchmark rate is expected to boost the development of more innovative Shariah-compliant financial products and enhance transparency by enabling market players to negotiate and standardise their financial contracts. Thus, efficient pricing across all financial instruments can be achieved. The establishment of MYOR-i will help deepen the onshore Islamic financial market and enhance the role of Shariah-compliant financing for real economic activities domestically.
- 4.4 Compared to the conventional repo market, the Islamic repo market is relatively less developed and inactive with far lesser volume. This is on account of the smaller number of players in the Islamic space, added procedures to be taken for product approval at the individual bank, extra documentation required and market segmentation from different IFIs preferring one type of repo (SBBA or CCM) over the other. In addition, the Shariah Board of some of the locally incorporated Islamic foreign banks, do not recognise SBBA as a Shariah-compliant transaction due to its resemblance with Bai Al-Inah structure. These banks may only conduct CCM transactions, which has a lower volume of transactions compared to SBBA in the Malaysian Islamic financial market.
- 4.5 In the equity space, there is a very limited number of listed Islamic banking stocks in the equity market for Islamic investors and fund managers to select from. Consequently, funds with a Shariah-compliant portfolio are unable to take advantage of the investing opportunities presented whenever the banking industry is performing. While 79% of listed equities on Bursa Malaysia is Shariah-compliant, to date only 1 Islamic bank is listed in the financial services category¹⁰. As such, Islamic banks in Malaysia are huge potential to benefit from continued growth in investor demand for Shariah investing through further listings, and this could, in turn, allow for greater avenue for investor to diversify.

5. The Islamic financial market in selected regional countries

- 5.1 Within the Asian region, Malaysia and Indonesia are acknowledged to be at the forefront of Islamic finance, given the significance of the Muslim population in these two countries. Despite its relatively smaller size, the Islamic state of Brunei is also progressive in its development of the Shariah-compliant financial market. Islamic finance is also present in non-Muslim countries such as Hong Kong and Singapore, two of the major international financial centres.

¹⁰ Source: Bursa Malaysia website
Issued on: 13 April 2023

5.2

Country	Financial Market	Highlights
Indonesia	<ul style="list-style-type: none"> Sukuk market size: \$88 billion¹¹ Islamic securities include: <ul style="list-style-type: none"> Bank Indonesia Islamic Certificate (SBIS) Bank Indonesia Islamic Facility (FASBIS) Islamic repo facility via SBIS and Government sukuk (SBSN) repo Indonesia Shariah Stocks Index as the Islamic stocks composite index Other Islamic financial products include: <ul style="list-style-type: none"> Mutual funds Exchange traded funds (ETF) Asset-backed securities (ABS) Real estate investment trust (REIT) 	<ul style="list-style-type: none"> Launched the Islamic Banking Development Roadmap 2020 – 2025 The merger of three Islamic state-owned banks, resulting in Bank Syariah Indonesia (BSI), one of the world's largest Islamic banks Bank Indonesia issued regulations on hedging transactions based on Shariah principles that granted Shariah hedging facility. Ongoing discussions on the use of Murabahah, Tawarruq and Islamic derivatives. BSI's merger resulted in more appetite and interest in bigger ticket deals Challenges include: <ul style="list-style-type: none"> Low literacy rate Low inclusion rate Limited Shariah products Too dependent on Murabahah and sukuk financing Limited number of expertise
Singapore	<ul style="list-style-type: none"> Sukuk market size: \$231 million¹² Islamic securities include Government sukuk (Singapore Government Securities equivalent) Malaysian issuers include: <ul style="list-style-type: none"> EXIM Bank Axiata Group Khazanah Nasional FTSE ST Singapore Shariah Index Existence of Islamic wealth management and REIT 	<ul style="list-style-type: none"> First AAA rated country to issue sovereign sukuk in 2009 Increasing interest observed in Islamic repo via SBBA Challenges include: <ul style="list-style-type: none"> Awareness of retail Islamic financial products Absence of Islamic home financing and takaful products Lack of Islamic investment options
Brunei	<ul style="list-style-type: none"> Sukuk market size: \$150 million¹² Islamic securities include: <ul style="list-style-type: none"> BDCB Islamic Bills Brunei Government Sukuk under the Ijarah Conventional capital market license holders are allowed to conduct Islamic investment business via the Islamic window 	<ul style="list-style-type: none"> Islamic finance is a key area in the Brunei Financial Sector Blueprint (2016 – 2025) Future initiatives include: <ul style="list-style-type: none"> Issuing a standardized sukuk legal document Launching of retail sukuk Challenges include: <ul style="list-style-type: none"> Lack of information accessibility by the public on Islamic financial products Limited amount of expertise in

¹¹ Source: Refinitiv Eikon & Bloomberg

¹² Source: Refinitiv Eikon & Bloomberg

	portfolio management
Hong Kong	<ul style="list-style-type: none"> Sukuk market size: \$1 billion¹² Government sukuk issued in 2014, 2015 and 2017 totalling \$3 billion, which are listed on the Hong Kong Stock Exchange (HKSE), Bursa Malaysia and NASDAQ Dubai Listing of global sukuk on HKSE Existence of Islamic funds
	<ul style="list-style-type: none"> Amendment of Inland Revenue Ordinance and Stamp Duty Ordinance to provide tax structure comparable to conventional bonds Challenges include: <ul style="list-style-type: none"> Islamic finance and sukuk remain largely unknown Limited number of expertise Small Muslim population

5.3 In comparison, Malaysia has the largest sukuk market size at \$285 billion¹², followed by Indonesia. While Islamic finance is gradually picking up pace in the region, an observable common challenge affecting these countries are the lack of expertise as well as the low public awareness on the availability of Islamic financial services.

6. The Islamic financial market in Gulf Cooperation Council countries

6.1 Alongside Malaysia, the GCC countries are home to a high concentration of global Islamic finance assets. In the context of the sukuk market size, Saudi Arabia is a close second to Malaysia with both countries breaching the \$200 billion¹³ level. The Shariah structure utilised for sukuk in Malaysia is quite varied, such as Murabahah, Musharakah, Wakalah, Bai Bithaman Ajil, Ijarah, Mudharabah as compared to the GCC countries. In addition, Malaysia is a frontrunner in the composition of publicly listed Shariah-compliant stocks in its equity market, at 79% of the total number of listed stocks (750/959)¹⁴.

6.2 Despite strong activity in the sukuk market early in 2022 due to the high demand from foreign investors, international sukuk issuance's momentum began to decline in the first half of the year. Among the factors contributing to this slowdown are lower government borrowing needs in the main sukuk markets, especially in the Middle East due to a rise in oil prices along with heightened global tensions and numerous impending rate hikes which are predicted to restrict issuances¹⁵.

Country	Financial Market	Highlights
United Arab Emirates (UAE)	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$49.5 billion¹³ Shariah structure: Murabahah, Wakalah, Ijarah, Mudharabah Shariah-compliant stocks: 40% (48/121)¹³ 	<ul style="list-style-type: none"> Majid Al Futtaim issued the Middle East's first corporate green sukuk (\$600 million) on the Dubai NASDAQ stock exchange Sukuk issuance slowed down in 2021 due to Shariah confusion after the UAE's central bank adopted a new standard No single regulatory code for Shariah-compliant institutions, except AAOIFI
Saudi Arabia	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$209 billion¹³ Shariah structure: 	<ul style="list-style-type: none"> Saudi Aramco's \$6 billion debut sukuk was a record order book worth over \$60 billion from 29

¹³ Source: Refinitiv Eikon & Bloomberg

¹⁴ Source: Refinitiv Eikon

¹⁵ Source: S&P Global

	<ul style="list-style-type: none"> Murabahah, Musharakah, Wakalah, Ijarah, Mudharabah, Istithmar Shariah-compliant stocks: 78% (157/202)¹³ 	<ul style="list-style-type: none"> bookrunners Issued ESG disclosure guidelines to promote sustainable growth, developed in line with the UN SSE model guidance Challenges include: <ul style="list-style-type: none"> Limited product offerings and liquidity SMEs have limited access to Islamic financing due to the limited number of banks and high demand for liquidity
Oman	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$8 billion¹⁶ Shariah structure: Musharakah, Ijarah, Wakalah, Mudharabah Shariah-compliant stocks: 24% (27/114)¹⁷ 	<ul style="list-style-type: none"> Returned to the sukuk market after conventional issuances in 2020 Developing a lender of last resort facility and a deposit insurance scheme Challenges include: <ul style="list-style-type: none"> Small capital base Low customer awareness Limited short-term investment options due to ban on funds placement funds with conventional/parent banks and on Tawarruq products
Qatar	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$22 billion¹⁶ Shariah structure: Ijarah, Mudharabah, Wakalah Shariah-compliant stocks: 51% (24/47)¹⁷ 	<ul style="list-style-type: none"> Issued draft regulations to introduce waqf, green and blue sukuk Challenges include Qatar Islamic Bank (Qatar's largest Islamic bank) operations are focused on Qatar, resulting in high financing concentration given the economy's limited diversification
Kuwait	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$9 billion¹⁶ Shariah structure: Mudharabah, Musharakah Shariah-compliant stocks: 48% (84/174)¹⁷ 	<ul style="list-style-type: none"> The potential merger of KFH and Ahli United Bank would create one of the largest Islamic banks Challenges include the smaller number of sukuk issuances compared to bonds due to the lack of: <ul style="list-style-type: none"> Clear law and regulation Expertise Absence of government sukuk
Bahrain	<ul style="list-style-type: none"> Sukuk: <ul style="list-style-type: none"> Market size: \$15 billion¹⁶ Shariah structure: Ijarah, Mudharabah, Wakalah, Salam Shariah-compliant stocks: 38% (16/42)¹⁷ 	<ul style="list-style-type: none"> Highest concentration of IFI in MENA: 15 wholesale and 6 retail Challenges include: <ul style="list-style-type: none"> Lack of competent and qualified resources Almost a fifth of its population did not have a bank account in 2017

¹⁶ Source: Refinitiv Eikon & Bloomberg

¹⁷ Source: Refinitiv Eikon

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- 6.4 As the situation in Malaysia, the GCC countries are also looking to innovate and develop more Islamic products, with the Islamic repo being one of them. Due to differences in Shariah interpretation, only CCM-like instrument is recognised as Shariah-compliant repo instrument in GCC unlike in Malaysia where SBBA and CCM are endorsed by the Shariah Advisory Council (SAC) as Islamic repo instruments. However, the use of CCM is mostly limited to the UAE players with the Central Bank of UAE (CBUAE) adopting the repo product as part of their monetary instruments¹⁸. CBUAE uses the instrument to conduct Islamic repo by accepting Islamic certificates of deposit as collateral.
- 6.5 Combining sustainability with Islamic finance is also a key topic across these countries. Other trends observed in the GCC countries include Shariah-compliant deposits and structured funding. Similar to their Asian counterparts, the GCC countries are experiencing a shortage of qualified human resources in Islamic finance, which is required to further advance Islamic finance. Consequently, their governments are continuously introducing measures to build the capabilities and expertise of Islamic finance professionals. To illustrate, CBUAE has come out with a resolution to the IFIs to hire UAE nationals as trainees in the field of fatwa, that include guideline on membership of the trainees, required qualifications and competencies, appointment process and training and development plan¹⁹.

¹⁸ Source: Islamic Finance News

¹⁹ Source: Zawya by Refinitiv
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PART C CHALLENGES FACING THE MALAYSIAN ISLAMIC FINANCIAL MARKET

7. Rising interest rates and inflation

- 7.1 Rising interest rates and inflation should, in theory, affect conventional and Islamic markets in the same way. Generally, this presents challenges for borrowers (rising floating rates on loans, higher IPRS rates for hedging, higher sukuk coupons which may potentially lead to default risk/non-performing loans) but also an opportunity for investors and savers (higher deposit rates, higher structured product coupons).
- 7.2 MGII yields have increased significantly reflecting the effect of rising Overnight Policy Rate (OPR) at the short end of the tenure. Whilst the repricing is in-line with global rates movements and not unexpected, supply of Islamic government guaranteed bonds and corporate bonds continue to remain strong on the back of regular issuances for infrastructure-related projects from DanaInfra, Prasarana, Air Selangor, Pengurusan Aset Air SPV, amongst others. Despite the rise in funding cost, the relative depth and size of the MYR bond market has enabled issuers with larger funding size and longer tenor requirements to continue to access the market.
- 7.3 On the flipside, the cessation of previous withdrawal schemes under the Employees Provident Fund (EPF) has played a positive role in terms of stabilizing investors' demand for bonds. As elevated yields begin to look attractive in terms of return, demand by institutional investors, both local and foreign, is seen to be improving. Separately, there is growing interest from retail investors to invest in shorter tenor bonds and structured products with bonds as underlying instrument, as an asset diversification strategy and alternative to traditional term deposit rates.
- 7.4 Wholesale investors, however, tend to place short-term money in view of rising rates. The average tenor profile of short-term deposits has been trending lower impacting the liquidity coverage ratio (LCR). The strategy to prioritise asset growth for Islamic banks amplifies this pressure as the liability (deposits) of Islamic banks' balance sheet reprices higher in an increasing rate environment than its asset (loans), hence creating an increase in funding cost before the actual increase in rates for the assets. The heavy reliance on wholesale funding may pose liquidity challenges in the Islamic space due to its volatility and higher cost incurred.
- 7.5 The challenge is to look for alternative avenues to facilitate intermediation; Islamic FX swaps market liquidity is still limited, and depth of the Islamic repo market is yet to improve materially. Other avenues involve CCM, SBBA or the issuance of bonds and/or bilateral financing to assist Islamic banks' funding. There is a need to create an ecosystem to enable short-term financial products to hedge this risk while resolving structural issues in the long run via channelling new retail funding under Islamic banking and encouraging greater participation from IFIs. Additionally, the credit profile, regulatory implications, operational and settlement processes to transact domestic sukuk with international investors who are more familiar with conventional documentation and processes needs to be refined.

8. State of MGII post pandemic

- 8.1 MGII auctions throughout 2022 have drawn healthy participation from investors. YTD, MGII auctions recorded average BTC of 2.49x which indicated healthy interest on government bonds from market participants despite the increased aggregated issuance size in recent years.
- 8.2 For institutional investors, MGII, especially the long-end ones provide a good level with some spread against MGS (with no added credit risk). These funds, particularly those with HTM/AC business model is expected to strongly support government bonds due to an acceptable long-term rate of return with a risk-free profile.
- 8.3 Increases in yields resulting from a larger supply size have largely been absorbed by the market, particularly as it enhances the reinvestment rates of these funds with no penalty from a MTM perspective (since HTM is not marked-to-market). Hence, the market will be able to absorb the incoming government bonds supply as current yield levels (vs previous years) have increased to the levels that investors will take interest.

9. Issuance of equity-type instruments

- 9.1 Mudharabah is a widely accepted Shariah principle within the Islamic finance space. It is applied in various financial and banking products. However, the disallowance of profit smoothing by BNM for Mudharabah has become a significant challenge from a business point of view. The Investment Account Guidelines by BNM has made the prohibition very clear in clause 13.5: The IFI must not implement profit smoothing practices or displaced commercial risk (DCR) techniques. Because of this prohibition, Islamic banks and financial institutions are unable to manage its profits, transfers, liquidity and risk based on commercial requirements. This disallowance also causes Shariah-compliant instruments to be less competitive compared to conventional, particularly if/when there is underperformance.
- 9.2 Mudharabah is also not suitable as the underlying base in Structured Products or Structured Investments. Islamic Structured Products are typically deposits combined with derivatives. The derivatives can be in the form of a swap or an option. The deposit though, which serves as the base, must be able to preserve the value of the principal amount. A deposit based on Mudharabah would not be able to guarantee such preservation which results in various challenges in terms of pricing and valuation. Whilst this may appear to be complicated, the bigger challenge is actually to create an acceptance of the risk that a Mudharabah based investment carries. Changing investors' perspective, to be accepting of the risks, in return for certain benefits and rewards, will require greater understanding and deeper appreciation of the spirit of Mudharabah principle.
- 9.3 In the absence of fixed-rate Mudharabah deposits, the most viable alternative for Islamic banks in Malaysia is still tawarruq deposits, also known as Commodity Murabahah deposits. In a Commodity Murabahah Deposit, the profit can be

determined upfront and mutually agreed between both parties. The profit is known and certain to both parties, because a Commodity Murabahah trade will be executed, which is payable on the maturity date. The Commodity Murabahah covers both the principal and profit amount, both of which will be paid together on the maturity date,

which is a date that would have been agreed upfront too. By applying the Commodity Murabahah, the deposit can be flexible in terms of amount and tenure, and even pre-liftment can be arranged accordingly. Such flexibility in the terms of the product, coupled with certainty in the rates, make the Commodity Murabahah deposits the most attractive structure for Islamic banks and financial institutions at this juncture.

10. Lack of usage and range of Islamic hedging instruments

- 10.1 The term hedging implies the reduction of risk. A fully functioning hedging market requires liquidity, accessibility, low barriers to entry and enforceability of the contract. At least two or three of the desired requirements exists for most of the non Shariah-compliant hedging instruments in the Malaysian financial market.
- 10.2 To this end, further development in the Shariah-compliant hedging instruments space is warranted . To have a sustainable hedging market with variety of products and high usage, Islamic banks and participants need to solve the equation of a fully functioning hedging market. The statistics provided in the 2021 BNM league table report which shows that Islamic Profit Rate Swap volume only made up 0.1% of the total derivative market share shows that fundamental issues have not been resolved.
- 10.3 To address liquidity, a variety of factors must be considered which includes Islamic banks themselves must be able to provide the desired liquidity that market so requires. Capital and capability considerations must be addressed by each Islamic bank. Islamic banks need to rise up to the challenge of independent hedging offerings. Islamic banks must consciously make a collective effort to commit resources into an active Islamic secondary market as there are very few Shariah impediments. This includes providing secondary liquidity thru market making in Islamic derivatives by utilising the principle of Anticipatory Hedging.
- 10.4 Islamic banks in their continuous goal to improve market liquidity and offerings have taken on the role to ensure standardisation and commonality. Association of Islamic Banks of Malaysia (AIBIM) through the Treasury & Markets Committee (TMC) have released a localised market standard schedule for the Tahawwut Master Agreement together with an Islamic Credit Support Annex for Islamic hedging and derivatives transactions. This should provide the fundamental base, previously absent, for Islamic participants to choose and commit into Islamic hedging.
- 10.5 However, a foreseeable operational challenge in implementing the Tahawwut Master that the adoption of Shariah structures and Islamic transactions are not similar across IFIs. As such, industry standardisation is required to enable all IFIs to utilise this contract holistically.
- 10.6 As of late, we have seen emergence of new Islamic hedging instrument that cater to the strong demand. However, the challenges to have a comparable hedging product across the Malaysian market remains with differences in building blocks often

resulting in complications when operationalising the product. Being the late comer to the market, Islamic participants have the added complexity to ensure the processes of the Islamic hedging products can be operationalised using the infrastructure that is already developed in the non shariah compliant hedging instruments to ensure cost is not driven upwards. As it stands Islamic hedging instruments does indeed incur additional cost and although these differences have narrowed over time, more effort needs to take place to remove remaining price differential.

11. Low foreign participation and interest in Malaysian sukuk

- 11.1 Current challenges faced by the Islamic financial markets with regards to low foreign participation/interest in Malaysian sukuk (Government and corporate bonds) is due to credit constraint for onshore participants i.e., limited repo facilities for sukuk which limits market making activities resulting in lower liquidity versus the conventional equivalent. The lower volume makes the MGII less attractive to foreign investors. Current ratio for secondary trades against outstanding Malaysian sukuk stood at 0.68 as compared to conventional which is more than double at 1.47. This present significant opportunity to develop market further.
- 11.2 However, the demand trend for MGII from offshore investors have increased with Q2 2022 showing 9% foreign holdings (as a percentage of total MGII) versus 6% as at end Q4 2020. These offshore investors are those with a fixed investment mandate and purchasing MGII when yields are attractive.
- 11.3 Providing more incentives would further enhance foreign interest in the domestic sukuk and anchor creation of longer-term benchmark yield curve for Islamic capital market. Inclusion of domestic sukuk in more global indices will also enhance its visibility among the investors and assist in attracting global players to the onshore market.
- 11.4 Other incentive to increase foreign interest is by having a regulation that encourages active secondary trading in the MYR market that eventually will give greater confidence to global investors. Local issuers are also encouraged to do global roadshows to help promote the domestic credits.
- 11.5 Other than that, local issuers should explore obtaining ratings from the top international rating agencies so that international investors can more easily determine the credit worthiness of domestic credits as well as establishing a benchmark against other credits and papers. Additionally, depth of hedging market is important to manage FX and interest rate risk. Interlinkages between domestic and international settlement infrastructure i.e. Euroclear/Clearstream are also critical to support foreign participation.

PART D DEVELOPMENT AREAS

12. Sustainability agenda

- 12.1 Government and the financial market players have both embraced the agenda with various initiatives set to achieve United Nations' Sustainable Development Goals (SDG) goals by the end of 2030. Among the government's efforts to prioritise sustainability, the government has pursued aspects such as the Sustainable Development Goal (SDG) Tagging of Development Expenditure, the establishment of the MySDG Trust Fund, the introduction of the Sustainability Sukuk, and Government Green Procurement through the Integrated National Financing Framework. It also aligned the national budget measures with the SDGs to fund SDG-related projects. As part of the initiative, the government had issued sustainable sukuk in 2021 via the issuance of \$800 million 10-year and \$500 million 30-year Trust Certificates. Malaysia's maiden Sustainability Sukuk is the world's first US Dollar Sustainability Sukuk issued by a sovereign, with the proceeds used for eligible social and green projects aligned to the UN SDG Agenda²⁰. The Sukuk was issued based on the newly-established The Government of Malaysia SDG Sukuk Framework which was developed to demonstrate how the Government of Malaysia intends to enter into the SDG Sukuk to fund projects that will deliver environmental and social benefits which are in close alignment with SDGs. Most recently, the government has agreed to set up a National Sustainable Development Goals centre aimed at empowering and accelerating programmes for a better and sustainable future for the nation. The centre will also monitor the progress and implementation of all SDG-related programmes.
- 12.2 BNM on its parts, has also taken steps to promote sustainable development objectives. This includes advancing Value-based Intermediation (VBI), financial inclusion, climate resilience and environmental sustainability. BNM has partnered with the VBI Community of Practitioners (CoP) and VBI for Takaful (VBIT) Steering Committee in developing strategic frameworks and building industry capacity²¹. BNM also recently introduced the Low Carbon Transition Facility (LCTF), with RM2 billion in funds to support SMEs in adopting sustainable and low carbon practices.
- 12.3 Industry players have played their part in supporting the sustainability agenda. To date, more than 5 IFIs have introduced their own SDG framework with various focus. Maybank, CIMB, AmBank, HSBC and SME Bank have taken the initiative to introduce SDG framework. This is in line with government call for financial institutions to assist the government in mainstreaming the sustainability agenda across as many sectors and industries, as the nation races against time to mitigate the effects of climate change and other future shocks. The financial sector has been supporting the transition agenda through product offerings and solutions. Several banks are offering financing with preferential rates for green projects e.g., green manufacturing, clean and renewable energy, hybrid vehicles and green-certified properties. Among the significant ESG related transactions by industry players are RM1.0 billion landmark sustainable collateralised commodity Murabahah (CCM) transaction between CIMB

²⁰ Source: <https://www.mof.gov.my/portal/en/news/press-citations/malaysia-s-sustainability-sukuk-oversubscribed-by-6-4-times-allocation-well-spread-globally>

²¹ Source: BNM Annual Report 2021
Issued on: 13 April 2023

Islamic and Standard Chartered Saadiq Malaysia. Maybank Islamic also executed a 10-year sustainability-linked Islamic Profit Rate Swap with Axis Real Estate Investment Trust that embeds ESG key performance indicator and sustainability performance target (SPT) in their commitment to support and shape sustainable business models.

13. Islamic hedging instruments

- 13.1 Over the last two years, the world went through the Covid-19 pandemic which caused increased market volatility, the two most relevant to us are currency exchange and interest (profit) rates. With the changing financial landscape, financial needs have also gone through some transformation. One of the topics that has surfaced again is the effective use of hedging tools by Shariah-compliant financial institutions and further to this, whether customers of such institutions are being educated and offered the hedging tools or not.
- 13.2 Derivatives when used appropriately are powerful risk management tools to ensure good governance in addressing risks in balance-sheet management. Malaysia seems to be at the forefront in the development of such tools. Even so, the use of these tools by IFIs in Malaysia has been somewhat a reactive approach rather than proactive. Some IFIs are only limited to using IPRS and ICCS unlike conventional financial institutions which utilise various hedging products, despite the risks faced by IFIs are the same as conventional banks.
- 13.3 Another area of concern is hedging on anticipatory basis. Conventional banks have now allowed more and more of their customers to hedge their potential exposures based on their historical data. This does not seem to be the case for IFIs here as the practice for many IFIs is to ensure there is actual underlying exposure (trade transactions) as proof before the customer is allowed to enter into a hedging contract. Anticipatory hedging in a volatile (future) currency exchange market may be the best hedging tool for the customers, on per expected trade transaction basis or even on the expected portfolio basis, ultimately it will provide a certain degree of safety net for customers in their normal course of business. Customers should be educated on how to use such powerful tools in managing their risk exposures.
- 13.4 With the usage of various hedging tools, this would certainly benefit not just IFIs but also customers of IFIs in managing the multiple risks surfacing as financial transactions become more complex. Enhanced management of risks via hedging tools will translate into improved balance-sheet management and optimum cashflow control.
- 13.5 At this juncture, there are no requirements for Shariah-compliant listed companies and Islamic fund managers to financially measure their participation in and usage of Islamic hedging tools as a percentage of total borrowings as one of their Shariah-compliant status indicators. A lower requirement could be implemented in the beginning as the market develops. This could be considered, along with, any other incentives for IFIs and corporates to utilise Shariah-compliant hedging solutions.

14. Islamic repo

- 14.1 Progress and initiatives have been observed in the exploration and operationalisation of Islamic repo, namely SBBA and CCM, in the continuous effort to enhance and create an Islamic repo that is acceptable to Shariah councils, regulators and market players. Nevertheless, Islamic repo are still at its early stages of adoption in the financial market.
- 14.2 It is an ongoing challenge to push the Islamic financial market to grow further and create a sustainably active market where market participants can manage their own liquidity portfolios independently during liquidity stress periods without over reliance on the central bank.
- 14.3 The main hindrance to the progress and adoption of Islamic repo is the differences in the interpretation of Shariah contract application to the repo structure, lack of consensus between practitioners, Shariah scholars and regulator, as well as limited innovative recommendations to introduce Shariah-compliant repo structure.
- 14.4 Other identified issues would be the lack of clear rules governing these transactions and a clear acceptance from regulators on these transactions, apart from Islamic financial market participants' confidence to adopt Islamic repo given contradicting views surrounding Islamic repo transaction.
- 14.5 These underlying issues delay market participants' ability to adopt a repo structure that is deemed Shariah- and regulatory compliant.
- 14.6 In Malaysia, PPKM and AIBIM have been developing and promoting SBBA and the Joint Committee on Islamic Technical Market is working on a standard SBBA agreement and a Practice Note on SBBA. With the completion of these documents, SBBA volume is projected to improve not only within the Malaysian market but also with offshore IFIs.
- 14.7 One of the key differentiations of the said standard SBBA agreement is the enhancement of the agreement and repo structure to meet the globally accepted Global Market Repurchase Agreement (GMRA) standards. This is pertinent to the global acceptance and adoption of SBBA to allow for margining, netting practices and other key features in a repo transaction. The introduction of these features in the SBBA agreement will address counterparty and market risk faced by both parties in an Islamic repo whilst ensuring Shariah-compliance of the transaction. The enhancement and the utilisation of GMRA will bring SBBA up to par with the conventional repo.
- 14.8 Accordingly, the BNM Guidance Notes on Sell and Buy Back Agreement will need to be updated to match with the Policy Document on Repurchase Agreement Transactions and the issue of variation margin should also be addressed.
- 14.9 Other efforts to promote Islamic repo by regulators include making CCM netting friendly under the Netting of Financial Agreements Act 2015, pending approval from the relevant authorities.

14.10 On the same note, the industry must also seek to find ways for the IFIs to transact in Islamic repo with conventional FIs during the early stages of the market's development. That way, liquidity can be mobilised between the two markets as the environment evolves to become more conducive for the Islamic market players.

14.11 In order to promote cross border liquidity among Islamic markets in differing jurisdictions and for the SBBA agreement to be globally accepted, a focused marketing and product awareness exercise must be instituted. Malaysia market participants can collaborate in organising a workshop and promotional trips to build business relationships. It should be noted that the credit risk attached to interbank transactions between different jurisdictions can be minimised via securitised transactions like SBBA or CCM.

14.10 It is also crucial to address the shortage of Shariah-compliant interbank instruments to support the growth of an independent Islamic financial market whilst leveraging Malaysia's position as the leading global sukuk market. The abundance of securities and collateral is a gateway to tap into deeper liquidity and funding at a lower cost for Islamic market participants which can begin with the exploration of Islamic repo.

15. Other areas of development

15.1 Areas of development include:

- Sustainability-linked Treasury products

Introduction of sustainability linked instruments would further lend support to the sustainability agenda. The industry had taken the stride to launch wider range of sustainable linked products. Landmark CIMB Islamic and Standard Chartered Saadiq's CCM transaction, Maybank Islamic Berhad sustainability-linked Islamic Profit Rate Swap (IPRS) with Axis Real Estate Investment Trust (Axis-REIT) and ESG Sukuk issuances are among the sustainability linked instruments issued by the market. More innovations are expected ahead as many corporations have made the sustainability agenda an urgent business priority.

- Increase non-residents participation in the sukuk market

Improving non-residents participation requires continued coordination between the regulators and the financial market community in promoting, marketing and improving the transparency to broaden the investor base of the Malaysian sukuk market. For example, further details and visibility on Malaysia's sukuk issuances and secondary trading need to be made available to end investors.

15.2 Areas which require further assessment and studies includes:

- New intermediaries to provide liquidity or market making for sukuk i.e. non-bank dealers

Inclusion of new intermediaries such as Non-Bank Financial Institutions (NBFI) dealers will enhance liquidity and market making for sukuk in the secondary market. However clear parameters are required to ensure accountability to

regulators and due to their ability to operate outside the customary banking rules and regulations. Oversight by different authorities must also be considered—the Companies Commission of Malaysia (SSM) and Bursa Malaysia if they're public companies, or BNM if they're brokerage firms.

- Market making or trading of regional sukuk securities

Market making and trading of regional securities could enhance further liquidity of sukuk due to larger investors base. Sufficient market making and trading framework including appropriate infrastructure need to be in place to facilitate cross-border transactions. Apart from enhancing price discovery process, it will further close the development gap between regional sukuk market.

PART E CONCLUSION

16. Conclusion

- 16.1 Standardisation is essential for the Islamic financial market to progress. However, the Committee is of the view that diversity of contracts is necessary and should even be celebrated but economic, regulatory and legal certainty is key to promotion of liquidity.
- 16.2 Recent wholesale funding activities are shifting toward short-term tenures due to anticipation of rising rates. As Islamic banks continue to grow their assets resulting in close to 40% of total banking assets, the shift to short-term funding can potentially create a near term funding squeeze for Islamic financial institutions which are more reliant on wholesale funding.
- 16.3 More effort is needed to pull in participation of foreign investors into the Malaysian sukuk market. This includes pooling together resources from the regulator and financial community in promoting, marketing and creating awareness for Islamic financial products. Some of these efforts include greater utilisation of the MYOR-i, adopting MGII as benchmarks, deepening the liquidity pool for MGII through active market making and secured funding and providing a viable Islamic hedging market.
- 16.4 The strategic direction of Islamic finance cannot be left primarily to regulators and more collaborative efforts are needed between practitioners, Shariah scholars and regulators in the formation of laws or regulations to cater for the diversity of Islamic finance.
- 16.5 Islamic finance participants need to invest resources from an industry perspective to raise significant awareness in the availability of Shariah-compliant products for liquidity and hedging amongst the client segments to increase participation. Islamic FIs also need to walk the talk by increasing their usage of these tools to create the awareness and necessary liquidity. This in turn requires an investment of capital into the IFIs and investment of Shariah understanding to the acceptability of creating liquidity in markets.
- 16.6 The Islamic finance market should take the ownership of the sustainability agenda as the goals are in line with Shariah principles and can be used as the catalyst to drive further investments into Islamic assets and in turn creating the necessary liquidity and spill over into ancillary Islamic products.
- 16.7 There is far-reaching potential in integrating the capabilities of the main geographical Islamic markets, i.e., the GCC countries and South East Asia (SEA). As an example, there appears to be opportunities for the GCC countries to bridge funding needs in SEA and conversely, SEA can address the limited product offerings and short-term investment options in the GCC countries. Cross border liquidity management linking different Islamic financial centres should also be explored by leveraging on existing platforms such as The International Islamic Liquidity Management (IILM), International Islamic Financial Market (IIFM) and domestic money market players.

PART F APPENDIX

Glossary

Terms	Definition
<i>Ijarah</i>	Lease or service contract
<i>Maqasid Shariah</i>	The objective of Shariah, the deeper meanings and inner aspects of wisdom considered by the lawgiver in all or most of the areas and circumstances of legislation
<i>Mudharabah</i>	Profit-sharing contract
<i>Murabahah</i>	Sale and purchase of an asset where the acquisition cost and the mark-up are disclosed to the purchaser
<i>Musarakah</i>	Profit-and-loss-sharing contract
<i>Qard</i>	Interest-free loan
<i>Rahnu</i>	Pawnbroking for short-term collateralized borrowing
<i>Tawarruq</i>	Purchasing an asset with a deferred price, either based on <i>musawamah</i> or <i>murabahah</i> , and subsequently selling it to a third party to obtain cash
<i>Wa'd</i>	Unilateral promise which refers to an expression of commitment given by one party to another to perform certain action(s) in the future
<i>Wakalah</i>	Agency contract