

**Sukuk: Efficient Diversification Mechanism and New Asset Class**

**Rapid Growth of the Global Sukuk Market**

The global sukuk industry experienced enormous growth over this recent five years and is now at the centre of the rapid development of the Islamic financial system. The size of the global sukuk market, including sukuk denominated in domestic currencies, has grown from only USD336 million (or RM1.3 billion) in 2000 to an estimated USD82 billion (or RM281 billion) as at end-2007, representing an average annual growth of 40%. Total issuances in 2007 are valued at USD47 billion (or RM161 billion), an increase of 73% over the total value issued in 2006<sup>1</sup>.

**Sukuk Salient Features**

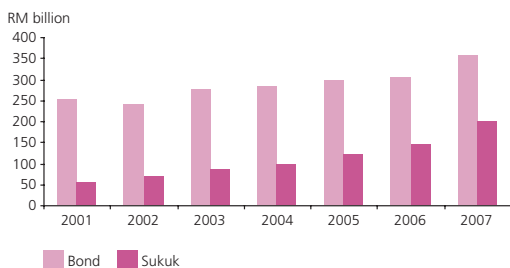
- Sukuk is certification or trust of ownership for an asset or usufruct.
- It is an asset-based instrument structured in compliance with the precepts of Shariah.
- Returns on sukuk are tied to the underlying asset. Therefore, sukuk needs to be backed by a specific asset or usufruct throughout its entire tenure.

Initially regarded as a niche capital market instrument catering to corporate issuers, governments, state-owned enterprises and financial institutions in Islamic economies for capital-raising exercises, the appeal of sukuk has since extended to large international banks and corporate issuers. Established international financial centres have also taken a more active role in developing the market for this asset class, including enacting enabling legislative provisions which have contributed towards accelerating the development of the global sukuk market.

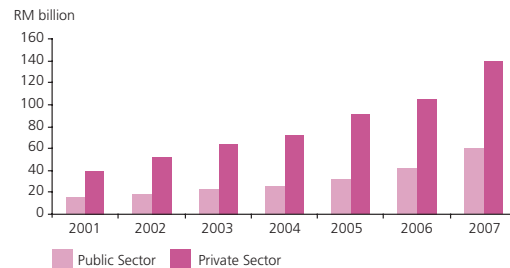
**Record Growth of Malaysian Sukuk Industry**

Malaysia continues to be at the forefront of the development of Islamic finance. Malaysia is the world's largest sukuk market with 68.9% or USD62 billion (RM213 billion) of the global outstanding sukuk as at end-2007 having been originated in Malaysia. Total issuances of corporate sukuk in Malaysia amounted to more than RM30 billion in 2007. Malaysia's lead in the development of the sukuk market extends beyond just volume, including as well the introduction of innovative and competitive sukuk structures that appeal to a wider investor base.

**Chart 1**  
Malaysia: Outstanding Sukuk vs. Bonds



**Chart 2**  
Malaysia: Total Outstanding Sukuk



Beginning with a modest issue size of RM125 million by Shell MDS Sdn. Bhd. in 1990, the Malaysian sukuk market has grown in size and sophistication. The depth of the sukuk market was clearly demonstrated by the recent issuance of the largest sukuk to date, valued at RM15.4 billion (USD4.7 billion), by Binariang GSM Sdn. Bhd., an investment-holding company that facilitated the privatisation of a cellular phone operator. Despite its significant size, the Binariang sukuk was twice oversubscribed.

<sup>1</sup> Source: Islamic Finance Information Service

The primary sukuk market in Malaysia is now one of the world's fastest growing, with an average annual growth in issuances of 22% recorded for the period 2001-2007. Having introduced the world's first global sovereign sukuk in 2002, Malaysia has continued its pioneering efforts in facilitating innovative structures such as the exchangeable *sukuk musharakah* by Khazanah Nasional Berhad, the investment-holding arm of the Malaysian Government. This landmark issuance is the world's first sukuk that incorporates full convertibility features that were previously common only to conventional equity-linked transactions.

Secondary trading in the Malaysian sukuk market has increased in depth and liquidity, with more corporations, including foreign-owned corporations, continuously tapping the market for funding. A significant number of corporate issues have been undertaken to finance long-term funding needs. The wide array and increasing size of sukuk transactions also offer attractive value proposition for investors seeking to diversify their asset portfolios, thus creating a vibrant secondary market.

### Key Growth Factors Underpinning Strong Sukuk Development

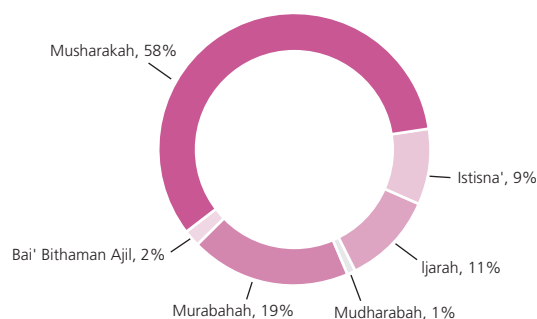
The strength of sukuk lies in its distinct structure. Sukuk is an asset-based instrument, bringing unique value proposition to both investors and issuers. For investors, sukuk offers added portfolio diversification benefits and investment opportunities in the form of new asset classes, while issuers can benefit from increased liquidity by tapping into the growing demand among an increasing number of high net-worth individuals and institutional investors for Shariah-compliant investment products.

The strong growth of sukuk, particularly in the recent five years has been supported by the following key factors:

#### I. Growing Sophistication of Structures

The flexibility of sukuk structures is a key factor that has led to its growing acceptance. Sukuk are tailored to meet the requirements and preferences of specific target markets. Over the years, sukuk structures have evolved from debt-based structures which are premised on cost-plus sale agreements (*murabahah*), to lease-based (*ijarah*), profit-sharing (*musharakah*) and manufacturing contracts-based (*istisna'*) sukuk, as well as hybrid structures based on combinations of Shariah contracts that appeal to a wider range of investors.

**Chart 3**  
**Sukuk Approved in 2007 Based on Various Shariah Principles**



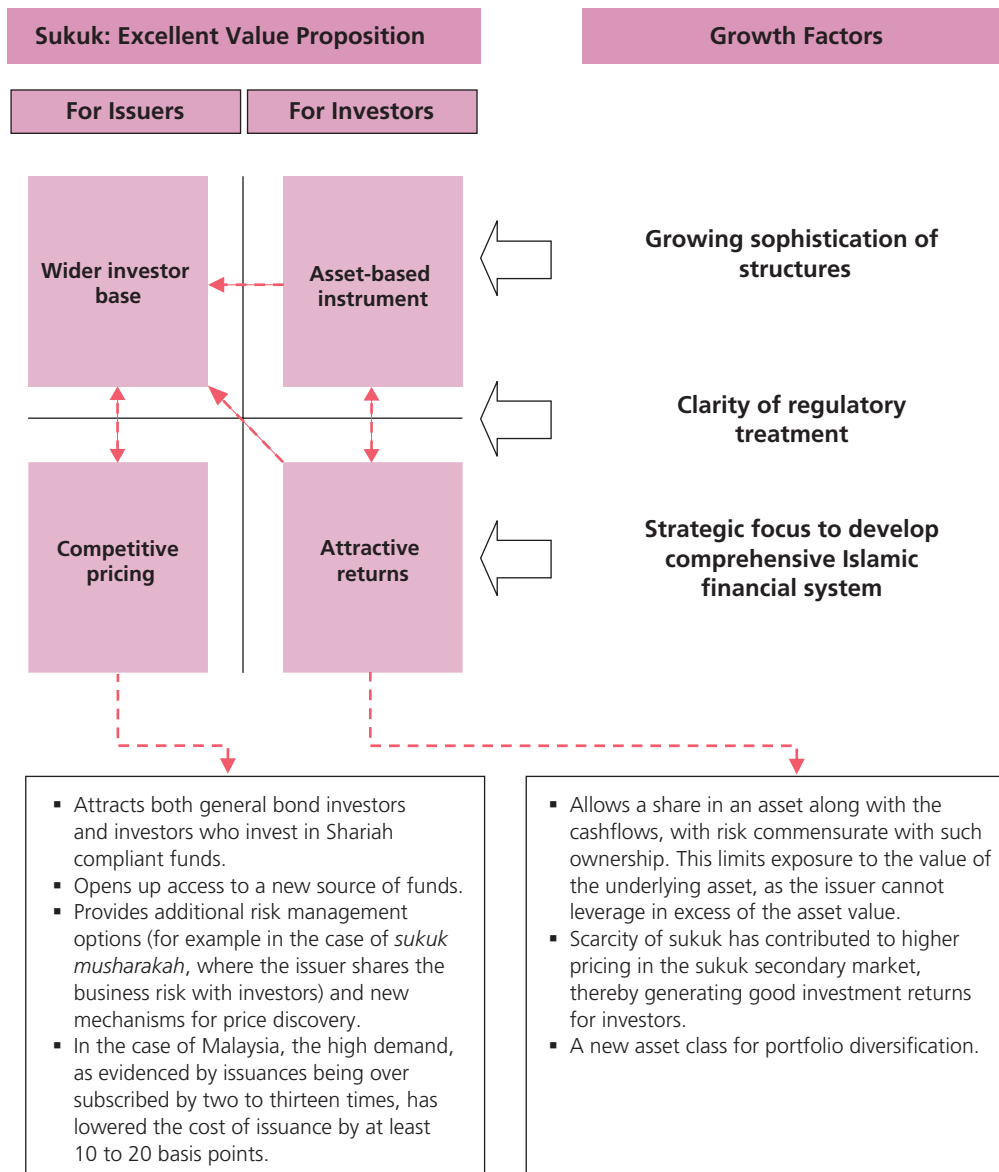
Source: Malaysian ICM Quarterly Bulletin (January 2008), Securities Commission Malaysia

**II. Clarity of Regulatory Treatment**

Greater clarity on the regulatory treatment of sukuk has provided regulatory certainty to Islamic financial institutions with regard to their investments in these instruments. This has been achieved through the adoption of the Capital Adequacy Standard issued by the Islamic Financial Services Board (IFSB), which specifies the prudential treatment of sukuk investments for regulatory capital purposes. Further work has also been undertaken by the IFSB to develop prudential standards for sukuk securitisation.

**III. Strategic Focus to Develop Comprehensive Islamic Financial System**

The broader range of instruments as well as structured products offered by the Islamic financial market in response to customer demands has also led to greater demand for sukuk. Sukuk has now become important in supporting the growing number of structured products offered by Islamic banks, takaful operators as well as fund management companies. For example, investments by takaful operators in sukuk have provided a good match for the medium- and long-term liabilities of takaful funds.

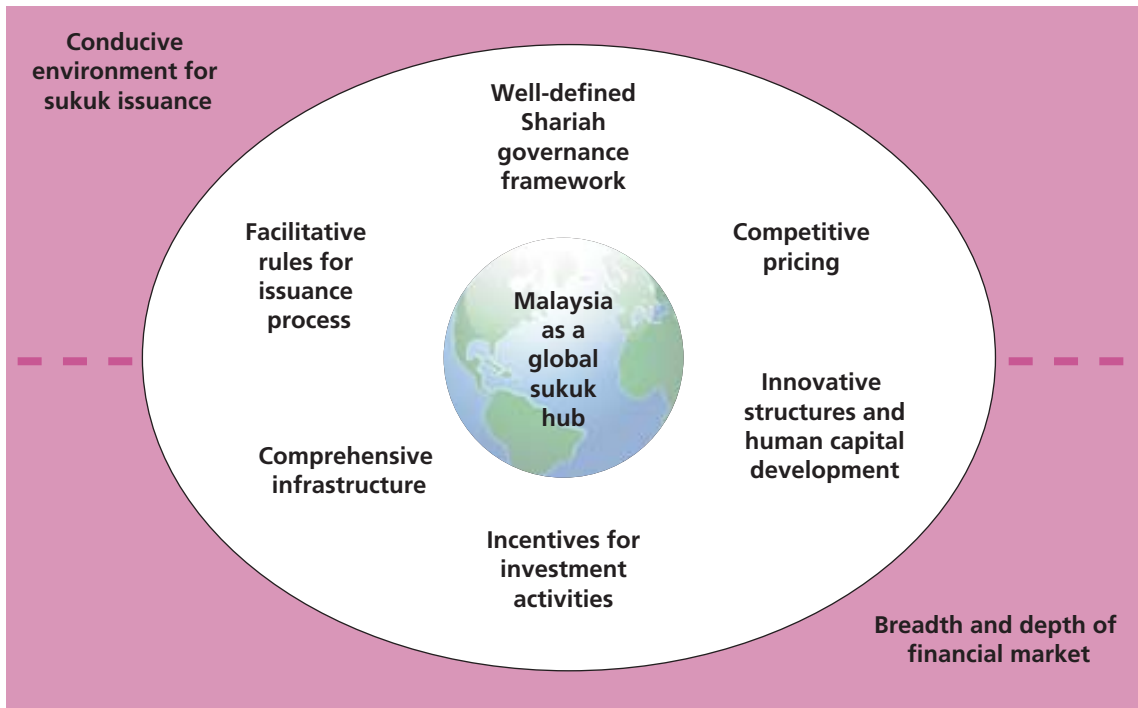


### Malaysia's Leading Edge as a Global Sukuk Hub

Malaysia has emerged as a vibrant sukuk hub, offering a total solution for sukuk activities through its conducive issuance environment, facilitative policies for investment activities and comprehensive Islamic financial infrastructure. This has attracted global investors and issuers to Malaysia as a preferred sukuk issuance and investment destination. Global issuers have included international financial institutions such as the International Finance Corporation and the International Bank for Reconstruction and Development.

To further strengthen Malaysia's international position, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched in 2006. MIFC serves to promote Malaysia as a centre for the offering of Islamic financial products and services in the global marketplace by facilitating the growth of investments in Islamic financial markets and by connecting international Islamic financial centres. The promotion of domestic and foreign currency sukuk origination, distribution and trading is one of the MIFC's key focus areas.

### Total Solution Approach



### Facilitative Rules for Issuance Process

The MIFC Secretariat and Promotion Unit, located in Bank Negara Malaysia, undertakes the coordination and promotion of MIFC's strategic initiatives, including in the area of the sukuk market. Formalised arrangements between the regulatory agencies in Malaysia through MIFC ensures a coordinated approach in continuously improving the delivery channel and efficiency in raising sukuk denominated in any currency in Malaysia. In 2007, flexibility under the foreign exchange administration rules was accorded to multilateral development banks, multilateral financial institutions, sovereigns, quasi-sovereigns and local or foreign multinational corporations to issue foreign currency-denominated sukuk in Malaysia.

Simplified issuance procedures are adopted for international issuers with good credit ratings. Applications by issuers with a credit rating of at least 'A-' are deemed approved upon proper filing of requisite documents with the Securities Commission at least two working days prior to the issuance of foreign currency sukuk. Applications are also deemed approved upon receipt by the Securities Commission for issuance of ringgit sukuk by AAA-rated foreign sovereign or quasi-sovereign agencies.

To further facilitate the issuance process, no restrictions are placed on the ability to use international rating services, hedge positions and swap issuance proceeds into foreign currency.

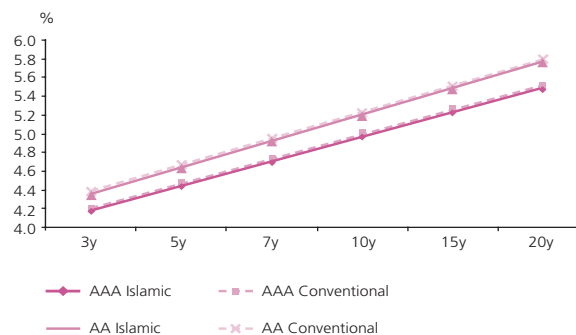
### **Well-defined Shariah Governance Framework**

Malaysia's well-defined Shariah governance framework has been instrumental in promoting the development of Islamic finance in general, including sukuk. Sukuk issuances must be approved by Shariah advisors at the respective originating financial institutions. For issuances involving new concepts or structures, further endorsement by the Shariah Advisory Council of the Securities Commission, which advises the Commission on matters pertaining to Islamic capital markets, is required. Together with the Shariah Advisory Council of Bank Negara Malaysia (which is the authoritative body on Shariah matters for financial institutions regulated by the Bank), the Councils serve to ensure compliance with Shariah principles which form the tenets of Islamic finance, while supporting innovation through their pronouncements on the Shariah-compatibility of innovative structures.

### **Competitive Pricing**

One of the hallmarks of an efficient international financial centre is a conducive environment for cost efficient fund-raising platforms. In this regard, the high demand for sukuk, as evidenced by the over subscription of sukuk issuances, has kept the cost of issuance below that of similar rated conventional bonds.

**Chart 4**  
**Yield Curve for Corporate Bonds and Sukuk**



Source: Bondweb Malaysia (as at 31 December 2007)

Various tax and regulatory incentives have further reduced the cost of issuance and time-to-market for sukuk issuances. These include the following:

- Special Purpose Vehicles (SPVs) used for the issuance of sukuk are not subject to the administrative tax procedures under the Income Tax Act 1967;
- Companies that establish SPVs are given tax deductions on the cost incurred by the SPV for the issuance of sukuk;

- The issuance cost for all Islamic securities approved by the Securities Commission are also eligible for tax deduction; and
- Stamp duty exemption is given on instruments relating to Islamic securities issued under the MIFC until 31 December 2016.

These measures and incentives are expected to further stimulate international currency sukuk issuances, thus expanding the diversity of the sukuk base in Malaysia.

### ***Innovative Structures and Human Capital Development***

Apart from the more common Shariah structures based on *musharakah*, *mudharabah*, *istisna'* and *ijarah*, Malaysia has pioneered many of the world's innovative sukuk structures. Among the various sukuk structures that were originated in Malaysia are:

- 1990** – First *bai' bithaman ajil* Islamic debt securities by Shell MDS Sdn. Bhd. (RM125 million)
- 1994** – First *sukuk mudharabah* by Cagamas Berhad (RM30 million)
- 2001** – First corporate *sukuk ijarah* by Kumpulan Guthrie Berhad (USD150 million)
- 2002** – First sovereign *sukuk ijarah* by the Government of Malaysia (USD600 million)
- 2003** – First tradable *sukuk istisna'* by SKS Power Sdn. Bhd. (RM5.6 billion)
- 2005** – First *sukuk musharakah* by Musharakah One Capital Berhad (RM2.5 billion)
- 2006** – First exchangeable sukuk by Khazanah Nasional Berhad (USD750 million)

This would not have been possible without the pool of requisite human capital available in the Malaysian Islamic finance industry. Skills and expertise in this area of finance is in high demand globally, resulting in the need to deepen the talent pool further to sustain current and future needs. In this context, strategic initiatives under the MIFC also include developing Malaysia into an international centre for Islamic finance education. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in 2006 is aimed at supporting the dynamic and evolving global Islamic finance industry through the development of high calibre Islamic financial professionals. To achieve this, INCEIF offers the Chartered Islamic Finance Professional (CIFP) qualification programme, which is its flagship programme, as well as postgraduate Masters and PhD programmes.

Given the parallel financial system in Malaysia featuring both conventional and Islamic finance, the human capital requirements for the country's sukuk and Islamic financial activities are not only met by the pool of Islamic financial professionals, but are also supported by the workforce in conventional financial institutions. This ability to leverage on cross-sectoral expertise has been important in driving product innovation with sound structures and risk management foundations, while complying with Shariah requirements.

### ***Incentives for Investment Activities***

To further stimulate and attract investments in sukuk by global investors, several incentives and measures have been announced. These include the following:

- No withholding taxes are imposed on non-resident investors for the profit or income received on foreign currency sukuk originated in Malaysia and approved by the Securities Commission;
- Foreign investors in Malaysia are allowed to hedge their positions with onshore banks with respect to committed flows of funds, such as the repatriation of investment proceeds, dividends and profits from Malaysia as well as the purchase of ringgit assets in Malaysia; and
- Free inward and outward movement of funds relating to both foreign direct investments and portfolio capital investments.

### ***Comprehensive Infrastructure***

Malaysia's Islamic capital market continues to register strong growth as seen from the increasing year-on-year growth in assets and diversity of products offered. This can be attributed to the existence of a complete and well-established Islamic financial system with considerable depth and

breadth in the capital market, a responsive and facilitative regulatory environment, as well as an increasing number and sophistication of intermediaries which continue to push the frontiers of product innovation.

A carefully planned and strategic approach which has been adopted in Malaysia to develop a comprehensive Islamic financial system that co-exists with the conventional system within the broader financial system has produced positive results. Malaysia has increased its appeal as an investment destination, offering a wide range of investment opportunities with considerable market depth and breadth. Of importance, the building blocks necessary for an efficient and well-functioning market, are now well entrenched.

A facilitative platform for sukuk issuance and trading activities has also supported more efficient issuances and enhanced the price discovery process. Malaysia's payment and settlement systems, including the Real-time Electronic Transfer of Funds and Securities (RENTAS) system, provide an efficient platform for the trading of bonds, with a high level of post-trade transparency and market liquidity. For global investments, flexibility is also accorded for foreign investors to leverage on international clearing and settlement systems.

Malaysia has continuously strengthened the legal, regulatory and Shariah framework underpinning the Islamic financial system. Its securities laws are formulated to incorporate best practices, and are comparable to those of developed markets, with regularly refinements made to ensure their continued efficiency and relevance. This is necessary to take into account the rapid pace of financial innovation and evolving practices of financial institutions. Malaysia's securities laws were recently updated with the passage of the Capital Markets and Services Act 2007 that came into effect in September 2007. The new Act reinforces a sound investor protection framework and orderly market development, while promoting international best practices in the capital market and among its participants. The Act also clarifies the legislative framework applicable to Islamic securities and provides for the universal nature of the Islamic banking licence accorded under the Islamic Banking Act 1983. With the coming into force of this new legislation, Islamic banks are positioned to take on a more pivotal role in the development of the Islamic capital markets.

The MIFC portal ([www.mifc.com](http://www.mifc.com)) was launched in 2007 as the primary public source of information on the latest MIFC initiatives and developments. Closer linkages are also being fostered with other Islamic financial centres to promote international economic and financial cooperation in the field of Islamic finance. Memoranda of Understanding (MoUs) were signed between Bank Negara Malaysia and two Islamic financial services authorities, namely, the Dubai Financial Services Authority and the Qatar Financial Centre Regulatory Authority. The MoUs signify the authorities' joint commitments to promote the development of the global Islamic financial services industry and pave the way for better cooperation between Islamic financial centres operating in different time zones. Areas covered under the MoUs include capacity building, human capital development and initiatives to enhance the breadth and depth of financial markets as well as promote Shariah harmonisation.

### **ENHANCING OPERATIONAL EFFICIENCY AND EFFECTIVENESS**

With increasing competition in the financial sector placing continued pressure on profit margins, measures to enhance operational efficiencies have become more critical to financial institutions' long-term viability. In the banking sector, gross interest margins continued to decline from 3.2% in 2001 to 2.7% in 2007. This has increased the need for more strategic management of cost structures, product risks, and group synergies. To support the ability of financial institutions to respond quickly to changing market conditions, several regulatory guidelines and processes have been reviewed to accord financial institutions greater operational flexibilities. These included:

- Flexibility allowed for insurance companies to outsource fund management activities to