3RD QUARTER 2011 VOL 6 NO 3

Suruhanjaya Sekuriti
Securities Commission
Malaysia

malaysian ICM

Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission Malaysia

Contents

Enabling a Corporate Structure for Islamic Finance[1]

The year was 1977 when promoters of Islamic finance held the benchmark conference in Mecca, discussing the way forward for Islamic finance and seeking to define 'Islamic finance'. The discussion then veered much closer to the colonial legacy that was inherited. Many countries had ruled out capitalism because of its association with colonialism rather than anything else. The Arab world was inclined to look at the solution of infusing Islam into communism, to see if that path can somehow make progressive economics work. As it was only 10 years after the Arab nationalist model collapsed in 1967, there were not that many illusions about the nature and weaknesses of the state. As the other options were no less problematic, it was decided, at that benchmark conference, to pursue Islamic finance in a direction which would not require the government to introduce drastic changes which would impact on the existing social-economic climate or the political structure back then.

[1] This article is extracted from a speech delivered by Iqbal Asaria, Takaful Advisory Group, Institute of Islamic Banking & Insurance UK, at the Second SC-OCIS Roundtable in March 2011.

page 3 ▶▶

The Use of Asset from Mixed Activities as an Underlying Asset in Sukuk Ijarah

In line with the current development in the sukuk market, there are suggestions to use an asset for mixed activities as the underlying asset in the structuring of sukuk particularly sukuk *ijarah*. The question is whether such arrangement is acceptable because the structuring of a sukuk requires an underlying asset that is Shariah compliant.

For example, a hypermarket has both elements of *halal* and *haram* as the goods sold typically include liquor and other non-Shariah compliant goods. The rental income from these activities will be the means to pay the sukuk *ijarah* holders.

The Shariah Advisory Council (SAC) has decided[1] that an asset utilised for mixed activities may be used as the underlying asset in sukuk *ijarah* if the rental received from non-Shariah compliant activities is below the 20% benchmark compared to the total rental received for the said asset. The SAC decision is based on the following factors:

(1) The 20% benchmark for mixed rental income from non-permissible activities in Islamic Real Estate Investment Trusts (i-REITs)

The SAC has resolved that an Islamic REIT is permitted to purchase a property, provided that the rental income from non-compliant activities for the property does not exceed 20% of the REIT's revenue.

(2) The 20% benchmark for mixed rental income from non-permisible activities in evaluating listed securities

The SAC uses the 20% benchmark to assess the level of contribution of mixed rental income from non-permissible activities to total revenue and profit before tax of a listed company in determining its Shariah-compliant status.

"...under fiqh muamalat, both sale contracts (bai) and rental (ijarah) are classified under `uqud mu`awadah. The SAC has applied this precentage in determining the benchmark for rental arising from non-permissible activities."

The stance taken by the SAC is premised on the view of the Hanafi School of law. Nevertheless, the view was with regard to establishing a benchmark of 20% for the sale of fixed assets involving *ghabn fahisy*[1]. This was chosen as the closest precedent benchmark since under *fiqh muamalat*, both sale contracts (*bai*) and rental (*ijarah*) are classified under *`uqud mu`awadah* (contract of exchange). The SAC has applied this precentage in determining the benchmark for rental arising from non-permissible activities.

The SAC, based on *ijtihad*, has applied this 20% benchmark when determining the upper limit for the rental from non-permissible activities. Thus, if the rental income from non-permissible activities is below the 20% benchmark, then the asset is considered to be Shariah-compliant.

Conclusion

Based on the above, an asset utilised for mixed activities can be used as an underlying asset in the issuance of sukuk *ijarah* provided that the contribution from non-permissible activities is below the 20% benchmark set by the SAC.

---

[1] *Ghabn* refers to the act of cheating or deceiving to enable selling of goods above the market price or norm. *Ghabn* can be divided into *ghabn fahisy*, i.e. excessive, and *ghabn yasir* i.e. minimal. However, if the price is transparent and mutually acceptable to both parties, then this does not fall under *ghabn*.

cover page ▶▶

The path chosen at that crossroad was a pragmatic one – to start something and then see what comes. The need for public good in Islamic finance was not considered at that time. Over the years, however, most Islamic economists have started to advocate that Islamic finance must serve the public good. We cannot leave economic management to the state because that poses a bigger risk than having markets. Professor Galbraith in his last book, titled 'Innocent Fraud', outlined a number of frauds perpetrated on mankind and one of them is the rebranding of capitalism as market economy. Capitalism is a charged term, market economy appears much friendlier and more benign, without which we would not have progressed. Nonetheless, Islamic economists also adopted that market mantra too.

Since the state is not adequately empowered to deliver all the objectives in relation to the redistribution of wealth and equitable management etc., we had to do most of it through the markets. On the other hand, when we came to the markets, the end point of the glorified market economy is summarised in this post-crisis balance sheet, where you see that there is nothing right on the left side of the balance sheet and there is nothing left on the right side. We are completely out of business. This is what brought Lord Turner[2] to say that most of the present-day financial activities are socially useless. This brings us to the question of public good: Where are we today? We start our analysis by using these two as take-off points and see what we could do.

The first thing to consider would be the nature of ownership itself. The main characteristic of a capitalist market economy is that ownership is absolute though many Muslim economists have said that it is not as absolute as we would wish. There is an underlying notion of stewardship in resource ownership of mankind. The implications of this are that there is a right of collectivity in anybody's ownership. Ownership is not just due to one's own effort but also a trust from God. When we translate that into things like limited liability, corporate structures and so on, we will begin to face conflicts with our stakeholders. If we complicate that by superimposing some of the *maqasid* of Shariah on top of public good achievements, then we have to make major adjustments to our ideas on ownership and entitlement to ownership. This can be seen in agriculture-based societies where the question that is often raised is how much land should one own if one is not using it.

In industrial countries, this would translate into other kinds of disputes on how much wealth or how much disparity in wealth can we have in a fair society.

The last question would be what can Islamic finance do to address some of these conflicts? Even promoters of Islamic finance are saying, "We do not want to carry the entire burden (of solving conflicts). We probably have to look to other places to situate that…."

“The other thing which emerged following current developments is that whilst markets are central, they are not infallible. Even in the freest of markets, like the financial markets, stakeholders were priding themselves by light regulations, saying that the freest of markets will be self-regulating while effectively rigged by tax-payers' subsidies.”

The other thing which emerged following current developments is that whilst markets are central, they are not infallible. Even in the freest of markets, like the financial markets, stakeholders were priding themselves on light regulations, saying that the freest of markets will be self-regulating while effectively rigged by tax-

[2] Chairman of the Financial Services Authority, UK.

payers' subsidies. So when the freest of markets are rigged by tax payers' subsidies, the implication is that regulation of markets becomes imperative.

The second part of this is that there are areas where markets have simply failed. This is in terms of considering inter-generational equity and distributional equity. In distributional equity for example, the classic argument was that if you achieve growth, there will be a trickle-down effect and therefore growth would be democratised. But to use a phrase "nothing grows from the top down", what we have seen since then is a disparity in wealth; the sort of concentration of wealth from the top has been increasing despite a general growth, so there is inequity in that sense.

We now come to the idea that we have to address both rigged markets and market failures and that has to be done through regulations. Unfortunately, in all these, we cannot avoid the state one way or another. Thus we have to figure out how to empower or control the state to manage these conflicts. In terms of stakeholders, if we dilute the ownership, we obviously have this notion that managers are there to maximise shareholder wealth.

We can take a more enlightened view of shareholder wealth, for example in the UK, where there is a big debate on the rights of pensioners in corporate wealth. In many cases, companies are being sold with huge pension deficits in the companies' pension funds, and the rights of the pensioners have not been respected. In the last few years representatives of pension funds were appointed and given a veto right on mergers and acquisitions. A classic case was the failed attempt by the Qatar Investment Authority to acquire Salisbury because the pension fund deficit was not adequately funded according to pension trustees. So, there was an additional stakeholder who came into play, claiming a right to that wealth. In the same way, if we increase the common good standard, and take into consideration the rights of the society and future generations; then there will be more stakeholder limits imposed on ownership, which the management will need to take into account.

At the moment, this check and balance process is achieved through corporate governance but these are really proxy euphemisms to avoid the problem which can only be addressed by changing the whole ownership structure. In terms of corporate structure, this crisis also showed that we cannot have the same structure for different corporations. Financial institutions are different from productive institutions or non-profit organisations. Each one has its own unique characteristics. In financial institutions for example, if we guarantee debt, incentivise debt through our taxation structure and then we give tax payers guarantee to the whole structure, we are essentially creating a casino. This may not be the same in a productive institution. If we create a huge incentive for debt through tax incentives, then we effectively distort Modigliani Miller's finance theorem that the debt equity structure effectively is neutral to value. There are other considerations which may take us there i.e. what is neutral to the value of the corporation. Then we have what is now a big debate on whether bondholders should also bear the losses if something goes wrong. At the moment the answer is no. We can see in the sovereign default or near default in some European countries, this is the big discussion. And all these lead to mispricing of capital and therefore, we will get allocation to financial resource risks, which should have gone elsewhere – creating bubbles, like the property asset bubbles in the US and Europe.

"One of the things which we have not taken on board in Islamic finance is leverage. Are we opposed to leverage because of riba or because of risks? The question arises because a lot of leverages have been created through Islamic instruments – Islamic bonds or Sukuk which avoided the question of riba but left the risk question unanswered."

One of the things which we have not taken on board in Islamic finance is leverage. Are we opposed to leverage because of *riba* or because of risks? The question arises because a lot of leverages have been created through Islamic instruments – Islamic bonds or Sukuk which avoided the question of *riba* but left the risk question unanswered. Finance professionals would like to think that the *riba* restrictions are because of risk. Shariah scholars would think that as long as there is no *riba*, risk is not their problem. In reality it is indeed a problem of the market. So we have highly indebted Shariah-compliant customers who are defaulting and what do we do with them? What do we do with institutions which said that they have complied with the letter of the law?

Lastly, as far as the issue of equitable distribution is concerned, we can no longer ignore it as we did in 1977 (as we are seeing in developments across the region in Muslim countries like those in North Africa and the Middle East). Unless we address this question, we are going to have upheavals of one kind or another. The question is can we address it through institutional mechanisms or is it a question of charity?

In the UK now, there is this big debate which is subsumed under the term of The Spirit Level debate. This was named after a book written by two health economists in York University, who showed that for countries with the same level of income, those which have better equitable distribution suffered less social problems than others. At the bottom of the pile was the United States. If you look at other countries in the same income range, then the best income distribution was seen in the Scandinavian countries. So you could see obviously that this is not a Shariah objective without merit. This is a very valid objective which needs to be pursued.

In countries like the UK, we can sometimes see that people on different parts of the same borough live longer than others. Is this socially defensible? Is it something which can be addressed through Islamic finance or through financial mechanism in general?

If we want to introduce socially responsible investing (SRI) considerations, there are a number of things that Islamic institutions can do. For example, every Islamic financial institution can look at its lending portfolio, measure the carbon footprint of that portfolio and then target to reduce that carbon footprint over a number of years in its lending priorities. Another suggestion is to implement a living wage rather than minimum wage and absorb the costs incurred by customers whom they lend to, as practised by some of the co-operative banks in Europe. There are many things which can be done. In this era, Islamic finance can no longer avoid addressing the question of public good.

Revision to the Islamic Securities Guidelines (Sukuk Guidelines)

The SC has issued the revised *Islamic Securities Guidelines* (Sukuk Guidelines) as part of efforts to enhance the regulatory framework for fundraising and product regulation in the sukuk market.

The revisions are in line with the broader objectives of the *Capital Market Masterplan 2* (CMP2) which seek to achieve higher levels of operational efficiency, enhance standards for fair and ethical business practices, strengthen internal controls for business conduct and risk management.

The revised Sukuk Guidelines, which came into effect on 12 August 2011, provide greater clarity on the application of Shariah rulings and principles endorsed by the SC's SAC in relation to sukuk transactions. The revised Sukuk Guidelines will help Malaysia maintain its leading position by continuously attracting both local and international issuers and investors into the sukuk market.

News Round-up

Federation of Investment Managers Malaysia's Industry Dialogue

Federation of Investment Managers Malaysia organised a dialogue entitled 'Marketing and Distribution of Islamic Funds' on 11 July 2011 at Sime Darby Convention Centre for unit trust management companies and other registered persons. The dialogue provided a platform to discuss the challenges in the marketing and distribution of Islamic unit trusts and to identify issues and methods to overcome such challenges.

The SC presented keynote addresses in the morning and afternoon sessions for unit trust management companies, institutional unit trust advisers and corporate unit trust advisers respectively.

Islamic Finance Structured Programme for CIS Countries

The ICM Business Group representative was invited to present a topic on Islamic capital market in one of the sessions of Islamic Finance Structured Programme for Commonwealth of Independent States (CIS) countries. The programme, organized by Bank Negara Malaysia (BNM) for CIS countries e.g. Tajikistan, Kyrgyzstan and Kazakhstan, was held from 18 to 22 July 2011 in Kuala Lumpur. It discussed, among others, Shariah principles in Islamic finance, overview of Islamic finance and the Malaysian legal and taxation framework for Islamic banking, Islamic money market as well as Islamic capital market.

Islamic Fund Management Programme, Jakarta

In conjunction with the High Level Joint Conference on Islamic Finance hosted by Bank Indonesia and BNM, the SC held a programme on Islamic fund management in Jakarta on 19 July 2011.

Through the programme, Malaysian Islamic fund management companies were able to share information and network with the Indonesian fund managers and institutional investors. It also provided an opportunity for the participants to discuss issues on Islamic fund management as well as to explore business opportunities between Indonesian and Malaysian industry players.

Workshop on Islamic Finance: Structure and Instruments, Turkey

The workshop was organised by BNM, in collaboration with the Islamic Development Bank and the Central Bank of the Republic of Turkey, from 26 to 30 September 2011 in Ankara, Turkey. The workshop was attended by policy makers from the Central Asian Countries, Middle East and Asian Region. The SC representative presented three topics – 'Overview of Islamic Capital Market', 'Regulatory Framework for Islamic Capital Market' and 'Islamic Debt Capital Markets/Sukuk: Shariah Contracts and Operations'.

MIFC Business Trip to Istanbul, Turkey

The Malaysia International Islamic Financial Centre (MIFC) organised a business trip to Turkey from 28 to 29 September 2011 to foster linkages between the Turkish and Malaysian market players and to explore potential collaboration initiatives between both countries. The SC's representative also participated in an industry dialogue with fellow regulators and gave a brief presentation on current development in Malaysia's Islamic capital market.

Malaysian ICM – Facts and Figures

Shariah-compliant securities on Bursa Malaysia

	Sept 2011	Sept 2010
No. of Shariah-compliant securities+	847	847
% to total listed securities	89%	88%
Lastest market capitalisation:		
Shariah-compliant (RM billion)	723	719
Total market (RM billion)	1,172	1,150
% of Shariah-compliant securities to total market	62%	63%

+ The SAC of SC releases the updated Shariah-compliant securities list twice a year in May and November

Islamic unit trust funds (UTF)

No. of launched funds	Sept 2011	Sept 2010
Islamic UTF	163	148
Total industry	590	561
NAV (RM billion)	**Sept 2011**	**Sept 2010**
Islamic UTF	25	23
Total industry	235	223
% to total industry	11%	10%

Islamic wholesale funds (WF)

Number of launched funds	Sept 2011	Sept 2010
Islamic WF	24	20
Total industry	130	102
NAV (RM billion)	**Sept 2011**	**Sept 2010**
Islamic WF	6.5	4.7
Total industry	23	18
% to total industry	28%	25%

Corporate sukuk

Sukuk approved	Q1–Q3 2011	Q1–Q3 2010
No. of sukuk	26	13
Size of sukuk approved (RM billion)	40.7	19.8
Size of total bonds approved (RM billion)	63.8	35.9
% of sukuk approved to total bonds approved	64%	55%
Sukuk issued	**Q1–Q3 2011**	**Q1–Q3 2010**
Size of sukuk issued (RM billion)	33	18.9
Size of total bonds issued (RM billion)	53	34.8
% of sukuk issued to total bonds issued	62%	54%
Sukuk outstanding	Sept 2011	Sept 2010
Size of outstanding sukuk (RM billion)	200	135
Size of total outstanding bonds (RM billion)	343	310
% of outstanding sukuk to total outstanding bonds	58%	56%

Chart 1
KLCI and Shariah Index Performance

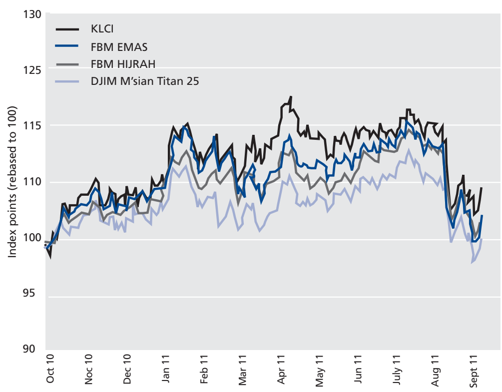
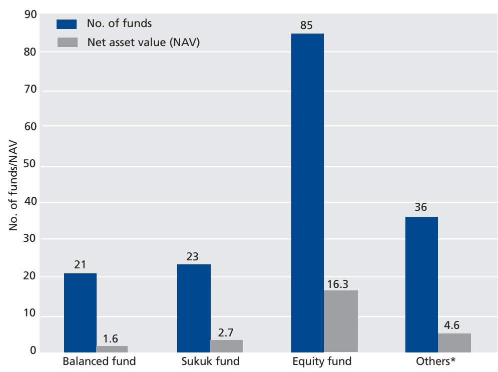
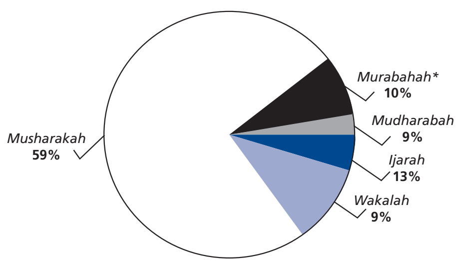


Chart 2
Islamic unit trust fund by category



*Including feeder funds, fixed income funds, money market funds, structured products and mixed asset funds

Chart 3
Sukuk approved based on various Shariah-principles in Q1-Q3 2011



*includes the approval of combination issuance (conventional bond and sukuk).

Islamic assets under management* (AUM)

(RM billion)	Sept 2011	Aug 2011
Islamic AUM	58	58
Total industry	398.2	409.58
% to total industry	14.6%	14.22%

* includes assets that are sourced from collective investment schemes as well as private mandates

Equity market indices	30 Sept 2011	30 Sept 2010	% change
KL Composite Index (KLCI)	1,387.13	1,463.50	-5%
FBM EMAS Shariah	9,126.66	9,471.35	-4%
FBM Hijrah Shariah	9,765.66	9,984.45	-2%
DJIM Malaysia Titans 25	790.94	796.61	-1%

Islamic Exchange-traded Funds (ETF)

No. of ETF	Sept 2011	Sept 2010
Islamic ETF	1	1
Total industry	5	5
NAV (RM billion)	**Sept 2011**	**Sept 2010**
Islamic ETF	478	631
Total industry	1,088	1,196
% to total industry	44%	53%

Islamic real estate investment trusts (REIT)

No. of REIT	Sept 2011	Sept 2010
Islamic REIT	3	3
Total industry	14	14
Market capitalisation (RM billion)		
Islamic REIT	2.4	2.2
Total industry	11.3	10.1
% to total industry	22%	22%

List of companies offering Islamic stockbroking services as at September 2011

No.	Company	Type
1.	BIMB Securities Sdn Bhd	Full Fledged
2.	Affin Investment Bank Bhd	Window
3.	AmInvestment Bank Bhd	Window
4.	CIMB Investment Bank Bhd	Window
5.	Maybank Investment Bank Bhd	Window
6.	Jupiter Securities Sdn Bhd	Window
7.	RHB Investment Bank Bhd	Window

Sukuk listing under Bursa Malaysia's exempt regime as at September 2011

No.	Issuer Name	Listing Date
1	Wakala Global Sukuk Bhd	7-Jul-11
2	IDB Trust Services Limited (Islamic Development Bank)	1-Dec-10
3	Malaysia Airports Capital Bhd	30-Nov-10
4	AmIslamic Bank Bhd	1-Oct-10
5	Tadamun Services Bhd (Islamic Development Bank)	24-Aug-10
6	Nomura Sukuk Limited (Nomura Holdings PLC)	13-Jul-10
7	1Malaysia Sukuk Global Bhd (Government of Malaysia)	8-Jun-10
8	Sime Darby Bhd	28-Jan-10
9	Cherating Capital Limited	31-Dec-09
10	Paka Capital Limited	31-Dec-09
11	Khazanah Nasional Bhd	31-Dec-09
12	Danga Capital Bhd	31-Dec-09
13	Rantau Abang Capital Bhd	31-Dec-09
14	CIMB Islamic Bank Bhd	29-Dec-09
15	G.E Capital Sukuk Limited (General Electric)	30-Nov-09
16	Cagamas MBS	14-Aug-09
17	Petronas Global Sukuk Limited	14-Aug-09

Source: Bursa Malaysia Berhad
For more information on Sukuk listed on Bursa Malaysia, please visit www.bursamalaysia.com:Market Information > Listed Sukuk/Bonds > Listed under Exempt Regime

Sukuk listing on LFX as at September 2011

No.	Issuer Name	Listing Date
1	MBB Sukuk Inc.	27 Apr 07
2	Cherating Capital Limited	6 Jul 07
3	Dar Al-Arkan International Sukuk Company	31 Jul 07
4	Paka Capital Limited	14 Mar 08
5	Petronas Global Sukuk Ltd	14 Aug 09
6	1Malaysia Sukuk Global Bhd	8 Jun 10
7	Danga Capital Bhd	12 Aug 10

Source: Labuan International Financial Exchange (LFX)
For more information on sukuk listed on LFX, please visit: www.lfx.com.my

List of Islamic fund managers as at 30 September 2011

No.	Company	No.	Company
1	Aberdeen Islamic Asset Mgmt Sdn Bhd	9	KFH Asset Management Sdn Bhd
2	AmIslamic Funds Mgmt Sdn Bhd	10	Muamalat Invest Sdn Bhd
3	Amundi Islamic Malaysia Sdn Bhd	11	Nomura Islamic Asset Mgmt Sdn Bhd
4	Asian Islamic Investment Mgmt Sdn Bhd	12	OSK-UOB Islamic Fund Mgmt Bhd
5	BNP Paribas Investment Partners Najmah Malaysia Sdn Bhd	13	Prudential Al-Wara' Asset Mgmt Bhd
6	CIMB-Principal Islamic Asset Mgmt Sdn Bhd	14	Reliance Asset Mgmt (M) Sdn Bhd
7	Franklin Templeton GSC Asset Mgmt Sdn Bhd	15	RHB Islamic Asset Mgmt Sdn Bhd
8	*i*-VCAP Management Sdn Bhd	16	Saturna Sdn Bhd

We appreciate your feedback and comments. If you would like to know more about the Malaysian Islamic capital market or require further information from the Securities Commission Malaysia, please contact the following persons at the Islamic Capital Market Business Group:

Mohd Radzuan A Tajuddin
Tel: 03–6204 8000 ext 8718
E-mail: Radzuan@seccom.com.my

Badlishah Bashah
Tel: 03–6204 8000 ext 8373
E-mail: badlisha@seccom.com.my

Azmaniza Bidin
Tel: 03–6204 8000 ext 8280
E-mail: azmaniza@seccom.com.my

Mohd Lukman Mahmud
Tel: 03–6204 8000 ext 8385
E-mail: lukman@seccom.com.my

Securities Commission Malaysia
3 Persiaran Bukit Kiara, Bukit Kiara
50490 Kuala Lumpur Malaysia
Tel: 03–6204 8000 Fax: 603–6201 5082
Website: www.sc.com.my