1ST QUARTER 2011 VOL 6 NO 1

Suruhanjaya Sekuriti
Securities Commission
Malaysia

malaysian ICM

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

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Malaysia's Shariah Stock Screening Methodology and Index

The origins of stock screening

The concept of screening corporations before investing in them is derived from the Shariah principle that Muslims should not partake in activities that do not comply with the teachings of Islam. As in the legal convention, the Shariah also recognises that the ownership of shares in a company is considered a proportionate ownership of the company's business and assets. Muslim investors therefore cannot own an entity that is involved in Shariah non-compliant activities. Due to the prevalence of the interest-based conventional banking system, most of the corporations end up with dealings that have elements of interest, even though it is not part of their major business activities.

Recognising the important role of listed corporations in the economy, Shariah scholars have come up with certain criteria where mandates containing a set of sector and financial screens are properly defined.

Prior to 1983, Malaysian investors who wanted to invest in Shariah permissible stocks had few leads. There were counters that were clearly non-permissible (Table 1). On the other hand, there was little guidance as to whether a counter was truly Shariah compliant, even though its principal activities appeared permissible. There was also a possibility that these corporations might involve in a myriad of non-permissible secondary activities.

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SC Appoints Executive Director for ICM Business Group

Malaysia's Islamic capital market (ICM) has grown rapidly over the past decade, generally outpacing the conventional sector, with double-digit growth. This prominence as an important contribution to economic growth necessitated the transformation of the SC's ICM Department into a business group.

The appointment of Zainal Izlan Zainal Abidin as the Executive Director for the ICM Business Group, with effect from January 2011 provides the focused leadership impetus for the SC's continuing efforts to enhance Malaysia's capabilities in this segment, particularly in the challenging areas of sophisticated product innovation and cross-border financial transactions and linkages.

Zainal Izlan brings with him over 20 years of industry experience and international exposure. Prior to joining the SC, he was the Chief Executive Officer of i-VCap Management Sdn Bhd.

He has held a number of senior positions in professional bodies and associations such as Vice-Chairman of the Malaysian Association of Asset Managers (MAAM), Chairman of the Islamic Fund Management Sub-Committee of MAAM and Chairman/President of CFA Malaysia (local chapter of the CFA Institute, US).

Capital Market Masterplan 2

In April, the SC launched the Capital Market Masterplan 2 (CMP2) which provides strategic blueprint for the development of the Malaysian capital market over the next 10 years. CMP2 will leverage on the sound foundation built during the first Capital Market Masterplan or CMP1. Over its ten-year period, 95% of the 152 recommendations contained in CMP1 have been implemented, building a diversified market with strong intermediaries operating in a well-regulated environment.

Themed Growth with Governance, CMP2 tackles the challenges for Malaysia's capital market in expanding its role in invigorating national economic growth while addressing concerns about the efficacy of markets in the aftermath of the global financial crisis. A copy of CMP2 is available on the SC website and the publication is also available for purchase.

SC to Enhance Oversight on Credit Rating Agencies

On 30 March 2011, the SC issued the *Guidelines on the Registration of Credit Rating Agencies* to ensure independent and high quality ratings with appropriate oversight of the credit rating agencies (CRAs), given their key role in capital markets.

The guidelines enhance the agencies' standards in key areas such as transparency of rating criteria and policies, objectivity of rating process, managing conflicts of interest, and also enable the SC to supervise the CRAs in a more vigorous manner.

In January 2006, Malaysia was ahead of many jurisdictions when an effective regulatory and supervisory framework on the domestic CRAs was established. Nonetheless, global regulatory and supervisory standards on CRAs have recently experienced a dramatic shift following the global financial crisis. Revisions to the International Organization of Securities Commissions (IOSCO)'s Objectives and Principles of Securities Regulation in June 2010 now subject CRAs to adequate levels of oversight, through a system of registration and on-going supervision.

Major jurisdictions, including the US, European Union, Japan, Australia and India have also undertaken various regulatory measures to strengthen oversight on CRAs and to raise their standards.

> *"...global regulatory and supervisory standards on CRAs have recently experienced a dramatic shift following the global financial crisis."*

The SC engaged in structured consultations with key players comprising institutional investors, credit rating agencies, issuers, advisors and trustees in the domestic bond market, in developing these guidelines. It will enable Malaysia's credit rating agencies to converge with the international standards and best practices set out by IOSCO and other advanced jurisdictions.

These guidelines supersede the *Practice Note on Recognition of Credit Rating Agencies for the Purpose of Rating Bond Issue*, issued by the SC on 25 January 2006. A copy of the guidelines is available at www.sc.com.my.

Underlying Assets in Sukuk Issuance

There has been a widening scope of asset underliers – both tangible and intangible – used to back the asset-based or securitisation process of sukuk issuances. Whilst this is a welcome development for the Islamic capital market, an issue that has often cropped up is on the utilisation of a building that operates mainly for Shariah non-compliant activities as the underlying asset in *bai` bithaman ajil* (BBA) or *murabahah* contracts.

This article will look into views of Islamic jurists and the resolution of the SAC of the SC on underlying assets in sukuk issuance.[1]

Background

Various views of past Islamic jurists relating to selling grapes or its juice to liquor manufacturers formed the basis for the SAC resolution. What is apparent here is that the underlying asset (grapes) is *halal* but the sale transaction is for an activity that is prohibited in Islam (liquor manufacturing). It is worth noting that a majority of Islamic jurists have declared that the sale of grapes and its juice to liquor producers is prohibited (*haram*), an opinion which is preferred to other opinions.

First view: It is prohibited to sell something for use in an activity that is prohibited in Islam.

Allah (swt) stated in the Quran:

> *"And do not help each other in sin and transgression."*
> (Surah *al-Maidah*: verse 2)

This verse clearly states that helping others to commit sin is prohibited. We can infer that a transaction is prohibited if the execution of the transaction is for a purpose which Islam forbids, and the purpose is clearly stated in the contract or can be easily identified.

A hadith from Prophet Muhammad (pbuh) which states that any activity related to something prohibited in Islam is considered haram, further supports this view (as narrated in Ibn Majah, *Kitab al-Ashribah, Bab Lu`inat al-Khamr `ala `Asharah Awjuh*, hadith no: 3380):

> *"The cursing of liquor comes in 10 forms, the liquor, the producer, the processor, the seller, the buyer, the person who delivers it, the recipient, the person who accepts its price (proceeds from sale of the liquor), the person who drinks it and the person who serves it."*

This view is declared by the Maliki school, Hanbali school, Abu Yusuf and Muhammad based on the principle of *istihsan*.[2]

The Shafi'i school also shares the same opinion, provided that the seller knows that the buyer will use the grapes/juice to produce liquor.

Al-Suyuti in his book *al-Asybah wa al-Naza'ir* wrote:

> *"A sale transaction falls into several categories: (first) valid, (second) fasid, (third) valid based on a more authoritative view, (fourth) fasid based on a more authoritative view, (fifth) prohibited but valid - such as the sale of grapes where the seller knew that the buyer will produce liquor from the grapes or a sale during the Friday azan – and (sixth) makruh[3] – such as the sale of grapes whereby the seller has zan[4] that the buyer will produce liquor from the grapes."*

On the other hand, al-Ramli in his book *Nihayah al-Muhtaj* wrote that if the seller has *zan* (and the buyer will use the subject matter to commit sins), then the sale contract becomes *haram*. On the contrary, if the seller

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1 Securities Commission Malaysia, 2009, Ground Rules for Sukuk Issuance in Islamic Capital Market Series – Sukuk, Kuala Lumpur.
2 This refers to disregarding a Shariah ruling that is backed by evidence and applying another Shariah ruling that is more convincing and stronger than the former, based on evidence of *Syara`* in permitting the act in question.
3 *Makruh* means you are rewarded if you avoid committing a certain act but you are not punished even if the act is committed.
4 *Zan* is a state between *shak* (doubtful) and *yaqin* (certain).

has *shak* (doubtful) it is considered as *makruh*.

Second View: It is *makruh* to sell something for the purpose of undertaking Shariah non-compliant activity

The transaction is *makruh* according to the views of Imam al-Shafi'i and others like al-Syirazi in the Shafi'i school.

Third view: It is permissible to sell something for the purpose of undertaking Shariah non-compliant activity

In this case, the sale transaction is treated as valid as the subject matter is *halal* and that the buyer's intention does not affect the validity of the transaction.

Al-Sarakhsi wrote in his book *al-Mabsut*:

> *There is no harm in selling juice to liquor producers because the juice is clean and halal. Therefore, it can be sold and the seller can use the money generated from the transaction. There is no negative intention from the seller. The negative intention only comes from the buyer. No one is obliged against other people's sins.*

This view is given by Abu Hanifah and others Hanafis like Ibn Abidin.

SAC Resolution

The SAC has therefore ruled that the underlying assets in sukuk issuances must be Shariah-compliant. The views of a majority of Islamic jurists, who have declared the prohibition of selling grapes or its juice to liquor producers, justify the ruling of the SAC.

“...The SAC has therefore ruled that the underlying assets in sukuk issuances must be Shariah-compliant. The views of a majority of Islamic jurists, who have declared the prohibition of selling grapes or its juice to liquor producers, justify the ruling of the SAC.”

Going back to the question at the beginning of this article, a building therefore does not qualify as an underlying asset (for sukuk) if the major tenant operates an activity that is not permissible in Islam, for example, a conventional bank.

Conclusion

Clearly, any asset that is used for activities that do not comply with the tenets of Shariah cannot be used as the underlying asset in sukuk issuance under`*uqud mu`awadhat* (contracts of exchange) such as BBA, *murabahah*, *istisna*` and *ijarah*. What differentiates between sukuk and conventional bond is the requirement of Shariah-compliant underlying assets for sukuk. Allowing the utilisation of Shariah non-compliant assets as underliers in sukuk issuance would contaminate Islamic equities in particular and taint the image of Islamic finance in general.

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Table 1

Non-Permissible Activities	
Non-Shariah permissible activities	
(a)	Financial services based on *riba* (interest);
(b)	Gambling and gaming;
(c)	Manufacture or sale of non-halal products or related products;
(d)	Conventional insurance;
(e)	Entertainment activities that are non-permissible according to Shariah;
(f)	Manufacture or sale of tobacco-based products or related products;
(g)	Stockbroking or share trading in Shariah non-compliant securities; and
(h)	Other activities deemed non-permissible according to Shariah.

The initial effort of providing a list of Shariah-compliant stocks was undertaken by Bank Islam Malaysia Bhd in 1983. The formalisation of the Shariah equity market in Malaysia began with the creation of the world's first Shariah index by RHB Securities in 1996. Meanwhile, the SAC of the SC developed its screening methodology in 1995 and issued its first list of Shariah-compliant securities two years later. This was to be the sole Malaysian standard.

Methods in Shariah screening

Different Shariah boards have different approaches to Shariah screening that may produce different Shariah compliant outcomes for a given stock. The most established method is "Index-screening" made by Standards & Poor (S&P), Dow Jones and FTSE . The SAC of the SC on the other hand conducts stock screening of all stocks on Bursa Malaysia. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) does not have a screening method but has Standard Number 21 on stocks and bond trading and stipulates a minimum of 30% on *`ayn* assets in the case where the corporations' assets are composed of tangible assets, benefits, cash and debts.[1] This approach is adopted by the S&P, Dow Jones and FTSE.

SAC of the SC's stock screening

The first step in the SAC's methodology is the elimination of corporations involved in non-permissible activities. This is followed by application of the benchmark test[2] (Table 2) which is based principally on items in the profit and loss statement (P&L). The rationale of using the P&L is that it captures the activities of the company for the entire financial period.

In conducting its Shariah screening, the SC, by virtue of its role as a market regulator, is empowered to request additional information from the listed corporations to further clarify the composition of non-permissible income and dividends, which are normally not disclosed in the financial statements. In this way, the SAC screening gains its credibility from the SC's authority.

Table 2

Shariah Advisory Council Benchmarks
The 5% benchmark – used to assess the level of mixed contributions from activities that are clearly prohibited such as *riba* (interest-based companies like conventional banks), gambling, liquor, and pork.
The 10% benchmark – used to assess the level of mixed contributions from activities that involve the element of *"umum balwa"* which is a prohibited element affecting most people and difficult to avoid. An example of such a contribution is the interest income from fixed deposits in conventional banks. This benchmark is also used for tobacco-related activities.
The 20% benchmark – used to assess the level of contribution from mixed rental payment from Shariah non-compliant activities such as the rental payment from premises used in conjunction with gambling, sale of liquor, etc.
The 25% benchmark – used to assess the level of mixed contributions from activities that are generally permissible according to Shariah and have an element of *maslahah* to the public, but there are other elements that may affect the Shariah status of these activities. Among the activities that belong to this benchmark are hotel and resort operations, share trading, stockbroking and others, as these activities may also involve other activities that are deemed non-permissible according to the Shariah.

1 AAOIFI Shariah standard no. 21, item 3/19
2 In determining the permissible status, the SAC also takes into consideration the public perception of the corporations, *maslahah*, *umum balwa* and *uruf*. For further information, go to http://www.sc.com.my/eng/html/icm/sas/sc_syariahcompliant_101126.pdf.

Financial ratios for stock screening

The most widely used Shariah screening uses ratios based on the balance sheet which highlights the financial position of the company at a particular point of time i.e. the balance sheet date. When items such as conventional debt (*dayn*) receivables and cash are significant, trading of the stocks is akin to trading of the *dayn* or leading to *riba* itself. The global index providers such as S&P, Dow Jones and FTSE take this approach which they have termed as accounting-based screening. Information is relied upon from published annual reports. (Table 3)

The SAC did not adopt the balance-sheet approach because it recognises that corporations could materially transact in non-permissible activities before the balance sheet date and this would not be captured or reflected at all in the balance sheet date, not to mention when corporations undertake window-dressing of the balance sheet. But the SAC does acknowledge that using the accounting ratios from the balance-sheet is a useful measure to ensure that a corporation's cash, debt or receivables do not constitute a significant portion of its entire assets.

The attraction and perception of debt

The debt: asset ratio is not an unwavering condition but also depends on *ijtihad*. This is supported by the following–

- In 2003, the Islamic Development Bank issued a hybrid sukuk which required it to be backed by no less than 51% *ijarah* assets. This translates to a ceiling of 49% for *dayn* receivables in the form of *murabahah* financing and *istisna`* assets. When IDB wanted to issue *sukuk wakala bil istismar* in 2009, the portfolio of asset was reduced to a minimum of 30% *ijarah* assets. Perhaps owing to the lack of sufficient *ijarah* assets or equity-like receivables, the issue tolerated a maximum of 70% debt. This affirms the reality that *fatwa* depends on *ijtihad* of conditions surrounding the events.

- Consider project finance deals that are highly leveraged which sometimes go as high as 90:10. This is the reality of project finance[3] deals. Would it do justice for project finance deals to be excluded from being permissible and not qualified for Shariah-compliant initial public offering even though the nature of the activity is permissible?

Secondly, preference for debt should not be looked at in isolation but rather on the factors influencing it. Debt capital has its advantages (over equity) including interest expense[4] being tax-deductable, lower cost of financing, avoidance of dilution in shareholding (from new share issues), preservation of profits (from being distributed to new shareholders), ability to pare down debts to reduce cost of capital. Considering all this, debt-capital certainly has its lure.

Table 3

Ratio	S&P and Dow Jones	FTSE
Leverage compliance[1]	Debt: Market capitalisation < 33%	Debt: Total asset < 33%
Cash compliance	Cash and interest bearing securities: Market capitalisation < 33%	Cash and interest bearing securities: Total asset < 33%
Accounts receivables compliance	Accounts receivables: Market capitalisation < 49%	Accounts receivables + cash < 50% of total assets
Non-permissible revenue[2] (other than interest) Non-operating interest income	< 5% of total revenue	< 5% of total revenue < 5% of total revenue

Note:
1 The one-third rule is premised on one saying by the Holy Prophet that one third is big or abundant.
2 The reliability of the information cannot be determined as such figures are not classified in the annual reports, unless information is given by the corporations.

3 *Mudharabah/musharakah* VC or PE arrangements don't normally fit into project financing as the project sponsors would want to maintain control over the company
4 Or profit paid in the case of Islamic financing.

Thirdly, and a paramount point, is that a corporation's capital structure is very much dependant on the weighted average cost of capital which derives an optimal cost of capital based on a certain weightage of debt and capital.

The equity market is usually a transitional phase. When a company first seeks capital, it would be from its shareholders. Then it seeks credit from suppliers and financing from banks. In the next stage, if it is eligible, the company goes for listing. Eventually, it would tap the sukuk market. So, under the different phases of capital requirements, equity may have its limitations (again as compared to debt).

Until we are able to establish an Islamic financial system which predominantly operates on risk-sharing as opposed to debt-based, the fact that the debt-based system will continue to have its lure over equity is unavoidable. Having established this, the next section is a comparative study between the SAC's screening and index screening methodologies. Without any malice or intention of singling out any of the index screen providers, for this purpose, we will use S&P as a general representation of index screening.

An analysis of index screening outcome

As at 31 December 2010, the bourses of Saudi Arabia and Malaysia had 81% and 30% Shariah-compliant corporations, respectively. The S&P BMI Index is summarised in Table 4. The detailed index can be found under Tables 5–7.

Table 4

	Malaysia (No. of companies)	Saudi Arabia (No. of companies)
Listed companies	961	146[1]
Eligibility test	126 (13%)	107 (73%)
Shariah compliance	38 (30%)	87 (81%)

Note:
[1] http://www.gulfbase.com/site/interface/MarketWatch.aspx?m=1.

The composition of corporations passing S&P's eligibility criteria[5] is higher for Saudi Arabia than for Malaysia, that is, 73% versus 13%, respectively. On further analysis, we can deduce that:

- Malaysia has fewer corporations with sizeable market capitalisation, liquid shares, large public float, and sustained profitability in terms of percentage (though greater in numbers, as in the next bullet)
- There were more Malaysian corporations which were leveraged. While 20% more Malaysian corporations (in terms of stock count) are observed to have passed the eligibility test, further Shariah filtering has resulted in fewer Malaysian than Saudi Arabian Shariah-compliant corporations.

Clearly, a low-leverage structure is a consequence of recurrent liquidity and an underdeveloped debt/fixed-income market. Moreover, low leverage is not so much about being debt-averse but rather an outcome of the economic and market conditions of a country. In other words we could assume that when corporations become more inclined towards debt as a result of changes or development in market conditions, the number of Shariah-compliant corporations not passing the financial ratios

"Having established this, the next section is a comparative study between the SAC's screening and index screening methodologies. Without any malice or intention of singling out any of the index screen providers, for this purpose, we will use S&P as a general representation of index screening."

[5] Considers market capitalization, liquidity, public float, sector class, financial viability.

Table 5

S&P Malaysia BMI (31 December 2010)

Sector	Conventional			Shariah		
	Index Market Cap (US$bil)	Index Weight (%)	Stock Count	Index Market Cap (US$bil)	Index Weight (%)	Stock Count
Consumer Discretionary	17,651	14.11	17	470	1.21	2
Consumer Staples	18,547	14.83	13	14,196	36.69	8
Energy	3,489	2.79	8	2,519	6.51	4
Financials	30,028	24.01	30	1,569	4.05	3
Health Care	1,905	1.52	7	1,263	3.26	4
Industrials	23,619	18.88	28	10,219	26.41	9
Information Technology	728	0.58	4	352	0.91	3
Materials	7,463	5.97	9	799	2.06	1
Telecommunication						
Services	11,974	9.57	5	6,202	16.03	3
Utilities	9,664	7.73	5	1,106	2.86	1
Total	**125,069**	**100**	**126**	**38,695**	**100**	**38**

Table 6

S&P Saudi Arabia BMI (31 December 2010)

Sector	Conventional			Shariah		
	Index Market Cap (US$bil)	Index Weight (%)	Stock Count	Index Market Cap (US$bil)	Index Weight (%)	Stock Count
Consumer discretionary	2,099	1.49	11	2,099	2.16	11
Consumer staples	7,570	5.38	12	7,570	7.80	12
Energy	2,352	1.67	4	1,438	1.48	3
Financials	55,960	39.74	25	29,332	30.21	15
Health care	712	0.51	2	712	0.73	2
Industrials	9,185	6.52	16	4,035	4.16	13
Materials	48,598	34.51	30	37,555	38.68	24
Telecommunication	11,176	7.94	4	11,176	11.51	4
Utilities	3,162	2.25	3	3,162	3.26	3
Total	**140,814**	**100**	**107**	**97,080**	**100**	**87**

Table 7

Sector	Malaysian Stock Count		Saudi Arabian Stock Count	
	Conventional	Shariah	Conventional	Shariah
Consumer discretionary	17	2	11	11
Consumer staples	13	8	12	12
Energy	8	4	4	3
Financials	30	3	25	15
Health care	7	4	2	2
Industrials	28	9	16	13
Information technology	4	3	–	–
Materials	9	1	30	24
Telecommunication	5	3	4	4
Utilities	5	1	3	3

will rise in tandem. Already, as more and more borrowers tap into the Islamic debt market, some quarters have anticipated that the GCC may take over Malaysia as the leading sukuk destination. It would be interesting to see whether corporations that make the debt test now would still pass when that happens.

Currently, there are two local Shariah indexes comprising Malaysian stocks. They are the FBM Emas Shariah Index and the FBM Hijrah Shariah Index.[6] FBM Emas Shariah Index[7] is based on eligible stocks which are approved by the SAC while the FBM Hijrah Shariah Index is based on eligible stocks that have passed FTSE's Shariah screening methodology.

At first glance, it can be concluded that there is a limited number (38) of Malaysian Shariah-compliant counters in the S&P BMI Malaysia Index. The reason for the smaller number, as been mentioned above, is a two-fold result of the:

- Eligibility screening which removes small capitalisation, illiquid and small public float corporations; and
- Shariah debt-screening.

The index screening unfortunately removes stocks that are otherwise Shariah compliant but not eligible (small capitalisation, illiquid and small public float corporations). Therefore, it displaces the choice which could otherwise be made available to investors.

Additionally, Shariah screening methodology is a matter of preference or marketing and is not something universal. If you are comfortable with the SAC's screening, then you would certainly choose an index such as the FTSE-Emas Bursa Malaysia which has 281 Shariah-compliant corporations (Table 8).

Another factor that the index screening considers is that the conversion of conventional debts to *ijarah*, *musharakah* and *mudharabah* financing would enable corporations to "pass" the debt-screening test. Accordingly, there is therefore an incentive to convert the conventional into Islamic debts. However, in reality, many of these sukuk are still debt-based, given that the issuer is required to repay the financing through the purchase undertaking, instead of true risk-sharing or lease structure. That begets the next question: If, and only if, these sukuk are debts and they had not been accounted for in the debt count, then the total

[6] Bursa Malaysia and FTSE collaborated to introduce a new series of Bursa Malaysia indices known as the FBM index series or the FTSE Bursa Malaysia Index Series.

[7] *Ibid*

Table 8

FTSE Bursa Malaysia Emas Shariah Index Top 10 Constituents

Rank	Constituent Name	ICB Supersector	Net Market Cap (RM)	Index Weight (%)
1	Sime Darby	Industrial Goods & Services	39,587	9.91
2	Axiata Group	Telecommunications	30,086	7.54
3	IOI Corporation	Food & Beverage	29,031	7.27
4	Tenaga Nasional	Utilities	27,135	6.80
5	MISC	Industrial Goods & Services	14,927	3.74
6	Digi.Com	Telecommunications	14,345	3.59
7	Petronas Chemicals Group	Chemicals	13,248	3.32
8	Maxis	Telecommunications	11,925	2.99
9	Kuala Lumpur Kepong	Food & Beverage	11,810	2.96
10	Telekom Malaysia	Telecommunications	9,418	2.36
		Total	**201,511**	**50.47**

FTSE Bursa Malaysia Emas Shariah Index Portfolio Characteristics

	ICB Supersector	FTSE Bursa Malaysia EMAS Index
Number of Constituents	281	361
Net Market Cap (RM)	399,274	679,958
Constituent Sizes (Net Market Cap RM)		
Average	1,421	1,884
Largest	39,587	47,384
Smallest	29	29
Median	245	284
Weight of Largest Constituent (%)	9.91	6.94
Top 10 Holdings (% Index Market Cap)	50.47	47.96

Source: FTSE Group, data as at 30 December 2010.

debt was actually understated in the total debt test. Would this have not led to overstating the number of companies that passed the Shariah test?

Ijtihad of the SAC

When the SAC came up with the screening methodology, it was intended to cater for the Malaysian market, taking into account *maslahah*, *urf* and other secondary sources of *fiqh muamalat*. The creation of benchmarks is the result of a pragmatic approach in recognising the diversity within the social fabric i.e. the diverse ethnic, socio-economic and religious background in Malaysia. The barometer reflects varying degrees of Shariah tolerance measured against the degree of maturity of the Islamic financial industry. What was instituted in Malaysia was the *ijtihad*, after assessing local market conditions. By *ijtihad*, we mean making them relevant to modern times and within the Shariah framework. It was not meant as a strict black-and-white screening methodology, but rather one that reflects the domestic *urf* (customs). Market conditions in one jurisdiction may be unique to another. For example, one may question why is that 10% becomes the ceiling for interest-income received?[8] The explanation is that, at one point, Islamic banks are still new (to the market) and it takes time for the market to migrate their deposits to Islamic banks. Thus, there is an element of tolerance and 10% was the *ijtihad* and certainly this *ijtihad* can be re-visited as and when the market environment develops.

This is certainly the case, for example, when Dow Jones revised its interest income ratio before removing it; and applying a trailing 24-month average market capitalisation from the previous 12 month-base. As Dr Mohammad Obaidullah of Islamic Research and Training Institute (IRTI) stated *"... screening is a subject matter of continuous change in the light of new insights and that these should not be taken as "divine" rules of Shariah compliance..."*

Thus, investors are free to choose and the SAC screening methodology may very well be applied in other jurisdictions although its benchmarks could possibly differ because of conditions unique there. Therefore, one can certainly apply his own *ijtihad* in the absence of other screening methodology in his own country.

Conclusion

The SAC is respectful of the decisions of Shariah scholars even if they differ. Interestingly, they (the differences) only make up a minute percentage of *fatawa* but more often than not, these minute differences often gets highlighted, giving the impression that there are numerous. The creed of the four *imams* establishes a say that if a *fuqaha* has made a *fatwa* to his best knowledge but had erred, he would still receive God's blessings although by a lesser degree. Even a leading international Shariah scholar has remarked that just because some SAC resolutions differ from the GCC, that does not make them unacceptable.

Each screening methodology has its own objectives. The SAC continues to assess and revisit its resolutions based on *ijtihad*. The legal maxim,

لا ينكر تغير الأحكام بتغير الأزمان

which may be translated as "rulings may change in accordance to the demands over the progress of time", reaffirms this stand.

At the same time, the push for Shariah-based financing through more risk-sharing financing should complement the screening methodologies. This is because the inducement for such instruments would coherently lead to more companies passing the Shariah litmus-test and expanding the Islamic finance universe.

[8] Interest income received from placements with conventional bank, interest bearing securities under conditions that are difficult to avoid.

Year in Review: 2010[1]

Malaysia continued to strengthen its position as an international Islamic financial centre through various initiatives. Amidst the uncertainties of the global financial system in the aftermath of the recent crisis, the ICM went through many positive developments. In line with maintaining an innovative approach in product design, the Malaysian ICM recorded a number of achievements in the structuring of sukuk and the institutionalisation of laws within a Shariah-governance framework as well as played host to a number of high-profile branding and capacity building programmes.

The year 2010 also presented the Islamic finance industry with many opportunities to promote the virtues of a Shariah-compliant financial system.

Progress in sukuk market

Malaysia once again proved its strength as a leader in sukuk origination with Cagamas Bhd's issuance of Sukuk al-Amanah Li al-Istithmar (Sukuk ALIm). Sukuk ALIm is a type of mixed-asset sukuk, comprising 51% tangible *ijarah* assets and 49% intangible *bai` bithaman ajil* receivables, which adopts the Shariah principles of *ijarah* (lease transaction), *bai`* (sale of assets), *wakalah* (contract of agency) and *bai` bithaman ajil* (sale of assets with deferred payment). Sukuk ALIm is tradable in the secondary market.

Another notable exercise was the up to RM4.2 billion Sukuk Ijarah Programme by Celcom Transmission (M) Sdn Bhd (CTX). The sukuk structure involved a head lease and sub-lease between CTX and investors. For a one-off rental payment, CTX will lease telecommunication towers and network assets to investors under a 100-year term head lease agreement. The sukuk issued represents the investors' proportionate, undivided beneficial interest, i.e. *manfa'ah* (usufruct) in the *ijarah* assets, pursuant to the head lease agreement, and entitles the investors to the rental under the sub-lease agreement entered with CTX.

The Budget 2011 proposal, that expenses for the issuance of Islamic securities which adopt the principles of *murabahah* or *bai` bithaman ajil* based on *tawarruq* (tripartite arrangement) be tax deductible, was introduced with the objective of maintaining the competitiveness of the sukuk market. This incentive will commence from year of assessment 2011 until year of assessment 2015. Aside from benefitting sukuk issuers who utilise any commodity trading platform in facilitating the sukuk issuance.

Islamic fund management hub

Reflecting Malaysia's value proposition as the global hub for dedicated Islamic fund management companies, the SC approved another four Islamic fund management licences for the year, bringing the number of full-fledged Islamic fund management companies to 15. Of the four newly-approved companies, two are foreign-owned, namely, Franklin Templeton GSC Asset Management Sdn Bhd and Saturna Sdn Bhd. The other two fund management companies were OSK-UOB Islamic Fund Management Bhd, a joint venture between a foreign and local entity, and Muamalat Invest Sdn Bhd.

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[1] This article is extracted from the *Securities Commission Malaysia 2010 Annual Report*

Strengthening the SAC

The SAC of SC has been instrumental in the development of innovative Islamic financial products and services, and played a key role in transforming the niche ICM into a core component of the Malaysian capital market. The amended *Capital Market and Services Act 2007* (CMSA), which came into force on 1 April 2010, has strengthened the role of the SAC. Pursuant to the amendments, the SAC is empowered to make rulings on any Shariah matter relating to an ICM business or transaction that is referred to it by any court, arbitrator, industry participant or other parties.

New Shariah Advisory Council members

Following the amendments to the CMSA, His Majesty the Yang di-Pertuan Agong appointed 11 new members of the SAC. The appointment of these members, who are well-versed in *fiqh al-muamalah* (Islamic law relating to financial transactions), Islamic jurisprudence, Islamic finance and other relevant disciplines, took effect from 1 July 2010 for a period of two years.

Dr Mohd Daud Bakar, President/CEO of Amanie Business Solutions Sdn Bhd, is the Chairman of the SAC and the members are:

- Tun Abdul Hamid Haji Mohamad, Former Chief Justice of the Federal Court, Malaysia
- Tan Sri Sheikh Ghazali Haji Abdul Rahman, Shariah Legal Advisor, Attorney General's Chambers
- Datuk Haji Md Hashim Haji Yahaya, Very Distinguished Academic Fellow of Ahmad Ibrahim Kulliyyah of Laws, International Islamic University Malaysia
- Dato' Dr Abdul Halim Ismail, Former Executive Director of BIMB Securities Sdn Bhd
- Associate Professor Dr Shamsiah Mohamad, Lecturer, Department of Fiqh and Usul, Academy of Islamic Studies, University of Malaya
- Professor Mohammad Hashim Kamali, Founding Chairman and CEO of the International Institute of Advanced Islamic Studies, Malaysia
- Professor Dr H. Fathurrahman Djamil, Vice Chairman of Fatwa Commission of Indonesian Council of Ulama
- Assistant Professor Dr Aznan Hasan, Department of Islamic Law, Ahmad Ibrahim Kulliyyah of Laws, International Islamic University Malaysia
- Ahmad Suhaimi Yahya, Chief Officer and Regional Head of Shariah, Kuwait Finance House (Malaysia) Bhd
- Rafe Haneef, CEO, HSBC Amanah Malaysia Bhd

Registered Shariah advisers

In the area of compliance, Shariah advisers form the backbone of the ICM industry. In this respect, it is crucial that only qualified individuals and corporations provide advice on all Shariah-based products and services regulated by the SC. This is in line with the requirement as set out in the *Registration of Shariah Advisers Guidelines*. As in the previous years, several new registrations from individuals and corporations, both local and foreign were seen this year. As at end 2010, the SC registered a total of 46 individuals and 11 corporations. Of these, six individuals and five corporations were foreigners.

Key resolutions by the SAC in 2010

***Ijarah Mudhafah Ila Mustaqbal* (Future Lease)**	This contract is permissible in the Shariah.
***Hamisy jiddiyyah* (security deposit) in *ijarah* contract**	The application of *hamisy jiddiyyah* in *ijarah* contract is permissible. The purpose of this payment is to secure the asset for the potential lessee to lease the asset. The lessor has the right to invest the *hamisy jiddiyyah* paid by the lessee subject to permission obtained from the lessee.
`*Urbun* (down payment) in *ijarah* contract	The application of `*urbun in ijarah* contract is permissible. The payment of `*urbun* is made at the execution of *ijarah* contract.
Underlying asset of Islamic capital market products insured under conventional insurance policy.	All underlying assets of Islamic capital market products must be covered using *takaful* policy. However, if *takaful* operator could not afford to offer such services, the asset owner can opt for conventional insurance policy. If the asset has been covered under conventional insurance policy upon entering into the contract, the said insurance policy can still be used until its expiry date. Upon its expiry, the asset owner must renew it with *takaful* policy. This ruling only applies to *ijarah* assets.

The Royal Award for Islamic Finance

Efforts to raise the international profile of the Malaysian ICM were also intensified. The Royal Award for Islamic Finance was inaugurated by the SC and BNM as an initiative under the Malaysian International Islamic Financial Centre (MIFC) to identify and acknowledge a unique individual's outstanding contribution and impact towards the advancement of Islamic finance globally, beyond commercial achievements.

To establish and preserve the credibility and stature of the award, an independent jury panel consisting of seven eminent individuals – Shariah scholars, academicians and Islamic finance practitioners from round the world was convened.

The Deputy Yang di-Pertuan Agong and Sultan of Kedah, on behalf of The Yang di-Pertuan Agong, presented the Royal Award at a gala dinner and award presentation on 25 October 2010 to Shaikh Saleh Abdullah Kamel, Chairman and founder of the Dallah Al Baraka Group, in recognition of his visionary drive, extraordinary leadership and personal commitment to the advancement of Islamic finance globally.

Avenue for intellectual discourse

As part of our commitment to provide an avenue for intellectual discourse and bring about a greater awareness and understanding among scholars, industry practitioners, regulators, intermediaries and investors, both local and international, the SC collaborated with the Oxford Centre for Islamic Studies (OCIS) in 2009, upon the recommendation of our International Advisory Committee (IAC). The result was the high profile inaugural SC-OCIS Roundtable and Forum held in March 2010. The roundtable looked into "Developing a Scientific Methodology on Shariah Governance for Positioning Islamic Finance Globally", while the public forum was on the theme "Contribution of Islamic Finance Post Global Financial Crisis".

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Prominent international Islamic finance experts including Dr Mohamed Ali Elgari, Dr Abbas Mirakhor, Abdulkader Thomas, Dr Mohamed Nedal Alchaar, Professor Habib Ahmed, Mushtak Parker, Dr Salman Ali and Davide Barzillai, joined Malaysia's own experts, Professor Mohammad Hashim Kamali, Dr Mohamed Akram Laidin, Badlisyah Abdul Ghani, Dr Mohd Daud Bakar, Rafe Haneef and Andri Aidham, in providing insightful comments, ideas and inputs.

The SC also continued to organise various capacity building programmes with a view to developing new talent and strengthening skills and knowledge among existing ICM professionals. The programmes were:

- The 4th International Islamic Capital Market Forum (IICMF);
- The 5th Islamic Markets Programme (IMP);
- The 6th Shariah Advisers' Workshop;
- 2nd and 3rd Islamic Capital Market Graduate Training Scheme (ICMGTS);
- International Shariah Investment Convention (ISIC); and
- Expert Talk series.

News Round-up

Expert Talk

On 7 January, the SC organised an Expert Talk on Islamic Structured Products. The talk was delivered by a representative from Maybank Islamic Bhd. The session discussed the application of Shariah principles in the structuring of structured products, the mechanisms involved as well as the examination of several case studies.

Islamic Capital Market Graduate Training Scheme

The fourth Islamic Capital Market Graduate Training Scheme (ICMGTS), held from 7 January to 7 March, saw the participation of 44 local graduates. During the programme, graduates were exposed to a combination of structured and experiential learning comprising lectures, illustrative examples, case studies, simulation, and interaction to equip them with the necessary technical knowledge and skill to enter the industry.

Presentation at the Institute of Islamic Training Malaysia

On 24 February, the SC representative delivered a presentation on the Malaysian ICM at the Institute of Islamic Training Malaysia (ILIM). The session discussed three main areas namely, the Islamic finance system in Malaysia, ICM and its current development.

Third Visiting Scholar Programme

The third Visiting Scholar Programme, a collaboration between the SC and the University of Malaya, commenced on 12 January with Dr Volker Nienhaus, currently a Visiting Professor at the University of Reading, UK, as the visiting scholar. Dr Nienhaus was in Malaysia for three weeks.

He delivered a public lecture on 25 January at the SC entitled "Building Blocks of Islamic Finance: Regulation and Shariah in Perspective". During his visit, he had given series of lectures and workshops at the University of Malaya. Dr Nienhaus was also a guest panel speaker at a discussion on "Enhancing the Shariah Structure and Compliance in Promoting Financial Stability", jointly organised by International Shariah Research Academy of Islamic Finance and Islamic Financial Services Board.

Second SC–OCIS Roundtable on Islamic Finance

The SC and the OCIS – convened a two-day closed-door Roundtable on Islamic Finance in Ditchley Park, Oxfordshire on 12 and 13 March 2011.

The Roundtable was part of the collaboration between the SC and the OCIS that began in 2009. The inaugural Roundtable and Forum were held on the 15 and 16 March 2010, respectively, in Kuala Lumpur.

This year, under the theme "Islamic Finance and the Public Good", a selected group of key industry practitioners, senior academicians, Shariah scholars, standard setters and regulators from around the world came together to discuss three topics, namely "Shariah, Finance and the Public Good"; "Shariah, Recourse to Law and Enforceability of Financial Contracts"; and "Creating an Enabling Corporate Structure for Islamic and Ethical Finance".

Workshop on IFSB Standards for Islamic financial Institutions and ICM

From 16 to 17 March, the SC hosted the Workshop on IFSB standards for Islamic financial institutions and ICM. The workshop, specially tailored for institutions offering Islamic financial services as well as supervisory and regulatory authorities, covered the following IFSB standards:

- Guiding Principles on Governance for Islamic Collective Investment Schemes
- Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate Investment
- Guiding principles on Conduct of Business for Institutions Offering Islamic Financial Services
- Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Principles

The workshop was attended by representatives from the SC, Bursa Malaysia, Islamic fund management companies, unit trust management companies managing Shariah-compliant unit trust funds, as well as, Islamic stockbroking companies and relevant association bodies, i.e. FIMM and MAAM.

Malaysia ICM – Facts and Figures

Shariah-compliant securities on Bursa Malaysia

	Mar 2011	Mar 2010
No of Shariah-compliant securities+	846	846
% to total listed securities	88%	88%
Lastest market capitalisation:		
Shariah-compliant (RM billion)	769.12	670.35
Total market (RM billion)	1,310.99	1,061.06
% of Shariah-compliant securities to total market	58.67%	63.18%

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

Equity market indices	31 Mar 2011	31 Mar 2010	% change
KL Composite Index (KLCI)	1,545.13	1,320.57	17%
FBM EMAS Shariah	10,373.21	8,925.85	16%
FBM Hijrah Shariah	10,837.3	9,458.09	15%
DJIM Malaysia Titans 25	899.69	769.66	17%

Islamic unit trust funds (UTF)

Number of approved funds	Mar 2011	Mar 2010
Islamic UTF	156	156
Total industry+	590	574
NAV (RM billion)	**Mar 2011**	**Mar 2010**
Islamic UTF	25.02	22.69
Total industry	240.24	204.40
% to total industry	10.42%	11.10%

+ including feeder funds, fixed income funds, money market funds and structured products.

Islamic wholesale funds (WF)

Number of approved funds	Mar 2011	Mar 2010
Islamic WF	23	20
Total industry	119	99
NAV (RM billion)	**Mar 2011**	**Mar 2010**
Islamic WF	4.26	4.17
Total industry	18.17	15.09
% to total industry	23%	28%

Islamic exchange-traded funds (ETF)

Number of approved ETF	Mar 2011	Mar 2010
Islamic ETF	1	1
Total industry+	5	3
NAV (RM billion)	**Mar 2011**	**Mar 2010**
Islamic ETF	0.64	0.67
Total industry	1.25	1.2
% to total industry	51%	56%

+ including bond ETF - ABF Malaysia Bond Index Fund

Chart 1

KLCI and Shariah Index Performance

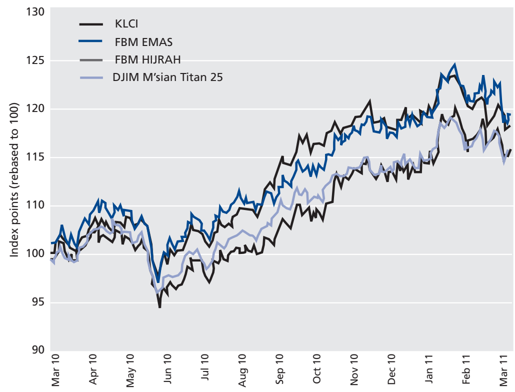
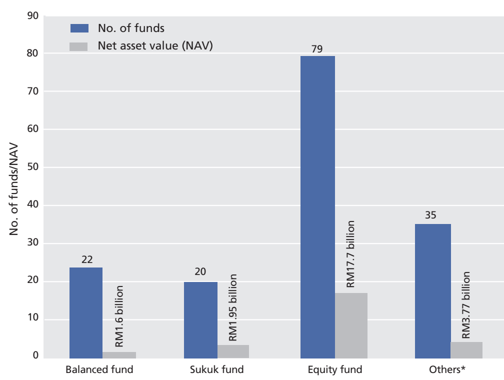


Chart 2

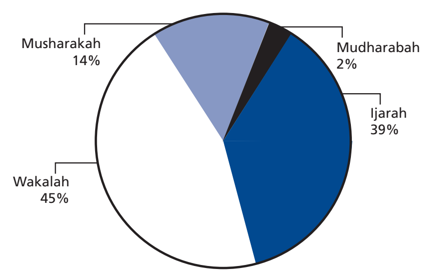
Islamic unit trust funds by category*



*As at March 2011

Chart 3

Size of sukuk approved based on various Shariah principles in Q1 2011



Islamic real estate investment trusts (REITs)

Number of REITs	Mar 2011	Mar 2010
Islamic REIT	3	3
Total REITs	14	12
Market capitalisation (RM billion)	**Mar 2011**	**Mar 2010**
Islamic REIT	2.35	1.89
Total REITs	10.84	5.42
% total industry	22%	35%

Corporate sukuk

Sukuk approved	Q1 2011	Q1 2010
Number of sukuk	5	2
Size of sukuk (RM billion)	7.8	0.6
Size of total bonds approved (RM billion)	13.7	9.2
% of size of sukuk to total bonds approved	57%	6%
Sukuk issued	**Q1 2011**	**Q1 2010**
Size of sukuk issued (RM billion)	9.5	2.2
Size of total bonds issued (RM billion)	12.3	5.1
% of sukuk issued to total bonds issued	78%	43%
Sukuk outstanding	**Mar 2011**	**Mar 2010**
Size of outstanding sukuk (RM billion)	183	168
Size of total outstanding bonds (RM billion)	320	295
% of outstanding sukuk to total outstanding bonds	57%	57%

Sukuk Listing on Bursa Malaysia's Exempt Regime (As at 31 March 2011)

No.	Issuer Name	Listing Date
1	IDB Trust Services Limited (Islamic Development Bank)	1 Dec 10
2	Malaysia Airports Capital Berhad	30 Nov 10
3	AmIslamic Bank Berhad	1 Oct 10
4	Tadamun Services Berhad (Islamic Development Bank)	24 Aug 10
5	Nomura Sukuk Limited (Nomura Holdings PLC)	13 Jul 10
6	1Malaysia Sukuk Global Berhad (Government of Malaysia)	8 Jun 10
7	Sime Darby Berhad	28 Jan 10
8	Rafflesia Capital Limited	31 Dec 09
9	Cherating Capital Limited	31 Dec 09
10	Paka Capital Limited	31 Dec 09
11	Khazanah Nasional Berhad	31 Dec 09
12	Danga Capital Berhad	31 Dec 09
13	Rantau Abang Capital Berhad	31-Dec-09
14	CIMB Islamic Bank Berhad	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 *(www.bursamalaysia.com)*
For more information on Sukuk listed on Bursa Malaysia, please visit: Bursa Malaysia Exempt Regime.

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:

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