



malaysian ICM

Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

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REMARKABLE PROGRESS IN 2006

Capital seekers and providers have continued to show great interest in the Malaysian Islamic capital market (ICM) in line with the growing demand for Islamic financial services. Islamic equity and *sukuk* markets have expanded rapidly with the introduction of various innovative Shariah-compliant products over the past few years.

To position Malaysia as a global ICM hub, essential regulatory, tax and Shariah frameworks have been put in place. Broad-based initiatives have also been aggressively pursued to widen the range of instruments to cater to the different needs of issuers and varying risk-return appetites of investors. As a result, we have seen more sophisticated and innovative ICM products being developed, most of which are internationally acceptable.

Several significant milestones were achieved in 2006 to fulfil the government's agenda of issuing more globally accepted *sukuk*, based on concepts of *mudharabah*,

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UNDERSTANDING THE PRINCIPLE OF BAY` MUZAYADAH

In Islamic financial transactions, price is determined on a willing buyer, willing seller basis. In most instances, the seller will sell to the highest bidder. From a Shariah perspective, a transaction that involves bidding is known as *bay` muzayadah*.

Bay` muzayadah is the offering of goods for sale in a market by a seller, with numerous buyers competing to offer the highest price. This process ends with the seller selling the goods to the highest bidder. It is similar to an auction and other names for this principle used by past Islamic jurists include *bay` fuqara'*, *bay` man kasadat bidha'atuhu*, *bay` mahawij*, and *bay` mafalis*.

This concept is relevant in many issues for the ICM, especially in relation to the behaviour of market participants profiteering from price differences. It is also used as an argument to permit speculation so long as it does not contradict Shariah principles.

Reference and evidence of bay` muzayadah

Bay` muzayadah is a form of trading which has existed and has been applied in the *muamalat* system for a long time. Past Islamic jurists had debated the topic to determine its status. Thus, in evaluating its status from the Shariah aspect, the opinions of the past Islamic jurists were studied.

Athar as basis

The following are the *athar* (practices based on the Companions of the Prophet s.a.w.) supporting *bay` muzayadah*:

- Imam Bukhari had written a specific topic on the

concept and views of `Ata' who said that *bay` muzayadah* was practised by society in the sale of war booty.

- Anas had reported the Prophet s.a.w. calling out for customers when selling a carpet and a water vessel. A man offered to buy them for one dirham. The Prophet s.a.w. then asked for a higher bid. Another man offered two dirham and the Prophet s.a.w. sold him the wares.

Opinions of the past Islamic jurists

There were two dividing opinions among past Islamic jurists on the Shariah status of *bay` muzayadah*. The majority viewed it as permissible by Shariah, while the minority thought otherwise. The main reason for the difference in opinion was the interpretation of the *hadith* of the Prophet s.a.w., which prohibited bidding on another person's bidding (*saum `ala saum akhihi*).

Al-Kasani, a jurist of Hanafi *Mazhab*, said that *bay` muzayadah* is not prohibited because the Prophet s.a.w. himself practised it. Ibnu Humam, another jurist of Hanafi *Mazhab*, also permitted the principle using the same argument.

Ibnu Juzay, a jurist of Maliki *Mazhab* permitted this principle because it is different from *saum `ala saum akhihi* which is forbidden, and there is no element of unfairness in choosing goods. Ibnu Qudamah, a jurist of Hanbali *Mazhab*, stated that *bay` muzayadah* is permitted according to *ijma`* based on what was practised by the Prophet s.a.w.

In summary, although there are different views on the permissibility of *bay` muzayadah*, the majority of jurists allow it.



RECENT SAC RULINGS

For more than 10 years, the Shariah Advisory Council (SAC) of the SC has facilitated the development of the ICM industry through its key resolutions on various ICM issues. All key resolutions of the SAC since 1996 were published in the book, *Resolutions of the Securities*

Commission Shariah Advisory Council in 2003. The second edition of the book was launched in conjunction with the SAC's 10th anniversary in 2006. Table 1 lists the key resolutions made by the SAC in 2006, while Table 2 lists the current members of the SAC.

Table 1
Key resolutions made by the SAC in 2006

Equity	
Redeemable preference shares	<p>Redeemable reference shares (RPS) are in line with the Shariah principles. The ruling was made on the basis that the application of buy back in <i>musyarakah mutanaqisah</i> can be similarly applied in RPS.</p> <p>For RPS to conform with Shariah principles, the purchase price set at the time of issuance must be based on the principle of <i>wa'd</i>, in which the issuer promises to buy back the preference shares from the shareholders at a future date based on the purchase price promised at the date of issuance.</p>
Regulated short selling	Regulated short selling (RSS) is Shariah compliant because there is no element of <i>gharar</i> (ambiguity) involved. However, the underlying securities must be Shariah compliant.
Benchmark for non-permissible rental activities of listed companies	The benchmark for non-permissible rental activities of listed companies is 20%, consistent with the benchmark for non-permissible rental activities of Islamic real estate investment trusts (REITs).
Futures	
Single stock futures	Single stock futures are Shariah compliant provided that the underlying assets are Shariah-compliant securities. This resolution is made on the basis that the instruments are free from elements of <i>muqamarah</i> (gambling), <i>bai' ma'dum</i> (buying and selling something which does not exist), <i>jahalah</i> (ignorance) and <i>gharar</i> (uncertainty). The instrument is traded in clear quantities and pricing is based on market demand and supply.
Sukuk	
The usage of <i>sukuk</i> for the issuance of Islamic bonds	The term <i>sukuk</i> will be used for all Islamic bonds. However, it must be used together with Shariah principles applied in the structure, such as BBA, <i>murabahah</i> and <i>istisna`</i> for underlying transactions based on indebtedness, or <i>musyarakah</i> and <i>mudharabah</i> for underlying transactions based on partnership.



Table 1 (continued)

Key resolutions made by the SAC in 2006

Sukuk	
Maintenance of <i>ijarah</i> asset	Parties who are responsible for the maintenance of <i>ijarah</i> properties must adhere to the terms as stated in the contract; otherwise they must follow <i>`urf</i> or custom.
The use of asset from mixed-activities as underlying asset in <i>sukuk ijarah</i>	Assets from mixed activities can be utilised as an underlying asset in a <i>sukuk ijarah</i> structure, provided the amount of rental received from Shariah non-compliant activities is below 20% of the total rental revenue.

Table 2

SAC members

Name	Designation
Datuk Sheikh Ghazali Haji Abdul Rahman (Chairman)	Director General/Shariah Chief Justice, Department of Shariah Judiciary Malaysia
Datuk Haji Md Hashim Haji Yahaya	Very Distinguished Academic Fellow, Ahmad Ibrahim Kulliyah of Laws, International Islamic University Malaysia
Prof Dr Abdul Monir Yaacob	Lecturer, Shariah and Law Department, Academy of Islamic Studies, University Malaya
Dato' Hassan Haji Ahmad	Mufti of Penang
Dato' Dr Abdul Halim Ismail	Executive Director, BIMB Securities Sdn Bhd
Dato' Abdul Hamid Haji Mohamad	Judge, Federal Court of Malaysia
Dr Mohd Daud Bakar	President/CEO, Amanie Business Solutions Sdn Bhd
Assoc Prof Dr Abdul Halim Muhammad	Lecturer, Law Faculty, Universiti Kebangsaan Malaysia
Dr Mohd Ali Haji Baharum	Deputy President, Angkatan Koperasi Kebangsaan Malaysia Bhd



PIONEERING ISLAMIC EQUITY-BASED INVESTMENT INDUSTRY

Shariah-compliant securities are securities (ordinary shares, warrants and transferable subscription rights) of a Bursa Malaysia-listed company which have been classified as Shariah permissible for investment, based on the company's compliance with Shariah principles in terms of its primary business and investment activities.

In the 1970s and 1980s, participation of Muslim investors in the ICM was minimal as there was insufficient guidance on which securities Muslims can invest in. Although investments in equities were generally permissible, the lack of clear guidance and authoritative views made it difficult for Muslim investors to identify securities that were deemed permissible from the Shariah point of view. Companies that issued securities were involved in various kinds of business activities, some of which were deemed impermissible for Muslims to invest in as the returns in the form of dividends or capital gains could contain non-permissible elements. This, to a large extent, handicapped Muslims in this area of economic activity which had undergone rapid growth and transformation from a simple to a much more sophisticated market. This missed opportunity was felt most in the early 1990s when a significant number of companies were listed on the stock exchange.

In response to the need for such investment guidelines, Bank Islam Malaysia Bhd (Bank Islam) took the initiative to review and identify companies which were deemed permissible for Muslims to invest in. It provided the much needed breakthrough for Muslim investors to meaningfully participate in the stock market. Bank Islam provided investors with a list of Shariah-compliant shares by excluding shares of companies that were involved in activities with non-permissible elements such as *riba*, gambling and gaming, non-*halal* food and liquor-related activities.

The effort was given a further boost with the introduction of the Shariah-compliant securities

list in June 1997 by the Shariah Advisory Council (SAC) of the SC. In the process of determining the Shariah status of listed securities, the SAC developed several basic Shariah criteria as guidance. The criteria were based on the Quran and the Sunnah, as well as the general principles of *Syara'*. In this process, the SAC focused on the core activities of the companies, such as goods and services that were offered to their customers. Goods and services which are involved in the following activities were considered Shariah non-compliant:

- Financial services based on *riba* (interest)
- Gambling and gaming
- Manufacture or sale of non-*halal* products or related products
- Conventional insurance
- Entertainment activities that are non-permissible according to Shariah
- Manufacture or sale of tobacco-based products or related products
- Stockbroking or share trading in Shariah non-compliant securities
- Other activities deemed non-permissible according to Shariah.

The SAC gave further consideration to companies that were involved in both Shariah-compliant and non-compliant activities by applying the concept of *maslahah* (public interest) and *umum balwa* (common plight). For this purpose, specific benchmarks and additional criteria, such as interest income and image were formulated to enable the SAC to determine the

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SHARIAH-COMPLIANT EQUITY-LINKED STRUCTURED INVESTMENT

Shariah-compliant structured investment products are still new to the Malaysian market and the demand for such products is considered to be at the infancy stage. Broadening our globally accepted ICM product and services range has always been our main agenda under the Malaysia International Islamic Financial Centre (MIFC) initiative. Up till February 2007, Malaysia witnessed the approval and launch of two Shariah-compliant structured investment products. Both products are capital protected if held until maturity and

linked to Shariah-compliant equity assets. Basically, structured investment products allow investors to invest in an offshore market based on their risk profiles and investment objectives.

Restricted mudharabah structured investment

The first Shariah-compliant structured investment

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Shariah status of such companies. In such cases, where the financial contributions from the non-permissible activities fall below the benchmark level, the SAC will classify the securities of these companies as Shariah compliant.

The Shariah-compliant securities list is updated twice a year by reviewing the companies' annual financial reports, responses to a survey aimed at obtaining detailed company information and through specific inquiries made to the respective company's management. From 1997 until 2006, the updated lists were released to the public in April and October. In March 2007, the SC revised the months of the official release to May and November. The release of this list has, to a large extent, given investors the necessary guidance, opportunities and also confidence to choose and invest in listed securities that comply with Shariah principles.

The list of Shariah-compliant securities also stimulates the development of Shariah-based unit trust funds by providing necessary means for Muslim investors who

prefer their investments to be managed professionally. Just like conventional unit trusts, Islamic unit trusts are regulated under the *Guidelines on Unit Trust Funds*. Since the early 1990s, the number of Shariah-based unit trust funds has grown steadily. Although there were only two Shariah-based unit trust funds as at end-December 1993, this number increased significantly to 100 funds by end-December 2006, with total net asset value (NAV) and total units in circulation amounting to RM9.17 billion and 18.54 billion units respectively.

Furthermore, the list also resulted in the introduction of an Islamic index that tracks the performance of Shariah-compliant securities on Bursa Malaysia. In April 1999, Bursa Malaysia introduced its first Shariah index, the Kuala Lumpur Syariah Index (KLSI). In January 2007, the market witnessed the launch of new index known as the FBM EMAS Shariah Index by Bursa Malaysia in collaboration with the FTSE Group (FTSE), a global index provider. Although both indices are in use currently, the FBM Emas Shariah Index will replace the existing KLSI effective from 1 November 2007.



product was launched in January 2007 by the CIMB Group. The product known as the Islamic All-Stars Global uses the "restricted *mudharabah*" Islamic principal, which is based on profit-sharing and linked to the performance of 20 Shariah-compliant global blue-chip multinationals stocks.

Generally, the Islamic All-Stars Global aims to cater to the needs of investors looking for a Shariah-compliant investment which is fully competitive with conventional products. Its minimum investment amount is RM250,000 and the product allows investors to efficiently access global equity markets, while still being assured that their capital, if held until maturity, is fully protected.

Equity-linked structured investment

In February 2007, OCBC Bank (M) Bhd introduced a Shariah-compliant structured investment product, the three-year closed-ended Equity-Link RM Structured Investment (ELRSI). The product is based on the *wakalah fi al-Istithmar* contract.

Major portions of the fund will be invested in Islamic money markets/Islamic fixed income securities to enable the fund to protect the principal if held until maturity, while the rest will be invested in Shariah-compliant foreign derivative options trading activities linked to an underlying equity asset. The ELRSI is targeted at both equity and institutional investors, and the minimum investment is RM250,000.

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musyarakah and *ijarah*, as investors are now getting more mature and sophisticated. The issuance of globally accepted *sukuk* has shown remarkable progress in which 27 out of 64 *sukuk* approved by the SC were based on the profit and loss sharing (*musyarakah*), leasing (*ijarah*), progressive sale (*istisna'*) and profit sharing (*mudharabah*) principles. In terms of value, *sukuk* structured using *musyarakah* contributed RM29.4 billion or 70% of the total *sukuk* approved.

In line with the SC's objective to widen the range of Islamic collective investment schemes, the number of new Shariah-based unit trusts funds has grown substantially while the types of funds offered are now more diversified in terms of structure. From a small number of simple-structured Islamic equity funds in the early years, we now have a wide spectrum of funds, such as *sukuk* funds, Islamic real estate

investment trusts (REITs) and global funds. The availability of these funds has attracted the interest of various investors with different risk appetites, who need to diversify their investment portfolios and enhance their investment yields; hence creating greater opportunities for the industry.

Several liberalisation measures were introduced in 2006 to facilitate cross-border issuance. These include the issuance of foreign currency-denominated *sukuk* by multilateral development banks, multilateral financial institutions, sovereigns and quasi-sovereigns, and local or foreign multinational corporations.

The Malaysian ICM is expected to experience rapid growth in the future. There is strong momentum for Malaysia to become an international centre for the origination, distribution and trading of ICM products.



SUKUK

Subordinated sukuk mudharabah

In November 2006, OCBC Bank (M) Bhd (OCBC) introduced a subordinated *sukuk mudharabah* in the Malaysian capital market, making it the first bank in the country to offer another innovative Islamic instrument based on the Islamic principle of *mudharabah* (profit sharing).

The *sukuk* was based on a 15 years non-call 10-year structure, which is currently the longest dated bank capital instrument in Malaysia. It represents a pioneering initiative for raising *mudharabah*-based debt capital market products.

In this structure, under the *mudharabah* principle, OCBC acts as a *mudharib* – administrator of the investment capital and the assets of the *mudharabah* venture – while investors participate as *rabb al-mal* (investment capital providers). These comprise a pool of specifically identified Islamic financing portfolios and/or any other Shariah-compliant financing contracts concluded between OCBC and its customers.

This *sukuk* was rated AA2 by Rating Agency Malaysia Bhd (RAM), which qualifies as Tier-2 capital and was offered by way of private placement to strategic investors.

Subordinated sukuk musyarakah

Another subordinated *sukuk* was introduced in the Malaysian capital market by Amlslamic Bank, a subsidiary of AMMB Holdings in December 2006. The RM400 million *sukuk* was known as subordinated *sukuk musyarakah* (SSM).

In this *sukuk* structure, Amlslamic Bank issued SSM to investors in consideration of their capital contributions. The *musyarakah* venture refers to the

participation by the investors in Amlslamic's Shariah-compliant financial activities. Amlslamic was appointed by the investors as their manager in respect of the *musyarakah* venture, to receive the investors' capital contributions and apply the funds towards the *musyarakah* venture, with the potential of receiving a portion of the income generated from the venture.

This unlisted SSM has been awarded a long-term rating of A3 by RAM and bears an expected profit rate of 4.80% per annum for the first five years.

AEON Credit's inaugural effort to tap into the Malaysian capital market

A diversified retail company, AEON Credit Service (M) Sdn Bhd (AEON Credit), issued a seven-year bank guaranteed conventional and Islamic commercial papers/medium-term notes (CPs/MTNs) programme with an aggregate nominal value of up to RM400 million.

The Islamic CPs/MTNs or *sukuk* was issued under the Shariah principle of *musyarakah* which is a partnership between the holders of the CP/MTN to invest in the *sukuk*. The CPs/MTNs were accorded the highest stand-alone short-term investment grade rating of P1, as well as the highest investment grade rating of AAA (bank guarantee) by RAM for the CPs/MTNs programme.

The programme will accord AEON Credit the flexibility to issue CPs and/or MTNs at different length of tenors to meet its short- to medium-term funding requirements. Aseambankers Malaysia Bhd, Bank of Tokyo-Mitsubishi UFJ (M) Bhd and CIMB Investment Bank Bhd are the joint-lead arrangers, managers and

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FIRST ISLAMIC PLANTATION REIT

Since the introduction of real estate investment trusts (REITs), the SC has approved a total of 11 issues with a total market capitalisation of over RM3 billion. The first Islamic REIT, the Al-'Aqar KPJ REIT was listed on the Main Board of Bursa Malaysia on 10 August 2006. In February 2007, the second Islamic REIT, Al-Hadharah Boustead REIT made a commendable debut on Bursa Malaysia. The Al-Hadharah Boustead REIT, the first REIT to be backed by plantation assets offers investors an attractive alternative to plantation stocks, with a profit sharing of at least 98% of its distributable earnings to be paid to unit holders for the first three financial years.

Apart from being the first Islamic plantation REIT, the sale and lease-back of plantation assets of the Boustead Group provide investors with the opportunity to participate in plantation ownership. The Al-Hadharah Boustead REIT which is managed by Boustead REIT Managers Sdn Bhd can be an example

“The Al-Hadharah Boustead REIT, the first REIT to be backed by plantation assets offers investors an attractive alternative to plantation stocks, with a profit sharing of at least 98%...”

for other industry participants to attract local and international investors alike. The REIT includes eight oil palm estates and two palm oil mills, all located in Peninsular Malaysia.

With the listing of both KPJ and Boustead REITs on Bursa Malaysia, Malaysia has the distinction of being the first market in the world to list Islamic REITs. This achievement will further enhance Malaysia's position in the forefront of Islamic REIT markets.

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book runners for the programme, whereas Mizuho Corporate Bank Ltd Labuan Branch (Mizuho Corporate Bank), Malayan Banking Bhd and Bank of Tokyo-Mitsubishi UFJ Ltd Labuan Branch are the bank guarantors for the programme. The bank guarantee was arranged by Mizuho Corporate Bank, as the lead arranger, through syndication.

Under the programme, AEON Credit has the alternative to issue CPs in various tenors of below 12 months and MTNs in tenors of one year up to five years. Further

the CPs/MTNs are expected to be well received by investors as the programme caters to both conventional and Islamic investors, and AEON Credit's receivables comprise both conventional and Islamic receivables.

The establishment of the programme marked an important chapter in the continued growth and evolution of AEON Credit, representing its inaugural effort to tap into the Malaysian capital markets for its funding needs.



NEW SHARIAH BENCHMARK INDEX

In its effort to continuously support the *Capital Market Masterplan (CMP)*, Bursa Malaysia has selected a leading international index provider, the FTSE Group (FTSE), to embark on revamping its indices. The new FTSE Bursa Malaysia Index Series is one of the key initiatives to build Malaysia into a developed market. Phase I of the series was launched in June 2006. On 22 January 2007, Bursa Malaysia further expanded its index series by launching a new Shariah benchmark index, the FTSE Bursa Malaysia (FBM) EMAS Shariah Index.



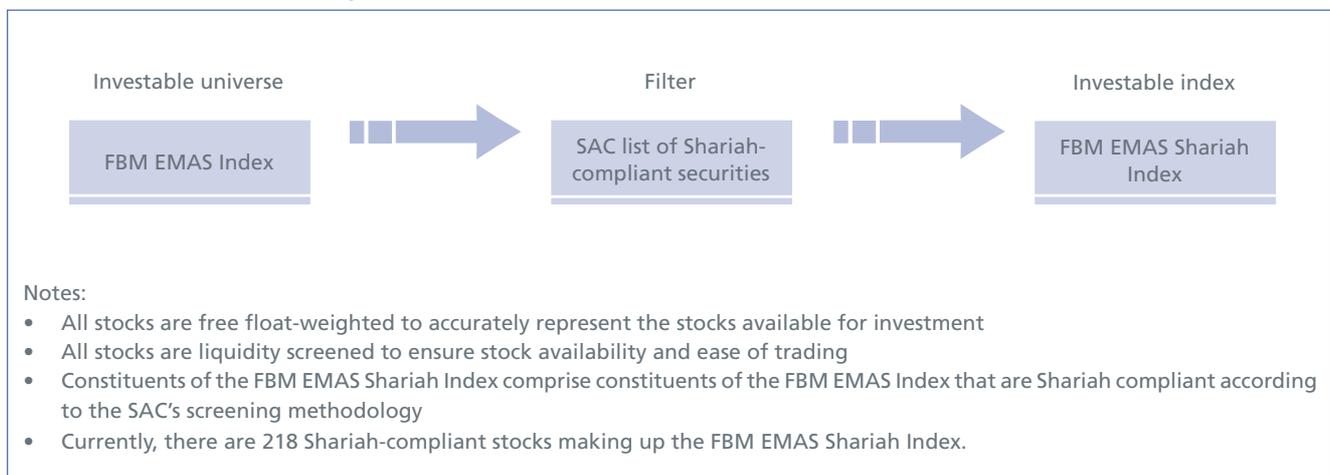
The FBM EMAS Shariah Index was subjected to the same international indexing features, such as free float and liquidity, and ultimately the Shariah-compliance filter by the SC's Shariah Advisory Council or SAC (Figure 1). The free float and liquidity screening ensures stocks availability and ease of trading. It also provides a set of ground rules which offer transparency to the market.

This garners more international recognition for the domestic market as investors will have a clearer picture of the quality of Shariah investments in the Malaysian equity market. With globally adjusted criteria, the new

performance benchmark index makes it easier for institutional investors to track our Shariah-compliant investment offerings more effectively.

The FBM EMAS Shariah Index sets the foundation for the creation of new Islamic products. With the index's debut, Bursa Malaysia can now work on developing a tradable Shariah index. This will allow the introduction of Islamic exchange-traded funds (ETFs) as well as derivatives, hence improving the diversity of the Malaysian ICM.

Figure 1
FBM EMAS Shariah Index design





MALAYSIAN ICM: YEAR IN REVIEW

Sukuk

The year 2006 saw the launch of new *sukuk* which were benchmarked against international best practices. The fact that *sukuk* originating from Malaysia account for over two-thirds of the total *sukuk* issued in the global *sukuk* market also clearly confirms not only the capabilities of market intermediaries but also the opportunities available to them.

The application of *sukuk* as the preferred choice for corporations to raise new funding from the bond market can be attributed to several factors. Firstly, it is due to strong demand from fixed income investors who are looking for Shariah-compliant instrument (such as *Takaful* operators, Shariah-based funds and Islamic institutional investors) and those who want to diversify their investment portfolios as well as invest in liquid instruments. Secondly, *sukuk* provides more

competitive pricing as it tends to be cheaper for issuers and finally, the issuance of *sukuk* is more cost effective as issuers can claim the issuing expenses against their income as part of domestic *sukuk* market.

As a result, the issuance of globally accepted *sukuk* has shown remarkable progress as 27 out of 64 *sukuk* approved by the SC were based on the profit and loss sharing (*musyarakah*), leasing (*ijarah*), progressive sale (*istisna`*) and profit sharing (*mudharabah*) principles. In terms of value, *sukuk* structured using the profit and loss sharing principle (*musyarakah*) contributed RM29.4 billion or 70% of the total *sukuk* approved (Chart 4 on page 22).

There were many landmark *sukuk* issuances in 2006 (Table 3). The most innovative product was the issuance of Khazanah Nasional Bhd's RM2.75 billion exchangeable *sukuk*. This is the world's first

Table 3

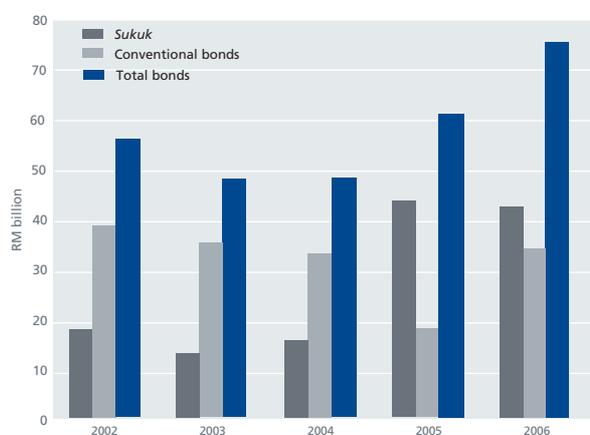
Notable *sukuk* issues in 2006

Issuer	Shariah principle	Amount (RM million)
PLUS Expressway Bhd (three issues)	<i>Musyarakah</i>	9,100
Rantau Abang Capital Sdn Bhd (two issues)	<i>Musyarakah</i>	10,000
Nucleus Avenue Bhd (three issues)	<i>Musyarakah</i>	7,900
Khazanah Nasional Bhd*	<i>Musyarakah</i>	2,750
Sarawak Power Generation Sdn Bhd	<i>Musyarakah</i>	215
Mukah Power Generation Sdn Bhd (two issues)	<i>Mudharabah</i>	950
OCBC Bank (M) Bhd	<i>Mudharabah</i>	200
Segari Energy Ventures Sdn Bhd	<i>Ijarah</i>	930
Penang Bridge Sdn Bhd	<i>Istisna`</i>	695
Dynamic Communication Link Sdn Bhd	<i>Istisna`</i>	100

* Issued out of Labuan amounting to US\$750 million.



Chart 1
Sukuk approved by SC 2002–2006



exchangeable *sukuk* issue which incorporates full convertibility features usually seen in the conventional equity-linked transactions.

The popularity of the *sukuk* as a debt instrument continues to increase on the back of strong demand from *Takaful* operators and Shariah-based institutional investors (Chart 1). This, together with the fiscal incentives, ensured that *sukuk* was competitively priced.

Shariah-based unit trust funds

In 2006, the SC approved 17 new Shariah-based unit trust funds. This brought the total of Shariah-based unit trust funds to 100 or 24.0% of the total of 416 approved funds (Table 4). Of the Shariah-based unit trust funds, 50 were equity funds, 18 were *sukuk* funds, 19 were balanced funds while the remainder were money market funds and structured products, feeder funds and fixed income funds (Chart 3 on page 22).

In addition, the net asset value (NAV) of Shariah-based unit trust funds grew at a compounded annual growth rate of 33.8% from 1997 to 2006; outstripping the industry growth rate of 15.4%. This reflects the strong latent demand for Islamic investment products.

“Throughout the year, 69 equities were added to the list of Shariah-compliant equities by the Shariah Advisory Council while 20 were removed.”

Table 4
Shariah-based unit trust funds

	2006	2005
Number of approved funds		
Shariah-based	100	83
Total industry	416	340
Total approved fund size (billion units)	64.3	50.5
Units in circulation (billion units)	18.54	18.62
NAV		
Shariah-based (RM billion)	9.17	8.49
Total industry (RM billion)	121.77	98.49
% of Shariah-based to total industry	7.5%	8.6%



Following the release of *Guidelines for Islamic Real Estate Investment Trusts* (I-REITs Guidelines) in 2005, the first Shariah-compliant REIT known as Al-'Aqar KPJ REIT, issued by KPJ Healthcare Bhd was listed on Bursa Malaysia. A total of 180 million units or 53% was placed with institutional investors and the public. Malaysia was the first jurisdiction to issue specific guidelines for Islamic REITs and also the first to launch such funds.

Shariah-compliant equities

In 2006, two reviews were conducted on all listed companies and the results were published on 28 April 2006 and 27 October 2006 respectively. Throughout

the year, 69 equities were added to the list of Shariah-compliant equities by the Shariah Advisory Council (SAC) while 20 were removed (Table 5). In total, there were 886 Shariah-compliant equities or 86.1% of the total listed equities on Bursa Malaysia as compared to 857 or 84.8% of the total listed equities in 2005.

In November 2006, Bursa Malaysia updated its Shariah index. Fourteen Shariah-compliant equities were added and six equities removed from the Kuala Lumpur Syariah Index's (KLSI) index basket. As at end-2006, the KLSI comprised 521 Shariah-compliant equities. The market capitalisation of Shariah-compliant equities stood at over RM548.4 billion or at more than 64.6% of total market capitalisation.

Table 5

Shariah-compliant equities

	2006	2005
Number of equities		
Shariah-compliant equities	886	857
Total listed equities	1,029	1,011
% of Shariah-compliant to total listed equities	86.1%	84.8%
Market capitalisation		
Shariah-compliant equities (RM billion)	548.4	440
Total listed equities (RM billion)	848.7	699
% of Shariah-compliant to total listed equities	64.6%	62.9%

Note: Market capitalisation figures as at end-2006. The SAC released the list of updated Shariah-compliant equities in April and October 2006.



UNDERSTANDING REGULATORY ASPECTS OF ICM¹

The defining success factor for *sukuk* is the fact that it appeals to both Islamic and non-Islamic investors. *Sukuk* has been positioned as a competitive and viable investment on its own merits, and not as a leap of faith. It has been marketed and accepted by both Islamic and non-Islamic investors and the pool of investors has been significantly broadened.

For ICM products and services to be acceptable to all investors and issuers, it is absolutely vital that they comply with universally accepted principles of securities regulation, i.e. they must provide the same level of protection for investors; be offered within markets that are fair, efficient and transparent; and must not be more susceptible to systemic risks than conventional products. In order to be competitive, they must also be offered on terms, which are just as or more attractive and cost effective than those of conventional products.

Furthermore, the components of market discipline, i.e. corporate governance, disclosure and transparency, are even more pertinent in the context of the ICM. The risk-sharing principle, which is based on Islamic concepts

of partnership and profit sharing, underscores the need for disclosure, transparency and governance. For example, in Malaysia, it is mandatory for an information memorandum to be issued to investors for transactions structured under principles of *musyarakah* or *mudharabah*, to ensure that there is a sufficient level of disclosure to enable investors to make informed investment decisions.

In July 2004, the IOSCO Task Force on Islamic Capital Market released a report on the state of development and regulation of the ICM globally. The task force found that the ICM constitutes a segment of the wider securities market, and that the conventional securities regulation framework and principles apply equally to the ICM with additional Shariah approval or certification processes. This finding is significant as the task force postulated that ICM products and services may be introduced and developed within any existing well-structured securities market.

Appropriate Shariah governance is essential

Certainly, Shariah compliance is the key distinguishing feature of the ICM. In order to be deemed as Shariah compliant, ICM products and services need to undergo a pre-defined vetting and approval process by Shariah advisers.

In Malaysia, the establishment of a Shariah Advisory Council (SAC) for the capital market at the regulator level in 1996 provided the single most important impetus for the success of other initiatives. With the SAC presiding as the highest point of reference on all

“... in Malaysia, it is mandatory for an information memorandum to be issued to investors for transactions structured under principles of musyarakah or mudharabah, to ensure that there is a sufficient level of disclosure...”

¹ This article is written based on the SC Chairman's presentation at the Seminar on Islamic Finance: Challenges and Opportunities for Japan on 23 January 2007.



“The SC’s extensive powers with respect to issuance and offer of securities in the market paved the way for the SC to issue legally-binding guidelines and requirements with respect to the ICM.”

Shariah matters in the capital market, many other building blocks were able to be put in place. The SC’s extensive powers with respect to issuance and offer of securities in the market paved the way for the SC to issue legally-binding guidelines and requirements with respect to the ICM.

ICM regulation emphasises disclosure and transparency

The regulatory framework for ICM products and services is based on two approaches to achieve disclosure and transparency. The first is based on a market approach and relies solely on market disclosure with no specific guidelines. The second is based on a facilitative approach whereby specific rules and guidelines exist to provide guidance and facilitate disclosure.

For example, the Shariah approval or certification process can be carried out through these approaches. The first market approach is where financial institutions have their own in-house independent Shariah advisory bodies for screening and endorsing their ICM products and services. This process is driven by private sector-led initiatives, and is not mandated by any specific regulatory or policy requirement.

The second approach is where the regulatory authority assesses Shariah compliance and issues the appropriate Shariah certification for all ICM products and services under its purview. Jurisdictions, e.g. Malaysia, use this approach where the Shariah certification process is

undertaken at the regulator level and regulatory authorities establish their own Shariah advisory bodies to formally advise the relevant regulatory authorities on issues pertaining to ICM products and services. Shariah-compliance issues are taken into consideration in the regulator’s functions, such as approving products, establishing eligibility criteria for intermediaries, reporting requirements of regulated entities and enforcing regulatory requirements.

ICM regulation must be backed by enforceable legal documentation

With respect to legal perspectives, ICM products must be backed by sound legal documentation to protect the interests of all parties, and appropriate sanctions are enforceable in the ordinary courts of law, as ICM transactions involve both Shariah and secular jurisdictions. In this respect, the choice of governing law for transactional documentation in each type of jurisdiction is a critical factor in effecting these transactions and the growth of these markets.

It is worth noting that if the courts of a country are chosen as the forum, the law of that country is chosen as the governing law. Currently, most transactional participants choose English law or New York law as the governing law of capital market transactions because they are perceived to have a high degree of certainty, predictability and transparency.

Further, the choice of a body of law which is enforceable in nature is also important. For example, in the Islamic Development Bank’s (IDB) *sukuk* issue by Solidarity Trust Services Ltd, the IDB provided the financial guarantee for the full maturity value of the notes, whose terms are governed by English law and whose chosen jurisdiction is England.

In addition, the legal mechanism should work in a manner to resolve all disputes effectively and expeditiously. In this case, disputes can be settled either by court proceedings or arbitration. Various arbitration



centres were established to offer the best available resolution outside of court.

For instance, the Kuala Lumpur Regional Centre for Arbitration (KLRC) was established in 1978 under the auspices of the inter-governmental international law body called the Asian-African Legal Consultative Organisation. The centre provides a neutral system for the settlement of disputes in trade, commerce and investment, including Islamic finance within the Asia-Pacific region. Presently, it is the only recognised centre for arbitration in Malaysia and the government strongly supports international arbitration, as evidenced by the financing of the centre.

Conclusion

There are vast opportunities to be tapped globally for the ICM, not just by the Muslim investor community, but by all participants in the global financial market. High standards of disclosure, transparency and governance will ensure sufficient levels of investor confidence, paving the way for the development of a robust and credible market. Indeed, the major challenge for the regulators is to ensure greater uniformity in regulation and practices to achieve a satisfactory level of protection for investors.

“High standards of disclosure, transparency and governance will ensure sufficient levels of investor confidence, paving the way for the development of a robust and credible market.”

It is a key challenge as ICM products have to conform to Shariah principles and Muslims who subscribe to these products and services do so for these reasons. Hence, regulators have to ensure that ICM products and services are indeed true to label and that the trust in the system is safeguarded. Providing such assurance is one of the main investor protection challenges for market regulators in any nascent market, including the ICM.

The strategy going forward must be to focus on convergence rather than differentiation; on similarities with, rather than differences from, conventional products. It is therefore imperative that standards of documentation; governance structures and practices; levels of transparency, disclosure and the protection accorded to investors, are benchmarked against existing international standards, best practices and codes.



BOOK REVIEW: RESOLUTIONS OF THE SECURITIES COMMISSION SHARIAH ADVISORY COUNCIL (2ND EDITION)

Global recognition and acceptance of resolutions made by the SC's Shariah Advisory Council (SAC) is another milestone for the Malaysian ICM. The first edition of the book on SAC resolutions has been translated into Persian and Thai, and there is a request for an Arabic version. The second edition of the book was launched in September 2006 and like its predecessor, is expected to be an essential reference point for domestic and international market participants, and the investing public on the application of Shariah principles for the ICM. Associate Professor Dr Engku Rabiah Adawiah of Ahmad Ibrahim Kulliyah of Laws, International Islamic University Malaysia has written a review of the book. Her observations are summarised below, highlighting the gist of issues covered.



Department (ICMD) and the establishment of the SAC, which had its origin in the initial Islamic Instrument Study Group (IISG). The book then gives a summary of the sources and research methodologies adopted in the conduct of ICM study and deliberations.

The presentation of the actual resolutions, are divided into four broad sections, namely: "Principles of *Muamalat* in the Capital Market"; "Capital Market Products According to Islamic Jurisprudence"; "Capital Market Issues According to Islamic Jurisprudence"; and "Shariah Criteria for Listed Securities".

The book under review, the *Resolutions of the Securities Commission Shariah Advisory Council*, is the second edition of a previous book of the same title, first published in 2002. The second edition provides updates on the latest SAC resolutions, with a total of eight new resolutions added.

The publication of the 2006 edition is indeed timely to keep the public informed of all the resolutions adopted by the SAC in their series of meetings and deliberations, together with a brief and simple presentation of the Shariah arguments and views in arriving at the resolutions. Although some of the SAC resolutions may differ from those made by Shariah experts in other places, and some readers may have their own views and conclusions on some of the issues raised and decided in the resolutions, such varied and divergent opinions are not uncommon in the tradition and history of Islamic law.

The book begins with a brief description on the role of the SC, the development of the Islamic Capital Market

Under the section on "Principles of *Muamalat* in the Capital Market", a total of 13 resolutions are discussed, of which, the last four are new resolutions that were not included in the previous edition. The new resolutions include the ones on *kafalah* on *mudharabah* capital; *ujrah* for guarantees; *ibra'* clause in a document or agreement; and *iqta'*. In all the four resolutions, the SAC confirms the permissibility of third-party *kafalah* (guarantee) on *mudharabah* capital, *ujrah* (fee) for guarantees, inclusion of *ibra'* (rebate) clause in a document or agreement, and the acceptability of concessionary rights as a type of asset that can be transacted based on the principle of *iqta'*.

The section on "Capital Market Products According to Islamic Jurisprudence" generally discusses the same resolutions as those in the earlier edition. However, the fourth resolution in the section has been updated and revised to include a new dimension into the product, that is the resolution on permissibility of regulated short selling (RSS). The SAC specifically resolves that RSS is in line with the Shariah as the inclusion of securities borrowing and lending (SBL) in RSS eliminates the



element of *gharar*. Although generally short selling involves the selling of shares not owned by the seller, thus falling under the category of *bai` ma`dum*, the issue of *gharar* can be overcome by the inclusion of SBL to increase the probability that the shares sold will be delivered. The practice of SBL, on the other hand, had been approved in a previous resolution already captured in the first edition of the book, which was based primarily on the application of *istihsan* (juristic preference) with *maslahah* (public interest) and *`urf iqtisadi khas* (specific economic custom) in the context of an *ijarah* contract.

In the third section on "Capital Market Issues According to Islamic Jurisprudence", four new resolutions are added to the nine resolutions presented in the first edition. The new resolutions include those on *hibah ruqba*, conditional *hibah*, when issue process, and price fixing based on forward pricing.

In relation to *hibah ruqba*, the SAC resolved that the use of *hibah ruqba* is acceptable in implementing the *hibah* declaration forms for transactions involving joint account holders of unit trust accounts. *Hibah ruqba* is a conditional gift that allows the *hibah* property to be owned by the *hibah* recipient if the *hibah* giver dies; but if the *hibah* recipient dies first before the *hibah* giver, the *hibah* property will be returned to the *hibah* giver. This resolution on *hibah ruqba* allows Muslim joint account holders of Islamic unit trusts to have the same "survivorship" right as enjoyed by other joint account holders in other unit trust funds.

The resolution on conditional *hibah* in the form of *hibah bi syart `iwadh* confirms that such practice is in line with the principles of Shariah, and is applicable in structuring *sukuk*. This allows a party to a *sukuk* transaction to make a gift of a particular property to a special purpose vehicle (SPV) on the condition that the

property will be returned in the future after the SPV has used the property in issuing the *sukuk*.

The resolution on "when issue process" relates to securities futures trading, where the practice is approved on the basis of conformity with the *wa`d* (promise) principle. Whereas the resolution of "price fixing based on forwards pricing" relates to the use of forward pricing in creating and cancelling units in unit trust funds that occur between the management company and unit trust holders. This method of pricing is approved by the SAC on the basis that the method of price determination has been agreed by both parties, buyer and seller, and thus there is no issue of *gharar*. This is further supported by arguments based on the practices of *mithl* (market value), *bai` al istijrar* and *bai` bima yanqati` bihi si`r*.

In the final section on the "Shariah Criteria for Listed Securities", the book explains and illustrates the application of certain criteria to select and approve stocks of companies listed on Bursa Malaysia. The Shariah-compliance criteria are generally the same with the ones discussed in the first edition, but with additional explanations on some of the criteria. There are also detailed explanations on the various benchmarks used in selecting the stocks.

The book provides a comprehensive and precise coverage of the resolutions made by the SAC of the SC on various aspects of the ICM, together with their justifications and Islamic legal reasoning. This book proves to be handy for quick and easy reference on the resolutions made, as well as provides adequate accounts on both sides of the juristic opinions, either the one supporting the resolutions or against them. The book will definitely be an invaluable addition to any library or personal collection of those interested in this exciting aspect of the Islamic financial system.



NEWS ROUNDUP

Kuala Lumpur International Islamic Finance Expo

The SC was a patron to the Kuala Lumpur International Islamic Finance Expo (KLIIFEX 2006) held on 24–29 November 2006 at the Putra World Trade Centre. The event was organised by the Association of Islamic Banking Institutions Malaysia (AIBIM) and the Centre of Research and Training (CERT).

The objectives of KLIIFEX were to provide a platform for the financial institutions and intermediaries, and

for the general public to exchange information on Islamic financial services, as well as to promote Islamic banking and finance products.

The SC participated in KLIIFEX to educate the general public on ICM-related matters. The November issue of the *Malaysian ICM* quarterly bulletin and other ICM information kits were distributed to those visiting the exhibition.

3rd Kuala Lumpur Islamic Finance Forum

In conjunction with KLIIFEX 2006, the 3rd Kuala Lumpur Islamic Finance Forum (KLIFF 2006) was held on 27–29 November 2006 under the theme of “Islamic Finance: Maturing Towards a Globalised Market”. Datuk Dr Awang Adek Husin, the Deputy Finance Minister II

officiated the event. The SC was represented by Dr Nik Ramlah Mahmood, Senior Executive Director of Strategy and Development as a panelist in one of the sessions, entitled “Boardroom Panel Session: Critical Success Factors Towards a Globalised Islamic Financial Market”.

Enhancing awareness among government officers

As part of ongoing efforts to promote an awareness of the ICM among government officers, the SC organised a briefing for Unit Perancang Ekonomi Negeri Pahang on 18 December 2006. The briefing covered general information on the ICM and the application of Shariah principles. The SC organised a visit to Majlis Ugama Islam

dan Adat Resam Melayu Pahang on 20 December 2006, aimed at networking with the state religious bodies and learning more about their operations and the scope of their responsibilities. The visit also provided an opportunity for the SC to highlight ICM developments and enhance their general understanding of the ICM.

Revision of release date for the list of Shariah-compliant securities

In March 2007, the SC announced the revised date of its updated list of Shariah-compliant securities from the last Fridays of April and October to the last Fridays of May

and November every year. Subsequently, the SC will release its first updated list of Shariah-compliant securities for 2007 on 25 May 2007.



SC becomes a new member of Islamic Financial Services Board

In December 2006, the SC joined the Islamic Financial Services Board (IFSB) as a new member, bringing the total IFSB membership to 110. The admission of the SC into the IFSB marked a major step as it is the first from an IOSCO member country to do so. The admission of the SC also marked the entry of a securities regulatory authority in the IFSB since it

opened its full membership to securities, insurance and *Takaful* regulators. The SC was admitted at an IFSB council meeting in Jeddah on 29 November 2006. The IFSB now comprises 27 regulatory and supervisory authorities, five international inter-governmental organisations and 78 market players from 21 countries.

Roundtable on Malaysia's debt capital markets²

Institutional Investors, the international magazine, organised a roundtable on Malaysia's debt capital market on 8 January 2007 in Kuala Lumpur. Prominent figures in the Malaysian finance industry and from regulatory bodies attended the discussion. The SC was represented by Dr Nik Ramlah Mahmood, Senior Executive Director of Strategy and Development.

The discussion was aimed at highlighting Malaysia's debt capital market with strong emphasis on the developments of the market and the potential for further achievements under the Malaysia International Financial Centre (MIFC) initiative. The establishment of the MIFC is aimed at positioning Malaysia in the global arena by providing a common platform catering to investors' different backgrounds and investment needs. Malaysia has come long way since the first Islamic banking licence was issued in 1983. To date, about 50% of the domestic bond market comprises *sukuk* – on par with its conventional counterparts.

The roundtable also touched on product innovative issues, i.e. various *sukuk* structures based on various Shariah principles. Topics of interest included the US\$750 million Khazanah Nasional Bhd exchangeable *sukuk* which was well received by international investors.

Moving forward, further products innovations in the forms of currency and derivative products will need to be developed in order to widen the Islamic finance sphere and to address the supply and demand issues. These new products should also deliver the same economic benefits to their users in a similar fashion to their conventional counterparts. Looking forward, the Malaysian *sukuk* market is expected to benefit from the country's sound macroeconomic fundamentals, the Shariah Advisory Council's (SAC) continuous efforts to provide support at the regulatory level, and the strong underlying infrastructure.

² Source: Institutional Investor Sponsored Roundtable, February 2007.



SC-Citigroup Global Shariah Dialogue on Sukuk Market

On 6 March 2006, the SC and Citigroup successfully organised the Global Shariah Dialogue on Sukuk Market. The SC Chairman, in her welcoming remarks at the event, urged the local industry to benchmark against and comply with global standards of compliance, transparency and governance, given the increasing internationalisation of the *sukuk* market. The dialogue aimed to promote greater cross-fertilisation of Shariah views to facilitate the smooth development of the ICM globally.

The dialogue, with a theme of "Recent Trends in the *Sukuk* Market", attracted more than 100 participants from local and international Islamic financial institutions, as well as Shariah experts from both the SC and Citigroup. The Citigroup's global Shariah scholars were represented by Dr Nazih Hammad, Dr Mohammed Elgari and Sheikh Nizam Yacuby, while the SAC of the SC were represented by Dr Mohd Daud Bakar, Dr Abdul Halim Muhammad and Dato' Dr Abdul Halim Ismail (who acted as a moderator).

The objective of the dialogue was to update participants on the latest trends and developments in the *sukuk* market, particularly, in the Middle East. Moreover, this dialogue deliberated on the recent innovations in the *sukuk* market, and the latest developments and opportunities in the Middle East through case studies of various *sukuk* issuances, such as the US\$3.5 billion Convertible Musharakah Sukuk by the Ports and Customs and Free Zone Corporation, UAE and the US\$2.35 billion Exchangeable Mudarabah Sukuk by Aldaar Properties, UAE.

The dialogue, held at the SC, was in line with the country's aspiration to promote greater interaction between Malaysian and foreign Shariah scholars. It also promoted greater awareness among Malaysian companies, encouraging them to issue ringgit-denominated and non-ringgit denominated Islamic instruments such as *sukuk*, in accordance with the MIFC initiative.





MALAYSIAN ICM – 2006

Shariah-compliant securities on Bursa Malaysia

Number of Shariah-compliant securities – Oct 2006 ¹	886 securities		
% of Shariah-compliant securities to total listed securities	86%		
Market capitalisation (end-January 2007)	(RM billion)		
Shariah-compliant securities	591.62		
Total market capitalisation	920.70		
% of Shariah-compliant securities to total market capitalisation	64.26%		
Equity market indices	30 Dec 06	31 Jan 07	% change
Kuala Lumpur Composite Index	1,096.24	1,189.35	8.5%
Kuala Lumpur Shariah Index	157.36	169.55	7.7%
FBM EMAS Shariah Index ²	n/a	7,868.37	n/a

¹ The SAC released the updated Shariah-compliant securities list in April and October 2006.

² Launched on 22 January 2007.

Shariah-based unit trust funds

Number of approved funds	2005	2006
Shariah-based	83	100
Total industry	340	416
Net asset value (NAV) of approved funds	2005	2006
Shariah-based	RM8.5 billion	RM9.2 billion
Total industry	RM98.5 billion	RM121.8 billion
% of Shariah-based to total industry	8.6%	7.6%

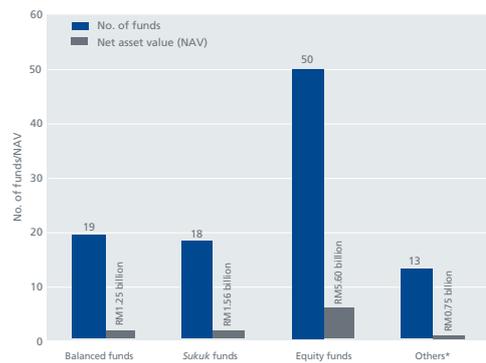
Sukuk

	2005	2006
Size of outstanding <i>sukuk</i> (excluding government <i>sukuk</i>)	RM91.3 billion	RM105.2 billion
% of outstanding <i>sukuk</i> to total outstanding bonds	43.85%	47.75%
Sukuk approved by the SC	2005	2006
Number of <i>sukuk</i>	77	64
Size of <i>sukuk</i>	RM43.32 billion	RM42.02 billion
Size of total bonds approved	RM60.66 billion	RM75.83 billion
% of size of <i>sukuk</i> to total bonds approved	71.41%	55.41%

Chart 2
KLCI vs KLSI performance



Chart 3
Shariah-based unit trust funds by category



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

Chart 4
Sukuk approved based on various Shariah principles

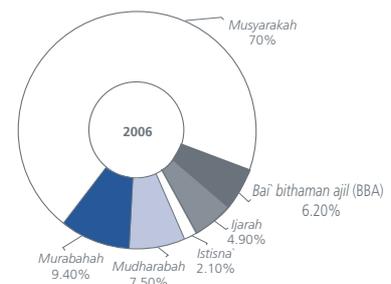




Table 6

Sukuk approved by the SC in Q4 2006

Issuer	Shariah principle	Facility	Size of issues (RM million)	Date of issuance	Rating
1. AEON Credit Service (M) Sdn Bhd	<i>Musyarakah</i>	Bank guaranteed ICP/MTN (combined limit)	200	31 Jan 07	AAA (bg) P1
2. Amlslamic Bank Bhd	<i>Musyarakah</i>	Subordinated <i>sukuk</i>	400	21 Dec 06	A3
3. Boon Koon Group Bhd	<i>Murabahah</i>	ICP/MTN	100	7 Dec 06	A _{ID} MARC-2 _{ID}
4. Gamuda Bhd	<i>Musyarakah</i>	ICP (combined limit)	100	n/a	P1
5. Gamuda Bhd	<i>Musyarakah</i>	IMTN (combined limit)	700	n/a	AA3
6. KMCOB Capital Bhd	<i>Murabahah</i>	MTN	630	14 Dec 06	AA-ID(cg)
7. Kuala Lumpur Sentral Sdn Bhd	<i>Musyarakah</i>	Serial <i>sukuk</i>	720	n/a	AA2(s)
8. Nucleus Avenue (M) Bhd	<i>Musyarakah</i>	Senior <i>sukuk</i> MTN	5,600	n/a	AA3
9. Nucleus Avenue (M) Bhd	<i>Musyarakah</i>	Senior <i>sukuk</i> CP/MTN	600	n/a	AA3 P1
10. Nucleus Avenue (M) Bhd	<i>Musyarakah</i>	Cumulative non-convertible junior <i>sukuk</i>	1,700	n/a	A2
11. OCBC Bank (Malaysia) Bhd	<i>Mudharabah</i>	Redeemable Islamic subordinated bonds	200	24 Nov 06	AA2
12. Sabah Ports Sdn Bhd	<i>Bai` Bithaman Ajil</i>	<i>Sukuk</i>	80	n/a	AA3
13. Sabah Ports Sdn Bhd	<i>Murabahah</i>	MUNIF/IMTN	70	n/a	AA3 P1
14. Sunway City Bhd	<i>Murabahah</i>	MTN	500	n/a	A2 P2
15. Sunway City Bhd	<i>Murabahah</i>	CP	100	n/a	P2
Total			RM11,700		

n/a: not applicable.



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, please contact:

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