

The Malaysian *Sukuk* Market

A. Current Status of the *Sukuk* Market in Malaysia

Malaysia is at the forefront in the development of Islamic banking, an Islamic capital market, and *takaful* insurance. It has a strong and comprehensive Islamic financial system with a robust business-driven regulatory regime and legal framework. Malaysia has emerged as the largest *sukuk* market in the world, with total outstanding *sukuk* valued at MYR173.5 billion, or 57% of the global market, as of March 2015. The *sukuk* market has become an integral part of the Malaysian capital market.

The increasing popularity of Islamic bonds is attributable to several factors. First, *sukuk* provide an avenue for Islamic investors who need to invest in Shariah-compliant instruments. Second, *sukuk* also appeal to conventional investors who are constantly looking for liquid, attractively priced instruments to obtain capital gains and income. The strong demand by investors also provides the opportunity for issuers to raise funds at a lower cost. Third, the Government of Malaysia has been actively involved in creating an efficient price-discovery process for Islamic securities through its issuance of MITB and MGII, which has led to the establishment of an Islamic benchmark yield curve. This has been complemented by *sukuk* indexes published by BPAM.

Over the years, Islamic capital market products have garnered universal acceptance as viable alternatives to conventional products. There has been clear evidence of the acceptability of the products to non-Muslim issuers and investors alike. As an indication of the success of Malaysia's Islamic capital market, 35% of funds raised (MYR62 billion) through all *ringgit* bond issuances in 2014 were through *sukuk*. The success of mainstreaming *sukuk* can be replicated internationally, considering the estimated size of the global Islamic financial system and the latent demand for Shariah-compliant financial instruments.

B. The Nature of *Sukuk*

In their simplest form, *sukuk* are certificates of equal value that represent an undivided interest (proportional to the investor's interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services, or investments in particular projects or special investment activities. Unlike conventional debt securities that mirror debts or loans on which interest is paid, *sukuk* can be structured based on innovative applications of Islamic principles and concepts. Nonetheless, *sukuk* share some similarities with conventional debt securities in that they are similarly structured based on the ability of the issuer to pay the periodic distribution and principal repayment.

A prerequisite for *sukuk* is the compliance with Islamic or Shariah principles. A *sukuk* is structured so that it involves an exchange of Shariah-compliant assets for financial consideration that allows investors to earn profits and rentals from transactions in the future.

There are various types of *sukuk*, given that a number of different Shariah principles are used for the creation of *sukuk*. The more prominent types are the sale and purchase of an asset based on *bai' bithaman ajil* (deferred payment), the leasing of specific *ijarah* (assets), and a *musyarakah* (profit and loss-sharing scheme). There are also a number of innovative instruments pioneered by market participants involving the gamut of Islamic financial principles, including *istisna* (project finance), *murabahah* (cost-plus sale), *mudharabah* (profit sharing), and *qard* (interest-free loan). In Malaysia, the majority of *sukuk* are debt-based instruments (*murabahah* and *bai' bithaman ajil*).

C. Legal Implications for Investors

Sukuk represent ownership claims on a pool of assets, or rights to receivables or participation. *Sukuk* may be issued as offers to retail investors, private placements, or under the Lodge and Launch Framework, as well as by nonresident (foreign) entities.

The various transaction contracts that form the genesis of a *sukuk* issue have different legal implications for investors. *Sukuk* investors should therefore be fully apprised of and knowledgeable about their rights and obligations under the various underlying Islamic concepts and principles, which are explained as follows.

1. Rights to an Underlying Asset and Its Cash Flow

For *sukuk* that represent the ownership of assets, their usufruct or services (the underlying asset), the claim embodied in the *sukuk* is not just a claim on the underlying asset used in the *sukuk* transaction, but also the right to the cash flow and proceeds from the sale of the asset. For example, in *sukuk ijarah*, the *sukuk* are akin to trust certificates establishing undivided ownership of the leased asset and the right to the cash flow arising from it.

2. Rights to Cash Flow from the Contract of Exchange but not the Asset

For *sukuk* issued as evidence of indebtedness arising from the sale of the asset based on contracts of exchange other than *ijarah*—such as those originating from *bai' bithaman ajil*, *murabahah*, and *istisna*—the claim is on the obligations stemming from the applied contract of exchange, and not ownership of the physical asset, as ownership has been transferred to the obligor.

3. Rights to Undivided Interest in Specific Investments

For special investment activities funded through *musyarakah* (loss-sharing scheme) or *mudharabah*, the *sukuk* represent the holder's undivided interests in the specific investments. *Sukuk musyarakah* is used to raise funds for projects on the basis of partnership contracts. *Sukuk musyarakah* holders or investors then become the owners of the project, in proportion to their respective shares. Profits are distributed according to a preagreed proportion while losses are prorated according to their equity share. Each *sukuk mudharabah* holder or investor, on the other hand, holds equal value in the *mudharabah* equity. Profits will be shared on a preagreed ratio between the *mudharabah* investors and the *sukuk* shared equally among the *mudharabah* investors.

D. Sukuk Issuance in Malaysia

Conventional government bonds have counterpart Islamic bonds in Malaysia. These include

- (i) **Bank Negara Monetary Notes-i** (BNMN-i), which replaced Bank Negara Negotiable Notes, are Islamic securities issued by BNM to manage liquidity in the Islamic financial market.
- (ii) **Malaysian Islamic Treasury bills** (MITB) are short-term securities based on Islamic principles issued by BNM on behalf of the government. The structure of MITB is based on the *bai al-inah* (sell-and-buy back) principle and are actively traded based on the *bai al-dayn* (debt trading) principle in the secondary market.
- (iii) MGII are non-interest-bearing government securities based on Islamic principles issued by the government and placed on a competitive tender with maturities of 3–20 years. Like MGS, MGII are issued by BNM on behalf of the government and the funds are used for development expenditures.
- (iv) **Sukuk Bank Negara Malaysia Issues** (SBNMI) are zero-coupon bonds with maturities of 1–2 years. SBNMI are based on *al-ijarah* (sale and lease back) principle.
- (v) **Merdeka Savings Bond** is a bond structure based on Shariah principles with the purpose of assisting retirees who depend primarily on interest income from deposits placed with banking institutions.
- (vi) **Sukuk 1Malaysia 2010**, which is based on Shariah principles, is an additional investment instrument for Malaysian citizens who are at least 21 years old. Sukuk 1Malaysia 2010 has a resalable feature that provides flexibility for investors to sell and purchase the *sukuk* before maturity date.

Corporates also issue *sukuk*. In fact, the corporate *sukuk* market has grown significantly in recent years, with average annual growth of corporate *sukuk* outstanding of 25% between 2010 and 2014. At the end of June 2015, corporate *sukuk* accounted for 64% of total outstanding corporate debt securities issued in Malaysia.

E. Regulations for Sukuk

The SC supervises the Islamic capital market, which operates parallel to the conventional capital market. The SC originally issued the Guidelines on Sukuk, which contained provisions specific to the nature and types of *sukuk*, and their inherent practices. These provisions have by now been folded into the SC Guidelines for retail bonds and issuances under the Lodge and Launch Framework. The SC Guidelines, and related Practice Notes and Technical Notes, contain detailed documentation requirements, approval and issuance processes, and other relevant provisions for *sukuk*, alongside those for conventional debt securities. For additional details, please refer to Chapter II.

Additional provisions for *sukuk* include the need for a particular type of *sukuk*, or iMTN, to conform to Islamic principles. For that purpose, the SC established the Shariah Advisory Council (SAC) in 1996 to ensure all Islamic domestic capital market products are in compliance with Shariah principles. The SAC comprises prominent Shariah scholars and jurists, as well as market practitioners, who advise the SC on matters relating to the Islamic capital market and provide Shariah guidance on Islamic capital market transactions and activities. BNM also features a SAC for the governance of debt and money market instruments under its purview.

On the basis that a *sukuk* type is principally acceptable in the market, a Shariah Adviser then has to certify whether the structure of a particular *sukuk* is Shariah-compliant. The Shariah Adviser must be registered with the SC under the Registration of Shariah Adviser Guidelines. In addition, a legal advisor has to certify that a Trust Deed for the trust underlying the *sukuk* is enforceable under Malaysian law.

F. Infrastructure for *Sukuk*

In Malaysia, the market infrastructure is the same for *sukuk* and conventional bonds and notes. *Sukuk* are traded OTC on the same registered electronic facilities as conventional debt securities, or as ETBS on BMS. Trades are captured in the ETP and cleared and settled via RENTAS.

BNM maintains an information portal dedicated to Malaysia, the International Islamic Financial Centre, and provides online access to information on the Islamic interbank money market. BPAM calculates and publishes the BPAM Sukuk Index in conjunction with Thomson Reuters.

For details on these domestic websites and market features, please refer to Chapter IV.

Malaysia is also host to the Islamic Financial Services Board, an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, which is broadly defined to include banking and insurance sectors, and the capital market.⁵⁵

The International Islamic Liquidity Management Corporation (the IILM) is an international institution established by central banks, monetary authorities, and multilateral organizations to create and issue short-term, Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. The corporation is hosted by Malaysia and headquartered in Kuala Lumpur. As an international institution, it enjoys a range of privileges and immunities conferred by the International Islamic Liquidity Management Corporation Act, 2011⁵⁶

In order to further spur the development of Islamic finance, in February 2016 Malaysia developed the marketplacelF, which provides access to the global community seeking financial solutions and services by linking them with Malaysia's Islamic financial institutions and professional ancillary services.⁵⁷

⁵⁵ See Islamic Financial Services Board at <http://www.ifsb.org>

⁵⁶ For more information, please see <http://www.iilm.com>

⁵⁷ For more information, please see www.marketplacelF.com