malaysian ICM
Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

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An Enabling Environment

Two decades ago, the market environment was rudimentary at best, and yet, that period saw the birth and formation of the Malaysian ICM. However, the environment at that time could not have brought the ICM to where it is today. The conditions then could not prepare Malaysia to face the increasingly globalised and competitive international financial arena.

Malaysia realised early that a quantum leap in this relatively new market segment depended on more than market forces alone. The government and regulators stepped in, particularly in formulating top-down policies and initiatives. They ensured that this new market would not only survive but thrive and flourish. They drove the ICM agenda by articulating the vision, putting in place necessary building blocks, removing impediments, and providing incentives for growth.

To strengthen Malaysia's position as an international Islamic financial centre, Budget 2008 incorporated specific measures to further bolster the attractiveness and value proposition of the country. A number of new measures were announced to encourage the development of the Islamic fund management industry and attract investments from the Middle East. They included 100% foreign ownership for Islamic fund management companies and the issuance of three new stockbroking licences for intermediating businesses from the Middle East.

Developing Waqf Assets

The Islamic financial industry has grown over the past two decades and it is timely to develop the *waqf* system. *Waqf* is a type of charity Muslims are encouraged to practise, besides *sadaqah* (giving donations). With new funds and wealth created among Muslims, more activities can now be undertaken to enhance *waqf* in a manner which will further boost the country's economic activities. As Murat Cizacka affirms, *waqf* played a major role in the Ottoman Empire's financial history, especially cash *waqf,* which was approved by the Ottoman courts around the 15th century.

Waqf is an Arabic word which connotes hold, confinement or prohibition. The word *waqf* (plural *awqaf*) is used in Islamic law which means to hold a certain asset and preserve it for the benefit of the beneficiary, and to prohibit its use other than for the specified objective. In other words, *waqf* is to retain the real asset with an implied ownership of the Almighty and to devote its utilisation for the benefit of mankind. In this case, a *waqf* asset is considered a trust asset, where the role of the trustee is to look after the asset and ensure its perpetuity for the beneficiaries.

Generally, *waqf* assets can be classified into fixed assets, movable assets or funds which are pooled into "*skim saham waqf*".[1] They all have the potential to generate benefits for the public and contribute towards wealth and prosperity. However, *skim saham waqf* for developing quality assets at strategic locations requires a large amount of capital. The prerequisites of having quality assets at strategic locations are to fulfil the perpetuity requirement and ensure that the returns generated can be continuously channelled to the beneficiaries.

In a modern economic system, Islamic financial institutions, such as Islamic banks, investment banks, stockbrokers and fund managers are continuously looking for Islamic financial products to channel their funds. *Waqf* assets, through the issuance of *sukuk*, offer an alternative investment by the private sector.

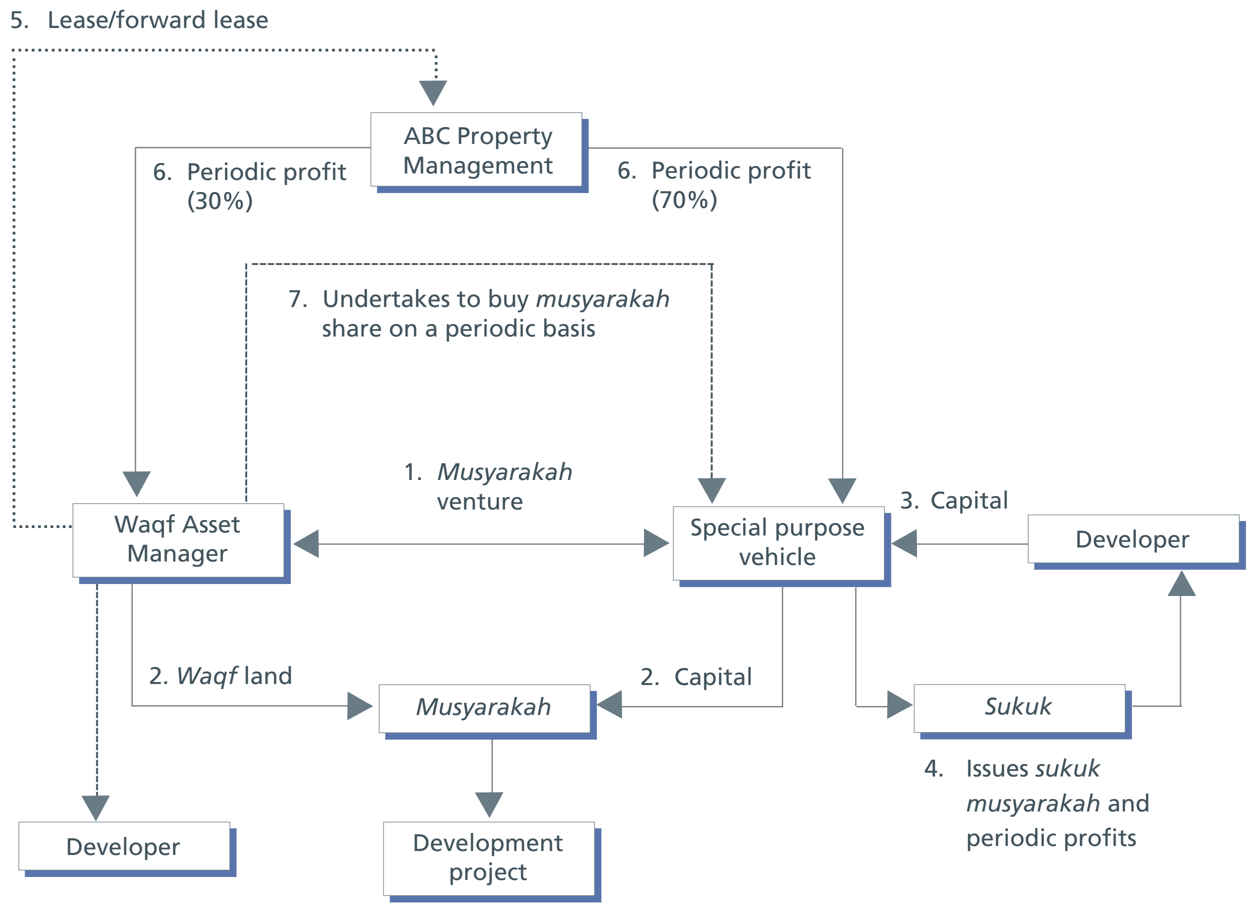
Sukuk is a proven Shariah-compliant financial product which can be used to finance a specific economic activity permitted according to Shariah principles. For example, the construction of a shopping complex, an office building, a hospital and health centre or service apartment with a commercial centre. In the case of *waqf* assets, the issuer acts as a trustee or agent and uses a *waqf* fund to buy land located at a prime area. To develop the land, the trustee raises funds by issuing *sukuk*, based on the build and transfer technique. Service apartments in Saudi Arabia were built with *waqf* assets using *sukuk intifa'* based on time-share ownership of property.

The Malaysian ICM has a vast experience in developing and structuring *sukuk* from assets based on equity using various Shariah principles. The development of *waqf* assets through the issuance of *sukuk* can be done using the *musyarakah* principle, as illustrated in Figure 1.

In summary, *sukuk* can be used as a tool to develop *waqf* assets into quality assets at strategic locations. The returns from this initiative will be significant and benefit the beneficiaries of the *waqf* assets.

1 This scheme refers to purchasing units of shares offered by a particular institution (as a trustee), to be donated as *waqf* for the benefit of the Muslim community.

Figure 1
Developing waqf asset through sukuk musyarakah



- Waqf Asset Manager (WAM) and special purpose vehicle (SPV) enter into a *musyarakah* venture to develop *waqf* land for a period, e.g. six years, profit-sharing at a ratio determined at 70:30
- WAM contributes land to the *musyarakah*
- SPV contributes cash as capital to build commercial building on the *waqf* land
- WAM enters into a two-year forward lease agreement with ABC Property Management
- The *musyarakah* appoints WAM as an agent to develop the land. WAM may appoint a developer to construct the building and when it is leased, the returns will be distributed according to a predetermined ratio. WAM will undertake to buy at a preagreed price, the *musyarakah* shares of the SPV on a periodic basis and at the end of six years, the SPV will no longer have any share in the *musyarakah*.

Guidelines for the Offering, Marketing and Distribution of Foreign Funds in Malaysia

To facilitate the offering, marketing, and distribution of foreign funds in Malaysia, the SC introduced new guidelines which took effect from 1 July 2007. Under these guidelines, funds from or listed in recognised foreign jurisdictions can now be offered in Malaysia.

Foreign funds are collective investment schemes constituted or incorporated in a jurisdiction other than Malaysia and include, among others, retail unit trust funds or mutual funds, real estate investment trusts (REITs) or private funds whether unlisted or listed on an exchange. The Dubai International Financial Centre (DIFC) became the first recognised jurisdiction, following the signing of a mutual recognition arrangement between the SC and the Dubai Financial Services Authority on 27 March 2007.

The guidelines complement reciprocal liberalisation initiatives set in mutual recognition agreements, which will also benefit local unit trust management companies. Mutual recognition arrangements also allow Malaysian manufactured funds to be offered and distributed in recognised jurisdictions. Prior to this, local investors had to invest in a feeder fund in Malaysia to gain exposure to foreign funds. In addition, the guidelines include provisions on the eligibility, duties and responsibilities of local fund distributors in marketing and distributing foreign funds to Malaysian investors.

The list of recognised jurisdictions is set to expand with the signing of more future mutual recognition agreements by the SC. The *Guidelines for the Offering, Marketing and Distribution of Foreign Funds in Malaysia* can be obtained from www.sc.com.my.

Table 1
List of recognised funds and jurisdictions

Recognised jurisdiction	Recognised funds
Dubai International Financial Centre	Islamic funds which are notified or registered with the Dubai Financial Services Authority include– • public funds • private funds (100 participants) • umbrella funds • property funds (including REITs) • feeder funds • fund-of-funds • private equity funds • commodity-related funds.

Capital Markets and Services Act 2007 Strengthens Capital Market and Investor Protection

The *Capital Markets and Services Act 2007* (CMSA) came into force on 28 September 2007. It marked a major milestone in the SC's continuous effort to strengthen the capital market regulatory framework, improve business efficacy and enhance investor protection.

A key measure of the Act benefiting capital market intermediaries is the introduction of a single licensing regime. Under this measure, intermediaries hold a Capital Markets and Services Licence as opposed to multiple separate licences, which effectively reduces administrative and compliance costs, and ultimately saves time.

The law provides impetus to Malaysia's position as a competitive global Islamic financial hub by incorporating clear statutory provisions to recognise ICM products. Notably, under the CMSA, Islamic banks which carry out the whole range of capital market activities for all Shariah-based products and services are automatically granted "registered person" status.

To ensure a smooth transition to the new regulatory framework, the SC introduced the *Capital Markets and Services Regulations 2007* and *Guidelines on Regulation of Markets*, which also came into effect on 28 September 2007. Consequently, amendments are being made to the *Securities Commission Act 1993*.

The CMSA, FAQs, *Capital Markets and Services Regulations 2007*, *Guidelines on Regulation of Markets* and *Licensing Handbook* are available at www.sc.com.my.

Best Practices in Islamic Stockbroking Services

Bursa Malaysia Bhd released the *Best Practices Guidelines in Islamic Stockbroking for Stockbroking Companies Offering Islamic Stockbroking Business or Services*. These aim to broaden Islamic financial services and attract new funds to Malaysia. The guidelines promote uniformity in Shariah compliance, and facilitate the orderly development of a competitive environment of intermediation services.

The guidelines outline key areas for operations and compliance aspects of an Islamic stockbroking business. It sets out recommended best practices for stockbroking services in accordance with Shariah principles.

The guidelines can be used to assist intermediaries in setting up Islamic stockbroking businesses, through either a full-fledged or "window" basis. However, a participating organisation which conducts its stockbroking business in accordance with Shariah principles, whether on a full-fledged basis or "window" basis, is required to adhere to the same regulatory framework and requirements as that of a conventional participating organisation.

The guidelines can be downloaded from www.bursamalaysia.com.

BUDGET 2008: STRENGTHENING MALAYSIA'S POSITION AS AN INTERNATIONAL ISLAMIC FINANCIAL CENTRE

Malaysia is one of the leading centres for Islamic finance and product development. It offers a comprehensive regulatory infrastructure, a range of financial intermediaries and a variety of products. A significant development has been Malaysia's increasing ability to innovate sophisticated Shariah-compliant products which have gained worldwide acceptance.

Launched in August 2006, the Malaysia International Islamic Financial Centre (MIFC) initiative will position Malaysia as an Islamic financial centre specialising in: the origination, distribution and trading of ICM and treasury instruments; Islamic fund and wealth management services; international currency Islamic financial services; and *Takaful* and re-*Takaful* business.

Budget 2008 provides additional incentives to strengthen Malaysia's position as an international Islamic financial centre. The new incentives introduced are:

- To encourage the development of the fund management industry, the following measures were announced:
  - Foreign ownership on fund management companies and real estate investment trusts (REITs) management companies will be allowed up to 70%. The minimum Bumiputera ownership requirement will remain at 30%.
  - The SC will facilitate the licensing process and all dealings with other government agencies to expedite the approval process for the establishment of fund management businesses in Malaysia.
- In line with the objective of the MIFC, the government introduced several measures:
  - Islamic fund management companies will be allowed to be wholly owned by foreigners.
  - A sum of RM7 billion will be channelled by the Employees Provident Fund (EPF) to be managed by Islamic fund management companies.
  - Islamic fund management companies will be allowed to invest all their assets abroad.
  - Fund management companies will be given income tax exemption on all fees received in respect of Islamic fund management activities, until assessment year 2016.
- In developing Malaysia as an international Islamic financial centre, it is important to have a broad-based participation of leading global experts in Islamic finance. For this, the government proposed income tax exemption to non-resident consultants with the required expertise in Islamic finance.
- To attract greater investments from the Middle East, the government provided tax incentives for existing stockbroking companies to set up Islamic stockbroking subsidiaries. To further encourage greater flow of funds from the Middle East to Malaysia, three new stockbroking licences will be issued to leading stockbroking companies which are able to source and intermediate businesses and order flows from the Middle East.

These initiatives support the ICM to act as a driver of growth and to be a leading component of the Malaysian capital market's international value proposition. These developments will help create a more vibrant, liquid and mature ICM, thereby enabling equity investors to seek out new investment opportunities.

SUKUK

Second exchangeable sukuk

Following the pioneering exchangeable *sukuk* issued in 2006, Khazanah Nasional Bhd (Khazanah) issued another exchangeable *sukuk* totalling US$850 million in June 2007. Listed on the Dubai International Financial Exchange, Hong Kong Stock Exchange and Malaysia's Labuan International Financial Exchange, the *sukuk* set a new benchmark as the largest exchangeable instrument issued out of Malaysia to date. It has a maturity of five years with the option to exchange the *sukuk* into ordinary shares of PLUS Expressways Bhd.

Issued via Cherating Capital Ltd, an independent Labuan-incorporated special purpose vehicle, the *sukuk* was oversubscribed by 13 times with 50% of the issue being allocated to the Middle Eastern investors. Proceeds from the issuance are for additional working capital and for general corporate purposes relating to Khazanah's principal business activities.

Sukuk ijarah for telecommunications sector

The SC approved a RM180 million *sukuk ijarah* issuance by Total Mobile Sdn Bhd (Total Mobile), a wholly-owned subsidiary of Touch Matrix Sdn Bhd (Touch Matrix). Touch Matrix was appointed by the Pahang government to construct infrastructure facilities and telecommunication towers which were leased to various cellular operators.

Total Mobile is a special purpose vehicle set up by Touch Matrix to facilitate the issuance of the *sukuk*, comprising senior and junior *sukuk*. Under the medium-term notes programme, Total Mobile will purchase the identified telecommunication towers from Touch Matrix and lease them back to the latter for an agreed period and fixed rental. The proceeds from the issuance will be used to finance the construction of the towers.

Islamic stapled income securities

Telekom Malaysia Bhd (TM) and its wholly-owned subsidiary Hijrah Pertama Bhd (Hijrah Pertama) issued a RM3,000 million TM Islamic Stapled Income Securities (TMISIS). Hijrah Pertama, a special purpose vehicle, was incorporated specifically to facilitate the issuance of TMISIS. The issue comprises *sukuk ijarah* issued by Hijrah Pertama and non-convertible redeemable preference shares (NCRPS) issued by TM. The *sukuk ijarah* is divided into four classes with maturities ranging from 2013 to 2018.

Under the transaction, TM will sell and lease back the identified assets comprising local network equipment from Hijrah Pertama. Hijrah Pertama will issue *sukuk ijarah* to fund the purchase of the assets, whereas TM will issue NCRPS to the investors. The NCRPS is stapled to the TMISIS.

Hijrah Pertama's periodic distribution obligations under the TMISIS will be supported by either rental payments from TM under the *ijarah* agreement, or net dividend payments on the NCRPS. The unlisted TMSIS was awarded a long-term rating of AAA by Rating Agency Malaysia Bhd (RAM).

Shariah-based Unit Trust Funds

Regional sector fund

The SC approved PB Islamic Asia Strategic Sector Fund, the first Shariah-compliant regional sector fund offered by Public Bank Bhd. It aims to seek long-term capital appreciation by investing a minimum of 50% and up to 90% of the fund's net asset value (NAV) in a portfolio of Shariah-compliant securities from selected market sectors in domestic and regional markets, including Japan, South Korea, China, Taiwan, Hong Kong, India, Philippines, Indonesia, Singapore, Thailand, Australia and New Zealand. The fund is managed by Public Bank's wholly-owned subsidiary, Public Mutual Bhd.

The fund's equity exposure would range from 75% to 90% of its NAV. Designed for investors with an aggressive risk-reward temperament, the fund would be invested in three to six of the most promising market sectors which include basic materials, communications, consumer goods, industrial and technology.

Foreign investment fund

PacificMas Bhd through its unit trust arm, Pacific Mutual Fund Bhd, has introduced a new fund called Pacific Dana Dividen. It is a Shariah-compliant fund that will invest up to 50% of its NAV in foreign Shariah-compliant investment markets. The fund aims to provide capital growth and steady income in the medium to long term by investing in a portfolio of Shariah-compliant equities which pay or have the potential to pay attractive dividends.

The fund's strategy is to buy Shariah-compliant stocks, with sustainable and high dividend yields, offering attractive and potentially above average income and capital gains. Historical studies show that dividend stocks have a propensity to outperform their respective underlying markets.

The fund's portfolio will provide investors with access to Shariah-compliant equities of fundamentally sound companies with healthy cash balances and bright profit growth prospects, leading to enhanced dividend payout potential. Pacific Dana Dividen has an approved fund size of 200 million units.

Structured growth fund

Products offering principal protection have been very popular with investors who remain conservative in any market condition. Principal protection products like the CIMB Islamic Structured Growth Fund launched by CIMB-Principal Asset Management Bhd in May 2007. Its 400 million units were fully subscribed in just over three weeks.

The fund offers principal protection and the opportunity for capital gains over a three-year period, through Shariah-compliant investments. The fund, a smart alternative to fixed deposits, achieves principal protection with opportunity for capital growth by having the best-performing combination of international equity, property and commodity asset classes.

The fund will track the performance of Dow Jones Islamic Market Titans 100 Index for Shariah-compliant equity while the commodities basket will track the performance of WTI light sweet crude oil, zinc, and copper. The property basket, likewise, will track the performance of REITs from Singapore and Hong Kong, and the property company, the Westfield Group in Australia.

Malaysia as an Attractive ICM Investment Destination[2]

Malaysia's ICM continues to register strong growth as seen from the increasing size and diversity of products offered. This is due to a number of factors, including well-executed policies, a facilitative regulatory environment, increasing numbers and sophistication of intermediaries which continue to push the frontiers in terms of product innovation, as well as the existence of a complete, mature and well-established Islamic financial system. As an investment destination, Malaysia offers a wide range of investment opportunities with considerable market depth and breadth in a facilitative and internationally benchmarked regulatory environment.

Thus, Malaysia can now rightfully claim to have one of the most innovative and comprehensive ICMs in the world. Many "world-firsts" Islamic products have been issued out of Malaysia. These include the world's first sovereign global *sukuk*, world's first listed real estate investment trusts (REITs), and world's first rated Islamic residential mortgage-backed securities. Malaysia has a diversified range of products and services with significant size and scale. In the equity market, 86% of all securities listed on Bursa Malaysia are classified as Shariah compliant. This accounts for about RM685 billion or 65% of the total market capitalisation of Bursa Malaysia. On the demand side, there is a healthy growth in the Islamic unit trust industry. As at end-July 2007, there were 102 Islamic unit trust funds with a total net asset value (NAV) amounting to RM9.6 billion representing 7.2% of the total NAV of the overall unit trust industry. This accounted for 38% of the NAV of the global Islamic unit trust industry.

The Malaysian *sukuk* market too experienced unprecedented growth. In 2006, over 55% of all bonds approved by the SC were *sukuk* – with a total value of RM42 billion. In the first half of 2007, the SC approved a total of 19 *sukuk* valued at RM10 billion. Furthermore, as at end-June 2007, the global *sukuk* is valued at US$57 billion with Malaysia originating over US$32 billion or 56% of the world's *sukuk* issues.

"...Malaysia can now rightfully claim to have one of the most innovative and comprehensive ICMs in the world..."

Facilitative regulatory environment with strong investor protection

Malaysia established a Shariah Advisory Council (SAC) at the SC soon after the SC was established in 1993 to facilitate product innovation and development in the ICM. This was the most important catalyst for the development of ICM products and services in Malaysia. Not only is the SAC able to respond to inquiries and proposals from the industry, often times, the SAC is also able to make pronouncements to encourage innovation in the industry. The guidelines issued by the SC, such as those on Islamic unit trusts, Islamic REITs and Islamic securities, always attract considerable interest from across the globe. This speaks volumes of the pioneering work of the SAC. The resolutions of the SAC were published twice, in 2002 and the second edition in 2006. This book has been translated into several languages.

While great care is taken to ensure that Shariah-compliant products are true-to-label, the SC also ensures there are high standards of investor protection and market integrity on a consistent basis. All provisions of the law, such as those relating to disclosure, market integrity and investor protection, apply equally to Islamic products as they do to conventional products. Where additional or different requirements are

[2] This article is extracted from the keynote address of Dato' Dr Nik Ramlah Nik Mahmood, the SC's Senior Executive Director, delivered at the MIF 2007 – Issuers and Investors Forum, Kuala Lumpur on 14 August 2007.

necessary, the SC has introduced appropriate additional guidelines. These can be seen in the form of guidelines for Islamic securities, Islamic REITs, Islamic unit trust funds, and for structured products.

Furthermore, to ensure that product originators and fund managers are able to tap their own Shariah expertise, a system for the registration of Shariah advisers for unit trust funds and Islamic securities was introduced. For the market to have access to the best Shariah expertise, SC guidelines allow the registration of local and foreign advisers. To date, the SC has registered 47 Shariah advisers for unit trust funds and six Shariah advisers for Islamic securities. Currently, there are two foreign scholars registered as Shariah advisers. The number is expected to grow significantly in the near future.

To encourage new and innovative products, tax incentives were introduced for the use of globally-accepted Shariah structures. In relation to this, the government provided tax incentive on expenses incurred on *sukuk* issuance under the Shariah principles of *musyarakah*, *mudharabah*, *istisna`* and *ijarah*. The issuance of Islamic securities based on these Shariah principles is expected to draw greater interest from foreign investors, particularly from the Middle-East, since these principles are better known in the international market.

Rules that limit or inhibit the market from flourishing have been removed or are being reviewed. For instance, measures allowing non-residents, in particular, multinational companies and multilateral agencies to issue ringgit-denominated bonds in Malaysia have led the International Finance Corporation and the World Bank to issue their first *sukuk* in Malaysia. More recently, non-ringgit *sukuk* is allowed to be issued in Malaysia by multilateral development banks, multilateral financial institutions, sovereigns and quasi-sovereigns, and local or foreign multinational corporations. The increasing global interest in Malaysia's liberalised and facilitative environment indicate that Malaysia has the potential to compete for international issuances of *sukuk*.

In parallel with this, the SC has also taken initiatives to increase the connectivity of the Malaysian ICM to a global ICM network with the signing of a mutual recognition agreement between the SC and the Dubai Financial Services Authority (DFSA). This is a first such agreement between two Islamic markets, for the cross-border distribution and marketing of Islamic funds between the two Islamic centres. Under the agreement, Islamic funds approved by the SC may be marketed and distributed in the Dubai International Financial Centre (DIFC), with minimal regulatory intervention. At the same time, Islamic funds registered with the DFSA will have access to Malaysian investors. Malaysian capital market intermediaries will benefit from the gateway to distribute their Islamic funds to a fast growing market while Malaysian investors will have access to a range of Islamic funds from the DIFC. Both regulators will work closely in the areas of supervision and enforcement of securities laws to ensure adequate investor protection.

To complement the reciprocal liberalisation initiatives, the SC introduced guidelines to facilitate the offering, marketing and distribution of foreign funds in Malaysia which took effect on 1 July 2007. Under the guidelines, funds from or listed in recognised jurisdictions, i.e. foreign jurisdictions recognised by the SC can now be offered directly into Malaysia. In addition, the guidelines to distribute funds in Malaysia

"...Malaysia scored top marks for disclosure and transparency of accounting standards in the 2006 World Bank report on the country's observance of standards and codes in corporate governance."

include provisions on the eligibility, duties and responsibilities of local fund distributors in marketing and distributing the foreign funds to Malaysian investors.

Clearly, the Malaysian ICM is not only built on a strong and well-established Shariah foundation, its products and services are also offered within Malaysia's robust regulatory framework for the capital market – a regulatory framework which is modern and facilitative, and is internationally benchmarked. Malaysia has, over the years, successfully put in place all the necessary building blocks of an efficient and well-regulated market place. Its securities laws are comparable with the world's best and are continuously fine-tuned and calibrated to ensure efficiency and relevance. Malaysia has in place a comprehensive corporate governance framework, and an international accounting framework based on the International Accounting Standards Board (IASB). In addition, Malaysian securities and settlements systems, as well as regulations, conform to International Organization of Securities Commissions (IOSCO) principles. In fact, Malaysia scored top marks for disclosure and transparency of accounting standards in the 2006 World Bank report on the country's observance of standards and codes in corporate governance. Additionally, based on the *World Bank Doing Business Report 2006*, Malaysia ranked sixth in the world in terms of investor protection and third in terms of regulating liability of directors.

In terms of enforcement powers, the SC has a wide range of powers which is the envy of many, and over the years, the powers have been used to complement the powers of prosecution. As an active member of IOSCO, the SC has an extensive and strong network with fellow regulators globally. In addition, the SC has recently been accepted as a signatory to the IOSCO multilateral memorandum of understanding (MMoU) on information sharing and enforcement of securities laws. This acknowledgement marks a major milestone in strengthening supervision and enforcement efforts in the capital market and is a recognition of the SC as a credible regulator with strong enforcement capability.

High quality intermediation services

Malaysia also has a broad range of intermediaries to meet the needs of investors and issuers in the ICM, namely, investment banks, local and foreign Islamic banks, brokers and fund managers. The role played by these intermediaries has expanded dramatically in recent years. Intermediaries now engage in a broad range of complex financial transactions and operate in various market segments – banking, insurance and capital markets. Now, they underwrite complex financial transactions, provide specialised over-the-counter hedging and risk management products, and advise on sophisticated transaction structures.

In fact, Malaysian intermediaries are also blazing the ICM trail in other markets by offering their skills and expertise to the global financial community. Numerous awards and recognition have been given to local intermediaries for their innovativeness in structuring *sukuk*. Other institutions, like the credit rating agencies, too have the track record to seize opportunities by offering their expertise to the global market. This will enhance the role of local players in the international arena.

A few Malaysian intermediaries have already taken steps to strengthen their position by forging strategic alliances with foreign counterparts and venturing into regional markets while at the same time acquiring the necessary skills and expertise of new products and overseas investments. Similarly, a number of Islamic financial institutions from the various Gulf Cooperation Council (GCC) countries are already operating in Malaysia. Their presence has significantly changed the landscape of ICM intermediation in Malaysia. Efforts are currently being intensified to attract more foreign intermediaries to set up in Malaysia.

Continuous product innovation

The growth of the ICM is also a result of a wide range of Islamic products available in Malaysia. This can be attributed to Islamic institutions developing into originators of a wide range of Islamic products and services. Certainly, it portrays a marked development from the early days when financial institutions merely adapted conventional structures as templates for "off-the-shelf" Islamic products.

The Malaysian *sukuk* market is a fine example, progressing from the first issue of Islamic bonds in 1990. The product range has now expanded into a broad array of innovative instruments using contracts beyond sale and purchase transactions. In recent years, several new contracts based on *musyarakah*, *mudharabah* and *ijarah* were introduced. This change was partly influenced by the desire to distribute the *sukuk* outside the region and to cater to the different needs of global investors, particularly those from the Middle East.

One key factor driving product innovation is that users of Islamic finance have become much more sophisticated in their financial requirements. They are more aware of the benefits of diversifying the risk on their balance sheet. Investors in Islamic finance have become more adventurous and are investing in hedge funds and more complex capital market products.

"...investors buying Shariah products in Malaysia can be assured of "end-to-end" Shariah compliance."

The SAC of the SC has, therefore, been proactive in promoting and facilitating product innovation in the ICM. For example, the SAC approved the single stock futures (SSF), crude palm oil futures and crude palm kernel oil futures as Shariah-compliant instruments. This widens the universe of Islamic investment possibilities for Shariah-compliant investment and risk management.

The recent launch of the tradeable indices, such as FTSE-Bursa Malaysia Emas Shariah Index and the FTSE-Bursa Malaysia Hijrah Shariah Index will create more opportunities for investors seeking Shariah-compliant investments to benchmark their investments, and for asset managers to create new products serving the investment community. Examples of this include exchange-traded funds (ETFs) and structured products, such as index-linked notes.

Due to the contribution of all stakeholders, there is now a sufficiently-wide array of Shariah-compliant products in the capital market to fulfil the needs of investors looking for faith-based investing. Hence, investors buying Shariah products in Malaysia can be assured of "end-to-end" Shariah compliance.

Conclusion

The Malaysian ICM offers a strong and attractive value proposition to global investors in terms of a comprehensive infrastructure and the quality, competitiveness and innovativeness of product solutions. Moving forward, it is important to set our sights on the next phase, which is to propel the Malaysian ICM to the global arena through forging stronger alliances and linkages with other Islamic centres. This requires even greater commitment from the private and public sectors working in partnership – to invest in intellectual capacity and capabilities for product origination and distribution.

Islamic REITs: Growth and Opportunities

The rapid development of innovative ICM products has been a noteworthy achievement in Malaysia. This is vital for ensuring that the country's ICM adapts to and takes advantage of the ever-changing international environment. Malaysian Islamic equity markets, for example, have pioneered various innovative Shariah-compliant products in recent years. Of significance, is the introduction of the first Islamic real estate investment trusts (REITs).

Combining real estate and trust funds

REITs are collective investment vehicles (typically in the form of trust funds) which pool money from investors to buy, manage and sell real estate. The objective is to obtain reasonable returns on investment. Returns are generated from rental income plus any capital appreciation that comes from holding the real estate assets over an investment period. Unit holders receive their returns in the form of dividends or distribution and capital gains for the holding period.

REITs, in general, combine the best features of real estate and trust funds, and sit between bonds and equities. There are listed and non-listed REITs. While the former may be bought and sold through a stockbroker, like listed stocks, non-listed REITs may be bought from and sold to the management company or through other authorised agents. REITs, particularly the listed ones, are liquid assets and can be sold fairly quickly to raise cash and take advantage of other investment opportunities. By buying a unit of REIT, the holder actually owns a fraction of a pool of real estate that generates income via renting, leasing and selling the said property. As an added bonus, REITs provide a platform for international investors to invest in a particular country's real property without the hassle and responsibilities associated with direct ownership of such assets.

Islamic REITs

The SC released the *Guidelines for Islamic Real Estate Trusts* (Islamic REITs Guidelines) in November 2005, making it the first jurisdiction to introduce such guidelines in the global Islamic finance sector and set a global benchmark for the development of Islamic REITs. The thrust of the Islamic REITs Guidelines is to provide a new investment opportunity for those who wish to invest in real estate through Shariah-compliant capital market instruments. The guidelines facilitate the creation of a new asset class for investors and allow fund managers to further diversify their investment sources and portfolios.

Following the issuance of the Islamic REITs Guidelines, KPJ Healthcare became the first Malaysian company to establish and launch Islamic REITs. KPJ Healthcare identified seven hospitals within the group as its main asset class for the establishment of the REITs. In February 2007, Al-Hadharah Boustead REIT became the second Islamic REIT listed on Bursa Malaysia and the first Islamic plantation REIT to provide an opportunity for investors to participate in plantation ownership.

The Islamic REITs Guidelines complement existing guidelines on REITs, with the latter providing general rules on all aspects of investments in REITs and the former acting as a guide on Shariah compliance in structuring and managing investments of Islamic REITs.

As required under the Islamic REITs Guidelines, market players must appoint a Shariah committee/adviser to review, monitor and approve investments by Islamic REITs. The main criteria covered include rental of real estate for business purposes, investment, deposit and financing, *Takaful* schemes and forward sales or purchases of currency for risk management.

Rental of real estate is permissible, except where the property is used for non-permissible activities. These are financial services based on *riba* (interest), gambling/gaming, conventional insurance and entertainment activities which are forbidden by Shariah law, manufacturing or sale of tobacco-based products or related products, stockbroking or share trading in Shariah non-compliant securities, and hotels and resorts.

Apart from the activities listed above, the Shariah committee/adviser can apply *ijtihad* (the process of making a legal decision by independent interpretation of the sources of the law, the Quran and the Sunna) for other non-permissible activities to be included as a criterion in assessing the rental income for Islamic REITs. The benchmark for non-permissible activities is set at 20% of total turnover of the Islamic REIT.

To further promote Malaysia as an Islamic financial centre, the government has provided several tax incentives for foreign investors. Withholding tax on dividends received was reduced from 20% to 10% and a REIT is fully exempted from paying income tax on taxable income if it distributes at least 90% of income to investors. Encouraged by this development, foreign investors are beginning to actively seek Shariah-compliant financial instruments as an opportunity to invest in Malaysia's real property market.

As an added attraction, the government recently proposed in Budget 2008 to allow foreign investors to increase their equity ownership in a REIT management company up to 70% (previously 49%). With this measure, the Malaysian REIT industry, including Islamic REITs, is expected to gain through the transfer of knowledge and expertise, as higher foreign ownership will enhance the level of REIT management expertise. Over time, such a move will benefit the REIT industry, not only through the injection of fresh capital and innovative methods, but also through the development of the industry's broad skills base and the introduction of new technology.

The emergence of greater competition through enhanced foreign participation will therefore bolster activity and efficiency within the industry. Higher foreign ownership will allow foreign corporations with REIT management expertise to set up operations with a higher degree of control in Malaysia.

Opportunities

As tangible assets, real estate remains the preferred asset class among discerning Muslim investors and institutions. Affluent and savvy Arab investors are increasingly seeking viable investments using Islamic financing structures to satisfy their investment objectives. In this regard, Islamic real estate investment fits the bill perfectly as real estate can provide such investors with selected projects that yield good returns and a stable income. The increasing demand for Shariah-compliant real estate investment is reflected by the global rise in the number of Islamic REITs, mainly in the Middle East, and other parts of Asia.

In addition to the boom in the real estate sector in the Gulf Cooperation Council (GCC) countries, there is a growing interest to channel the petrodollars towards opportunities in the Far East. Post 9/11 GCC investors are eyeing Asian countries, such as India, China and Malaysia for infrastructure and property investments.

Malaysia, for example, has reaped the benefits from its efforts in attracting Middle Eastern investments. In August 2007, the Iskandar Development Region (IDR) in Johor secured more than RM4.1 billion (US$1.1 billion) in initial investments from four reputable Middle East consortia. This investment is the single largest foreign real estate development in Malaysia, one of the largest real estate developments in the region and one of the largest single foreign investments in Malaysia to date. The consortium's investment debut in Malaysia is expected to entice more investments from the Persian Gulf and stimulate domestic economic activities. Following the developments in the real estate sector in the Middle East and Asian region, it is envisioned that there will be further growth opportunities for Islamic REITs.

News Roundup

Islamic Market Programme

The Securities Industry Development Corporation (SIDC) organised the second Islamic Markets Programme (IMP) themed "Innovating for Growth" from 1–6 July 2007 at the SC. It aimed, among others, to position the SIDC as a leading ICM technical training centre under the Malaysia International Islamic Financial Centre (MIFC) initiative.

The programme catered to both experienced practitioners and newcomers in Islamic finance. Topics on Islamic finance including developments in the global ICM, *sukuk* structures, equities, derivatives, regulatory issues were covered together with the presentation of several case studies. Reputable speakers from various financial institutions and SC senior representatives shared their knowledge and experiences.

The course directors were Wan Abdul Rahim Kamil, an SC consultant, and Dr Mohd Daud Bakar, a member of the SC's Shariah Advisory Council (SAC). The programme attracted 40 local and foreign participants from the Maldives, Brunei, Bangladesh, Uzbekistan, Iran, Japan and Mauritius.

Shariah Advisers' Workshop

As Islamic structured products are becoming one of the fastest growing areas in global Islamic finance, Shariah advisers must keep abreast with latest developments to fulfil the needs of the ICM. Recognising this, the SC organised a Shariah Advisers' Workshop on 2 August 2007 to enhance the knowledge of Shariah advisers on Islamic structured products. This one-day workshop was also designed to encourage them to be effectively involved in the ICM and to enhance their capability and professionalism in the course of their duties.

More than 40 Shariah advisers registered with the SC and Bank Negara Malaysia, and members of the SC's SAC attended the workshop. Distinguished speakers from various financial institutions were invited to present papers on several topics.

Islamic Stockbroking Education Programme

On 12 September 2007, the SC and Bursa Malaysia jointly organised a half-day event entitled "Islamic Stockbroking Education Programme". The objective of the event was to explain Islamic stockbroking best practices, provide an overview of Shariah fundamentals and products in the ICM, and explain how these principles are applied to the operations of Islamic stockbroking services. Speakers from the SC, Bursa Malaysia and BIMB Securities presented their papers on various topics. More than 60 participants, including compliance officers, account officers, executive directors from participating organisations, attended this event.

2007 INCEIF global forum

The inaugural 2007 INCEIF global forum was held on 30 August 2007 in Kuala Lumpur. Divided into specialised topics and sessions, the forum aimed to bring together academicians, leaders and opinion makers from the East and West to further strengthen co-operation. The Prime Minister, Dato' Seri Abdullah Ahmad Badawi, inaugurated the forum and delivered a keynote speech. The SC Chairman, Dato' Zarinah Anwar presented a speech on the ICM industry, entitled "Enabling Islamic Environment – Malaysian Capital Market Growth." The forum attracted over 300 participants from Malaysia and abroad.

Malaysian Islamic Finance: Issuers and Investors Forum 2007

The Second Malaysian Islamic Finance Issuers and Investors Forum (MIF 2007), organised by RedMoney Sdn Bhd, was held from 13–14 August 2007 at Mandarin Oriental, Kuala Lumpur. The MIF 2007 focused on Malaysia's role as the dominant force in Islamic finance and the link between the Middle East and Asian countries. Dato' Dr Nik Ramlah Nik Mahmood, the SC's Senior Executive Director, presented a keynote address, entitled "Malaysia as an Attractive ICM Investment Destination" on the second day of the forum. The programme was specifically designed for issuers and investors. For issuers, topics of discussion included Islamic financing alternatives, product and market development, and regulatory requirements. Topics for investors included growth of Islamic funds and asset management, emerging Islamic markets, managing liquidity, risk and real estate financing. The two-day event attracted about 800 participants from several countries.

Malaysian ICM – Facts and Figures

Table 2
Shariah-compliant securities

Number and percentage			
Number of Shariah-compliant securities – May 2007[1]			875
% of Shariah-compliant securities to total listed securities			86%
Market capitalisation (end-August 2007)			
Shariah-compliant securities			RM615.04 billion
Total market capitalisation			RM984.83 billion
% of Shariah-compliant securities to total market capitalisation			62.45%
Equity market indices	**30 January 07**	**31 August 07**	**% change**
Kuala Lumpur Composite Index (KLCI)	1,189.35	1,273.93	7.11%
Kuala Lumpur Shariah Index (KLSI)	169.55	192.86	13.8%
FBM EMAS Shariah Index	7,868.37	8,899.99	13.1%
FBM Hijrah Shariah Index[2]	9,326.3	8,943.67	-4.1%

[1] *The SC SAC releases the updated Shariah-compliant securities list twice a year in May and November.*
[2] *Launched on 21 May 2007.*

Table 3
Shariah-based unit trust funds

Number of approved funds	2006	2007[1]
Shariah-based	100	116
Total industry	416	468
Net asset value (NAV) of approved funds	**2006**	**2007**
Shariah-based	RM9.2 billion	RM12.33 billion
Total industry	RM121.8 billion	RM146.60 billion
% of Shariah-based to total industry	7.6%	8.4

[1] *As at end-June 2007.*

Table 4
Sukuk

Size of outstanding and percentage	2006	2007[1]
Size of outstanding *sukuk* (excluding government *sukuk*)	RM105.2 billion	RM118.5 billion
% of outstanding *sukuk* to total outstanding bonds	47.75 %	50.53%
***Sukuk* approved by the SC in Q1 2007**	**2006**	**2007[2]**
Number of *sukuk*	64	19
Size of *sukuk*	RM42.02 billion	RM9.99 billion
Size of total bonds approved	RM75.83 billion	RM24.26 billion
% of size of *sukuk* to total bonds approved	55.41%	41.17%

[1] *As at end-June 2007.*
[2] *From January to end-June 2007.*

Chart 1
Performance of KLCI vs Shariah Indices

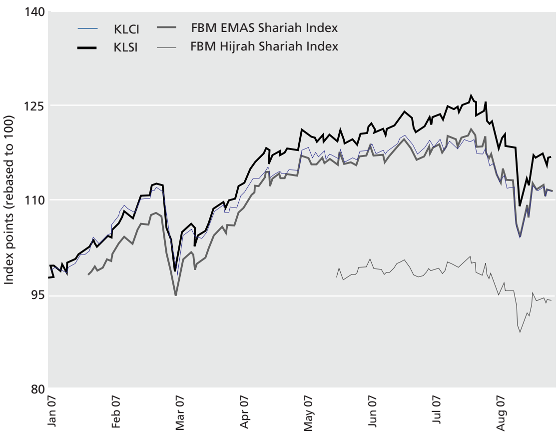
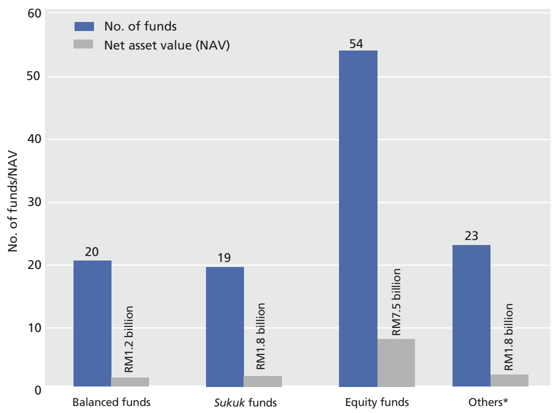


Chart 2
Shariah-based unit trust funds by category



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

Chart 3
Percentage of sukuk approved in terms of value according to various Shariah principles

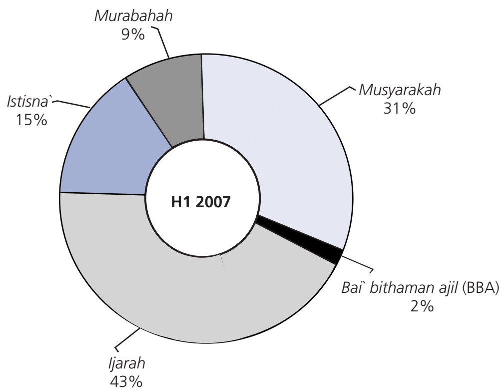


Table 5

Sukuk approved by the SC in H1 2007

Issuer		Shariah principle	Size of issues (RM million)	Date of approval	Initial rating
1.	Malaysian International Tuna Port Sdn Bhd	BBA	240	17 Jan 07	A+
2	Tomei Consolidated Bhd	*Murabahah*	100	19 Jan 07	MARC-1 A
3	Pins Capital Sdn Bhd	*Ijarah*	150	22 Jan 07	P1 AA2
4	Pins Capital Sdn Bhd	*Murabahah*	10	22 Jan 07	Not rated
5	Straight A's Portfolio Sdn Bhd	*Murabahah*	200	15 Feb 07	MARC-1
6	Lebuhraya Kajang-Seremban Sdn Bhd	*Istisna`*	820	15 Feb 07	AA3
7	Lebuhraya Kajang-Seremban Sdn Bhd	*Istisna`*	633	15 Feb 07	A1
8	Arapesona Development Sdn Bhd	*Murabahah*	200	26 Feb 07	AAA
9	Arapesona Development Sdn Bhd	*Murabahah*	70	26 Feb 07	MARC-1
10	United Growth Bhd	*Musyarakah*	800	14 Mar 07	AA2
11	Kuala Lumpur Kepong Bhd	*Ijarah*	500	26 Mar 07	P1 AA2
12	Capable Aspect Sdn Bhd	*Murabahah*	40	26 Mar 07	A+ MARC-2
13	Cagamas MBS Bhd	*Musyarakah*	2,300	7 May 07	AAA
14	Eastern & Oriental Bhd	*Murabahah*	150	10 May 07	P1 AA3
15	Cagamas Bhd	*Murabahah* *Ijarah* *Mudharabah* *Musyarakah* *Istisna`*	40,000*	11 May 07	AAA
16	Cagamas Bhd	*Murabahah* *Ijarah* *Mudharabah* *Musyarakah* *Istisna`*	20,000*	11 May 07	P1
17	Alam Maritim Resources Bhd	*Murabahah*	100	28 May 07	MARC-1
18	Alam Maritim Resources Bhd	*Ijarah*	500	28 May 07	AA-
19	Total Mobile Sdn Bhd	*Ijarah*	30	6 Jun 07	Not Rated
20	Total Mobile Sdn Bhd	*Ijarah*	150	6 Jun 07	AA2
21	Hijrah Pertama Bhd	*Ijarah*	2,997	7 Jun 07	AAA

** Combined issue/offer size with conventional issuance.*

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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