malaysian ICM

Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

Disclaimer

malaysian ICM

Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

MAY 2006 VOL 1 NO 1

Overview on the Malaysian Islamic Capital Market

Contents

Suruhanjaya Sekuriti
Securities Commission

The Malaysian Islamic capital market (ICM) plays a pivotal role, like other capital market components, in contributing to the economic growth and prosperity of Malaysia. The ICM runs in parallel to the conventional capital market for capital seekers and providers, as well as plays an equally important role in the vein of Islamic banking and *Takaful*, in broadening and deepening the Islamic financial markets in Malaysia.

For the past few decades, Malaysia has been in the forefront of global initiatives and efforts to establish a feasible ICM that caters to the needs of Muslims and also ensure that ICM products are attractive to all investors and issuers. The Malaysian community – comprising the government, regulators and financial intermediaries – strives to promote the universality of ICM products and to make such products known and accepted worldwide.

These persevering efforts are beginning to reap rewards as the world is becoming increasingly convinced of the value of ICM products and their ability to cater to different needs of investors and issuers. The continuous efforts have also resulted in the proliferation of new products in recent years, such as the issuance of *sukuk musyarakah* and *sukuk mudharabah*, Islamic structured products and the introduction of the Islamic index and *sukuk* index. These developments were supported by a conducive

▸▸ page 5

Capital Market Issues According to Islamic Jurisprudence

An ICM refers to a market where activities are carried out in ways that do not conflict with the conscience of Muslims and the religion of Islam. In other words, the ICM represents an assertion of religious law in capital market transactions, where the market should be free from the involvement of activities prohibited by Islam, as well as free from such elements as usury (*riba*), gambling (*maisir*) and ambiguity (*gharar*).

The Shariah Advisory Council (SAC) was established in May 1996 to advise the SC on Shariah matters pertaining to the ICM. The SAC members have vast experience in the application of Shariah, particularly in the areas of Islamic economics and finance, and are in a position to present Shariah opinions.

Members of the SAC

No.	Name	Designation
1.	Datuk Sheikh Ghazali Haji Abdul Rahman (Chairman)	Director General/Shariah Chief Justice Department of Syariah Judiciary Malaysia
2.	Dato' Hassan Haji Ahmad	Mufti of Penang
3.	Datuk Haji Md Hashim Haji Yahaya	Very Distinguished Academic Fellow Ahmad Ibrahim Kulliyyah of Laws, International Islamic University Malaysia
4.	Dato' Dr Abdul Halim Ismail	Executive Director BIMB Securities Sdn Bhd
5.	Datuk Prof Dr Abdul Monir Yaacob	Lecturer, Academy of Islamic Studies Universiti Malaya
6.	Dr Mohd Daud Bakar	President/CEO Amanie Business Solutions Sdn Bhd
7.	Associate Prof Dr Abdul Halim Muhammad	Lecturer, Law Faculty Universiti Kebangsaan Malaysia (UKM)
8.	Dr Mohd Ali Haji Baharum	Deputy President Angkatan Koperasi Kebangsaan Malaysia Bhd (ANGKASA)

Understanding fundamentals of Shariah principles

Riba

Islam forbids *riba* in economic and financial activities. This is based on arguments in the Quran and the Sunnah. Many verses in the Quran clearly oppose *riba*. Allah s.w.t. clearly states in *Surah al-Baqarah verse 278–279* :

> *"O you who believe! Fear Allah, and give up what remains of your demand for riba, if you are indeed believers. If you do it not, take notice of war from God and His Messenger. But if you turn back, you shall have your capital sums: deal not unjustly, and you shall not be dealt with unjustly."*

The threat of war as stated by Allah s.w.t. in the above verse shows that *riba* is an activity prohibited by Allah s.w.t. Muslims must purify themselves and avoid these activities.

Riba in Arabic means something that has increased, but it does not mean that everything that increases is *riba* according to Islamic jurisprudence. As narrated by Al-Tabari, *riba* was commonly practised during the *jahiliyah* (pre-Islamic times) period, for example, buying on credit. When the period of credit expired, and a buyer could not settle his debt, the seller would extend the loan period and increase the amount of debt.

In general, *riba* is divided into two categories:

- *Riba qurudh* is *riba* that occurs through debt/loan. According to Al-Jassas, *riba* as practised by the Arab Jahiliyah came in a few forms. When the verse prohibiting *riba* was given, the practice of *riba* was still being carried out. *Riba qurudh* involves lending money and imposing interest. Upon close examination, the type of *riba qurudh* prohibited by Allah s.w.t. is similar to activities practised by commercial banks and conventional finance companies. This is because banks or institutions give out loans and obtain interest from such loans

- *Riba buyu'* is *riba* that occurs through trade. *Riba buyu'* occurs in the trading of *ribawi* products as stated by the Prophet s.a.w. in his *hadith* (narrated by Muslims):

"Exchange gold for gold, silver for silver, grain for grain, barley for barley, dates for dates, salt for salt in the same amount and of the same type and must be handed over in an 'aqd ceremony. If what you have exchanged differs in type, you can trade according to your wishes but it must be done on the spot."

Gharar

In Arabic, *gharar* has the same meaning as *khatar* which means something dangerous. It also carries the meaning of *khida`*, cheating. In the literal sense of both meanings, it can be concluded that *gharar* refers to elements of cheating that can expose someone to danger. In the context of buying and selling, if it is said that an '*aqd* (contract) has the element of *gharar*, it means that there is an element of cheating in the *'aqd*. As an example, a sale and purchase contract which does not state its price is said to possess the element of *gharar* as price cheating can occur.

Further examples of *gharar* include conventional insurance where the buyer buys something where there is uncertainty as to whether the item bought will or will not materialise. The item bought (insurance) will only be claimed if an accident or disaster strikes the buyer, but the accident or disaster may or may not happen. Therefore, it is highly uncertain if the item bought by the buyer will ever materialise.

The basis of prohibition of *gharar* is a *hadith* (narrated by Muslims):

"Verily, the Prophet s.a.w. forbids gharar trading."

Views of past Islamic jurists

The esteemed *mazhab* of past Islamic jurists gave several perspectives on *gharar*. Their differing opinions had an impact on the resulting rulings. From studies of their works, three main definitions of *gharar* were derived.

First: *Gharar* which means *jahalah* about the products. Among *ulamas'* with such a view were Al-Sarakhsi and Al-Zaila`i from the Hanafi *Mazhab*. Al-Sarakhsi had defined *gharar* as something with unknown consequences.

Second: *Gharar* that refers to suspicion, according to Al-Kasani and Ibnu Abidin from the Hanafi *Mazhab* and Al-Dusuqi from the Maliki *Mazhab*. According to Al-Kasani, *gharar* is the potential risk faced by a person, with a 50% possibility that the goods may or may not eventually exist *(syak)*. To Al-Khasani, *gharar* is the suspicion that a good may not exist.

Third: *Gharar* refers to something with unknown consequences. This was the opinion of a majority of Islamic jurists.

The Syafi`i *Mazhab* defined *gharar* as *khatar* (of high risks). Al-Shirazi, a jurist in this *mazhab*, defines *gharar* as something whose condition and consequence are unknown. Al-Ramli stated that *gharar* is something that has two assumptions, positive and negative, with the negative being bigger. Al-Sharqawi and Al-Qalyubi, also jurists from the Syafi`i *Mazhab*, defined *gharar* as something whose consequence is unknown and has two assumptions, positive and negative, with the negative outweighing the positive.

Forms of gharar

Gharar may occur in two situations:

- *Sighah* contract: such as two sales and purchases in one transaction *(`urfatain fi `urfah)*
- Subject contract: such as *ma'dum* sales and purchase.

▸▸ page 12

Islamic REITS: The Latest Shariah-compliant Investment Opportunity

What are Islamic REITs?

Islamic real estate investment trusts or I-REITs are collective investment vehicles (typically in the form of trust funds) that pool money from investors and use this pooled capital to buy, manage and sell real estate. I-REITs provide a new investment opportunity for those who wish to invest in real estate through Shariah-compliant capital market instruments. 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 will receive their returns in the form of dividends or distribution and capital gains for the holding period.

The real estate that I-REITs invest in includes residential or commercial buildings, retail or industrial lots, or other real estate-related assets, such as shares in public-listed property companies, and listed or unlisted Islamic securities of property companies.

Ensuring Shariah-compliance of I-REITs

To ensure that I-REITs are Shariah compliant, their investments are reviewed, monitored and approved by an appointed Shariah committee or adviser, who must observe the following criteria outlined in the *Guidelines for Islamic Real Estate Investment Trusts:*

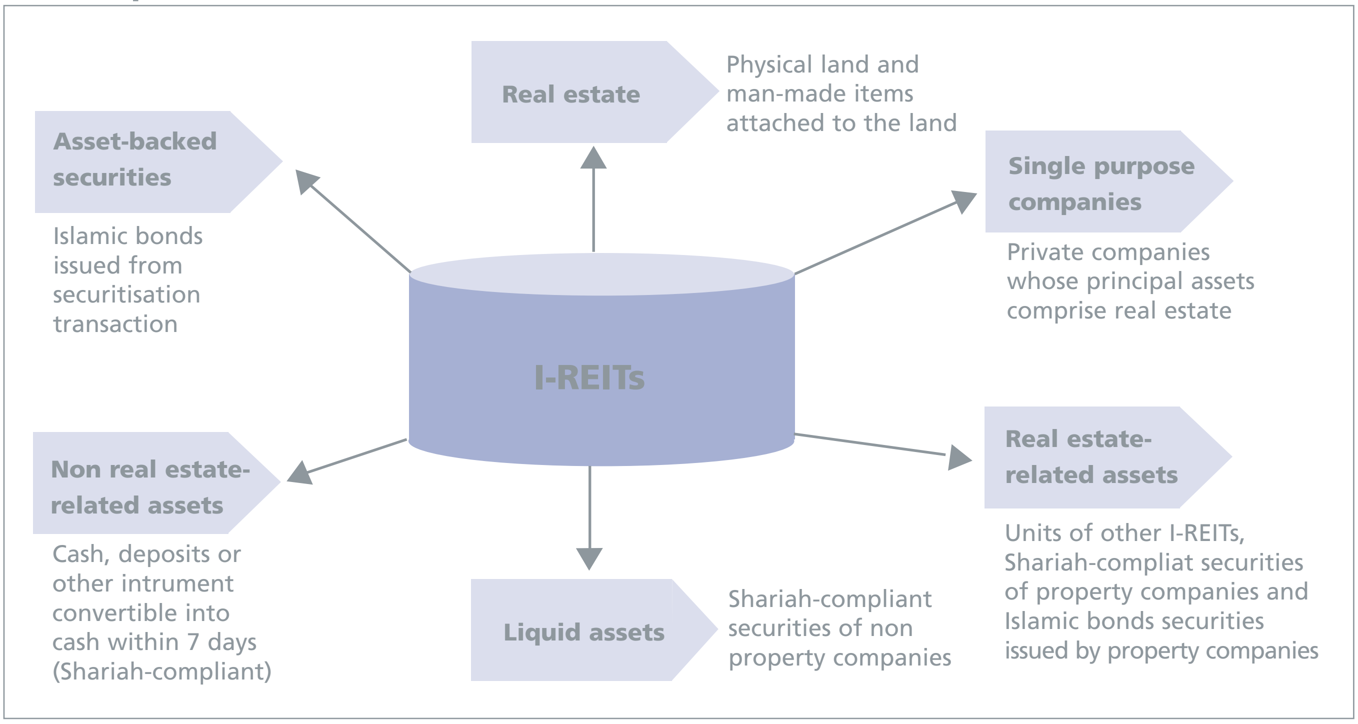
- Rental of real estate by I-REITs for business purposes
- Investment, deposit and financing for I-REITs
- *Takaful* schemes to insure real estate. A conventional insurance scheme is only allowed if *Takaful* schemes are unable to provide insurance coverage
- Forward sales or purchases of currency for risk management with Islamic financial institution under the concept of *wa'd* (only one party is obligated to fulfil his promise/responsibility). Participation in conventional forward sales or purchases of currency is permitted if the I-REIT deals with conventional financial institutions.

Rental of real estate is permissible, except when the property is used for non-permissible activities such as–

- financial services based on *riba* (interest)
- gambling/gaming
- conventional insurance
- entertainment activities that are not permissible according to Shariah laws
- manufacturing or sale of tobacco-based products or related products
- stockbroking or share trading in Shariah non-compliant securities
- hotels and resorts.

Apart from the activities listed above, the Shariah committee/Shariah 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 I-REITs.

Shariah-permissible investments for I-REITs



How to invest in I-REITs?

There are listed and non-listed I-REITs. For listed I-REITs, investors can buy and sell them like listed stocks. For I-REITs listed on the Bursa Malaysia, investors need to go through a stockbroker to invest in them. Like any products listed on the exchange, investors should be aware that I-REITs may trade at a premium or discount to their respective net asset values.

For unlisted I-REITs, investors can buy from or sell to the management company or through other authorised agents like any other unit trust products.

▸▸ *cover page*

regulatory and fiscal environment for the capital market, facilitated by recently released guidelines, such as the *Guidelines for Islamic Real Estate Investment Trusts* and *Guidelines on the Offering of Islamic Securities*, as well as tax incentives.

Moving forward, given the tremendous growth rates registered and the significant developments in the ICM, it can well be said that the ICM is recognised as a niche area of the Malaysian capital market. This will grant Malaysia a strategic comparative advantage that will boost its capital market's competitiveness in facing challenges and competition in the global arena. This competitive edge will prove vital in meeting the country's vision of becoming the global hub for ICM products and development.

Islamic Structured Product

In positioning the Malaysian ICM internationally, the SC encourages global market players to undertake ICM transactions in Malaysia. With the introduction of new products, investors are no longer restricted to invest within their own domestic borders; thus marking another milestone for the rapid growth of the Malaysian ICM.

In April 2006 the first Islamic dual currency structured investment product, based on Shariah principles was launched by HSBC Amanah. The Amanah Islamic Dual Currency Structured Investment Product is the country's first Shariah-compliant structured investment product with a minimum investment to the equivalent of RM250,000, targeted at institutions and high networth individuals. This is the first Islamic structured investment product approved under the *Guidelines on the Offering of Structured Products*.

The product is made of two components, namely the Commodity Murabahah-i and the Unilateral Promise to Exchange Currencies. It offers investors the opportunity to earn enhanced returns on short-term surplus funds.

The Commodity Murabahah-i allows an investor to invest a sum of funds through the purchase and sale of an underlying commodity in which the commodities and the profit rate are agreed upon upfront.

Under the second component, the investor will provide the bank with a unilateral promise to exchange currencies in which the amount of currencies to be exchanged is specified in the unilateral promise.

The product is expected to appeal to existing customers who are already investing in the conventional dual currency structured investment or for those with a need for various currencies, for instance, overseas education or foreign property purchase. It will also be an alternative for Malaysian institutions or corporations who want to manage their foreign currency exposures with a risk management instrument that is consistent with Shariah principles.

Subsequent to the introduction of this product, Malaysia has been chosen as a regional hub for HSBC's Islamic finance operations because of the country's strategic location with potential to create linkages between the Gulf Co-operation Council (GCC) region and the Asia-Pacific , especially in terms of bridging investment opportunities and foreign direct investment flow.

malaysianICM

Global Sukuk Index

In March 2006, the Dow Jones Citigroup Sukuk Index became the first global *sukuk* index which was launched in Kuala Lumpur. The index measures the performance of global Islamic fixed-income securities that comply with Islamic investment guidelines. The index was created primarily as a benchmark for investors seeking exposure to Shariah-compliant fixed-income investments.

Malaysia was a natural choice for the launch of the first global *sukuk* index as it is fast becoming a centre for excellence in Islamic banking and the development of Islamic financial products. Currently, two out of the seven global *sukuk* index components are Malaysian *sukuk* issues, namely Malaysia Global Sukuk issued by the government of Malaysia and the Sarawak Sukuk issued by Sarawak Corp Sukuk Inc.

With the issuance of Islamic bonds exceeding US$30 billion, it was time to provide investors with a *sukuk* benchmark which would further help the development of the *sukuk* or bond market.

Generally, to be included in the index, a bond must comply with both Shariah principles and the Auditing amd Accounting Organisation of Islamic Financial Institutions (AAOIFI) standards for tradable *sukuk*. It also must have a minimum maturity of one year, a minimum issue size of US$250 million, and an explicit or implicit rating of at least BBB-/baa3 by leading rating agencies.

Design criteria and calculation assumptions	
Composition	Global US dollar-denominated investment-grade bonds that are Shariah compliant
Stated coupon	Fixed rate, floating rate
Minimum maturity	One year
Weighting	Market capitalisation updated monthly
Minimum size outstanding	US$250 million
Minimum quality	An explicit or implicit rating of at least BBB-/Baa3 by S&P, Moody's or a leading rating agency
Yield curve	Citigroup Treasury Model (Off-the-Run) Curve
Reinvestment of	One-month USD Eurodeposit for the **cash flow** calculation period
Calculation frequency	Daily
Pricing	All pricing generally taken as of the local market close
Volatility	10% single volatility
Base date	October 2005

DEVELOPING THROUGH A FACILITATIVE TAX FRAMEWORK

The development of the ICM in Malaysia over the past few years can be attributed to the growing interest among market participants, in particular, investment institutions and unit trust funds that manage and invest their funds in accordance with Shariah principles. It is also due to greater acceptance among corporations – issuers and advisers that have regarded the ICM as a viable alternative for fund-raising activities in the capital market.

Notwithstanding the above, the growth of the ICM must be sustained and strengthened to ensure that it will continue to move forward to become an integral component of the capital market. However, its growth needs to be supported by various other measures, including the creation of an enabling and conducive environment that facilitates and promotes product and market innovation and competition.

With this in mind, several recommendations under the *Capital Market Masterplan* (CMP) were formulated to facilitate the development of the ICM, including establishing a facilitative tax framework that addresses potential impediments to the development of ICM products, and also expedites and accelerates the development and innovation of other new ICM products.

Issues relating to tax

The tax treatment of certain Islamic financial transactions has not always been consistent with that of conventional financial transactions, with the former being more likely to be subjected to an additional tax burden. This is due to the unique structure of the Islamic financial transactions requiring the execution of a specific underlying Shariah contract. Although initial progress has been made to address the disparities in the tax treatment, there is certainly scope for more comprehensive measures to be pursued, in order to allow consistent opportunities for development across the board in the capital market.

It is interesting to note that although Islamic financial activities are relatively small in the UK, its government has nevertheless given such activities serious consideration by addressing the double stamp duty treatment on Islamic mortgages. This should even be more critical if such segment of the financial system is considered to be an important sector for growth and development, such as the ICM in Malaysia.

To ensure neutrality in the current tax regime governing Islamic securities transactions, the SC together with the industry participants have collaborated and will continue to collaborate with the tax authorities to address relevant tax issues that may impede the product development and innovation process, and discourage participation in Islamic capital market transactions. This process will be supported by the introduction of an advance ruling procedure to determine the income tax profile of newly introduced transactions and products. This will apply to both conventional and ICM transactions, thus eliminating inconsistencies and uncertainties in the tax treatment of transactions with similar features.

Commonly-used Shariah principles

In Malaysia, Islamic securities are typically issued and structured based on various Shariah principles that fall generally under the concept of contract of exchange *(`uqud al-mu`awadat)* and contract of participation (*`uqud al-isytiraq)*. Such Shariah principles that belong to the concept of contract of exchange are deferred sale *(bai` bithaman ajil)*, mark-up sale *(murabahah)*, sale and buy back *(bai` inah)*, leasing *(ijarah)* and progressive sale *(istisna`)*. On the other hand, the two main Shariah principles that fall under the concept of contract of participation are trust partnership *(mudharabah)* and partnership *(musyarakah).*

Most Islamic securities structured under the contract of exchange involve the sale and purchase transactions of an underlying Shariah-compliant asset. Islamic securities under the contract of exchange reflect the element of indebtedness and obligation on the part of the issuer to repay the amount of debt owed to the creditor(s) after undertaking the sale and purchase transactions. This form of Islamic securities closely mirrors the debt structure of conventional securities. However, due to the requirements under the contract of exchange that there must be a transfer of asset, it will be subjected to some form of tax treatment that are not imposed on conventional securities. Hence, such treatment will place Islamic securities at a disadvantage compared to its conventional counterparts.

Illustration of contract of exchange

To illustrate an Islamic securities transaction under the contract of exchange as part of the process to facilitate fund-raising, the Shariah principles of deferred instalment sale *(bai` bithaman ajil)* and leasing *(ijarah)* are used.

Deferred instalment sale

The customer enters into an asset sale agreement with the financier, where the financier purchases the identified asset from the customer at a fixed price (purchase price) for cash. The financier simultaneously enters into an asset sale agreement with the customer to resell the asset to the customer at a higher price (selling price) which is made up of the purchase price plus profit margins. The customer issues Islamic securities for the amount equivalent to the selling price to reflect the indebtedness which will be settled by instalment over a period of time.

The securities to reflect the indebtedness of the customer to the financier are divided into two notes, as follows:

- Primary notes evidencing the principal, which can only be redeemed at maturity

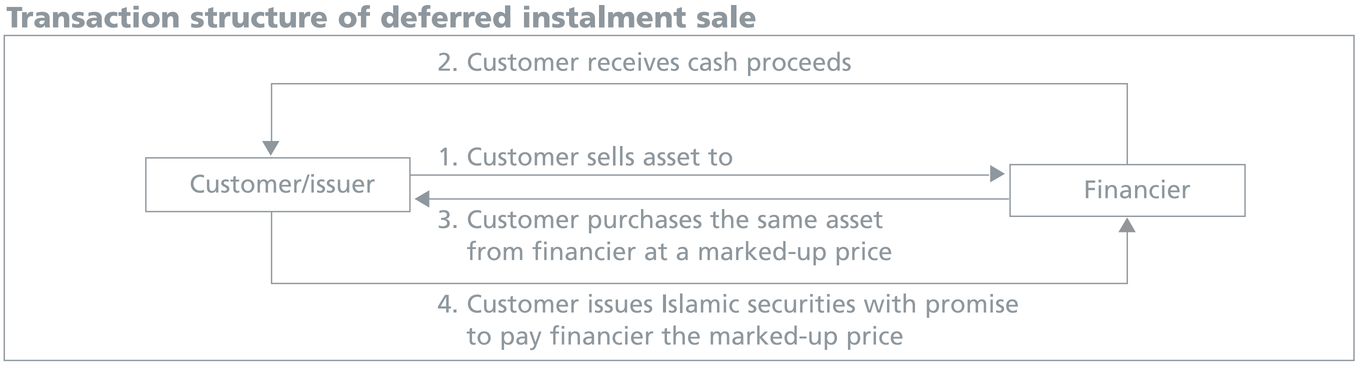
- Secondary notes evidencing the agreed value of profit margins, which are payable over a certain number of instalments, as mutually agreed.

Leasing

The customer enters into an agreement to sell an asset, for example, a machine to a third party. In this case, the third party can be a trustee or special purpose vehicle (SPV). The trustee acts on behalf of investors who will provide the funds for the purchase of the machine. The title of the machine will be passed to the trustee who acts as an agent and trustee for the investors immediately upon the sale of machine. The trustee, on behalf of the investors, then leases the machine to the customer under the Shariah principles of *ijarah* where the customer will make lease payments to the trustee throughout the leasing period.

The customer will issue Islamic securities to the investors to reflect the above financing arrangement. The returns to the investors are in the form of leasing profits and the principal amount (face value of the securities) will be paid to the investors upon maturity of the securities. The

Transaction structure of deferred instalment sale



customer grants a put option to the trustee where at the end of the *ijarah* facility period, the trustee can exercise the put option which requires the customer to purchase the machine from the trustee.

Tax treatment for Islamic securities

As mentioned ealier, the issuance of Islamic securities requires transactions such as a sale and purchase contract, or a leasing contract. Despite the fact that it is a sale, the whole objective of the transaction is to facilitate Islamic financing which requires an exchange of an asset with mutually agreed sale and purchase prices. Should the Islamic securities transactions under the contract of exchange be deemed as sales for the purpose of income tax, then various tax treatments under the *Income Tax Act 1967* and *Income Tax Leasing Regulations 1986* will apply. This will certainly place Islamic securities in a less competitive position.

Prior to the announcement made by the Minister of Finance in Budget 2004, the tax treatment on Islamic securities was not comprehensive, although considerations were given by the tax authorities on a case-by-case basis. In Budget 2004, it was proposed that a more comprehensive tax treatment be provided for Islamic securities to address tax neutrality issues, enhance certainty and transparency, and to ensure that the development of ICM is not impeded with unnecessary infrastructure issues.

To address the uncertainty of tax treatment, the government has proposed that financial transactions through the issuance of Islamic securities be subjected to the following tax treatment:

- The sale of asset by the party that needs financing to the financier and/or SPV and the resale of the same asset to the said party will not be deemed as sales for the purpose of income tax

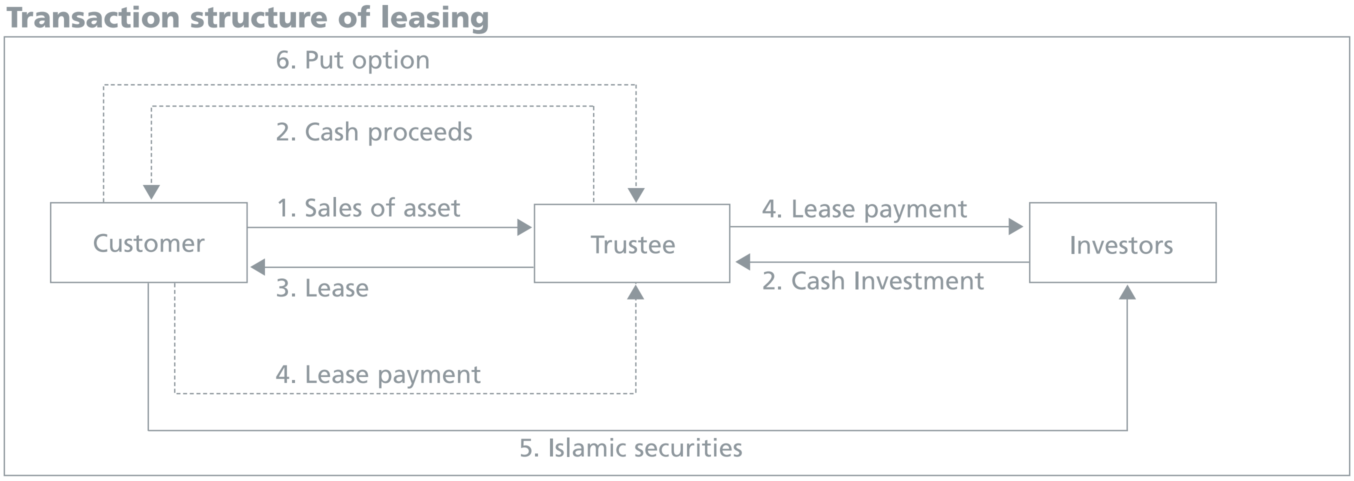
- The lease back of the same asset by the SPV to the said party will not be deemed as sales under the *Income Tax Leasing Regulations 1986*

- The issuance of Islamic securities by the SPV will follow the same treatment as for the asset-backed securities

- Financing transactions carried out by the SPV will be treated in the same manner as any person under the *Income Tax Act 1967*

- The said party continues to enjoy the tax incentives and allowances under the *Income Tax Act 1967* and *Promotion of Investments Act 1986* provided that it is still in the business of the approved activity.

Transaction structure of leasing



In addition to the above proposed tax treatments, the following measures were also accorded by the government:

- Gains from the disposal of Islamic securities by investors are exempted from real property gains tax
- Stamp duty is exempted on instrument of transfer of asset by the party that needs financing to the SPV
- The party that needs financing continues to enjoy tax exemptions under the *Customs Act 1967, Sales Tax Act 1972* and *Excise Act 1976*, provided that the said party is still in the business of the approved activity.

Subsequently, to provide further clarity, in Budget 2005, the government has granted the following tax treatments:

- Tax treatment for Islamic financial and capital market products – additional tax or duty be exempted or given specific treatment provided that–
  - o the Islamic capital market products are approved by the Shariah Advisory Council of the SC
  - o the Islamic financial products are approved by the Shariah Advisory Council of Bank Negara Malaysia
- Exemption of stamp duty on additional instruments required pursuant to approved Islamic financial and capital market products
- Exemption of real property gains tax on disposal of chargeable assets required under approved Islamic financial and capital market products.

Accelerating product development through tax incentives

In addition to addressing the tax anomalies for the ICM, there is also a need to provide appropriate tax incentives to further accelerate its development, consistent with the agenda of positioning Malaysia as an international ICM centre. The provision of the tax incentives is mainly to encourage innovation and development of new products, as it is understood that in general, the cost of pioneering new products will usually be higher than the cost of issuing existing products. However, once the products are made available and used regularly, the cost can be kept to the minimal. In this instance, the tax incentives will serve to "kick-start" innovation and utilisation of new products by investors and users.

In relation to this, the government has in Budget 2003 provided a tax deduction incentive for a period of five years on expenses incurred on the issuance of Islamic securities based on the Shariah principles of trust partnership *(mudharabah)*, partnership *(musyarakah)* and leasing *(ijarah)*. In Budget 2004, a similar tax deduction incentive for a period of five years has been provided on expenses incurred on the issuance of Islamic securities based on Shariah principles of progressive sale *(istisna`)*.

The tax incentives should be able to attract more interest among issuers to innovate and develop Islamic products that will not only provide the opportunity to widen the scope of their prospective investors but also help broaden the range of Islamic financial instruments. The issuance of Islamic securities based on the Shariah principles of trust partnership *(mudharabah)*, partnership *(musyarakah)* and leasing *(ijarah)* is also expected to draw greater attention from foreign investors particularly from the Middle-East since these principles are more acceptable to them compared to Shariah principles under the contract of exchange except for leasing *(ijarah)*.[1] The tax incentive given to *istisna`* principles, on the other hand, is to promote and encourage greater product innovation within the ICM.

[1] *Islamic securities based on ijarah principles is acceptable by Middle-East investors as was evident with the successful issue of the Malaysian Global Sukuk in 2002.*

Conclusion

The comprehensive measures proposed by the government to ensure neutrality of tax treatment, and where necessary, to provide appropriate tax incentives, for the ICM, will certainly facilitate wider opportunities for issuers to use Islamic capital market as a platform to raise long-term funds to finance their business activities and expansion. Similarly, the availability of more Islamic products in the market will provide greater investment opportunities for the general investors, particularly Islamic investors. This will also widen the investors' base for the ICM, which will lead to a more efficient and liquid market.

Nonetheless, having accorded a comprehensive tax framework including incentives and other basic infrastructure requirements for Islamic securities alone will not solely guarantee that Islamic securities will proliferate immediately. The government and the SC can facilitate the development process, but the pace and extent to which development can take place in the ICM are essentially dictated by the market participants. Therefore, industry participants must strive to further develop and produce more quality and innovative Islamic products and services that are cost competitive and can fulfil the different risk-return profiles and needs of issuers and investors.

With such a facilitative tax framework for the ICM, the industry has responded positively to the government's aspiration in positioning Malaysia as a global ICM hub. This is evident with the issuance of new types of Islamic bonds based on Shariah principles, such as *ijarah, istisna`, musyarakah* and *mudharabah*. To date, there are eight *ijarah*, five *musyarakah*, four *istisna`* and one *mudharabah* bonds available in the local market. It is expected that more issuance of Islamic bonds using these principles will be introduced to enhance Malaysian ICM international connectivity.

▸▸ *page 3*

Gharar is divided into three types – *gharar fahisy* (plenty), *gharar* yasir (a little) and *gharar mutawassit* (medium). *Ulamas'* unanimously say that *gharar fahisy* can nullify the contract especially *'uqud mu'awadhat* and *gharar yasir* does not give any effect on the contract. However, they have differences of opinions on *gharar mutawassit.*

Gambling

Gambling or in Arabic, *qimar* or *maisir* means activities which involve betting, whereby the winner will take all the bets and the loser will lose all.

Dalil on the prohibition on gambling

The prohibition of gambling is clear in the Quran, where Allah s.w.t. commands believers to eschew gambling as stated in *Surah al-Maidah verse 90:*

> *"O you who believe! Intoxicants and gambling (dedication of) stones, and (divination by) arrows, are an abomination – of satan's handiwork: eschew such (abomination), that you may prosper."*

As gambling is prohibited by Allah s.w.t. Muslims are forbidden to be involved in contributing towards developing companies which carry out businesses based on gambling. Hence, the securities of a company whose main activity is gambling will be excluded from the SAC's list of Shariah-compliant securities.

THE NEXT PHASE OF DEVELOPMENT

The Islamic capital market has seen considerable growth

Over the past two decades or so the ICM in Malaysia has emerged as a significant area of growth. It has come a long way since the first issue of Islamic bonds by Shell in 1990, the establishment of the first Islamic unit trust fund by Arab Malaysian Unit Trust Bhd in 1993 and the establishment of BIMB Securities, the first full-fledged Islamic stockbroking company, in 1994. The Malaysian ICM today has the full complement of products, infrastructure, institutions, intermediaries and investors contributing to greater depth and breadth of the entire capital market.

Today, we have 871 Shariah-compliant stocks listed on Bursa Malaysia with a market capitalisation of about RM461 billion or 63% of the total market capitalisation. The availability of Shariah-compliant stocks has also boosted the development of the Islamic funds management industry. Starting with two equity funds in 1993, Malaysia now has 85 Islamic unit trust funds comprising both equity and bond funds with a net asset value (NAV) of about RM8.6 billion or about 8.4% of the total NAV of the unit trust industry. Over the last 10 years, Islamic unit trust funds have been growing at a compounded annual rate of 26.6% while the unit trust industry grew at about 8.4%.

The same success story can be seen in the bond market. The growth and development of Islamic bonds is also very impressive as we have witnessed a significant increase in the size of Islamic bonds issued by corporate bodies. Total outstanding Islamic corporate bonds currently stand at about RM91.6 billion or 44% of total outstanding corporate bonds. In 2005, there were 77 issues of Islamic bonds structured based on various underlying Shariah principles including *mudharabah* and *musharakah*. With a total nominal value of RM43.3 billion, this represents 71.4% of the total corporate bonds issued in Malaysia during that period.

Achieving the effective and efficient mobilisation of Islamic funds

The efforts of the government over the past decade or so in developing the ICM has shown results. These efforts were initially driven by the specific need to address effective and efficient mobilisation of funds of Islamic banks, *Takaful,* as well as other Islamic institutions, such as Tabung Haji, and enhancing the liquidity management of these sectors. Today, not only has this objective been attained, ICM products and services have also become part and parcel of the broader capital market landscape in Malaysia, offering viable and competitive alternatives to conventional products and services, hence reflecting their increasing popularity and acceptability both as financing and investment tools.

To the extent that early efforts, policies, and strategies were intended to fill a gap and to bridge investors' faith-based demands for products and services with faith-based business and financial solutions and products, these policies and strategies have clearly been more than successful. 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. Malaysia has bonds structured using a variety of Islamic principles, Shariah-compliant stocks for direct investment in the capital market, as well as unit trust funds for those who prefer to invest in collective investment vehicles. The country also has the Shariah Index, as well as intermediaries and advisers offering expertise both on the demand and supply sides.

Government-driven policies and initiatives were key to the success of the initial phase

These have been achieved through clear policies and government-driven initiatives. The establishment of the SC, whose mandate includes not just regulating but also developing the market, provided ownership and leadership to the government's efforts in developing the ICM. This statutory developmental mandate enabled the SC to move very quickly to put in place the necessary institutional and regulatory infrastructure for the development of the ICM. In a nutshell, significant top-down initiatives were pursued.

The establishment of a Shariah Advisory Council (SAC) for the capital market at the level of the regulator in 1996 provided the single most important impetus for the success of other initiatives. With the SAC presiding as the highest point of reference with respect to all 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 the 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. This enabled, for instance, the SC to impose specific requirements for Islamic unit trust funds and Islamic bonds.

The adoption and pursuit of a screening process to determine Shariah-compliant stocks, the issuance of numerous guidelines to impose additional requirements on products that are identified as Shariah compliant, the ability to respond to queries and clarifications on Shariah issues from the market, coupled with the SC's own ability to address regulatory and tax impediments with the relevant authorities and to introduce education and awareness programmes through the publication of resolutions of the SAC and through specific programmes organised by the Securities Industry Development Centre (SIDC), enabled the necessary building blocks to be put in place.

Taking the ICM to its next phase of development – A strategic shift

Taking the Malaysian Islamic capital market to its next level of development requires a strategic shift on several fronts. First, we should move beyond the desire to fulfil the special needs of faith-based investors to providing real and viable investment alternatives to all. Second, the focus of our efforts should extend beyond the domestic market. Third, we have to move from product adaptation and imitation to product origination and innovation. Fourth, we have to move from government-driven, top-down policies and initiatives to market-driven efforts.

Providing real and viable investment alternatives to all

The ICM serves the same economic purpose as the conventional capital market. Hence, the ICM must move beyond bridging investors' faith-based demand for products with faith-based business and financial solutions and products. Universal acceptability, not exclusivity must be the objective and hallmark of the ICM going forward.

It is a well-known fact that in Malaysia, Islamic banking, *Takaful* and capital market products are beginning to be accepted as viable, competitive alternatives to conventional products. In fact, according to an ndependent survey, more than two thirds of financing provided by Islamic banks are to non-Muslims. More than half of the units offered by Islamic unit trust funds are subscribed by non-Muslims. Similarly, the issuance of Islamic bonds by corporations whose financing needs can also be met by the use of conventional instruments is testimony to this.

In this regard, it is no longer appropriate to talk of the potential market for the ICM in terms of the number of Islamic funds, the Muslim population and such narrow parameters. The entire financial system must be the potential for the ICM. The success in "mainstreaming" Islamic products and services in Malaysia, should be replicated on the international front. The potential market for global ICM products is, therefore, not the often quoted assets of 265 or so Islamic banks worth in excess of US$260 billion, with deposits growing at between 10 to 20% annually, or the total amount of investible funds belonging to GCC countries said to be in excess of 400 billion or those belonging to high networth individuals said to be in excess US$1.6 trillion. On the contrary, the potential global market for ICM products and services is the global financial system. A recent survey by McKinsey & Co estimated the global stock of financial capital available for intermediation stood at US$118 trillion in 2004 and is expected to exceed US$200 trillion by 2010. Roughly 80% of the global financial stock is in developed economies like the US, Europe and Japan. Today, almost all are likely to comprise conventional products.

Hence, the challenge going forward is how to make ICM products the products of choice for all issuers, intermediaries and investors, irrespective of their faith. ICM products and services must therefore compete against the best and most competitive in the world, not just against what is offered by other ICM centres. 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 structure and practices, levels of transparency, disclosure, and the protection accorded to investors, are benchmarked against existing international standards, best practices and codes.

From domestic to global focus

Looking beyond the domestic market to global market is in fact not a new strategy. It is clearly articulated in the *Capital Market Masterplan* (CMP). One of the six strategic objectives of the CMP is the establishment of Malaysia as an international ICM centre. This is because Malaysia has a comparative and competitive advantage with respect to ICM. Towards this end, the CMP calls for the enhancing of the value recognition of the Malaysian ICM internationally.

Among others, specific recommendations of the CMP include enhancing awareness of Malaysia's ICM at domestic and international levels. Establishing strategic alliance with other key ICM centres, issuance of international Islamic bonds by government and government-related entities and the possibility of listing Malaysia funds in the international market.

One of the specific initiatives, that are being pursued in the attainment of this initiative, is to continue the path of developing more universally acceptable Shariah-compliant products.

Of course, fundamentally and at the most basic level, this calls for the adoption of Shariah principles that are universally acceptable. But that is not all. As mentioned earlier, standards, practices and documentation must also be internationally benchmarked. Product developers, issuers and advisers must ensure international acceptability and compatibility through benchmarking against international best practices and standards, such as IOSCO's Objectives and Principles of Securities Regulation and OECD's Corporate Governance Principles. Furthermore, the listing of products on the international exchanges will enhance investor access to those products and facilitate the participation of conventional issuers and investors, thus further facilitating the integration with the global financial system.

The best way to achieve the above is to allow our products to be offered to investors across the globe and to open our markets not only to foreign investors but also to foreign issuers and intermediaries. The more diversified the issuer and investor base, the further ICM products move up the ladder of international compatibility, competitiveness and acceptability. In this regard, Malaysia's global sovereign *sukuk* in 2002 – the world's first – is a fine example. Facilitated by local and international intermediaries, this issue achieved by way of geographical distribution of investors, 51% from the Middle East, 30% from Asia, 15% from Europe and 4% from the US. On the flip side, Malaysia has more recently seen the issuance of ringgit-denominated Islamic bonds by supranationals, again facilitated by local and international intermediaries. These again attracted both local and international investors. In this regard, the involvement of global issuers, investors and intermediaries in the ICM will ensure that these goals are achieved, as they would demand standards of compliance, transparency and governance that they are familiar with and accustomed to. The licensing of foreign Islamic banks, foreign stockbroking and fund management companies will all contribute significantly to the achievement of this goal.

Recent liberalisation measures announced by the SC are also expected to facilitate cross-border issuance and investment with respect to ICM products. The liberalisation measures among others, allows non-ringgit bonds to be traded in Malaysia without the SC's prior approval if traded between sophisticated investors. Malaysian public-listed companies are also allowed to issue non-ringgit bonds to sophisticated investors in Malaysia. Additionally, Malaysian investors can now invest in foreign securities listed on recognised foreign exchanges while offering of foreign shares is allowed subject to SC approval. While these measures are not targeted specifically at the ICM, it is expected that they will go a long way in helping promote the ICM internationally.

From product adaptation to product origination

There is nothing wrong with adaptation and imitation. It is our willingness to unravel conventional products and structures, and address those portions that are not Shariah compliant that have brought success to the ICM in the first phase of development. In fact, to do otherwise in the first phase of development may not have been possible as investors would want to invest in products with which they have a certain degree of familiarity and comfort. But to continue to do so would mean that the ICM would always lag behind the conventional market. It would also mean that the richness of Shariah principles will never be fully utilised or tapped.

Product origination and innovation, however, cannot take place if ICM products must continue to fit into conventional regulatory straight jackets. Our experience, with respect to Islamic bonds, is a clear case study in this regard. As an effort to facilitate product innovation in the ICM, the SC released the *Guidelines on the Offering of Islamic Securities* in 2004. The guidelines introduced an umbrella framework for Islamic securities, enabling and facilitating the development of a more innovative and sophisticated ICM.

Prior to the issuance of the guidelines, the issuance of Islamic bonds was subject to the guidelines for the issuance of conventional bonds, subject to appropriate modifications, particularly, in terms of the requirements of Shariah advisers, etc. Conventional bonds, as we all know, are based on the legal concept of debentures, which involves the element of indebtedness. This had a limiting effect on the development of Islamic bonds based on structures involving elements of equity participation like *musharakah* (profit and loss sharing) and *mudharabah* (profit sharing) bonds. Hence, the issuance of Islamic bonds were then confined to those based on BBA (deferred sale) and *murabahah* (sale and purchase transaction involving cost plus profit margin) principles which had a constraining effect on the growth of the Islamic bond market. The introduction of the Islamic securities guidelines and some changes to the definition of securities in the law, effectively decoupled Islamic bonds from the definition of debentures and allowed issuers to structure products based on the very rich *fiqh muamalat* principles.

From policy-driven to market-driven initiatives

The ICM is no longer in the construction phase. The building blocks are all in place – the institutional and regulatory framework, the market infrastructure, the tax incentives and indeed the long-term policy direction. Of course, the government will need to address residual legal or tax issues and fine-tune existing frameworks to ensure relevance and effectiveness. The global market is now convinced of favourable policies and facilitative framework for Malaysia's ICM. What they need to see is more innovative products originating from Malaysia and marketed to the world, and Malaysian intermediaries offering their ICM skills and expertise to the global financial community. While it has to be acknowledged that even in the first phase this was beginning to happen, more needs to be done.

Hence, the focus of efforts in the next phase must be largely industry-driven. Product innovation, ensuring global compatibility and acceptance, branding and profiling and promotion must be pursued by the private sector. In the Islamic equity market for instance, a financial intermediary in Malaysia has developed a specialised product to meet the specific needs of their investors and clients in the form of the RHB-Dow Jones Islamic Index which was launched in June 2005.

Targeting beyond meeting the needs of faith-based investors means ICM products can no longer wait to be bought, they must be sold, and sold aggressively. In this regard, strategic cross-border alliances by our market intermediaries and institutions, as well as the direct participation of Malaysian intermediaries in some foreign markets will greatly contribute to achieving international presence for Malaysian ICM products and services.

Key challenges

What are some of the key challenges in taking the Malaysian ICM to the next phase of development? First, the need to ensure greater convergence on Shariah matters. Second, ensuring compliance with internationally acceptable standards. Third, ensuring availability of appropriate human capital. Fourth, the need for greater international co-operation and co-ordination.

A lot has been written and said about the need for greater Shariah convergence and this is also a matter being addressed at the international level. Clearly, the realisation is there and increasing acceptability of particular products by investors in various part of the world is testimony to the fact that there has been some progress in the process. With more regular dialogue and discussion among international Shariah scholars not only among themselves but also with academics and capital market practitioners, with efforts being pursued by the likes of the Islamic Development Bank (IDB) and with the growing demand for ICM products that are globally acceptable, we should be able to see greater convergence in the near future. Where complete convergence cannot be achieved, there must be greater tolerance and appreciation of differences in Shariah interpretation.

Efforts in ensuring Shariah compliance must be complemented with efforts to ensure international acceptability and compatibility through benchmarking against international best practices and standards, such as IOSCO's Objectives and Principles of Securities Regulation, OECD's Corporate Governance Principles and international accounting standards. In this regard, the significant efforts of organisations like the IDB, Islamic Financial Services Board (IFSB) and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOFFI) cannot be overemphasised. However, at the end of the day, the key driver for this is the need to attract global investors and global issuers.

Human capital is pivotal in taking the ICM to its next phase of development. There is a great need to enlarge the pool of human capital in areas like Islamic and conventional finance and specialised tax, legal and accounting expertise. In this regard, market professionals must complement and support the efforts of organisations like the SIDC and Islamic Banking and Finance Institute Malaysia (IBFIM).

For the ICM to make significant headway in the global financial system, international co-operation and co-ordination is vital. In this regard, the efforts of the IDB in formulating a 10-year Masterplan for the ICM is a good start. Furthermore, where appropriate, Malaysia can emulate efforts that are currently being pursued in the development of the conventional capital markets by various regional groupings and agencies, such as the Asian Development Bank (ADB), the ASEAN+3 Bond Market Initiative, as well as the APEC and ASEAN Finance Ministers' initiatives with regard to capital markets.

MALAYSIAN ICM – Q1 2006

Shariah-based unit trust funds*

Number of approved funds	85
NAV of Islamic unit trust (IUT)	RM8.55 billion
% IUT to total industry	8.38%

** as at 28 Feb 2006.*

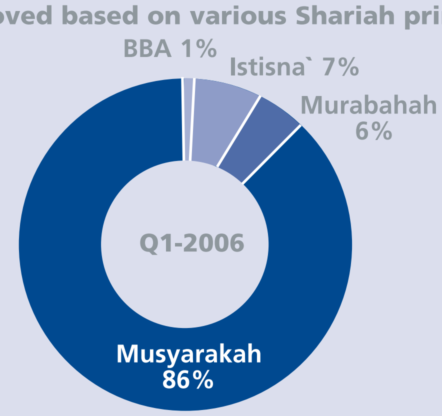
Shariah-compliant securities/shares

Number of Shariah-compliant securities – April 2006		871 securities	
% to total listed securities		85%	
Market capitalisation:			
Shariah-compliant		RM461.13 billion	
Total market		RM732.90 billion	
% of Shariah-compliant to total market		62.92%	
Equity market indices:	31 Dec 2005	31 Mar 2006	% change
KL Composite Index (KLCI)	899.29	926.63	(+3.04)
KL Shariah Index (KLSI)	127.12	132.34	(+4.11)
Dow Jones-RHB Islamic	909.72	939.12	(+3.23)

Islamic bonds (IBs)

Size of outstanding IBs* (exclusive of government bonds)	RM91.6 billion
% of outstanding IBs to total outstanding bonds	44%
IBs approved by the SC in Q1 2006:	
Number of IBs	16 issues
Size of IBs	RM11.6 billion
Size of total bonds approved	RM14.9 billion
% of size of IBs to total bonds approved	77.9%

IBs approved based on various Shariah principles



** as at 28 Feb 2006.*

Islamic bonds approved by the SC in Q1 2006

Issuer	Syariah principle	Size of issues (RM million)	Date of issuance	Rating
1 MM Vitaoils Shd Bhd	Murabahah	70	28 Feb 06	MARC-2ID
2 Cellular Structures Sdn Bhd	Murabahah	8	n/a	n/a
3 Cellular Structures Sdn Bhd	Murabahah	184	n/a	AAID MARC-1ID
4 Tele-Flow Capital Sdn Bhd	Murabahah	10	n/a	n/a
5 Tele-Flow Capital Sdn Bhd	Murabahah	90	n/a	AAID MARC-1ID
6 Prinsiptek Corporation Bhd	Murabahah	50	n/a	AID
7 Prinsiptek Corporation Bhd	Murabahah	30	9 Mar 06	MARC-2ID
8 Medi Innovation Sdn Bhd	Murabahah`	50	22 Mar 06	AID MARC-2ID
9 Medi Innovation Sdn Bhd	Murabahah	100	22 Mar 06	AID
10 Rantau Abang Capital Sdn Bhd	Musyarakah	7,000	14 Mar 06	AAA
11 Rantau Abang Capital Sdn Bhd	Musyarakah	3,000	14 Mar 06	AAA
12 Maxtral Industry Bhd	Murabahah	20	n/a	AID MARC-2ID
13 Maxtral Industry Bhd	BBA	80	13 Apr 06	AID
14 Penang Bridge Sdn Bhd	Istisna`	695	31 Mar 06	AA2
15 Dynamic Communication Link Sdn Bhd	Istisna`	100	n/a	AA3ID
16 Permanis Sdn Bhd	Murabahah	70	n/a	AID MARC-2ID
	Total	**11,557**		

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:

Mr Nik Ruslin Nik Jaafar
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8589
E-mail: ruslin@seccom.com.my

Dr. Md Nurdin Ngadimon
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8105
Email: nurdin@seccom.com.my

Mr Zainol Ali
Islamic Capital Market Department
Tel: 03–6204 8000 ext 8666
E-mail: zainol@seccom.com.my

Suruhanjaya Sekuriti
Securities Commission

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