

Building the Islamic Capital Market Infrastructure

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By

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Introduction

- Islamic capital markets covers a broad area of financing via equity and debt.
- We will focus on Sukuk, a specific subject on fundraising that has attracted global interest in the 21st century.
- Infra is the underlying framework of this system of financing.
- The main thrust of the discourse is analyzing market readiness to move to an environment where the Sukuk market is no longer driven by regulators but by the main element of the infra, the market players themselves.

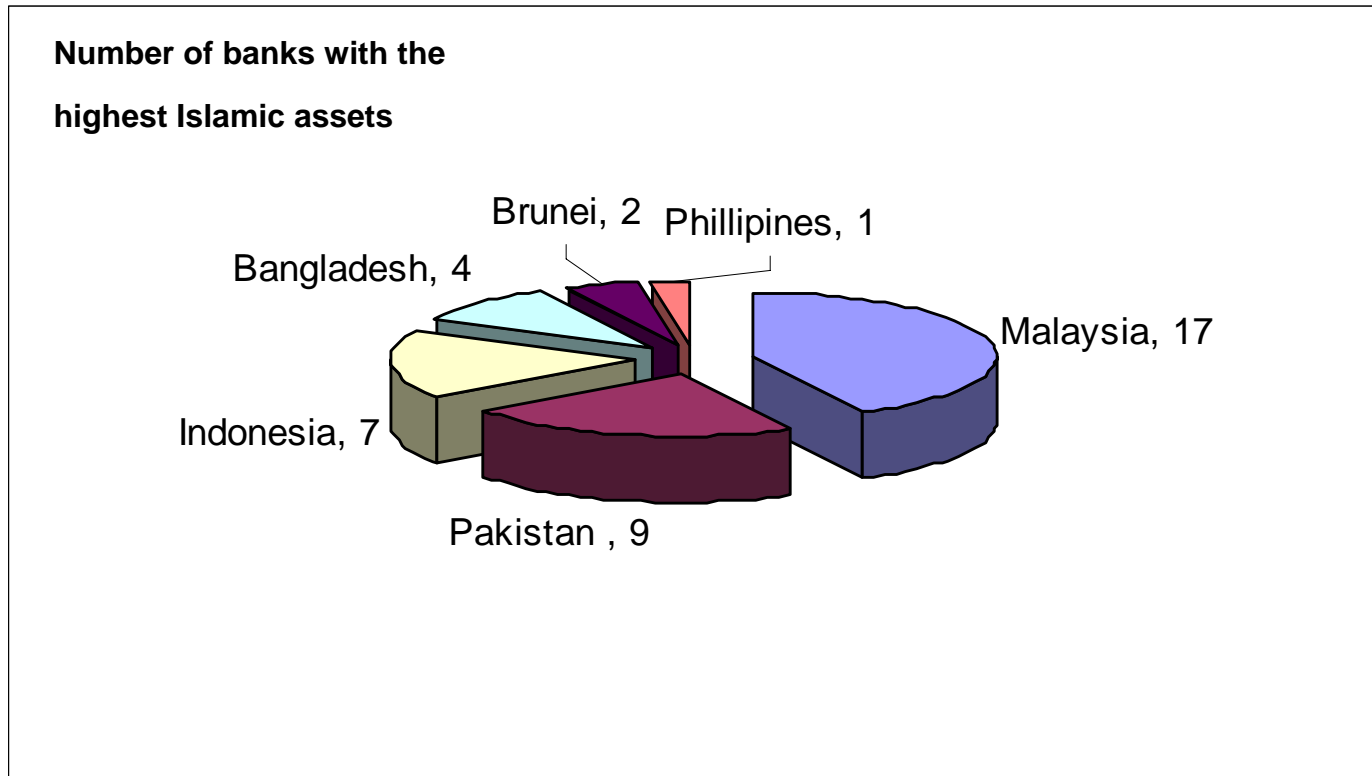
Executive Summary

- The global Sukuk market. We will start by looking at Islamic banking in Asia Pacific, Islamic banking in Malaysia and the Sukuk market in Malaysia. A comparison of market direction.
- Infra driving the Sukuk market. Examine the delivery system, capital seekers reaching investors with surplus resources. Analyzing what works and why.
- Is the market ready? Examining the endgame. Moving to a market no longer driven by regulators but by market players that forms a substance based industry.

1

The Global Sukuk Market

Islamic banking in Asia Pacific



- Malaysia dominates the pool of top 40 Islamic banks in Asia Pacific with 17 banks with 73% of the top 40's total assets.

Source: The Asian Banker Research

Islamic banking in Malaysia

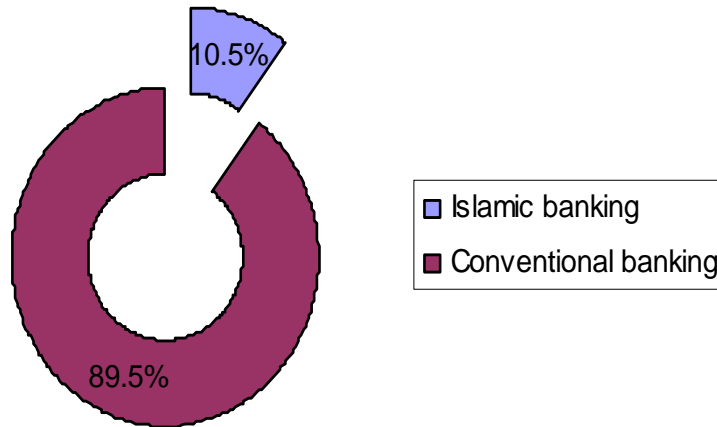
Year	RM '000	USD '000
1983	369,800	101,937
1984	325,533	89,735
1985	514,233	141,751
1986	1,093,000	301,292
1987	932,321	257,000
1988	1,133,955	312,581
1989	1,368,341	377,191
1990	1,425,927	393,065
1991	1,400,391	386,026
1992	1,676,211	462,057
1993	2,009,088	553,817
1994	4,885,046	1,346,591
1995	6,197,423	1,708,355
1996	10,132,461	2,793,071
1997	17,881,304	4,929,084
1998	21,183,061	5,839,232
1999	36,136,488	9,961,230
2000	47,013,583	12,959,564
2001	59,353,187	16,361,047
2002	68,070,426	18,764,003
2003	82,216,840	22,663,544
2004	94,986,056	26,183,451
2005	111,824,000	30,824,927
Nov-06	122,000,000	33,630,000

- From a modest start of USD\$101.2 million in 1983, Islamic banking assets in Malaysia is increasing at an average rate of 19% since 2000.
- As at November 2006, Islamic banking assets exceeds USD\$33.63 billion.

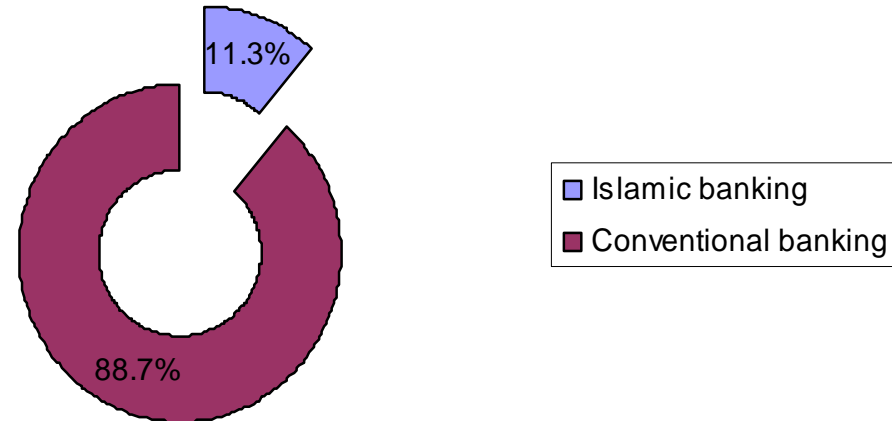
Source: Bank Negara Malaysia.

Islamic banking in Malaysia – cont'd

Islamic banking assets vs.
conventional banking Dec 2004



Islamic banking assets vs.
conventional banking Dec 2005

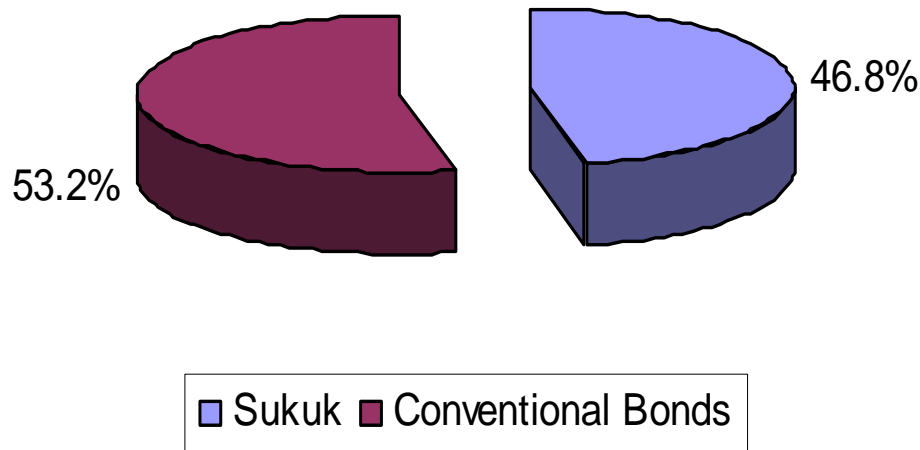


Source: Bank Negara Malaysia.

- Malaysia targets a 20% market share by 2010.
- Sukuk are expected to be a major contributor to this growth.

Sukuk in Malaysia

Sukuk vs. conventional bonds Sept 2006



Source: Securities Commission, Malaysia

- As at September 2006, Sukuk comprise 46.76% of the Malaysian bond market.
- From 1995 to 2005 Sukuk grew at CAGR of 28.3% compared to 14.5% of total bond issues.

A new industry emerging

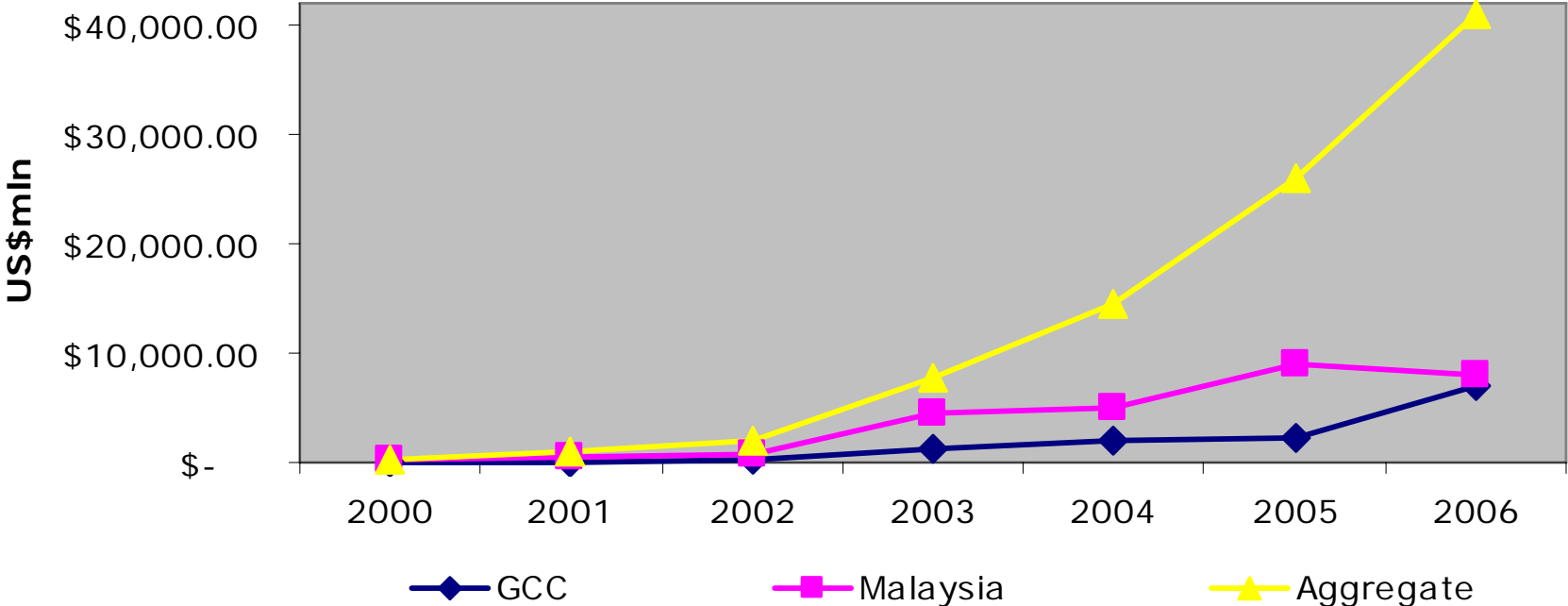
- Global Sukuk (excluding Malaysian domestic Sukuk) as at December 2006 totals USD\$16,925.9 million comprising 77 issues (Source: Liquidity Management Centre, Bahrain).
- Malaysian domestic Sukuk (excluding government Sukuk) as at September 2006 totals USD\$27,797.3 million, with Sukuk representing 46.76% of the Malaysian bond market (Source: Securities Commission, Malaysia) (47.1% in December 2006, Bank Negara Malaysia).
- Between January to October 2006, USD\$16.9 billion Sukuk was issued, up 43% from 2005 (Source: Islamic Finance Information Centre).

A new industry emerging – cont'd

- Dubai Ports issued its USD\$3.5 billion Sukuk, one of the largest Sukuk to date in January 2006.
- Almost half was taken up by non-Islamic investors, 11% went to European investors (source: The Wall Street Journal Asia).
- The Euro100 million Saxony-Anhalt Sukuk was issued from Germany in August 2004.
- The East Cameron Partner's USD\$166 million Sukuk backed by US based assets was issued in July 2006.

A new industry emerging – cont'd

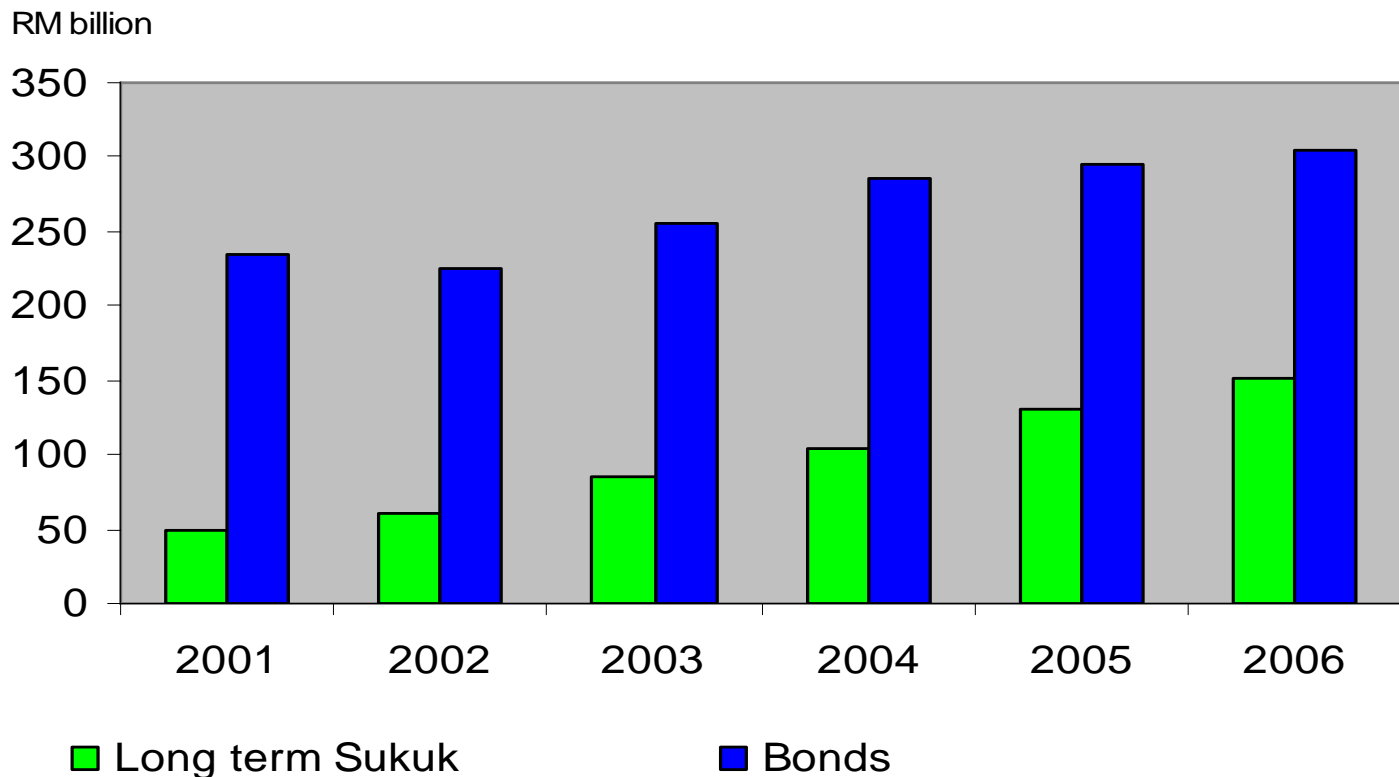
- As at June 2006, there continues to be tremendous interest in Sukuk financing, with Malaysia and the GCC as its centers.



Source: IFIS – Islamic Finance Information Services

A new industry emerging – cont'd

- December 2001 Sukuk outstanding was 22.5% compared to conventional bonds, December 2006 increased to 47.1%.



Source: Bank Negara Malaysia Annual Report 2006

Emerging trends in the GCC

- Short term Sukuk, typically not more than 5-years.
- Illiquid market, Sukuk normally held to maturity as investment.
- Rating not compulsory, resembles syndicated financing.
- Due to short tenor, redemption mainly thru IPO or bullet.
- Redemption typically related to credit strength of Issuer.
- Driven by foreign and conventional banks.
- A different degree of Shariah standard, high legitimacy.

Emerging trends in Malaysia

- Driven by *BBA* and *Murabahah* concept at inception.
- Tenures can range up to 20-years for project financing.
- Liquid market, Sukuk rarely held to maturity.
- SC requires rating by RAM or MARC to be tradable.
- Redemption based on strength of cashflow.
- A different degree of Shariah standard at inception, high efficiency but low legitimacy?

Some recent milestones

- Between 2004 and 2005, the World Bank and IFC issued Sukuk worth USD\$322 million under the *BBA* concept.
- Toll operator PLUS in September 2006 converted its Sukuk based on *BBA* to a more globally acceptable *Musyarakah* concept.
- September 2006 also saw Malaysia's investment arm Khazanah issue USD\$750 million exchangeable Sukuk.
- Illustrates desire to issue a more globally acceptable Sukuk.

Carrying the momentum

- Expectation continues to run high for Sukuk.
- China is expected to issue USD\$200 million Sukuk in 2007.
- Indonesia is expected to issue USD\$650 million Sukuk in 2007.
- Bahrain, Kuwait, Qatar, Saudi Arabia, the UAE and Oman are looking at approximately USD\$50 billion in infra financing in the next 3 years.

Source: The Wall Street Journal Asia, 19th November 2006.

Why choose Sukuk?

- Faith based factors.
- Attracting capital from Islamic funds e.g. petrodollars.
- Government and regulators initiatives.
- Supply and demand leads to attractive pricing.
- Limits Issuers exposure based on eligible asset.
- Attractive pricing in cases of Sukuk backed by quality and investor friendly assets.
- Unlocks the value of assets, useful for project financing, property financing or privatization of infrastructures.

Global penetration

- Sukuk however is concentrated in:
 - The GCC region.
 - The Malaysian domestic market.
- Sukuk issuance has had little impact in:
 - Europe, the US, other Islamic countries and has not penetrated mature Asian markets.
- Still a tiny fraction compared to the international bond market:
 - USD\$1.2 trillion during first half of 2006 (Source: Bank for International Settlements).

2

Infra driving the Sukuk market

Where demand meets supply

- A review of Islamic banking in Asia Pacific, Islamic banking in Malaysia and the Sukuk market in Malaysia displays on the most basic level, a function of supply meeting demand.
- This is where infrastructure in the financial system is crucial, ensuring efficient delivery of financing requirements to where financing is needed to boost economic activities.
- We will see that the main element of the infra is the willingness of the market players to work the market and examine what drives them.

Bringing Sukuk into the market

- Breaking down the system to its most basic component is bringing the product (Sukuk) into the market.
- There are 3 basic steps:
 - Origination (pitching, structuring, mandate).
 - Execution (due diligence, Shariah, regulatory approvals, issuance).
 - Post issuance (trading, agency, redemption).

Bringing Sukuk into the market – cont'd

- The process is driven by the market players in a mostly organized fashion that do not deviate from the 3-stages:
- Capital seekers: issuers.
- Capital providers: investors.
- Enablers: financial intermediaries, Shariah advisors, legal advisors, tax and reporting accountants.
- Market supervision: regulators.
- Post issuance: traders, trustee, facility agent, regulators.

Market operations

- Amongst the key infra that supports market operations:
- Legal: ensuring the intention of all parties to the transaction are captured within the legal framework.
- Regulators: in addition to supervisory role also key in ensuring the system is efficient throughout the 3-stages, liquidity management, advocacy, market concepts, keeping the market relevant, organized and attractive.
- Shariah: in an interplay between legal and regulators.

Maintaining the market's attractiveness

- Maintaining the market's attractiveness is an abstract way of describing what is really an onerous task of advancing Islamic finance as a viable alternative to conventional financing.
- Think of the complexity and challenges in providing an answer to a financial system that has been in existence since time immemorial.
- The regulators has played a tremendous role in ensuring the market is attractive but nonetheless at one point the market players must be prepared to lead the market.

Incentives for Issuers and financial intermediaries

- SPV set up under Sukuk structures are exempted from tax.
- Cost of issuing the Sukuk are tax deductible.
- Sukuk issued under the *Shariah* principles of *Musyarakah*, *Mudharabah*, *Ijarah* and *Istisna* are exempted from stamp duty until 2010.
- Allowing non-Ringgit Sukuk to be issued in Malaysia.
- Allowing non-Ringgit Sukuk issued in Malaysia to be traded offshore.

- New licenses for Islamic banking, Takaful and re-Takaful.
- Allowing foreign equity of up to 49% in existing Islamic banks and Takaful operators.
- Issuance of International Islamic Bank and International Takaful Operator licenses with 10-year tax holiday from 2007.
- Setting up of the International Currency Business Unit.
- Labuan offshore entities may operate anywhere in Malaysia and still apply Labuan tax law.

Expected changes in the near future

- Introduction of the Capital Market Services Act:
 - Consolidates existing laws into one legislation.
 - Broaden scope of Islamic banks by allowing new businesses without additional licensing.
- Further liberalizing of Sukuk:
 - Governing law English and New York.
 - Speedy approval process.
- MIFC as a one-stop centre e.g. supporting immigration policies, investment issues.

3

Is the market ready? Examining the end game

A regulator driven market

- *“The current state of the Malaysian bond market is the culmination of concerted efforts undertaken by the Government, Bank Negara Malaysia and the Securities Commission”* – BNM Annual Report 2006.
- Section 2 shows a market driven by regulators. We must look to the day when regulators are no longer driving the market but regulating the market.
- The infra that we focus next is the most important element i.e. the market players itself.

Examining issues market players must address

- Cost.
- Extending market reach.
- Legitimacy versus efficiency.
- Legal structuring risk.
- Competitiveness
- Regulatory risk.
- Skill sets.
- Benchmarking Sukuk.
- Chasing past returns.
- Attracting the Muslim market.

Cost

- 2000 – 2003 saw marked difference between Sukuk and conventional bonds in Malaysia due to demand.
- Pricing is inconsequential now but cost is attractive due to tax advantages.
- But also need to look at overall commercial cost. Rating for the Malaysian government global Sukuk was based on the repayment capability of the Malaysian government not the assets leased. Is leasing even necessary?

Extending market reach

- The ability to raise Sukuk for anyone from anywhere.
- Issuers: looks at Sukuk / Islamic financing as a long-term strategy, not a one-off deal.
- Investors: distribution network, coming in with firm bids.
- Intermediaries: reduce transaction cost, lead with products that looks at substance not just mechanics, presence.
- Shariah advisors: multidisciplinary expertise, angle of permissibility of products.

Legitimacy versus efficiency

- An oft-criticized feature of Malaysia's market is the prevalent use of BBA and Murabahah to drive the Sukuk market.

	2001	2002	2003	2004	2005	Sep-06
BBA	77%	67%	40.8%	56.8%	36.3%	8.6%
Murabahah	23%	33%	12.7%	38.2%	33.5%	8.6%
Istisna	0%	0%	46.5%	2.8%	14.5%	3.0%
Ijarah	0%	0%	0%	2.1%	2.9%	8.6%
Mudharabah	0%	0%	0%	0%	0.2%	3.3%
Musyarakah	0%	0%	0%	0%	12.6%	67.9%
Total	100%	100%	100%	100%	100%	100%

- However Malaysia is a highly liquid and efficient market.
- Did sacrificing legitimacy reduce barriers to entry in Islamic finance or harm the prospects of further growth?

Legal structuring risk

- Legal structuring risk.
 - Islamic Investment Company of the Gulf v Symphony Gems NV (2002, UK High Court).
 - Beximco Pharmaceuticals v Shamil Bank of Bahrain (2004, UK Court of Appeal).
 - Both *Murabahah* cases was decided on English law not *Shariah*.
 - Better drafting may help but do current legal framework protect investors in Sukuk default?

Competitiveness

- Competition is key in driving the market forward.
- The ability to compete fairly ensures market dynamics are protected from elements such as price fixing, collusion and market monopolization.
- Also nurtures market players with a competitive culture.
- Promotes competitive pricing and creates market efficiency that leads to driving down the transaction costs.
- Careful implementation required (failures as cautionary tale) but rewarding when done well.

Regulatory risk

- Structured finance tech used to develop Sukuk are highly complex. The complexities of Islamic structures necessitate for example layering techniques, incorporation of SPV.
- Currently market is driven towards the “low hanging fruits”.
- Are market players equipped to deal with mendacious deals designed to exploit the inherent complexity of products in this industry e.g. money laundering, Enron?
- Enron for example occurred in what is generally regarded as an advanced market.

Skill sets

- More bankers with Shariah expertise.
- Not just structuring skills bearing in mind that Islamic finance did not derive from classical law but from modern conventional financing with Islamic alternatives built in at a point where conventional practice is deemed as *haram*.
- Move away from the idea that what is permissible are “approved” products.
- Innovation is not replicating but providing *bona fide* alternative. Look at intermediaries *modus operandi*.

Benchmarking

- Still many misconceptions in non-Muslim countries to which stakeholders in Islamic finance may be partly responsible for.
- The benchmarking of Sukuk is one example often quoted and which has yet to have a satisfactory outcome.
- Global Sukuk especially sovereigns are benchmarked against LIBOR which measures English banks COF. In that respect more similar to loans. Measuring global economic risk may require a different benchmark.
- Alternative may be to benchmark with trading prices.

Chasing past returns

- Sukuk reduces the risk structures essentially to that of conventional bonds i.e. allowing for credit ratings and pricing to be similar to conventional bonds.
- We have highlighted the issue of increased transaction cost.
- Replicating conventional products *ad infinitum* dictates chasing past returns and past trends.
- Short term margins are created for first-movers of Sukuk arrangers but in the long run, margin by players chasing past returns tightens.

Attracting the Muslim market

- Market penetration is still poor necessitating a regulatory driven market for now.
- Have we overlooked substance in the efficiency versus legitimacy debate?
- The “Islamic” in Islamic finance should relate to social and economic ends of a transaction, not simply the contract mechanics thru which the financial ends are achieved.
- Focus on how Sukuk are used instead of how they are structured or constructed.



Thank you.
