Sukuk in Emerging East Asia: Trends and Future Challenges

Introduction

Sukuk, the plural form of the word *sakk*, refers to an investment certificate that is deemed to be compliant with Islamic financing principles. In the past, *sukuk* were used to facilitate trade transactions among merchants by serving as promissory notes. Historical records show that these notes were widely traded and exchanged.

Contemporary *sukuk* are used to raise funds for investments in a manner compatible with Islamic principles. Given that some *sukuk* are similar to conventional bonds, they have often been called "Islamic bonds." However, there are key differences between *sukuk* and conventional bonds. Most importantly, the structure of *sukuk* has to conform to that of the religious principles of *shari'ah*. In practice, a *shari'ah* advisory board is usually set up and consulted to ensure that the *sukuk* being structured comply with Islamic principles. An overarching principle in Islamic finance is that transactions should be grounded in real productive economic activities. Transactions that are mostly monetary or speculative in nature are forbidden. Specifically, there are five forbidden activities that *sukuk* have to avoid:

- **Prohibition against unjust enrichment (*riba*)**. This is more commonly known as the prohibition against the payment of interest. Under Islamic law, money is treated as a means of exchange rather than a store of value. Hence, there is no expectation of profiting from lending money. Instead profit should be the reward for entrepreneurs who are carrying out economically productive activities. Because of the prohibition against the payment of interest, Islamic financial contracts tend to be structured around real assets such as commodities and real estate.
- **Prohibition against gambling or speculation (*masir*)**. *Shari'ah* also does not allow transactions that are based on speculation or luck rather than productive activity. This is because Islam views gambling as immoral. Hence, most conventional futures, forwards, and options contracts are not permissible under *shari'ah*.
- **Prohibition against unnecessary risk (*gharar*)**. Under Islamic principles, there can be no uncertainty in a contract. All of a contract's terms have to be spelled out to avoid either party from taking on unnecessary risk.
- **Prohibition against taking unfair advantage (*jahl*)**. Islamic principles forbid one party in a contract to take unfair advantage of the other party. Hence, there should not be an attempt to exploit another party's lack of knowledge or financial situation.
- **Prohibition against corruption (*rishwah*)**. In addition for the structure of the financial transaction to comply with Islamic principles, the transaction also must not have unethical or illegal purposes. As a result, contracts cannot be written covering activities that are forbidden by Islam such as casino operations and many conventional financial services.

In an attempt to standardize the definition of *sukuk*, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in May 2003 defined *sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity." AAOIFI also distinguishes *sukuk* from conventional bonds by emphasizing that *sukuk* are not claims on cash flows and cannot be based on a pool of receivables. Instead, *sukuk* should be seen as investment certificates with claims on assets and the right to a share of the cash flow that accrues from the ownership of the assets.

AAOIFI has identified at least 14 types of permissible *sukuk*, ranging from instruments with equity-like characteristics to asset-backed securities. However, only several of the allowed *sukuk* structures are commonly used. They are *murabahah*, an arrangement where goods are sold at a mark-up and then payment is spread over a period of time; *salam*, an arrangement where the buyer prepays for an asset to be delivered in the future; *ijarah*, a lease arrangement where the use of an asset is leased out in return for regular payments; *istisna*, an arrangement used to finance the sale of an asset that is currently under construction or not yet built; *mudarahbah*, a partnership arrangement where one partner supplies capital and the other offers expertise; and *musharakah*, a joint venture arrangement where both parties provide capital.

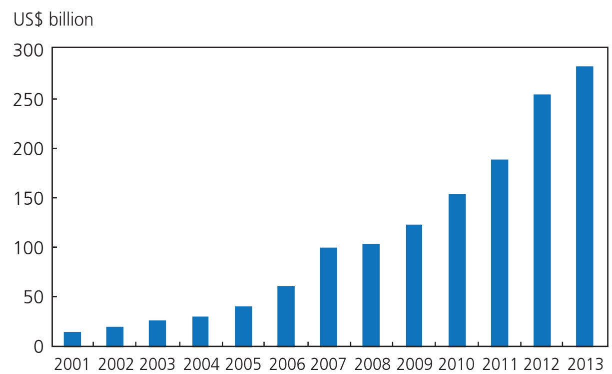
The most important characteristic of *sukuk* is that they represent a claim on an existing or well-defined asset. Meanwhile, conventional bonds represent an obligation to make periodic interest payments and principal upon maturity. Hence, *sukuk* can be seen as more closely related to asset-based securities. The other important characteristic is that the underlying asset for the *sukuk* must be *shari'ah*-compliant. This means that the assets cannot be involved in activities that are not permissible under Islamic law such as gambling or the sale of alcohol.

Global Trends in *Sukuk*

Islamic finance continued to post robust growth rates in 2013 amid a challenging global environment. Based on estimates released by the Malaysia International Islamic Financial Centre (MIFC), the size of the Islamic global asset portfolio reached US$1.8 trillion at end-2013, with double-digit expansions noted across all segments.[6] The Islamic banking sector continued to spur this growth, accounting for almost 80% of the total Islamic global asset portfolio. The *sukuk* segment followed with an asset contribution of 15% of the total, while funds and *takaful* (insurance) accounted for 4% and 1%, respectively. There is an opportunity for the *sukuk* segment to further expand its contribution to the Islamic asset portfolio. For example, there is huge unfulfilled demand for *shari'ah* investment products in the Middle East as well as in emerging East Asia.[7]

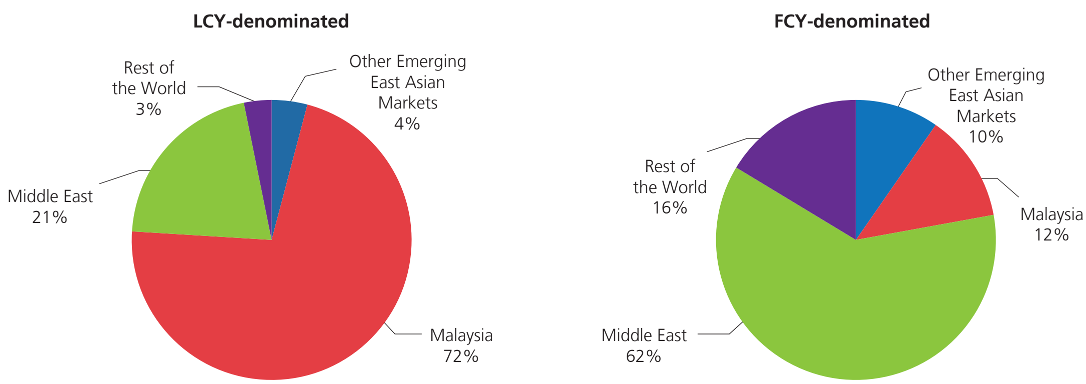
Since 2001, the global *sukuk* market has grown by leaps and bounds, posting compounded annual growth rates of 27.8%. From just US$14.8 billion in 2001, the amount of *sukuk* outstanding globally reached US$281.3 billion at end-2013 **(Figure 15)**. Malaysia remained the largest *sukuk* market, accounting for 58.1% of total outstanding *sukuk*. Middle Eastern countries account for 30% of the total, while other emerging East Asian markets (excluding Malaysia) only account for 6%. Malaysia continues to dominate the local currency (LCY)-denominated *sukuk* market, while the Middle Eastern markets are the most active issuers of foreign currency (FCY)-denominated *sukuk* **(Figure 16)**.[8] At

Figure 15: Size of Global *Sukuk* Market



Sources: Autoriti Monetari Brunei Darussalam, Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST), Bloomberg LP, Indonesia Debt Management Office, Indonesia Stock Exchange, and Otoritas Jasa Keuangan.

Figure 16: Global *Sukuk* Outstanding by Region (as of end-December 2013)



FCY = foreign currency, LCY = local currency.
Sources: Autoriti Monetari Brunei Darussalam, Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST), Bloomberg LP, Indonesia Debt Management Office, Indonesia Stock Exchange, and Otoritas Jasa Keuangan.

[6] MIFC. 2014. Islamic Finance Industry Outperforms in 2013. *Insights*. 15 January.
[7] In this special section, emerging East Asia refers to Brunei Darussalam; the People's Republic of China (PRC); Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

[8] LCY-denominated *sukuk* are defined as *sukuk* denominated in the issuer's home currency (e.g., a Malaysian company issuing MYR-denominated *sukuk*). FCY-denominated *sukuk* are defined as *sukuk* denominated in a currency other than the issuer's home currency (e.g., a Middle Eastern company issuing US$-denominated *sukuk*).

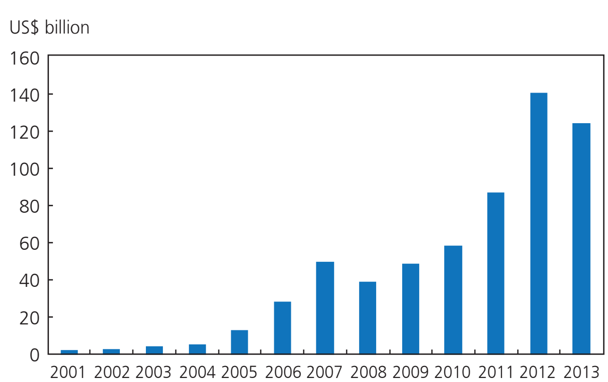
end-2013, the size of the LCY-denominated *sukuk* market reached US$216.2 billion, while FCY-denominated *sukuk* stood at US$65.1 billion.

Sukuk may be issued by sovereign and quasi-sovereign institutions, and corporate entities. In 2013, global *sukuk* issuance once again surpassed the US$100 billion mark, reaching US$123.7 billion **(Figure 17)**. Malaysia was the most active *sukuk* market with issuance amounting to US$83.7 billion, accounting for 67.7% of global *sukuk* issuance for the year. *Sukuk* issuance in Middle Eastern markets represented 20.6% of the total, while issuance in other markets in emerging East Asia (excluding Malaysia) comprised a share of 6.0%. After Malaysia, the most active *sukuk* market in emerging East Asia in 2013 was in Indonesia, with *sukuk* issuance of US$5.4 billion. The Indonesian government successfully issued US$1.5 billion of global *sukuk* in September, its largest global *sukuk* issue to date at a time when most sovereigns were hesitant to borrow overseas.

At end-2013, MYR-denominated *sukuk* accounted for nearly 60% of total *sukuk* outstanding, US$-denominated *sukuk* accounted for 21% of the total, and *sukuk* denominated in Middle Eastern currencies had a share of 16% **(Figure 18)**. *Sukuk* denominated in other emerging East Asian currencies (excluding Malaysia) only represented 4% of the total.

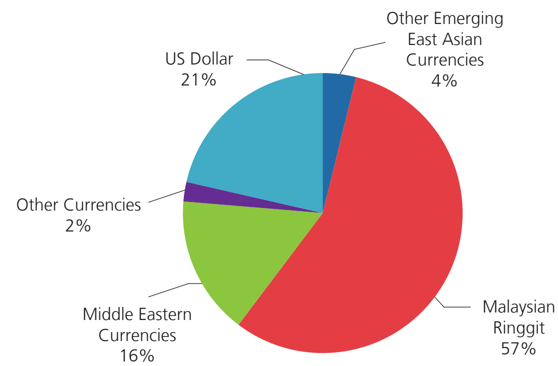
Malaysia is seeking to develop itself as an offshore *sukuk* center for other countries. There have been issuances of MYR-denominated *sukuk* from foreign issuers in the past, including National Bank of Abu Dhabi, Gulf Investment Corp., and Noble Group. Currently, Malaysia is developing itself as a multi-currency *sukuk* center. For example, two Malaysian entities issued the first CNH-denominated *sukuk*. Danga Capital's issuance of 3-year CNH-denominated bonds in 2011 was followed by Axiata's 2-year CNH-denominated bonds in 2012. The CNH *sukuk* are also designed to take advantage of regional demand for the reminbi.

Figure 17: Global *Sukuk* Issuance



Sources: Autoriti Monetari Brunei Darussalam, Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST), Bloomberg LP, Indonesia Debt Management Office, Indonesia Stock Exchange, and Otoritas Jasa Keuangan.

Figure 18: Global *Sukuk* Outstanding by Currency
(as of end-December 2013)



US = United States.
Sources: Autoriti Monetari Brunei Darussalam, Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST), Bloomberg LP, Indonesia Debt Management Office, Indonesia Stock Exchange, and Otoritas Jasa Keuangan.

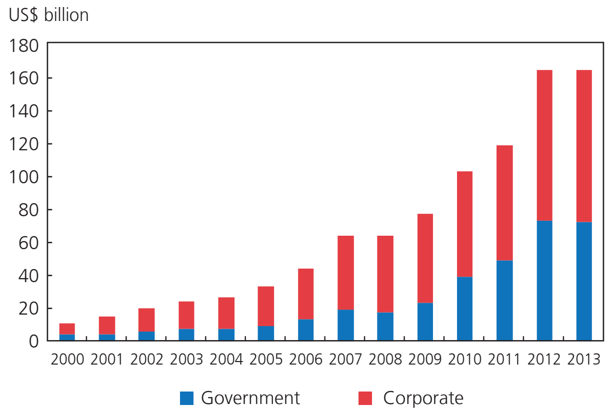
Malaysia and Hong Kong, China have partnered together to develop the Malaysian market as an offshore renminbi and Islamic finance center. In December 2013, a Joint Forum on Islamic Finance and a Dialogue on Offshore Renminbi Business was held. The two economies are seeking to leverage their respective strengths in the development of the renminbi *sukuk* market: Hong Kong, China in offshore renminbi and Malaysia in *sukuk*.

Sukuk Trends in Emerging East Asia

Malaysia

The Malaysian *sukuk* market has grown rapidly over the past decade to become the largest *sukuk* market in emerging East Asia. At end-2013, Malaysia's *sukuk* market, including LCY- and FCY-denominated *sukuk*, reached an estimated MYR535.4 billion (US$163.5 billion) from a modest size of MYR38.4 billion (US$10.1 billion) in 2000, representing compounded annual growth of more than 20% **(Figure 19)**.

Figure 19: *Sukuk* Outstanding in Malaysia



Notes:
1. Data include local currency and foreign currency *sukuk*.
2. Bloomberg LP end-of-period LCY–US$ rates are used.
Sources: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) and Bloomberg LP.

The enactment of the Islamic Banking Act of 1983 and the establishment of the country's first Islamic Bank, Bank Islam Malaysia, have been instrumental in the development of Malaysia's *sukuk* market. When Bank Islam Malaysia commenced operations in 1983, it could not purchase or trade interest-bearing instruments like government securities or treasury bills. To address the bank's operations and liquidity requirements, the Government Investment Act of 1983 was passed, enabling the Government of Malaysia to issue its first Islamic government debt, known as Government Investment Certificates (GICs), under the concept of *qard al-hassan* (arrangement to extend goodwill for welfare purposes) in July 1983. GICs were replaced by Government Investment Issues (GIIs) in July 2001, an instrument that is based on the *bay' al-inah* (arrangement that involves the sale and buyback of an asset) principle, to facilitate trading in the secondary market.

GIIs are an integral part of the Malaysian government *sukuk* market, representing 74% of total government *sukuk* **(Table 6)**. GIIs are long-term, non-interest-bearing government securities issued to raise funds for developmental expenditure from the domestic capital market. Just like conventional Malaysian Government Securities (MGSs), GIIs are issued through competitive auction by Bank Negara Malaysia (BNM) on behalf of the government. The GII issuance program is pre-announced, with issuance sizes ranging from MYR2 billion to MYR5 billion, and original maturities of 3, 7, 5, 10, 15, and 20 years. Beginning 22 July 2013, new GIIs were issued based on the *murabahah* structure, setting another milestone in the development of Malaysia's sovereign *sukuk* market.

Both the government and corporate *sukuk* markets have experienced tremendous growth momentum in

Table 6: Size and Composition of the Government *Sukuk* Market in Malaysia

Instrument	Outstanding Amount (billion)		Structure
	MYR	US$	
Total	**233.8**	**71.4**	
LCY Government	223.2	68.1	
Government Investment Issue	153.5	46.9	*Bay' al-Inah*
Government Investment Issue	19.0	5.8	*Murabahah*
Bank Negara Monetary Notes	38.8	11.8	*Murabahah*
Bank Negara Monetary Notes	1.0	0.3	*Istithmar*
Malaysian Treasury Bills	2.0	0.6	*Bay' al-Inah*
Sukuk Perumahan Kerajaan	8.9	2.7	*Murabahah*
FCY Government	10.6	3.3	
1Malaysia *Sukuk* Global	4.1	1.3	*Ijarah*
Wakala Global *Sukuk*	6.6	2.0	*Wakalah bi al-Istithmar*

FCY = foreign currency, LCY = local currency.
Notes:
1. Data as of end-December 2013.
2. *Bay' al-Inah* are Islamic bonds that involve the sale and buy-back of an asset.
3. *Murabahah* are Islamic bonds backed by a commodity mark-up sale transaction.
4. *Istithmar* are Islamic bonds based on a combined structure of ijarah and murabahah.
5. *Ijarah* are Islamic bonds backed by a lease agreement.
6. *Wakalah bi al-Istithmar* are Islamic bonds in which one person nominates another person to act on his behalf.
Sources: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) and Bloomberg LP.

terms of size and sophistication. At end-2013, total government *sukuk* outstanding rose to MYR233.8 billion, led by central government bonds. The first corporate issuance—a MYR125 million bond based on *bay' bithamin ajil* (arrangement that is based on the sale of assets on a deferred payment basis) issued by Shell MDS—was in 1990. Since 2000, the corporate *sukuk* sector has expanded from MYR23.9 billion to reach MYR301.6 billion at end-2013.

The growth of Malaysia's *sukuk* market is a result of years of building up comprehensive infrastructure, including the origination, listing, reporting, trading, and settlement systems that have resulted in an active primary *sukuk* market. There is also a robust *shari'ah* governance framework, which comprises *shari'ah* committees under Securities Commission Malaysia (SC) and BNM, providing regulatory guidance on the development of the Islamic finance market, including its instruments and institutions.

Moreover, the pioneering innovation of *sukuk* structures has also driven demand for *shari'ah*-compliant products and added depth to Malaysia's *sukuk* market. Over the years, *sukuk* structures have evolved from debt-based principles (*murabahah*) to lease-based (*ijarah*), profit-sharing (*musharakah*), and manufacturing contract-based (*istisna*), as well as to hybrid structures based on combinations of *shari'ah* contracts. At end-2013, Malaysia's *sukuk* were characterized by a wide distribution of *shari'ah* principles, including *bay' al-inah*, *murabahah,* and *musharakah*.

Examples of innovative issuances include the first global sovereign *sukuk ijarah* in 2002 (US$600 million), the first rated Islamic residential mortgage-backed securities by Cagamas MBS in 2005 (MYR2.05 billion), and the first exchangeable *sukuk musharakah* by Khazanah Nasional in 2006 (US$750 million). Other global milestones include Projek Lebuhraya Usahasama (PLUS) launching of the world's largest *sukuk* program in 2012 amounting to MYR30.6 billion. These bonds, with maturities ranging from 5 years to 25 years, were aimed at securing financing for the purchase of five toll road concessions **(Table 7)**.

Efforts to deepen the *sukuk* market have accelerated the growth of the primary market since 2005 **(Figure 20)**. Total new issuances rose almost eightfold from MYR35.5 billion in 2005 to MYR274.3 billion in 2013. New issuances reached a record MYR316.0 billion (US$103.3 billion) in 2012, the first time that the amount has surpassed the US$100 billion mark.

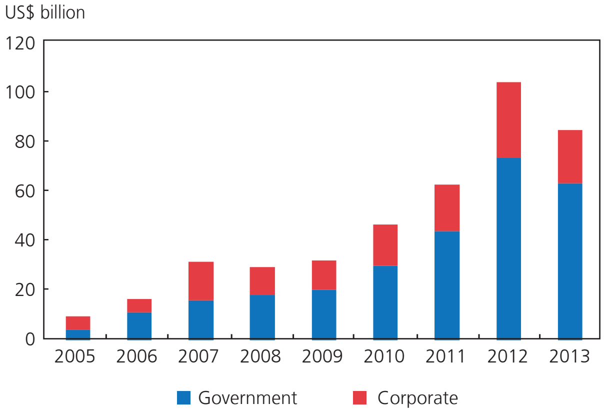
With Malaysia's vast experience in the *sukuk* market, robust governance framework, and diversified domestic sector, Islamic debt securities have become a fast-growing asset class attracting a wide range of institutional investors.

Table 7: Top 15 Issuers of LCY Corporate *Sukuk* in Malaysia

Issuers	Outstanding Amount LCY Bonds		Type of Industry
	(MYR billion)	(US$ billion)	
1. Project Lebuhraya Usahasama	30.60	9.34	Transportation and Logistics
2. Cagamas	12.64	3.86	Finance
3. Binariang GSM	12.57	3.84	Communications Equipment
4. Pengurusan Air	11.63	3.55	Utilities
5. Malakoff Power	10.28	3.14	Utilities
6. Prasarana	10.00	3.05	Railroad
7. Celcom Transmission	9.20	2.81	Communications Equipment
8. Malakoff Corp	8.40	2.56	Utilities
9. Projek Lebuhraya Utara Selatan	7.85	2.39	Transportation and Logistics
10. Tanjung Bin	7.64	2.33	Utilities
11. BGSM Management	6.87	2.10	Financial Services
12. Senai Desaru Expressway	6.77	2.07	Industrial
13. Danainfra Nasional	6.50	1.98	Construction Materials
14. Perbadanan Tabung Pendidikan Tinggi Nasional	6.00	1.83	Financial Services
15. Putrajaya Holdings	5.54	1.69	Industrial

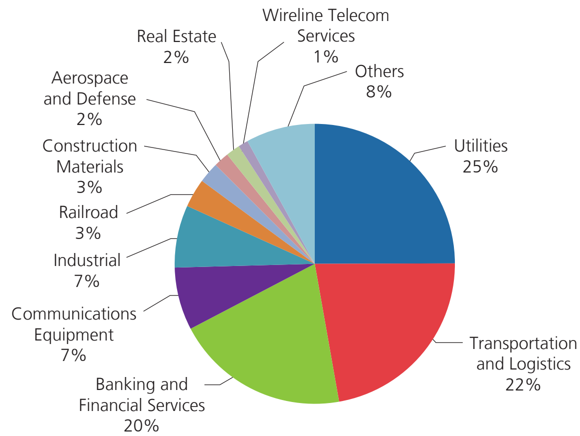
LCY = local currency.
Note: Data as of end-December 2013.
Source: Bloomberg LP.

Figure 20: *Sukuk* Issuance in Malaysia



FCY = foreign currency, LCY = local currency.
Notes:
1. Includes both LCY-denominated and FCY-denominated bonds.
2. Bloomberg LP end-of-period LCY–US$ rates are used.
Sources: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) and Bloomberg LP.

Figure 22: LCY Corporate *Sukuk* Issuer Profile in Malaysia

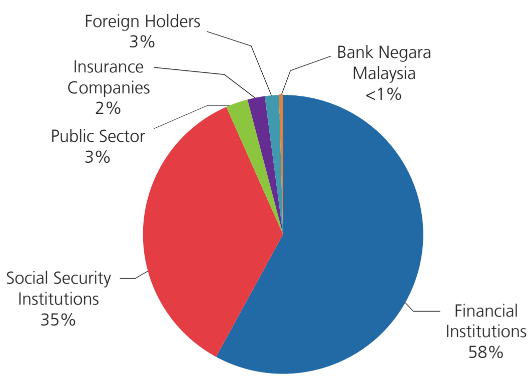


LCY = local currency.
Source: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST).

At end-September 2013, financial institutions such as banks, nominee and trustee companies, cooperative societies, and the National Savings Bank held the largest share of Malaysia's government *sukuk* outstanding at 58% of the total. This group was followed by social security institutions, comprising the Employees Provident Fund (EPF) and the Social Security Organisation of Malaysia (SOCSO), with a 35% share **(Figure 21)**.

Malaysia's *sukuk* market features various maturities for long-term financing requirements. At end-2013, 51% of government *sukuk* outstanding had tenors of less than 5 years, while 66% of corporate *sukuk* had maturities of more than 5 years. The longest corporate *sukuk* tenor issued is 50 years by a telecom operator Binariang GSM (MYR3.0 billion) and a power generation company Malakoff Corp. (MYR1.7 billion).

Figure 21: LCY Government Investment Issue Investor Profile (as of end-September 2013)



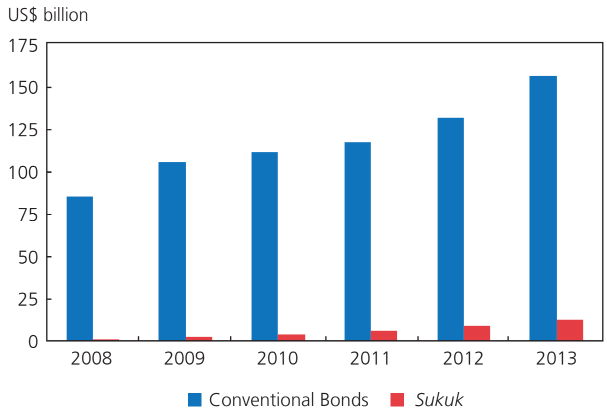
LCY = local currency.
Source: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST).

Corporate issuers with various backgrounds have tapped Malaysia's LCY *sukuk* market, representing a diverse collection of 32 different industries. Utilities and transportation and logistics, the two largest industries, have a combined market share of 47% **(Figure 22)**. There have been significant increases in issuances from these industries since 2010. For example, the average annual issuance of the utilities sector soared to MYR18.0 billion between 2011 and 2013 from just MYR4.6 billion in 2010, while issuance from transportation and logistics sector increased to as much as MYR32.0 billion in 2012 from MYR8.1 billion in 2010.

Indonesia

Indonesia's Islamic bond market is the second largest in emerging East Asia in terms of size. However, the pace of growth of its *sukuk* market pales in comparison to the robust growth of its conventional bond market **(Figure 23)**. The Indonesian *sukuk* market is still in a nascent stage of development and accounts for only 7.4% of the total bond market.

Figure 23: Growth of *Sukuk* Market in Indonesia



Notes:
1. Includes both LCY-denominated and FCY-denominated bonds.
2. Figures were based on end-December 2013 exchange rate to avoid currency effects.

Sources: Bloomberg LP, Indonesia Debt Management Office, Indonesia Stock Exchange, and Otoritas Jasa Keuangan.

The outstanding stock of Indonesia's *sukuk* market reached US$12.3 billion at end-2013, with growth mainly driven by the government sector. While the corporate sector preceeded the government sector in terms of *sukuk* issuance, its growth has not yet really taken off. Government *sukuk* accounted for 95.0% of total outstanding *sukuk* in Indonesia at end-2013, with most of the issuance coming from the sale of Islamic treasury bills and bonds, and global sovereign *sukuk*.

At end-2013, LCY-denominated *sukuk* accounted for 66.3% of the total *sukuk* and FCY-denominated *sukuk* accounted for the remaining 33.7%. To date, all FCY-denominated *sukuk* in Indonesia has been issued by the government.

The Government of Indonesia commenced issuance of Islamic bonds in 2008 after the State *Shari'ah* Securities bill was passed into law in May 2008. This regulation allowed the government to issue Islamic securities and provided a new source of funding for financing the government's budget deficit. Treasury *sukuk* are commonly called *Surat Berharga Syariah Negara* (SBSN).

The Indonesian government issued its first sovereign *sukuk* based on the *ijarah* principle in August 2008 with the sale of 7-year (IFR0001) and 10-year (IFR0002) Islamic bonds. Subsequently, the government issued its first retail *sukuk* in February 2009 with a 3-year tenor and its first global *sukuk* in April of the same year. The government issued its first Islamic treasury bills with a 6-month tenor in 2011 and its first project-based *sukuk* in 2012. **Table 8** presents the various type of *sukuk* issued by the Indonesian central government that remained outstanding as of end-2013.

The Indonesian government issues *sukuk* through a special purpose vehicle, *Perusahaan Penerbit* SBSN (PP SBSN), which acts as both the issuer and trustee. PP SBSN is wholly owned by the government but operates as a separate

Table 8: Government *Sukuk* Instruments in Indonesia

Type of Instrument	Outstanding Amount		*Sukuk* Structure	Underlying Asset
	IDR billion	US$ billion		
LCY Government *Sukuk*				
Islamic Treasury Bills (SPN-S)	8,633	0.71	*Ijarah* Sale and Lease Back	State-Owned Assets
Islamic Fixed Rate (IFR)	16,587	1.36	*Ijarah* Sale and Lease Back	State-Owned Assets
Retail *Sukuk* (SR-003)	7,341	0.60	*Ijarah* Sale and Lease Back	State-Owned Assets
Retail *Sukuk* (SR-004 and SR-005)	28,583	2.35	*Ijarah* Asset to be Leased	Government Projects
Project-Based *Sukuk* (PBS)	26,030	2.14	*Ijarah* Asset to be Leased	Government Projects
FCY Government *Sukuk*				
Sukuk Negara Indonesia (SNI)	–	4.15	*Ijarah* Sale and Lease Back	State-Owned Assets
Non-Tradable *Sukuk*				
Hajj Fund *Sukuk* (SDHI)	31,533	2.59	*Ijarah al-Khadamat*	*Hajj* Services

– = not applicable.

Notes:
1. *Ijarah* Sale and Lease *sukuk* are Islamic bonds backed by a sale and lease back agreement.
2. *Ijarah* Asset to be Leased *sukuk* are Islamic bonds backed by a lease agreement.
3. *Ijarah al-Khadamat* are Islamic bonds backed by services.
4. Data as of end-December 2013.

Sources: Indonesia Stock Exchange and Indonesia Debt Management Office.

entity. It acts as the issuer of *sukuk* on behalf of the government, while the government serves as the obligor to the issue and is responsible for the payment of the coupon and the principal of the *sukuk* at maturity.

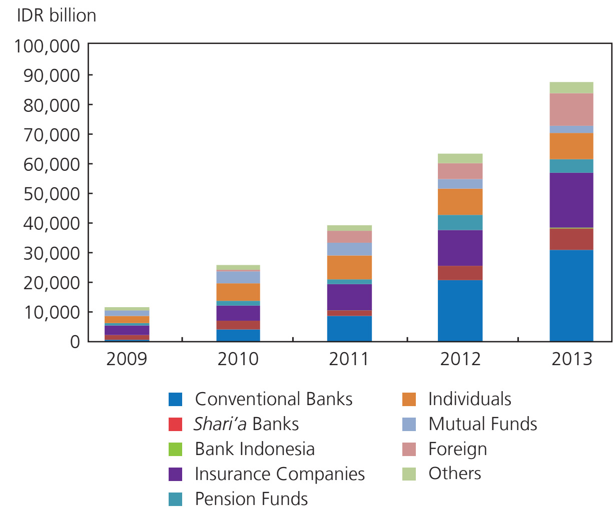
Through PP SBSN, the government has issued *sukuk* structured on the *ijarah* principle, with the *sukuk* backed by state-owned assets such as land and buildings. *Sukuk* issued under this structure are treasury bills and bonds, retail bonds, and sovereign US$-denominated bonds. In 2011, two scheduled domestic *sukuk* auctions were cancelled as the government had to wait for the approval of the underlying assets to back the issuance of *sukuk*.

In addition, PP SBSN has also issued *sukuk* under the structure of *ijarah*, with government infrastructure projects as the underlying asset to be leased. *Sukuk* issued under this structure include project-based *sukuk* (PBS) and some series of retail bonds. The issuance of PBS has become part of the government's *sukuk* auction since 2012. PP SBSN has also issued *sukuk* backed by funds for *Hajj*-related services under the structure of *ijarah al khadamat*. These *sukuk*, however, are issued through private placement and form part of the non-tradable stock of *sukuk*.

In 2012, the government began conducting regular auctions of Islamic treasury instruments. *Sukuk* auctions are currently conducted twice a month, alternately with the auction of conventional bonds. Unlike government auctions for conventional bonds where the government accepts bids in line with or even above its target, most *sukuk* auctions result with the government either rejecting all bids or accepting bids below its target amount. Demand for *sukuk* is quite strong as evidenced by the volume of bids during auctions. However, investors demand higher yields than the government is willing to accept. Furthermore, the trading of *sukuk* instruments are quite illiquid in Indonesia as most buyers tend to buy and hold.

At end-2013, conventional banks were the largest holders of *shari'ah*-compliant treasury instruments in Indonesia **(Figure 24)**. Their share of *sukuk* holdings steadily rose from only 3.7% of the total at end-2009 to 35.4% at end-2013. *Shari'ah* banks, on the other hand, only accounted for an 8.2% share of the total at end-2013. Insurance companies were the second largest holder of *sukuk* at end-2013 with a 21.1% share, while foreign investors held a 12.6% share of the total. To further develop the *sukuk* market and reduce reliance on foreign investors, the government is looking into using *Hajj* funds to buy more government *sukuk*.

Figure 24: Investor Profile for LCY Government *Sukuk* in Indonesia



LCY = local currency.
Source: Indonesia Debt Management Office.

Bank Indonesia also issues *shari'ah*-compliant central bank certificates, more commonly known as *Sertifikat* Bank Indonesia *Shari'ah* (SBIS). SBIS are *shari'ah*–compliant short-term instruments used by Bank Indonesia as one of its monetary tools to contain inflation and manage liquidity in the financial system. Prior to 2008, SBIS were structured under the *wadi'ah* (arrangement that is based on custodianship of an asset) principle. At present, SBIS are based on the *ju'alah* (arrangement that is based on service charges) principle. At end-2013, the outstanding stock of SBIS reached US$0.4 billion, representing a small 3.1% share of the total *sukuk* market in Indonesia. Auctions of SBIS are held once a month together with the auction of conventional SBI. SBIS carry a maturity of 9 months and require a holding period of 1 month.

The first *sukuk* issuance in Indonesia came from the corporate sector in 2002. Telecommunications firm Indosat issued IDR175 billion of 5-year *sukuk* based on a *mudarabah* contract. In 2004, the first *sukuk ijarah* were issued by an Indonesian retail company, Matahari Putra Prima, through an IDR150 billion 5-year Islamic bond.

Despite the headway made in issuing *sukuk*, the size of Indonesia's corporate *sukuk* market is relatively small

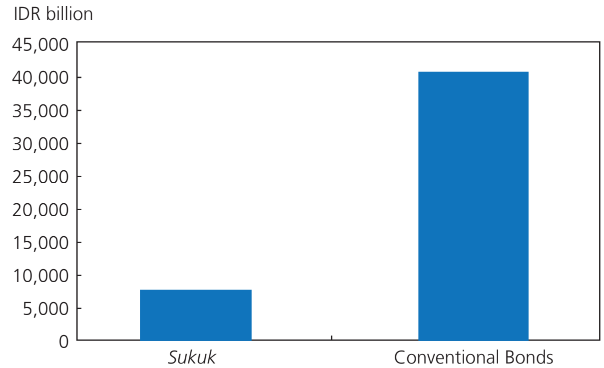
Table 9: Corporate *Sukuk* Instruments in Indonesia

Sukuk Structure	Outstanding Amount (IDR billion)
Sukuk Ijarah	4,974
Sukuk Mudharabah	1,079
Sukuk Mudharabah Subordinated	1,500

Notes:
1. *Sukuk Ijarah* are Islamic bonds backed by a lease agreement.
2. *Sukuk Mudharabah* are Islamic bonds backed by a profit-sharing scheme from a business venture or partnership.
3. Data as of end-December 2013.

Source: Indonesia Stock Exchange.

Figure 25: Comparison of Outstanding *Sukuk* and Conventional Bonds in Indonesia
(as of end-December 2013)



Sources: Indonesia Stock Exchange and Otoritas Jasa Keuangan.

compared with the government sector. Outstanding corporate *sukuk* reached US$0.6 billion at end-2013. To date, all corporate *sukuk* in Indonesia have been issued in LCY. **Table 9** presents corporate *sukuk* outstanding at end-2013 by type.

Corporate *sukuk* in Indonesia are structured following the principles of *ijarah* and *mudharabah*, as approved in *fatwas* issued by the National *Sharia'ah* Board. At end-2013, corporate *sukuk* based on an *ijarah* contract accounted for 65.9% of total corporate *sukuk* outstanding.

Issuance of corporate *sukuk* is concentrated among a few corporate names. At end-2013, there were 36 outstanding *sukuk* series issued by 17 corporate entities. The top three *sukuk* issuers accounted for 60% of total outstanding corporate *sukuk* **(Table 10)**, led by state-owned power firm PLN with *sukuk* outstanding totaling IDR2,140 billion. (PLN is also Indonesia's top corporate issuer of conventional bonds.) Bank Muamalat was in the second spot with IDR1,500 billion of *sukuk,* followed by telecommunications firm Indosat with IDR900 billion.

All corporate issuers of *sukuk* at end-2013 were also issuers of conventional bonds except for Bank Muamalat, which is an Islamic bank. However, the amounts of their outstanding conventional bonds are much larger than their amounts of outstanding corporate *sukuk*. **Figure 25** shows a comparison of the size of outstanding *sukuk* and conventional bonds issued by the 16 Indonesian firms in our list of corporate *sukuk* issuers.

Corporate *sukuk* issuers come from a diverse set of businesses, with two major sectors dominating the list. At end-2013, nearly half of total corporate *sukuk* outstanding were issued by firms from infrastructure, utilities, and telecommunications industries **(Figure 26)**. Finance-related companies accounted for about 30% of corporate *sukuk*. Other corporate issuers—including firms with business interests in real estate, consumer goods, and agriculture—had a share of 7% or less.

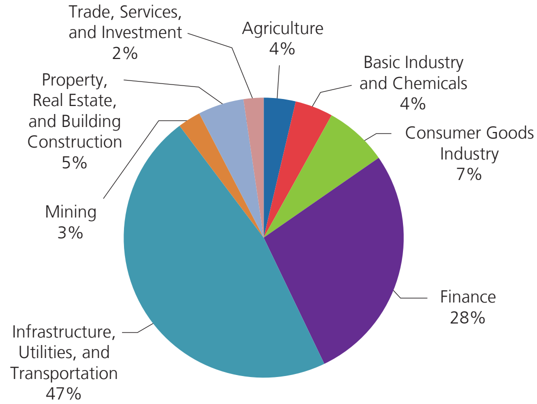
Most corporate *sukuk* in Indonesia carry medium-term (5-year) maturities. The longest-dated corporate *sukuk* was issued by PLN and carried a maturity of 12 years. The average issue size of an Indonesian corporate *sukuk* is about IDR210 billion or only about one-third of the average issue size of conventional bonds.

Table 10: Top Issuers of LCY Corporate *Sukuk* in Indonesia

Issuers	Outstanding Amount LCY Bonds		Type of Industry
	(IDR billion)	(US$ billion)	
1. PLN	2,140	0.18	Energy
2. Bank Muamalat Indonesia	1,500	0.12	Banking
3. Indosat	900	0.07	Telecommunications

LCY = local currency.
Note: Data as of end-December 2013.
Sources: Indonesia Stock Exchange and Otoritas Jasa Keuangan.

Figure 26: LCY Corporate *Sukuk* Issuer Profile in Indonesia



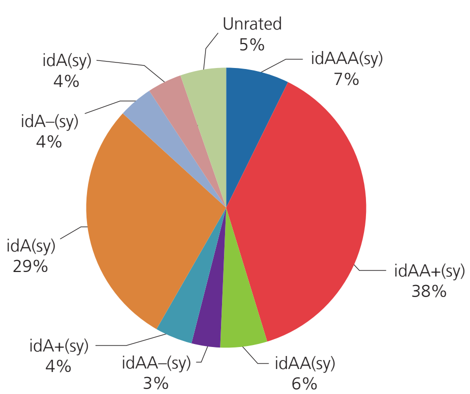
LCY = local currency.
Note: Data as of end-December 2013.
Sources: Indonesia Stock Exchange and Otoritas Jasa Keuangan.

At end-2013, corporate *sukuk* rated idAAA (sy), by Pefindo, accounted for 7% of outstanding corporate *sukuk*. All of these *sukuk* were issued by PLN, a state-owned energy firm. Most corporate *sukuk* are rated idAA+(sy) and idA (sy), with shares of 38% and 29%, respectively, at end-2013. **Figure 27** shows the distribution of ratings for *sukuk*.

Singapore

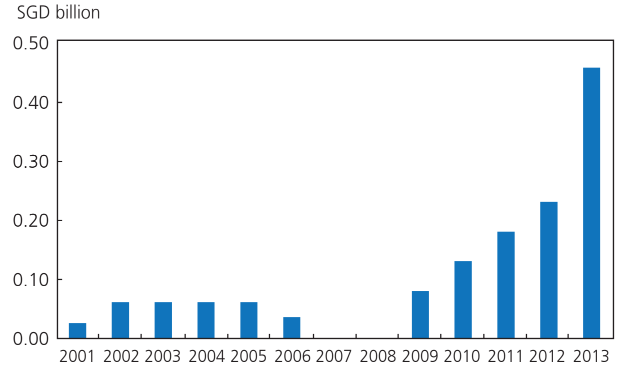
Singapore's *sukuk* market is the third-largest in emerging East Asia with an outstanding value of US$1.6 billion at end-2013. This includes US$0.4 billion (SGD0.45 billion) of LCY *sukuk* and US$1.2 billion (MYR3.9 billion) of FCY *sukuk* **(Figure 28)**. All issuances outstanding at end-2013 had maturities of between 2 years and 7 years. In the Singapore FCY *sukuk* market there are only two corporate issuers, Golden Assets International Finance and First Resources, that have issued MYR-denominated *sukuk* in Malaysia since 2012.

Figure 27: Pefindo Ratings of Corporate *Sukuk* in Indonesia



Note: Data as of end-December 2013.
Source: Indonesia Stock Exchange.

Figure 28: LCY *Sukuk* Outstanding in Singapore

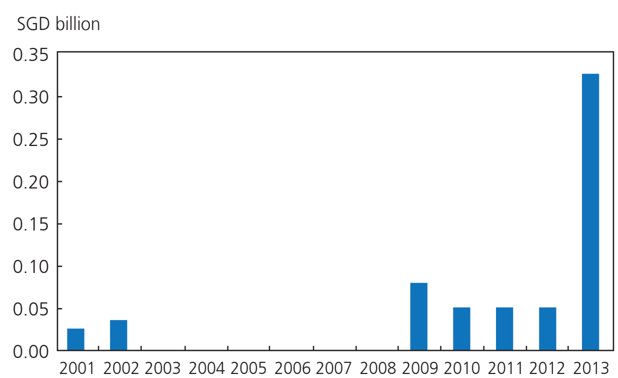


LCY = local currency.
Source: Bloomberg LP.

Since 1998, Islamic financial services, such as deposits and loans for both individuals and businesses, as well as *takaful* investment products, have been available through Islamic windows at certain banks in Singapore.

The issuance of LCY *sukuk* in Singapore only started in 2001 **(Figure 29)**. At end-2013, Singapore's LCY corporate *sukuk* market only comprised three issuers. The first two

Figure 29: LCY *Sukuk* Issuance in Singapore



LCY = local currency.
Source: Bloomberg LP.

SGD-denominated *sukuk* were issued in 2001 and 2002 by Majlis Ugama Islam Singapura (MUIC), or the Islamic Religious Council of Singapore, which is a Singapore government agency, at SGD25 million and SGD35 million, respectively. Both are 5-year tenors and were issued based on the *musharakah* structure (ownership arrangement in which a bank gradually sells its portion of the jointly-owned asset to the customer, allowing its share of the asset to diminish over time).

The LCY *sukuk* market in Singapore was dormant from 2003 to 2008 with no new issuance during this period. In 2005, the Monetary Authority of Singapore (MAS) allowed local banks to offer *mudarabah* (profit-sharing) financing. In the same year, Singapore was accepted as a full member of the Islamic Financial Services Board (IFSB) and since then MAS has shown its commitment to promote Islamic financing in Singapore by putting in place the necessary policy framework and infrastructure.

On 19 January 2009, MAS launched a SGD200 million *sukuk* facility on a reverse-enquiry basis that was structured following the *sukuk ijarah* principle and backed by rental income generated from the office units of MAS' headquarters. The facility was treated as the *shari'ah*-compliant equivalent of Singapore Government Securities (SGSs), with returns tied to the risk-free yield of an SGS of equivalent tenor. *Sukuk* can be qualified as an asset in the computation of capital and liquidity requirements of banks licensed in Singapore, and as eligible collateral for banks seeking to tap MAS' liquidity. Particularly, the facility is open to all financial institutions that are planning to offer or are currently offering *shari'ah*-compliant financial services in Singapore based on their capital and liquidity requirements.

In May 2009, MAS issued guidelines on the application of its banking regulations to Islamic finance and new regulations permitting Singapore-based banks entering into diminishing *musharakah* financing and spot *murabahah* transactions (transactions involving the purchase of assets at a marked-up price that has to be paid immediately instead of on a deferred basis). In addition, MAS ensured equal tax, regulatory, and liquidity treatment of SGD-denominated *sukuk* and SGS.

In November 2009, the LCY *sukuk* market saw new issuances with MUIC offering its third 5-year *sukuk* totaling SGD29 million. In December of the same year, Citydev Nahdah—a wholly owned subsidiary of Singapore-based private property developer City Developments—issued its debut *sukuk*. Citydev Nahdah is the largest issuer in the Singapore LCY *sukuk* market with total issuance of SGD375 million to date out of a planned SGD1 billion *sukuk ijarah* program.

In April 2010, MAS allowed banks to enter into *istisna* contracts for financing assets under construction. More recently, in 2013, Swiber Capital issued its debut 5-year *sukuk* amounting to SGD150 million. The issue marked the single largest LCY *sukuk* in Singapore and the company's first drawdown from its US$500 million Multi-Currency Islamic Trust Certificate Issuance Program, which was established in 2013 and structured based on the Islamic principle of *wakalah bi al-istithmar* (arrangement based on agency contract for investment). The proceeds from this issue were used to refinance debt, support capital expenditure, generate working capital, and meet general corporate obligations that are *shari'ah*-compliant. *Takaful* funds, pension funds, and banks accounted for 96.5% of the deal. Fund managers purchased 0.7% and private banks bought 2.8% of the bond. About half of the bonds were allocated to Islamic institutions. In terms of investors' geographical base, Singapore accounted for 43.7%, 46.3% were from Brunei Darussalam, and 10.0% were from Malaysia.

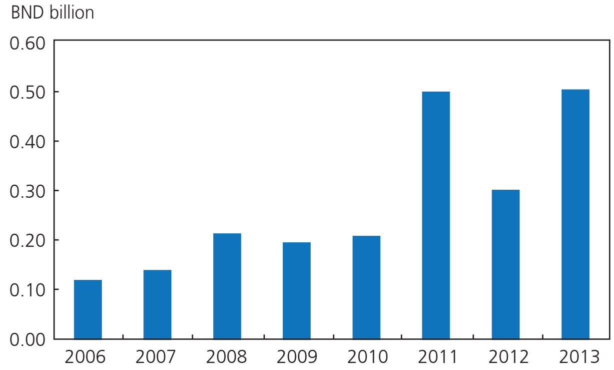
At present, Singapore has a number of commercial banks carrying out *shari'ah*-compliant financial services—Standard Chartered Bank, HSBC, OCBC, CIMB, and Maybank—and many fund managers have launched *shari'ah*-compliant *sukuk* funds, including Amanah Mutual and Franklin Templeton Investments. In 2007, Singapore also saw the establishment of its first fully Islamic bank, the Islamic Bank of Asia. Other Islamic financial institutions such as Arcapita, Al Salam Bank-Bahrain, and AEP Investment Management have also established offices in Singapore.

Brunei Darussalam

Brunei Darussalam's Islamic bond market is the fourth largest *sukuk* market in emerging East Asia, with outstanding bonds at end-2013 amounting to US$0.4 billion (BND0.5 billion). The market is solely composed of Brunei government *sukuk* based on the *ijarah* structure **(Figure 30)**. The Autoriti Monetari Brunei Darussalam (AMBD), Brunei Darussalam's statutory body acting as the central bank, is responsible for managing and administering issuances of *sukuk*.

In Brunei Darussalam, the government's three Islamic banks—Islamic Bank, Tabung Amanah Islam Brunei, and

Figure 30: LCY *Sukuk* Outstanding in Brunei



LCY = local currency.
Source: Bloomberg LP.

Islamic Development Bank—are regulated under the Islamic Banking Act.

In 2006, the government planned to strengthen banking and insurance services by offering conventional and Islamic financial instruments. The first government *sukuk* was issued with a 91-day tenor on 6 April 2006 amounting to BND150 million. Since then, the issuance of *sukuk* has become a regular activity. Over the past few years, Brunei Darussalam's government has issued 99 series of *sukuk* totaling BND6.7 billion and with tenors of 91, 182, 273, and 364 days.

People's Republic of China

The People's Republic of China (PRC) has not promulgated any specific laws regarding the development of Islamic finance or a *sukuk* market. However, there have been a number of *shari'ah*-compliant investment products that seek to invest in the PRC market.

For example, in 2006, a series of Islamic funds were launched to offer Islamic investors exposure to the PRC market. Shamil Bank launched a US$100 million Shamil China Realty Mudarabah, the first Islamic property fund targeting the PRC real estate market. Deutsche Bank also launched a series of *shari'ah*-compliant mutual funds, with the DWS Noor China Equity Fund targeting *shari'ah*-compliant PRC equity investments. The CIMB Group also launched a CIMB Islamic Greater China Equity Fund in 2009. Al-Rajhi Investments partnered with China Resources to launch the *Shari'ah* Asia Investment Fund (SAIF). SAIF seeks to invest directly in certain types of real estate projects in the PRC.

While there is no specific law promoting Islamic finance, the PRC's move to liberalize the banking sector in 2006 allowed foreign banks entry into the PRC banking sector. In 2012, Affin Holdings and the Bank of East Asia announced the submission of a proposal to the China Banking Regulatory Commission (CBRC) to establish the first Islamic bank in the country. The People's Bank of China is also an associate member of the IFSB.

Hong Kong, China

Hong Kong, China began its development of a *sukuk* market in 2007 when Financial Secretary John Tsang announced that Hong Kong, China would seek to develop a local Islamic bond market that would fit within existing regulations. The goal was to provide an investment outlet for Middle Eastern investors seeking to invest in the PRC. Over time, the government has pursued a number of initiatives to promote the development of a *sukuk* market.

For example, in January 2008, the Hong Kong Monetary Authority (HKMA) applied to upgrade its membership status in the ISFB. HKMA was granted observer membership status in 2007 and was subsequently upgraded to associate member in March 2008. In May 2008, HKMA signed a Memorandum of Understanding with the Dubai Financial Services Authority to support capacity- and knowledge-building in the area of Islamic finance, and promote the development of Islamic finance in both markets.

Other efforts have included establishment of a cross-border trading platform between Hong Kong, China and Malaysia that was established in March 2012. Hong Kong, China also released revisions to its taxation laws to put *sukuk* on a similar footing with conventional bonds.

However, Hong Kong, China has yet to issue any *sukuk*. In 2008, the Airport Authority of Hong Kong announced that it would issue *sukuk* but did not push through with the issuance. Hang Seng Bank did launch an Islamic equity fund, the Hang Seng Islamic China Index Fund. Also, Noble Group has an Islamic medium-term note facility and has issued three *sukuk* since 2012. However, the bonds were issued in the Malaysian *sukuk* market and denominated in ringgit.

One reason for the lack of issuance in Hong Kong, China is that there has been difficulty aligning *sukuk* market operations with the existing regulatory framework. For example, Hong Kong, China's banking laws allow for the establishment of an Islamic finance banking unit in existing banks. However, due to the prohibition regarding interest payments, Islamic bank deposits are closer to equity holdings and the "interest" earned may be classified as dividends under Hong Kong, China law. Islamic bank deposits are thus not subject to deposit insurance in Hong Kong, China.

Another example is that in Hong Kong, China, certain bonds may qualify for tax exemption or a reduced profit tax rate. However, *sukuk* may not qualify as a bond depending on the structure, and therefore payments may be subject to the full profit tax rate. This hurdle is what the 2013 amendment to Hong Kong, China's tax and stamp duty laws seeks to address.

Currently, the government is looking at the possibility of issuing *sukuk* under its existing government bond program and a bill may be passed to enable it to do so in 1Q14.

Japan

In Japan, there is currently no full-range regulatory framework or financial structure to operate Islamic finance. However, several initiatives and developments have been introduced to allow Japanese firms to participate in Islamic capital market transactions.

In 2007, eight Japanese private and public institutions started to explore Islamic finance as a means to tap funds from Islamic investors through investments in Japan. These institutions participated in the IFSB as observer members.

In 2008, Japan's Financial Services Agency amended the Ordinance for Enforcement of the Banking Law and the Insurance Business Law to allow the subsidiaries of Japanese banks to conduct certain Islamic finance transactions. This paved the way for Japanese banks and financial institutions to structure and place Islamic deals. Daiwa Asset Management arranged the listing of the first *shari'ah*-compliant exchange-traded fund for Japanese stocks in Singapore in 2008. In 2010, Daiwa Securities Capital Markets acted as co-lead arranger for Islamic real-estate investment trusts listed on the Singapore Exchange. Moreover, some Japanese firm's subsidiaries have also issued *sukuk* in the Malaysian market. For example, the Malaysian subsidiaries of AEON Credit Service and Toyota Financial Service issued MYR-denominated *sukuk al musharakah* in 2007 and 2008, respectively. In 2010, Nomura Holdings also issued its first US$-denominated *sukuk ijarah* worth US$100 million in Malaysia.

Meanwhile, there have been initiatives to establish a regulatory and legal framework for a *sukuk* market in Japan over the last few years. In 2011, the National Diet passed a bill to facilitate *sukuk* issuance. The bill included an amendment to the Asset Securitization Act containing provisions to accommodate a legal framework for the issuance of *sukuk*, particularly *sukuk ijarah*, to be established in the form of a special bond to be issued via a special purpose trust. Moreover, tax reforms were also introduced in which Japanese *sukuk* (J-*sukuk*) would be treated as conventional bonds for tax purposes. Following the enactment of the amendments, the Japan Securities Depository Center started to handle J-*sukuk* in its book-entry system in April 2012.

However, challenges are still prevalent in the Japan market. These include (i) a lack of domestic demand for *sukuk*, (ii) an established financial structure that will facilitate J-*sukuk* issuance and trading, and (iii) the expiration of the special tax measures that apply to J-*sukuk*.

Thailand

In Thailand, certain regulations related to *sukuk* have been introduced by the Securities and Exchange Commission (SEC). One was the SEC's notification of regulations for becoming a trustee in *sukuk* transactions, introduced in November 2010, and another was the SEC Capital Market Supervisory Board's notification on provisions for *sukuk* issuance, launched in January 2011. The regulatory framework on *sukuk* issuance is under the ambit of the Securities and Exchange Commission Act and the Trust for Transactions in Capital Markets Act.

The Islamic Bank of Thailand, established in 2003 as a state enterprise under the Ministry of Finance, has revived plans to issue THB5 billion worth of *sukuk*, according to an announcement made in June 2013. However, as of end-2013, no *sukuk* issuance had been made by the bank.

Financing Infrastructure Projects with *Sukuk*

The September 2013 edition of the *Asia Bond Monitor* highlighted the fact that the infrastructure financing requirements for Asia remain large. Given that emerging East Asian governments' fiscal deficits have been rising and that liquidity is likely to tighten amid the tapering of the US Federal Reserve's bond-buying program, there is a need to attract new sources of funds for infrastructure financing in the region. *Sukuk* have great potential for financing infrastructure projects as they have several characteristics that make them suitable for project financing. For one, infrastructure investments build tangible assets that generate revenues. Therefore, they are consistent with the Islamic finance stricture of creating economic value. Infrastructure financing also entails the sharing of risk between project sponsors and investors, which is another key principle of Islamic finance. Also, the structure of infrastructure financing can be easily adapted to accommodate Islamic finance instruments such as *ijarah, istisna, mudarabah, murabahah, and musharakah*. It can also be structured such that Islamic finance can be combined with conventional loans or bonds to finance a particular project.

Traditionally, banks have played an important role in financing infrastructure, but with new Basel III regulations coming into force, they are likely to scale back their participation in long-term infrastructure projects given higher capital charges. Hence, there is need for infrastructure projects to shift toward financing from bond markets and long-term institutional investors such as pension funds and insurance companies. Increasingly, economies in emerging East Asia with thriving bond markets have been able to mobilize funds through these markets to finance infrastructure.

While *sukuk* have been used for infrastructure projects in Malaysia, they have failed to take off as a source of infrastructure financing outside of Malaysia. Some of the reasons are that most Islamic countries have yet to develop a stable regulatory framework and economic environment that can encourage investors to invest in these markets. Their capital market is also relatively underdeveloped, which hinders the ability of infrastructure projects to raise funds. Another issue that needs to be addressed is the lack of consistency in *shari'ah* guidelines for structuring Islamic financing for infrastructure projects. There are different guidelines for different markets and even for different Islamic financial institutions. Hence, there is lack of certainty that the financing structure that is acceptable to an Islamic institution will be acceptable to other Islamic institutions, particularly those from different jurisdictions. The development of a consistent Islamic financing framework that can be applied throughout the region would help in promoting greater acceptance of *sukuk* among investors. A standard template of Islamic infrastructure financing can serve as a model to jumpstart the Islamic bond market for infrastructure and broaden its appeal. Finally, there may be capacity constraints among Islamic financial institutions in undertaking the complex tasks of structuring infrastructure projects. However, as more deals are undertaken, the knowledge gained can help bridge this gap.

If these constraints are addressed, there is potential for Islamic finance to offer a viable alternative to conventional financing. Given the large pool of savings in the Islamic world, additional investors could help to lower the financing costs of infrastructure projects. Islamic finance could also help bring in new investors that conventional lenders are not willing to bear.

Financiers of infrastructure projects can choose from a variety of *sukuk* structures. The three main types of structures that have been used for financing infrastructure based on *shari'ah* principles are *musharakah, ijarah, and murabahah*. *Musharakah sukuk* embed the principle of risk-sharing in their structure by having both investors and issuer agree to share the profits and losses resulting from the performance of the underlying infrastructure project. Given that this implies greater risk to be borne by investors, *sukuk* based on the *musharakah* structure usually attract higher yields. They also tend to offer higher profit-sharing rates to bring in investors. Meanwhile, *sukuk* based on the *ijarah* and *murabahah* are much more similar to conventional bonds in the sense that they offer certainty of returns. In the case of *ijarah* the rental amount is fixed, while in the case of *murabahah* the profit rate is set. Hence, they tend to attract more risk-averse investors. If there are shortfalls in the revenues from the underlying infrastructure project, the issuer will have to cover the shortfall and ensure that the investors in the *sukuk* receive the agreed rental or profit.

The *ijarah* structure for *sukuk* is normally used to refinance an existing infrastructure project (brownfield). The popularity of this structure is due to its similarity to a conventional lease. In this arrangement, typically the proceeds raised from *sukuk* investors will be used to purchase an interest in the existing infrastructure project. After the purchase, the infrastructure project will be leased back to the project company in return for regular payment of rent. Normally, the project company will use the revenue from the infrastructure project to service the rental payment.

It is also possible to structure a *sukuk* to finance a new infrastructure project (greenfield). Both risk-sharing structures of *sukuk*, *musharakah* and *mudarabah*, can be used to finance a greenfield project. But given the unfamiliarity with the risk-sharing *sukuk* structure, the most suitable *sukuk* structure for greenfield financing would be *istisna* combined with *ijarah*. The *istisna* structure allows for an asset to be sold before it has been built. To prevent unnecessary risk during the transaction, the price and specifics of the infrastructure project will have to be agreed upon when signing the *istisna* agreement. The *istisna* structure allows for the purchase price of the project to be paid in installments during the construction phase. This means that the *sukuk* payment for the infrastructure project can be linked to completion milestones agreed upon by both parties. The *istisna* structure is normally combined with that of *ijarah*. This is to allow for payments to be made by the infrastructure project to the *sukuk* holders under a forward lease arrangement, thus allowing investors to receive a return during the construction period. It also allows for the lease arrangement to come into force once the project is completed and operational.

There have been several large infrastructure projects financed through *sukuk* in Malaysia. Investment in infrastructure in Malaysia received a boost from the Economic Transformation Plan, which envisaged heavy spending on infrastructure amounting to US$450 billion to help Malaysia become a developed economy. While that is a huge amount of investment, Malaysia's deep and liquid capital market has allowed funds to be raised for infrastructure projects at long-term and relatively low cost. The stability of the Malaysian regulatory framework and long history of private participation in various infrastructure projects has also helped to underpin investor confidence.

A recent example of an infrastructure *sukuk* in Malaysia is the Project 3A *sukuk* launched by electricity utility Tenaga Nasional in January 2014. The issue is worth up to MYR4 billion and consists of a series of different maturities between 10 years and 20 years. The funds are being raised to fund a 1,000MW ultra-supercritical coal-fired power plant. The funds raised through the *sukuk* bond issuance will cover 74% of the project cost, with Tenaga Nasional contributing equity for the remaining portion. The *sukuk* are structured following the *ijarah* principle, with the distribution payments of the *sukuk* coming from the lease payments made by the special financing vehicle once the plant is up and running. A 25-year power purchase agreement with Tenaga will help the special financing vehicle to fund the project. The *sukuk* have been given the highest rating by the Malaysian Rating Corporation (MARC) due to the project completion support and guarantee from the project sponsor. Tenaga is underwriting the residual risk from building and operating the power plant that is not assumed by the builders. This has helped to raise confidence among investors in investing in a greenfield project in which they are taking on construction risk. This comes on the back of a successful MYR2 billion *sukuk* in 2013, also issued by Tenaga, to finance the construction of a gas-fired 1,000 MW power plant using a similar type of structure.

Other examples of large power infrastructure project *sukuk* are the Tanjung Bin Energy MYR3.29 billion *sukuk* with a maximum tenor of 20 years and the TNB Northern Energy MYR1.625 billion *sukuk* with a maximum tenor of 23 years. There have also been several successful *sukuk* issued to finance toll roads. Konsortium Lebuhraya Utara-Timur (Kesturi) raised MYR2.3 billion of senior *sukuk* and MYR180 million of junior bonds in December 2013 to refinance existing bonds and partly finance the extension of a Kesturi toll road. *Sukuk* have also financed improvements in the public transport network. The Klang Valley Mass Rapid Transit is expected to require MYR50 billion of funding. Out of that total amount, about half is expected to be raised through *sukuk*.

The development of financial markets in Malaysia, combined with a stable legal and regulatory environment, has resulted in Malaysia having a successful track record of financing greenfield infrastructure projects even without the use of credit enhancement. In addition, Malaysia has successfully developed its *sukuk* market and allowed it to thrive. The *sukuk* market has benefited from a clear regulatory framework and the existence of two local rating agencies that have a strong track record of evaluating Malaysian infrastructure projects. The success of *sukuk* financing for infrastructure has also been due to significant liquidity in the LCY *sukuk* market. As seen in the examples above, infrastructure projects have been able to raise funds through the issuance of *sukuk* with significantly longer tenors than bank loans. This shows that there is considerable appetite among local investors for holding long-term *sukuk* bonds.

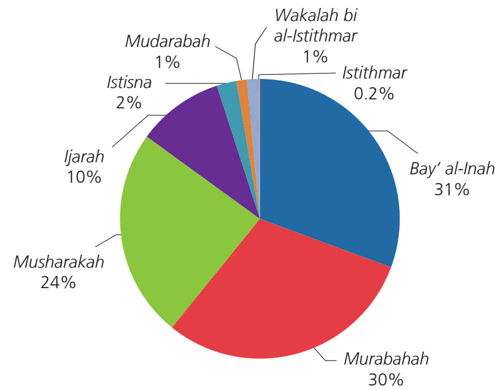
Future Developments

In the aftermath of the 2008/09 global financial crisis, there is understandable concern over whether the Western model of finance is still relevant. Some see excessive financialization as preventing financial systems from serving their intended useful social purpose. While financial systems are supposed to serve the real economy, there is a general uneasiness over the growing disconnect between purpose and actual function in advanced economies.

Some have suggested that Islamic financial systems may offer a better alternative. For one, Islamic financial systems are closely based on real productive assets in the economy. This means they offer a closer connection between financiers and the real activities they finance. Another benefit is that the risk-sharing principle ensures there cannot be an excessive build-up of debt.

Developments in the *sukuk* market offer encouragement on this front. *Sukuk* structured in profit-and-loss sharing partnerships (*musharakah*) have increased their share of the *sukuk* market in Malaysia **(Figure 31)**. The increased use of profit-sharing *sukuk* can lead to new forms of financing instruments that can facilitate long-term development. This is a potential improvement from the traditional *sukuk* structure of *ijarah* and *murabahah*, which focus more on replicating the structure of conventional bonds.

Figure 31: Composition of the *Sukuk* Market in Malaysia



Notes:
1. *Bay' al-Inah* are Islamic bonds that involve the sale and buy-back of an asset.
2. *Ijarah* are Islamic bonds backed by a lease agreement.
3. *Istisna* are Islamic bonds backed by a purchase order contract.
4. *Istithmar* are Islamic bonds based on combined structure of ijarah and murabahah.
5. *Mudarabah* are Islamic bonds backed by a profit-sharing scheme from a business venture or partnership.
6. *Murabahah* are Islamic bonds backed by a commodity mark-up sale transaction.
7. *Musharakah* are Islamic bonds backed by a joint-venture arrangement between two or more parties.
8. *Wakalah bi al-Istithmar* are Islamic bonds where a person nominates another person to act on his behalf.

Sources: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) and Bloomberg LP.

In moving toward a risk-based Islamic financial system, it is important not to lose sight of the need to maintain stability in the financial system. The underlying basis of Islamic finance is not that different from conventional financial markets. Both types of financial systems face the same credit, liquidity, market, and operational risks. Hence, most regulatory reforms designed to strengthen the international financial system after the 2008/09 global financial crisis should also apply to the global Islamic financial system. Islamic standard-setting bodies such as IFSB and AAOIFI have already started to introduce prudential standards for Islamic financial institutions.

For Islamic risk-sharing products to gain wider acceptance, there needs to be recognition by the regulatory authorities of the different nature of risk-sharing *sukuk*. Given that risk-sharing *sukuk* are relatively new products, there may be uncertainty over how they are treated, especially in terms of risk weighting. Also, there is the need to further strengthen and develop the infrastructure that underpins the Islamic financial system. One key constraint of Islamic financial institutions is the lack of supply of high-quality, liquid LCY and FCY Islamic paper. This makes it more difficult for Islamic financial institutions to comply with international regulatory standards for liquidity. The establishment of the International Islamic Liquidity Management (IILM) is aimed at addressing the lack of suitable Islamic financial instruments. Specifically, it has begun issuing short-term US$-denominated *sukuk* in the global market to enable Islamic financial institutions to manage their cross-border liquidity requirements.

While there have been impressive gains in the development of *sukuk* markets, both globally and within emerging East Asia, more needs to be done if *sukuk* are to be seen as a viable alternative to conventional financial products. The country in the region that has achieved the most in this regard is Malaysia, where the *sukuk* market has benefited from plentiful liquidity and strong demand for Islamic financial products among its large Islamic banking sector. However, for other economies in the region aiming to grow their *sukuk* market, there is still much to be done.

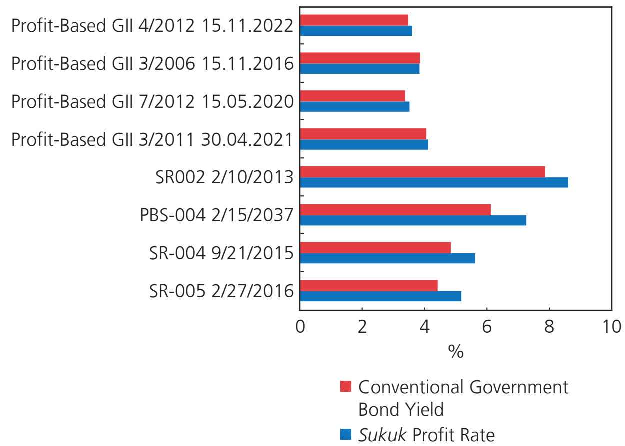
Islamic financing structures offer a hybrid of debt and equity financing that represents a new avenue for financial development. However, as these structures are relatively new, there may be reluctance to use them due to a lack of familiarity. Thus, there is a need to educate market participants so they can better understand the benefits of these new structures. Once the structures are well known, investors and issuers will be more willing to embrace them.

The more complex nature of *sukuk* compared with conventional bonds could also result in higher advisory fees during the issuance process. On the investor side, this higher level of complexity could result in higher costs for the process of conducting due diligence. Thus, another important role that governments can play is to put in place the regulations needed to support a *sukuk* market. Without the necessary legal framework, investors will remain wary of investing in *sukuk* that are perceived to be too complex. Related to this is the need to develop local credit rating agencies. While the major rating agencies rate *sukuk* as well as conventional bonds, their high fees usually mean that they are too expensive for corporate issuers focused on domestic markets.

Another constraint to the development of *sukuk* markets is that the cost of issuing *sukuk* tends to be higher than for conventional bonds. The lower volume of *sukuk* in the market usually results in lower liquidity for *sukuk* compared to conventional bonds. As a result, investors usually expect to be compensated with a higher yield. **Figure 32** shows the average yield difference between a sample of recent Indonesian and Malaysian government *sukuk* at the time of issuance versus the prevailing conventional government bond of comparable maturity.

The results from this comparison show that in Indonesia, government *sukuk* profit rates are on average 86 basis points (bps) higher than comparable conventional government bonds. This represents quite a substantial premium. While investors are happy with the extra yield, the issuer is faced with higher borrowing costs. In Malaysia, the profit rates for *sukuk* are on average only 8 bps higher than those for comparable government bonds. This is due to the much larger and more liquid market for *sukuk* in Malaysia than in Indonesia.

Figure 32: Conventional Government Bond Yields vs. Government *Sukuk* Profit Rates in Indonesia and Malaysia



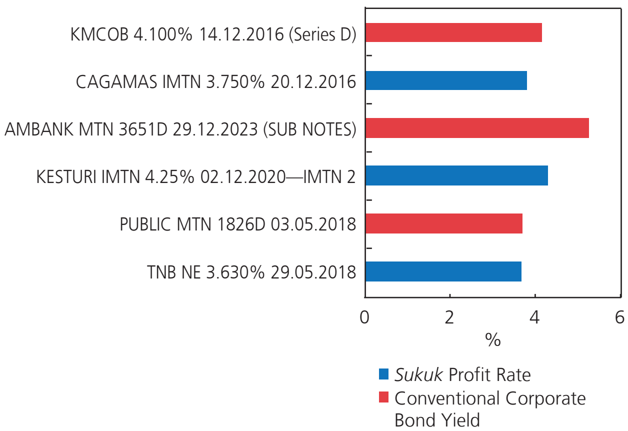
Sources: Bloomberg LP and Indonesia Debt Management Office.

Figure 33 compares a sample of Malaysian corporate *sukuk* with conventional corporate bonds with the closest available maturity dates and credit ratings at the time of issuance. Interestingly for Malaysia, corporate *sukuk* are trading at slightly lower yields compared to conventional corporate bonds, and in some cases they are trading at equal rates. Malaysia has a very liquid corporate *sukuk* market owing to its large size, which accounts for about 70% of total corporate bonds. Trading volumes for corporate *sukuk* are also higher compared with conventional corporate bonds. The highly liquid *sukuk* and conventional bond markets in Malaysia mean that *sukuk* profit rates and the yields on conventional corporate bonds are similar.

However, in the case of Indonesia, corporate *sukuk* and conventional bonds usually have the same coupon rates at issuance. For example, PLN's issuance in December of 5-year conventional bonds worth IDR593 billion and 5-year *sukuk* worth IDR321 billion both sported coupon rates of 9.0%. After issuance, however, yields tend to change due to differences in liquidity between the two issuances. The liquidity premium for corporate *sukuk* is much higher due to the Indonesian *sukuk*'s relative illiquidity, as the trading volume for Indonesia's corporate *sukuk* was only about 5% of the trading volume for conventional corporate bonds in 2013.

A comparison of yields based on recent trading prices for Indonesian corporate *sukuk* and conventional corporate bonds with the closest maturity dates and credit ratings

Figure 33: Conventional Corporate Bond Yields vs. Corporate *Sukuk* Profit Rates in Malaysia



Sources: Bank Negara Malaysia and Bloomberg LP.

indicated that corporate *sukuk* yields were higher. For example, Bank Sulselbar's *sukuk* profit rate was 20.5 bps more than Japfa Comfeed's conventional bonds, while Indosat's *sukuk* traded 74.5 bps higher than Bumi Serpong Damai's conventional bonds.

Authorities usually must play a key role in jumpstarting the market by issuing large quantities of *sukuk* as a large pool of sovereign *sukuk* can help to catalyze the market. The corporate sector will tend to follow the government's lead and also start issuing *sukuk*. Apart from the central government, municipal and government agencies can also help promote the growth of the *sukuk* market by sourcing a portion of their borrowing requirements from the Islamic market.

For the moment, there is a need to work toward standardizing existing structures for *sukuk*, as these structures can be numerous and quite different from conventional bonds. Furthermore, *sukuk* transactions are much more complex than conventional bond transactions. Investors must perform due diligence on the *sukuk* structures and review all related documentation. There is also a lack of uniformity regarding the interpretation of *shari'ah* law among different countries in terms of how it applies to regulations and structures. Agreeing on common standards for *sukuk* can help reduce transaction costs, encourage the development of a secondary market, improve liquidity, and provide greater pricing transparency. One way to do this is to create a central *sharia'ah* advisory board in every country, as has been done by Malaysia, to give clear guidance to investors on which financial products are *shari'ah*-compliant.

So far, most *sukuk* have been issued under either the *murabahah* or *ijarah* structure. While there is great potential to develop profit-sharing *sukuk* structures such as *mudarabah* and *musharakah*, these are still a small proportion of the *sukuk* market. However, they are seen as the most desirable structure for financing from an Islamic perspective because they share risk and reward between issuers and investors. Investors have been wary about profit-sharing *sukuk* whose structures are riskier than conventional bonds. There are also concerns about the lack of transparency, which can hinder a borrower's ability to monitor the financial performance of the underlying projects. Without proper transparency, investors may not be sure that they are getting their fair share of profits. Related to this issue is the underdevelopment of legal and accounting infrastructure in some countries, which can deter investors if they cannot easily verify the accuracy of data from projects.

Finally, there is a need to ensure that *sukuk* are not treated unfavorably by tax and regulatory regimes. The existing tax and regulatory frameworks of most countries were not designed with Islamic products in mind. Hence, Islamic financial products tend to be at a disadvantage compared with conventional financial instruments. For example, there may be unequal treatment in the tax systems of some countries between profit and interest payments. While interest payments are generally tax deductible, profits are taxable. As a result, profit-sharing *sukuk* may be less attractive to investors. Furthermore, *murabahah* transactions can face an additional sales tax, while *ijarah* transactions can be hit with double stamp duties. To further promote the development of Islamic finance, in many countries there is a need for the tax and regulatory framework to be reformed to level the playing field between Islamic and conventional products.