

Sukuk Developments in Emerging East Asia

Emerging East Asia's *sukuk* (Islamic bond) market held firm in 2Q15 despite headwinds from challenging developments in the global economy.⁶ The region's *sukuk* market managed to post modest growth in the first half of the year, amid uncertainties surrounding the anticipated interest rate hike by the United States (US) Federal Reserve and, more importantly, falling oil prices that affected oil-producing economies who are active participants in Islamic financial markets. Growth was largely driven by *sukuk*'s rising acceptance as an important source of financing as demand for infrastructure funding continues to grow and interest from nonmainstream *sukuk* markets begins to advance.

At the end of June, the outstanding amount of *sukuk* in emerging East Asia had reached US\$186.3 billion, up from only US\$59.9 billion at the end of 2008, which represented a compounded annual growth rate of 19.1%. In the first half of 2015, the *sukuk* market expanded 6.0% from US\$175.9 billion in 2014 (Figure 13).

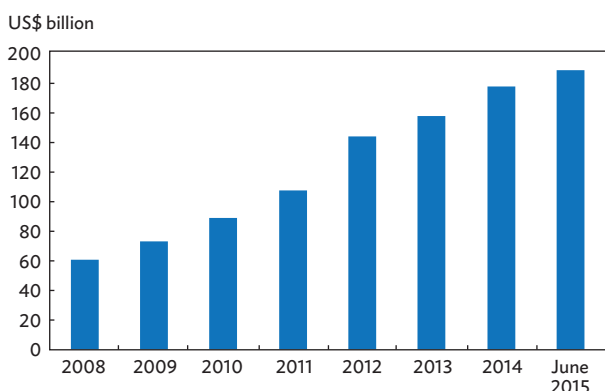
Malaysia is home to the largest *sukuk* market in emerging East Asia and the entire world. It dominates the region's market, accounting for an 86.5% share of the region's total

sukuk stock at end-June. It was followed by Indonesia with a share of 11.1%, while all other emerging East Asian *sukuk* markets (Brunei Darussalam; Hong Kong, China; and Singapore) together only represent a 2.3% share of the total.

Malaysia dominates both the local currency (LCY) and foreign (FCY) currency *sukuk* markets. LCY-denominated *sukuk* accounted for an 89.7% share of the region's total bond stock at end-June, while the remaining 10.3% share was accounted for by FCY-denominated *sukuk* (Figure 14).

At the end of June, the region's outstanding *sukuk* were primarily denominated in Malaysian ringgit, which had an equivalent value of US\$154.9 billion and represented an 83.1% share of the region's total stock (Figure 15). Other markets in the region have also issued MYR-denominated *sukuk*, taking advantage of Malaysia's pioneering efforts in creating a well-developed regulatory framework and market infrastructure for *shari'ah*-compliant financial products. The Indonesian plantation firm Bumitama Agri issued MYR-denominated bonds twice in 2014. In Singapore, all FCY corporate *sukuk* have been issued in

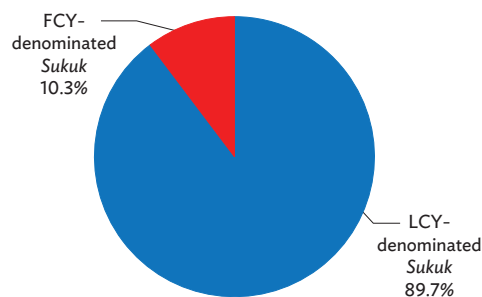
Figure 13: Sukuk Outstanding in Emerging East Asia



Notes:

- Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.
 - Data includes local currency and foreign currency *sukuk*.
 - Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.
- Sources: Autoriti Monetari Brunei Darussalam; Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

Figure 14: LCY and FCY Sukuk Outstanding in Emerging East Asia



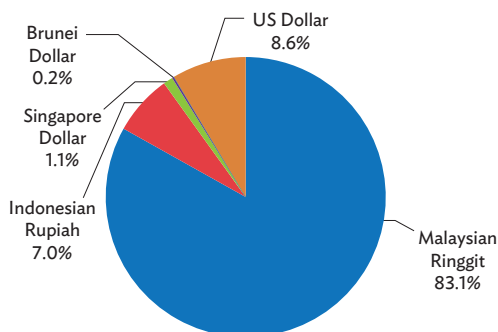
FCY = foreign currency, LCY = local currency.

Notes:

- Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.
 - LCY-denominated *sukuk* refers to a market's issuance of *sukuk* denominated in its home currency, while FCY-denominated *sukuk* refers to a market's issuance of *sukuk* denominated in a currency other than its home currency.
 - Data as of end-June 2015.
- Sources: Autoriti Monetari Brunei Darussalam; Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

⁶ Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.

Figure 15: Outstanding Sukuk in Emerging East Asia by Currency



Notes:

1. Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.

2. Data includes local currency and foreign currency *sukuk*.

3. Data as of end-June 2015.

Sources: Autoriti Monetari Brunei Darussalam; Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

Malaysian ringgit, including issuances by Golden Assets International and First Resources. Even Hong Kong, China's Noble Group issued MYR-denominated *sukuk* in 2012 and 2013.

Next to the Malaysian ringgit, the US dollar was the region's currency of choice for *sukuk* issues. Outstanding US\$-denominated *sukuk* totaled US\$16.0 billion at end-June. Indonesia is the most active market in terms of US\$-denominated *sukuk*, with a total outstanding amount of US\$7.5 billion. The Indonesian government regularly issues global *sukuk* as part of its budget financing plan and instrument diversification strategy. It also issues global *sukuk* to support the development of the global Islamic financial market and to create a pricing benchmark for global *sukuk* issues. At the end of June, the Indonesian government's outstanding global *sukuk* stood at US\$7.0 billion. The only other US\$-denominated *sukuk* from Indonesia was the US\$0.5 billion issuance of state-owned airline operator Garuda Indonesia in 2015.

Malaysia's aggregate US\$-denominated *sukuk* totaled US\$6.5 billion at end-June. Of this amount, global *sukuk* issued by the government comprised US\$3.5 billion and *sukuk* issued by corporate firms comprised the remaining US\$3.0 billion.

The remaining US\$2.0 billion was accounted for by Hong Kong, China, whose government sold its first *sukuk*

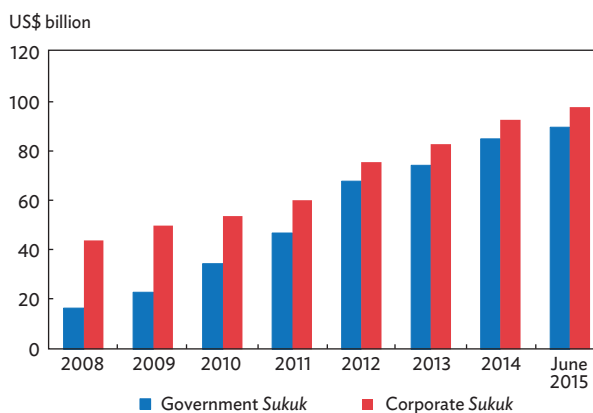
in September 2014 through the issue of a US\$1.0 billion 5-year *sukuk* at a profit rate of 2.005%. The *sukuk* was structured following the *wakalah* Islamic principle. The issuance was an important milestone for Hong Kong, China in its foray into the Islamic financial market. The government issued another US\$1.0 billion 5-year *sukuk* in June 2015 that carried a profit rate of 1.894%.

IDR-denominated *sukuk* accounted for a 7.0% share of the region's total outstanding *sukuk* at end-June. All of which were issued by the Indonesian government through the auction of Islamic Treasury bills (SPN-S) and Islamic Treasury bonds, known as *Surat Berharga Syariah Negara* (SBSN), and the issuance of retail *sukuk*. The government auctions Islamic Treasury instruments on a bi-monthly basis.

Sukuk denominated in Singapore dollars and Brunei dollars only accounted for an aggregate 1.3% share of the total. Issuance in Singapore dollars came from both Singapore and Malaysian corporates, while BND-denominated *sukuk* were mainly issued by Autoriti Monetari Brunei Darussalam, a statutory body acting as the central bank.

At the end of June, emerging East Asia's outstanding government *sukuk* reached US\$89.2 billion, while corporate *sukuk* stood at US\$97.2 billion (**Figure 16**). Unlike the conventional bond market, where the government sector

Figure 16: Composition of Sukuk Outstanding in Emerging East Asia



Notes:

1. Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.

2. Data includes local currency and foreign currency *sukuk*.

3. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.

Sources: Autoriti Monetari Brunei Darussalam; Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

dominates issuance, in the *sukuk* space, it is the corporate issues that account for a larger share. Nonetheless, government *sukuk* have steadily advanced over the years, with a share of total *sukuk* outstanding nearly doubling from 27.5% in 2008 to 47.8% at end-June.

Corporate *sukuk* accounted for a 52.2% share of the region's total *sukuk* stock during the review period. Only the markets of Malaysia and Singapore had a larger share of corporate sector *sukuk* vis-à-vis the government. In the case of Singapore, its entire stock of *sukuk* outstanding came from the corporate sector.

Sukuk issuance in emerging East Asia recorded a modest decline in 2014 to US\$78.5 billion from 2013's US\$79.5 billion and 2012's high of US\$89.2 billion (**Figure 17**). While still robust, issuance volume has been on a downtrend since the 2013 "taper tantrum" when emerging markets experienced large capital outflows in response to statements from the Federal Reserve that it planned to wind down its monthly asset purchases. In the first half of 2015, total *sukuk* issuance volume in emerging East Asia reached US\$26.9 billion.

Malaysia led the decline as its issuance volume has steadily dropped, particularly for government *sukuk*. In the first half of 2015, Malaysia ceased issuance of *shari'ah*-compliant Bank Negara Monetary Notes

(BNMNs), which accounted for 55.4% of total LCY issuance in 2014. However, issuance of *shari'ah*-compliant BNMNs resumed in August.

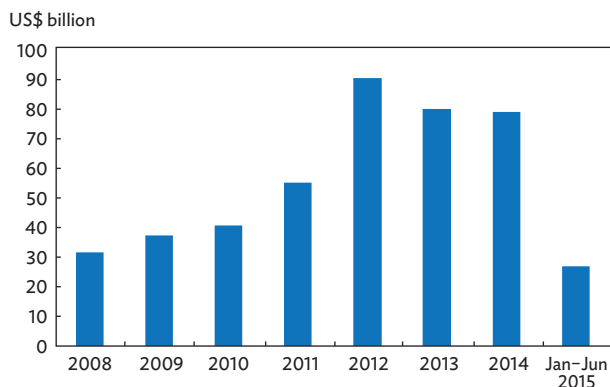
Bucking the declining trend in issuance volume was Indonesia, where *sukuk* issuance volume has steadily risen from only US\$1.5 billion in 2008 to US\$7.0 billion through the first half of 2015. Hong Kong, China also increased its total issuance volumes in 2014 and 2015 as a result of the government's successive issues of US\$1.0 billion *sukuk*.

Malaysia

Malaysia is home to the largest *sukuk* market in emerging East Asia, accounting for an 86.5% share of the region's total *sukuk* stock at end-June. The Malaysian *sukuk* market, including LCY- and FCY-denominated *sukuk*, reached a size of US\$161.3 billion at end-June, up from a modest US\$58.8 billion in 2008 on compounded annual growth of 16.8% (**Figure 18**).

In 2014, Malaysia's LCY *sukuk* market surpassed conventional bonds in terms of LCY bond market share with 52% of the total. This share has since climbed to 54% as of end-June 2015. The growth is a testament to Malaysia's vast experience in Islamic finance, given its established regulatory infrastructure in facilitating the

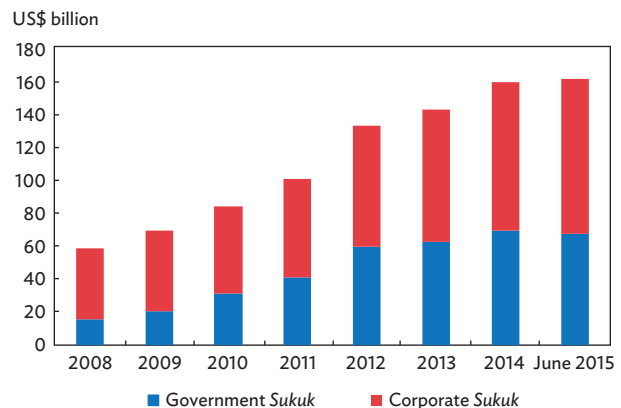
Figure 17: Sukuk Issuance in Emerging East Asia



Notes:

1. Emerging East Asia's *sukuk* market comprises Brunei Darussalam; Hong Kong, China; Indonesia; Malaysia; and Singapore.
 2. Data includes local currency and foreign currency *sukuk*.
 3. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.
- Sources: Autoriti Monetari Brunei Darussalam; Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

Figure 18: Sukuk Outstanding in Malaysia



Notes:

1. Data include local currency and foreign currency *sukuk*.
 2. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.
- Sources: Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) and Bloomberg LP.

sukuk market, including origination, listing, reporting, trading, and settlement systems. Malaysia also boasts a strong *shari'ah* governance framework that comprises *shari'ah* committees under the Securities Commission Malaysia (SC) and Bank Negara Malaysia (BNM). These institutions provide regulatory guidance in the development of the Islamic finance market in Malaysia.

Malaysia's lead in the development of Islamic finance not only translates into issuance volume, but also through the innovation of more *shari'ah* products to cater to a wider investor base. Over the years, *sukuk* structures in Malaysia have evolved from debt-based principles (*murabahah*) to lease-based (*ijarah*), profit-sharing (*musharakah*), and manufacturing contract-based (*istitna*), and also include hybrid structures based on combinations of *shari'ah* contracts. At end-June, Malaysia's LCY *sukuk* were characterized by a wide distribution of *shari'ah* principles, including sale and buyback (*bay al'inah*), *murabahah*, and *musharakah* (Figure 19).

Malaysia's government *sukuk* market has exhibited impressive growth over the years. At end-June, the total outstanding amount of Malaysia's government

sukuk reached US\$67.4 billion, up from a modest size of US\$15.8 billion in 2008. Moreover, the share of government *sukuk* to Malaysia's aggregate *sukuk* market has also increased from a share of 26.8% in 2008 to 41.8% at end-June.

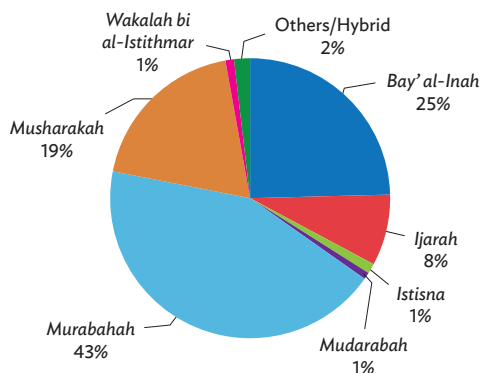
Government Investment Issues (GIIs) continued to account for the majority of total LCY government *sukuk* with a share of 86% at end-June. GIIs are long-term, non-interest bearing government securities issued to raise funds for developmental expenditure. GIIs are issued through competitive auction by BNM on behalf of the government and have maturities of 3, 7, 5, 10, 15, and 20 years. The different maturities of GIIs also provide a benchmark yield curve for Islamic market reference. Since the start of their issuance in 2001, GIIs had been based on the *bay' al-inah* principle, an arrangement that involves the sale and buyback of an asset. However, beginning in July 2013, GIIs have been based on the *murabahah* structure (Table 5).

Shari'ah-compliant BNMNs previously accounted for a sizable portion of government *sukuk* (Figure 20). These are short-term instruments, with maturities of up to 3 years, issued by BNM to manage liquidity in the Islamic money market. However, in 2015, BNM ceased issuance of the instrument. As a result, *Sukuk Perumahan Kerajaan*, which are Islamic bonds issued by the government to extend and refinance funding for housing loans to government employees, now account for the second largest share at 12%.

The Government of Malaysia had US\$3.5 billion worth of FCY-denominated sovereign *sukuk* outstanding at end-June, including a US\$2.0 billion dual-tranche *sukuk* issued in July 2011 under the special purpose vehicle *Wakalah Global Sukuk*. In April 2015, the Government of Malaysia again issued a US\$1.5 billion dual-tranche *sukuk* via special purpose vehicle *Malaysia Sovereign Sukuk*. The issue comprised a US\$1 billion 10-year tranche and a US\$500 million 30-year tranche. This extended the maturity profile of government *sukuk* to 30 years from 10- to 20-year GIIs.

At end-June, financial firms—including banks, development financial institutions, and nonbanking financial institutions—were the largest investor group in LCY government *sukuk* at 49.0% of the total. This group was followed by social security institutions, comprising the Employees Provident Fund and the Social Security Organisation of Malaysia, with a 37.4% share (Figure 21). Foreign holders and

Figure 19: Composition of the LCY Sukuk Market in Malaysia



LCY = local currency.

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. *Mudarabah* are Islamic bonds backed by a profit-sharing scheme from a business venture or partnership.
5. *Murabahah* are Islamic bonds backed by a commodity mark-up sale transaction.
6. *Musharakah* are Islamic bonds backed by a joint-venture arrangement between two or more parties.
7. *Wakalah bi al-Istithmar* are Islamic bonds where a person nominates another person to act on his behalf.
8. Data includes government and corporate *sukuk*.
9. Data as of end-June 2015.

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

Table 5: Size and Composition of the Government Sukuk Market in Malaysia

Instrument	Amount Outstanding (billion)		Structure
	MYR	US\$	
Total	254.2	67.4	
LCY Government			
Government Investment Issue	131.0	34.7	<i>Bay' al-Inah</i>
Government Investment Issue	76.0	20.1	<i>Murabahah</i>
Bank Negara Islamic Monetary Notes	4.2	1.1	<i>Murabahah</i>
Malaysian Treasury Bills	1.9	0.5	<i>Bay' al-Inah</i>
<i>Sukuk Perumahan Kerajaan</i>	27.9	7.4	<i>Murabahah</i>
FCY Government			
Malaysia Sovereign Sukuk	5.7	1.5	<i>Wakalah bi al-Istithmar</i>
Wakala Global Sukuk Bhd.	7.5	2.0	<i>Wakalah bi al-Istithmar</i>

FCY = foreign currency, LCY = local currency.

Notes:

1. *Bay' al-Inah* are Islamic bonds that involve the sale and buy-back of an asset.

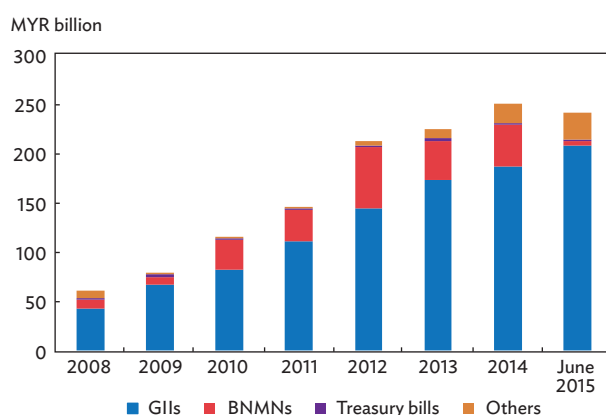
2. *Murabahah* are Islamic bonds backed by a commodity mark-up sale transaction.

3. *Wakalah bi al-Istithmar* are Islamic bonds in which one person nominates another person to act on his behalf.

4. Data as of end-June 2015.

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

Figure 20: LCY Government Sukuk Outstanding in Malaysia by Type of Instrument



BNMNs = Bank Negara Monetary Notes, GIIs = Government Investment Issues, LCY = local currency.

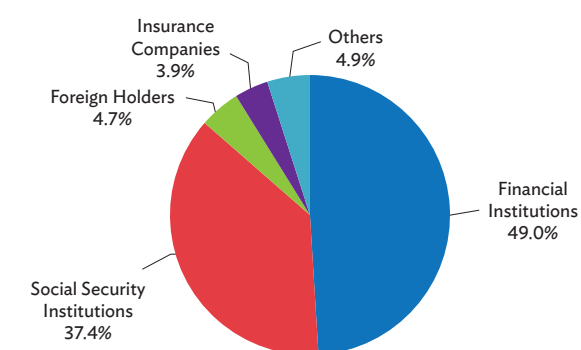
Note: Others refers to securities issued by Cagamas and Khazanah in 2008–2011. From 2012 until end-June 2015, it refers to *Sukuk Perumahan Kerajaan*, which are Islamic bonds issued by the government to refinance funding for housing loans to government employees and to extend new housing loans.

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

insurance companies, meanwhile, accounted for 4.7% and 3.9%, respectively. Others, which include statutory bodies, nominees, and trustee companies, had a share of 4.9%

The corporate *sukuk* market in Malaysia has continued to exhibit steady growth over the years. Total outstanding

Figure 21: GII Investor Profile in Malaysia



GII = Government Investment Issue.

Note: Data as of end-June 2015.

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

corporate *sukuk* reached US\$93.9 billion at end-June, more than double the amount of US\$43.0 billion in 2008, including US\$5 billion worth of FCY-denominated *sukuk*. Malaysia's LCY corporate *sukuk* now dominate the LCY corporate bond market with a share of about 72% of the total.

Given Malaysia's vast experience in Islamic finance, the number of firms that have tapped the *sukuk* market for funding requirements have grown exponentially over the years. Highway operator Project Lebuhraya Usahasama

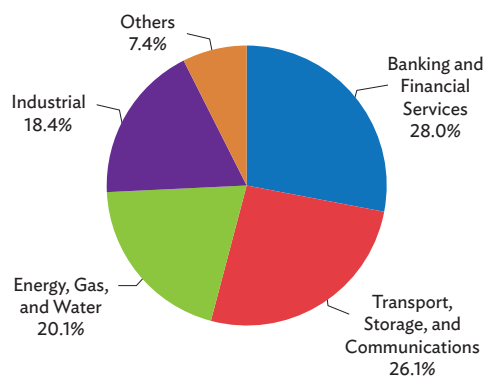
remained the largest issuer at end-June with outstanding bonds valued at MYR30.6 billion (US\$8.1 billion). Proceeds are being used to finance the purchase of five toll road concessions. State-owned institutions have also used the *sukuk* market as source-funding for various social and infrastructure projects. Khazanah Nasional, a sovereign wealth fund, was the second largest issuer of corporate *sukuk* with total outstanding bonds of MYR20 billion at end-June. The third largest issuer was Danainfra Nasional, which was established to fund Malaysia's infrastructure projects, with outstanding *sukuk* of MYR18 billion (Table 6).

The LCY corporate *sukuk* market of Malaysia is dominated by three major industries (Figure 22). Financial firms, including banks, accounted for the largest share at 28%. Firms involved in transportation, logistics, and telecommunications industries followed with 26%. Energy and utility companies—electricity, oil, gas, and water—followed with an aggregate share of 20%.

Given the industry profile of corporate *sukuk* issuers, which are predominantly in the infrastructure,

electricity generation, and water industries, and their corresponding long-term projects, almost two-thirds of the outstanding LCY corporate *sukuk* at end-June were longer-dated maturities ranging from 10 years to 50 years (Figure 23).

Figure 22: LCY Corporate Sukuk Issuer Profile in Malaysia



LCY = local currency.
Note: Data as of end-June 2015.
Source: AsianBondsOnline calculations based on Bloomberg LP data.

Table 6: Top 15 Issuers of LCY Corporate Sukuk in Malaysia

Issuers	Outstanding Amount		State-owned	Type of Industry
	(MYR billion)	(US\$ billion)		
1. Project Lebuhraya Usahasama	30.60	8.11	No	Transport, Storage, and Communications
2. Khazanah	20.00	5.30	Yes	Finance
3. Danainfra Nasional	17.60	4.66	Yes	Finance
4. Prasarana	13.70	3.63	Yes	Transport, Storage, and Communications
5. Pengurusan Air	11.93	3.16	Yes	Energy, Gas, and Water
6. Cagamas	11.07	2.93	Yes	Finance
7. Perbadanan Tabung Pendidikan Tinggi Nasional	11.00	2.92	Yes	Finance
8. Sarawak Energy	7.00	1.86	Yes	Energy, Gas, and Water
9. Aman Sukuk	6.72	1.78	Yes	Communications Equipment
10. BGSM Management	6.02	1.60	No	Transport, Storage, and Communications
11. Turus Pesawat	5.31	1.41	Yes	Finance
12. 1Malaysia Development	5.00	1.33	Yes	Finance
13. Celcom Networks	5.00	1.33	No	Transport, Storage, and Communications
14. Malakoff Power	4.88	1.29	No	Energy, Gas, and Water
15. Manjung Island Energy	4.85	1.29	No	Energy, Gas, and Water

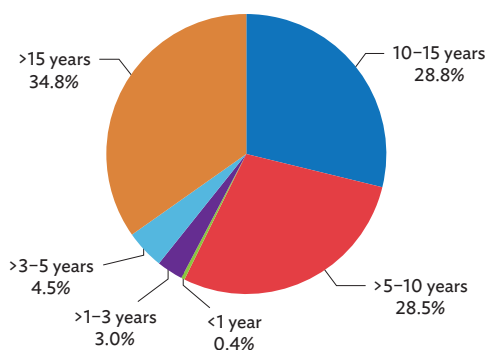
LCY = local currency.

Notes:

1. Data as of end-June 2015.

2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.

Source: AsianBondsOnline calculations based on Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST) data.

Figure 23: LCY Corporate Sukuk in Malaysia by Maturity

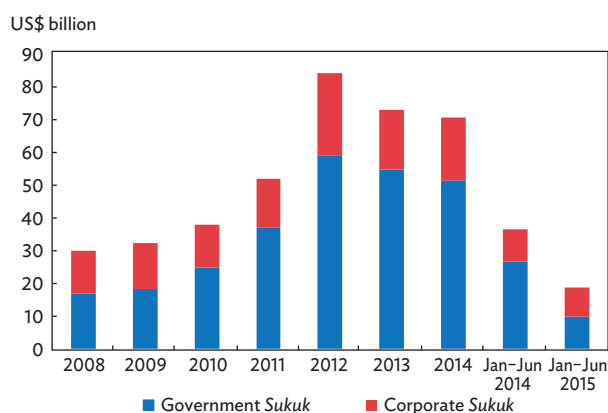
LCY=local currency.

Note: Data as of end-June 2015.

Source: AsianBondsOnline calculations based on Bloomberg LP data.

Since 2013, Malaysia's *sukuk* issuance has been on a downward trend (**Figure 24**). Total *sukuk* issuance dropped from US\$83.8 billion in 2012 to US\$72.8 billion in 2013, and further to US\$70.4 billion in 2014. *Sukuk* issuance fell amid volatility in the market in 2013, primarily on speculation over the Federal Reserve's quantitative easing policy. The drop in oil prices in the latter part of 2014 also broadly affected global *sukuk* markets, which are predominantly based in oil-producing economies.

In the first half of 2015, total *sukuk* issuance in Malaysia plunged to US\$18.5 billion from US\$36.3 billion in the same period in 2014. The drop in *sukuk* issuance was

Figure 24: Sukuk Issuance in Malaysia

Notes:

1. Data include local currency and foreign currency *sukuk*.

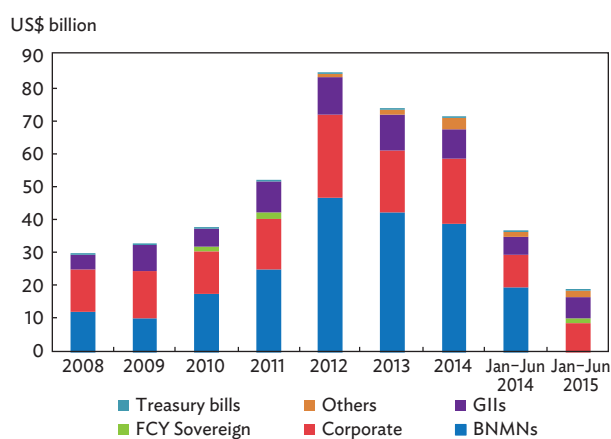
2. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.

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

primarily due to BNM ending its issuance of BNMNs, which on average accounted for almost half of total *sukuk* issuance in Malaysia (**Figure 25**). Not including the issuance of *shari'ah*-compliant BNMNs, total *sukuk* issuance for the first half of 2015 of US\$18.5 billion was on par with the US\$17.0 billion issued in the same period in 2014.

In its endeavor to further promote the development of Islamic finance, particularly the *sukuk* market, various landmark policy and regulatory developments have been announced and implemented in Malaysia. In 2014, the SC announced revisions to the guidelines for the issuance of private debt securities and *sukuk* in Malaysia. Effective 1 January 2015, subject to existing *sukuk* guidelines, unrated *sukuk* may be traded; for rated *sukuk*, the issuer may opt to discontinue the credit rating of the *sukuk*. This is expected to further deepen liquidity in the *sukuk* market.

Also in 2014, the SC launched the Sustainable and Responsible *Sukuk* Framework, adding to the existing investment channels for *sukuk* investors and issuers. Sovereign wealth fund Khazanah Nasional was the first issuer under this framework in June 2015, raising

Figure 25: Sukuk Issuance in Malaysia by Type of Instrument

BNMNs = Bank Negara Monetary Notes, FCY = foreign currency, GIIs = Government Investment Issues.

Notes:

1. Data include local currency and foreign currency *sukuk*.

2. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.

3. "Others" refer to *Sukuk Perumahan Kerajaan*, which are Islamic bonds issued by the governments to refinance funding for housing loans to government employees and to extend new housing loans.

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

MYR100 million worth of 7-year *sukuk* via a special purpose vehicle Ihsan *Sukuk*. The proceeds were used by Yayasan AMIR, a nonprofit organization involved in the Trust Schools Programme, which is a public-private partnership with the Ministry of Education.

On 15 June, the SC implemented the Lodge and Launch Framework for wholesale products, which incorporate the Guidelines on Unlisted Capital Market Products issued on 29 March. This initiative is expected to significantly reduce the time-to-market for wholesale products, including *sukuk*, from the current approval timeframe of 14–21 days. The Lodge and Launch Framework enables wholesale products to be launched once all required information is submitted via the SC's online system.

Indonesia

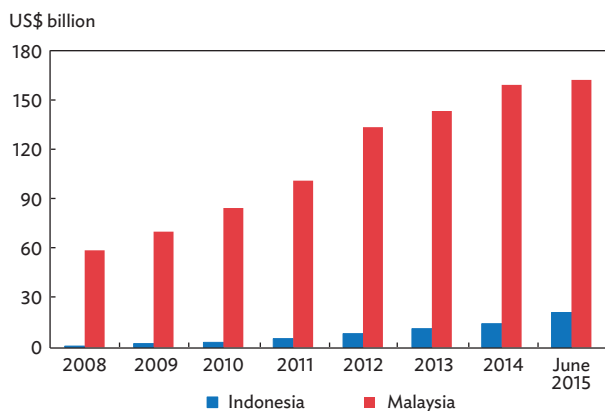
The second largest *sukuk* market in emerging East Asia is that of Indonesia, with an outstanding amount equivalent to US\$20.7 billion at end-June, up from less than US\$1.0 billion in 2008. This translates to a compounded annual growth rate of 61.1% since 2008, compared with the regional average of 19.1% and Malaysia's rate of 16.8%. However, while Indonesia is home to the second largest *sukuk* market in the region, its size is still significantly smaller than that of Malaysia (Figure 26).

The pace of growth of *sukuk* in Indonesia lags behind that of Malaysia despite being home to the largest Muslim population in the world. This may be partly due to the fact that Islamic banking assets in Indonesia remain small, accounting for less than 5% of total banking assets in 2014. The government, however, expects this to improve and aims to expand the market share of Islamic banks to 15% by 2023. In line with this goal, capital market regulator Otoritas Jasa Keuangan launched a 5-year roadmap for the development of Islamic banking in Indonesia earlier this year.

At the end of June, the *sukuk* market in Indonesia accounted for only one-tenth of the total outstanding bond stock. Much of the growth of the *sukuk* market is driven by the government sector, which totaled US\$19.3 billion at end-June, compared with corporate *sukuk* at US\$1.4 billion (Figure 27). This despite the early headway made by the corporate sector in issuing *sukuk* compared with the government. The first corporate *sukuk* issuance in Indonesia dates back to 2002, while the Indonesian government only commenced issuance of *sukuk* in 2008 following the passage of the State *Shari'ah* Securities Bill.

Since its initial *sukuk* issuance in 2008, the government has included *sukuk* issuance as a source of financing for the state budget. The government has issued a diverse

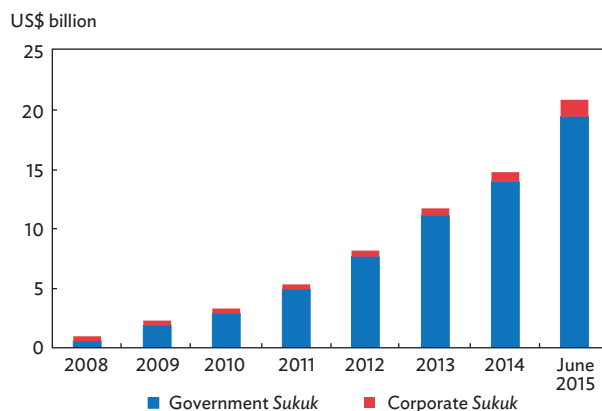
Figure 26: Sukuk Outstanding in Indonesia and Malaysia



Notes:

1. Data includes local currency and foreign currency *sukuk*.
 2. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.
- Sources: Bank Indonesia; Bank Negara Malaysia Fully Automated System for Issuing/Tendering (FAST); Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

Figure 27: Composition of Sukuk Outstanding in Indonesia



Notes:

1. Data includes local currency and foreign currency *sukuk*.
 2. Local currency and foreign currency values were converted based on 30 June 2015 currency exchange rate and do not include currency effects.
- Sources: Bank Indonesia; Directorate General of Budget Financing and Risk Management, Ministry of Finance; and Otoritas Jasa Keuangan.

array of *sukuk* instruments in line with its objective of supporting the depth and breadth of Islamic finance in both domestic and global markets, allowing it to tap a wider investor base in the process. The government issues *sukuk* through its special purpose vehicle, Perusahaan Penerbit SBSN. The various types of central government *sukuk* instruments in the market at end-June are presented in **Table 7**.

Tradable *sukuk* includes both LCY- and FCY-denominated government *sukuk*. LCY-denominated *sukuk* issues consisted of Islamic Treasury bills and bonds, known as SPN-S, and SBSN. The Indonesian government regularly issues these instruments through bi-monthly auctions. Target issue sizes normally range between IDR2.0 trillion and IDR2.5 trillion per auction date. SPN-S are 6-month Islamic Treasury bills carrying a zero-coupon rate, while SBSN are medium- to long-dated Islamic Treasury bonds carrying a fixed-rate coupon.

In terms of maturity, the government has extended the *sukuk* curve beyond 10 years with the issuance of 15-, 20-, 25-, and 30-year bonds. The longest-dated tenor is a 30-year project-based *sukuk* issued as PBS005 in May 2013. In 2015, the government's *sukuk* issuance has been focused on project-based *sukuk* with maturities of 1.5, 5, and 25 years.

Most *sukuk* auctions in the first half of the year were successful. Only three out of 12 auctions fell short of

the government's target amount. Investors were mostly interested in short-duration issues as reflected by the hefty demand for such issues during auctions. In most instances, the government rejects bids for long-dated maturities when investors are bidding up yields.

The government also issues retail *sukuk* once a year through a book-building process. Retail *sukuk* carry a 3-year maturity and are offered only for Indonesian individual investors. Foreigners, however, may participate in the secondary market. Since its first issuance of *sukuk* in 2009, the government has issued seven series of retail *sukuk*, most recently in March 2015 (SR-007) when it raised IDR21,985 billion.

The first few series of retail *sukuk* were structured following the Islamic principle of *ijarah* (sale and lease back), where the underlying assets were state-owned. Retail *sukuk* beginning with series SR-004 followed *ijarah* asset to be leased and utilized infrastructure projects as the underlying asset.

Domestic investors dominate when it comes to holdings of LCY central government *sukuk*. At the end of June, banking institutions were the largest holders of LCY central government *sukuk*, accounting for an aggregate 45.5% share to the total, driven largely by the increased holdings of conventional banks (**Figure 28**). *Sukuk* holdings of conventional banks steadily rose from a 3.7% share in 2009 to a 39.2%

Table 7: Central Government Sukuk Instruments in Indonesia

Type of Instrument	Outstanding Amount		Sukuk Structure	Underlying Asset
	IDR billion	US\$ billion		
Tradable Sukuk				
LCY Government Sukuk				
Islamic Treasury Bills	5,280	0.40	<i>Ijarah</i> Sale and Lease Back	State-Owned Assets
Islamic Fixed Rate	16,587	1.24	<i>Ijarah</i> Sale and Lease Back	State-Owned Assets
Retail Sukuk	69,871	5.24	<i>Ijarah</i> Asset to be Leased	Government Projects
Project-Based Sukuk	64,471	4.83	<i>Ijarah</i> Asset to be Leased	Government Projects
FCY Government Sukuk				
Sukuk Negara Indonesia	-	7.00	<i>Ijarah</i> Sale and Lease Back and <i>Wakalah</i>	State-Owned Assets
Memo Item:				
Nontradable Sukuk				
Hajj Fund Sukuk	33,197	2.49	<i>Ijarah al-Khadamat</i>	Hajj Services

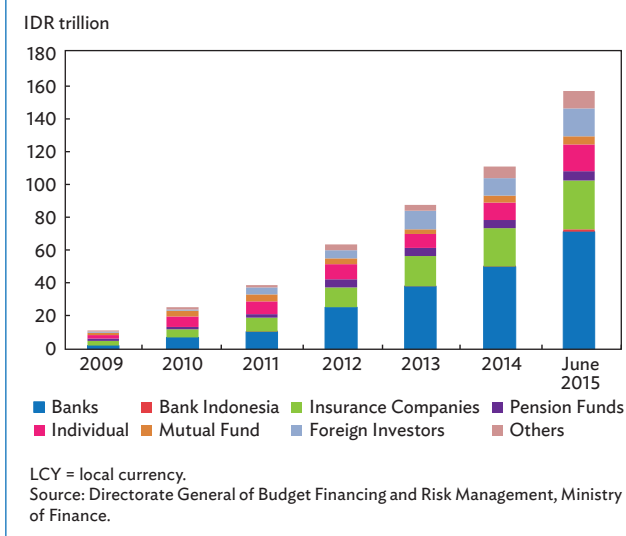
-- = not applicable.

Notes:

1. *Ijarah* 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 service.
4. Data as of end-June 2015.

Sources: Bank Indonesia; Directorate General of Budget Financing and Risk Management, Ministry of Finance; Otoritas Jasa Keuangan; and Bloomberg LP.

Figure 28: Investor Profile for LCY Central Government Sukuk in Indonesia



share at end-June. On the other hand, *shari'ah* banks' share has slipped from 15.4% in 2009 to only 6.3% at end-June.

The second largest investor group comprised insurance companies, who accounted for a 19.0% share of the total LCY central government *sukuk* stock at end-June. Insurance companies' holdings of government *sukuk* have fallen from a 27.6% share of the total in 2009. Both individual investors and foreign investors held about 10% of government *sukuk* at end-June.

The Indonesian government is also an active issuer of *sukuk* in the global market. It first issued global *sukuk*, known as *Sukuk Negara Indonesia*, in 2009. Since then, it has issued six series of global *sukuk*. Prior to 2014, the government's global *sukuk* were structured following the *ijarah* principle described above. In 2014, an important feature of the government's US\$1.5 billion global *sukuk* was its structure, which followed the Islamic principles of *ijarah* and *wakalah* (agency agreement using infrastructure projects procured from the government as the underlying asset).

The 2014 US\$-denominated global *sukuk* of Indonesia was also the government's first issuance of a US\$ global *sukuk* that included a Gulf Cooperation Council-based *shari'ah* board as deal adviser alongside the *shari'ah* boards of the international banks that managed the issuance.

In May 2015, the government issued a 10-year *sukuk* worth US\$2.0 billion, marking the largest-ever *sukuk* sale by Indonesia and the largest single-tranche sale globally. The *sukuk* was issued at par with a rate of return of 4.32%. The 2015 global *sukuk* was issued following the *wakalah* principle with 51% of the issue backed by state-owned assets, including land and buildings, and 49% by project assets under construction or to be constructed. The *sukuk* sale was oversubscribed with the order book exceeding US\$6.8 billion.

At the end of June, the government's nontradable *sukuk* stock stood at IDR33.2 trillion. Forming part of this category were *Sukuk Dana Haji* Indonesia, representing *sukuk* that were sold through private placement and issued following the principle of *ijarah al-khadamat* (bond backed by service), utilizing funds for *Haji*-related services as the underlying asset.

Bank Indonesia accounts for a small share of government *sukuk* via its issuance of *shari'ah*-compliant central bank certificates known as *Sertifikat Bank Indonesia Shari'ah* (SBIS). SBIS are short-term instrument for open market operations used to manage liquidity in the financial system. Currently, 9-month SBIS are being auctioned once a month and are structured following the *jua'lah* principle (arrangement based on service charges). At the end of June, the total SBIS stock reached a size of IDR8.5 trillion, broadly comparable with the size of Indonesia's corporate *sukuk* market. In August, Bank Indonesia began issuance of 12-month SBIS.

Corporate *sukuk* growth in Indonesia remains muted despite the corporate segment's early lead in *sukuk* issuance. The stock of corporate *sukuk* rose from a size of US\$0.4 billion in 2008 to US\$1.4 billion at the end of June. Prior to 2014, all corporate *sukuk* issuances were LCY-denominated. It was only in 2014 when FCY-denominated corporate *sukuk* were first issued by Bumitama Agri in Malaysian ringgit. Garuda Indonesia followed suit in 2015 with a US\$-denominated issue. The national flag carrier was the first corporate issuer to tap the offshore bond market following approval of *shari'ah*-compliant currency hedging tools by the National *Shari'ah* Board in April.

At the end of June, outstanding FCY-denominated corporate *sukuk* had surpassed LCY-denominated

corporate *sukuk*. FCY-denominated corporate *sukuk* comprise only three bond series issued by two corporate firms.

On the other hand, the LCY-corporate *sukuk* market in Indonesia comprises 42 bond series issued by 15 corporate firms. Nearly 60% of the bonds issued were structured following the Islamic principle of *ijarah*. A list of corporate *sukuk* instruments in Indonesia is provided in **Table 8**.

The top corporate *sukuk* issuer in Indonesia was state-owned power firm PLN with *sukuk* outstanding valued at

IDR1,847 billion, which accounted for 21.9% of the total corporate *sukuk* stock at end-June (**Table 9**). (PLN was also the second largest corporate issuer of conventional bonds.) The next largest issuer was Bank Muamalat, with an outstanding *sukuk* stock of IDR1,500 billion, followed by telecommunications firm Indosat with *sukuk* valued at IDR1,078 billion.

All LCY corporate *sukuk* issuers in Indonesia also issue conventional bonds, with the exception of Bank Muamalat Indonesia and Bank BNI Syariah. However, their conventional bond issues were larger than their *sukuk* issues. Most LCY corporate *sukuk* carry maturities of 5–10 years. The longest-dated LCY corporate *sukuk* is that of PLN's *sukuk ijarah* issued in July 2010, which carries a maturity of 12 years.

As part of efforts to boost Islamic finance in Indonesia, capital market regulator Otoritas Jasa Keuangan launched a 5-year roadmap involving various strategies including reduced fees for *shari'ah*-compliant banking products and intensified coordination and monitoring of the Islamic banking industry, among others. The roadmap also called for the consolidation of state-owned and commercial Islamic banks. In addition, Otoritas Jasa

Table 8: LCY Corporate Sukuk Instruments in Indonesia

Sukuk Structure	Outstanding Amount (IDR billion)
<i>Sukuk Ijarah</i>	4,525
<i>Sukuk Mudharabah</i>	2,419
<i>Sukuk Mudharabah Subordinated</i>	1,500

LCY = local currency.

Notes:

- Sukuk Ijarah* are Islamic bonds backed by a lease agreement.
- Sukuk Mudharabah* are Islamic bonds backed by a profit-sharing scheme from a business venture or partnership.
- Data as of end-June 2015.

Source: Indonesia Stock Exchange and Otoritas Jasa Keuangan.

Table 9: LCY Corporate Sukuk Issuers in Indonesia

Issuers	Outstanding Amount LCY Bonds		Type of Industry
	(IDR billion)	(US\$ billion)	
1. PLN	1,847	0.14	Energy
2. Bank Muamalat Indonesia	1,500	0.11	Banking
3. Indosat	1,078	0.08	Telecommunications
4. Adira Dinamika Multi Finance	919	0.07	Finance
5. Summarecon Agung	600	0.04	Property, Real Estate, and Building Construction
6. Bank BNI Syariah	500	0.04	Banking
7. Bank Internasional Indonesia	300	0.02	Banking
8. Berlian Laju Tanker	300	0.02	Transportation
9. Tiga Pilar Sejahtera Food	300	0.02	Consumer Goods
10. Adhi Karya	250	0.02	Property, Real Estate, and Building Construction
11. Mayora Indah	250	0.02	Consumer Goods
12. Aneka Gas Industri	200	0.01	Basic Industry and Chemicals
13. Sumberdaya Sewatama	200	0.01	Energy
14. Bank Sulselbar	100	0.01	Banking
15. Bank Nagari	100	0.01	Banking

LCY = local currency.

Note: Data as of end-June 2015.

Sources: Indonesia Stock Exchange and Otoritas Jasa Keuangan.

Keuangan announced plans to ease ceilings on foreign ownership of Islamic banks.

To further boost liquidity in the *shari'ah* financial market, a mini Master Repo Agreement (MRA) was signed between Bank Indonesia and 18 *shari'ah* banks and business units in July. The mini MRA will serve as a standard contract for *shari'ah*-compliant repurchase transactions, using government *sukuk* as collateral. The mini MRA is expected to boost interbank transactions in the *shari'ah* financial market.

Hong Kong, China

Hong Kong, China's *sukuk* market is the third largest in the region, with outstanding stock amounting to US\$2.2 billion at end-June. Growth has largely been driven by the government sector, which issued US\$1.0 billion each of global *sukuk* in September 2014 and June 2015. The only other *sukuk* issuances from Hong Kong, China are those of holding firm Noble Group, with three issuances of MYR-denominated *sukuk*.

Paving the way for *sukuk* issuance by the government was the passage of an amendment to the tax and duty legislation of Hong Kong, China in July 2013. The regulation allowed for equal taxation treatment for the issuance of *sukuk* and conventional bonds. The passage of this law marked an important milestone for the development of Islamic finance in Hong Kong, China.

Singapore

Singapore is home to the fourth largest *sukuk* market in the region with outstanding *sukuk* worth US\$1.7 billion at end-June. Its *sukuk* market comprises corporate issues only, both LCY- and FCY-denominated. About 70% of its *sukuk* stock are FCY-denominated, all in Malaysian ringgit, while the remaining 30% are denominated in Singapore dollars.

Sukuk growth remains undeveloped with issuance limited to only a few corporate names. At the end of June, there were only two issuers of FCY-denominated *sukuk* and five issuers of LCY-denominated *sukuk*. Hindering growth is the absence of appropriate regulatory measures and tax treatment guidelines for *shari'ah*-compliant financing structures, which are still being worked on by regulators and the Islamic finance industry.

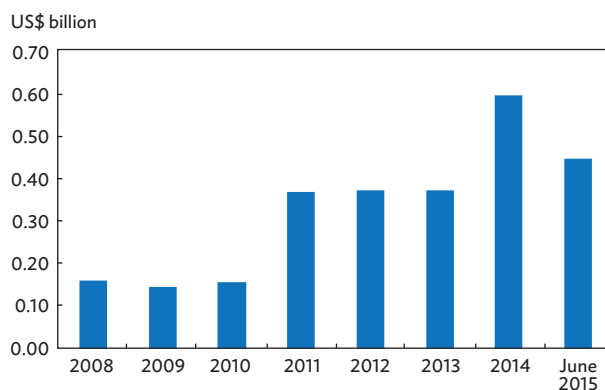
Brunei Darussalam

Brunei Darussalam's *sukuk* market is the smallest in the region with a total stock of US\$0.5 billion at end-June (**Figure 29**). The market solely comprises regular issuances of short-term government *Sukuk al-Ijarah* managed and administered by Autoriti Monetari Brunei Darussalam. The *Sukuk al-Ijarah* program was intended to pioneer the development of Brunei Darussalam's domestic capital market. Over the years, the program has served as a liquidity tool in regulating the banking industry and been used to establish a benchmark yield curve to further assist in the development of the domestic bond market.

The first government *sukuk* in Brunei Darussalam was issued in April 2006. By the end of June, Autoriti Monetari Brunei Darussalam had issued 119 series of *sukuk* totaling US\$6.5 billion and with maturities of 91, 182, 273, and 364 days (**Figure 30**). Brunei Darussalam's corporate *sukuk* market has yet to be developed as only one firm has ever issued corporate *sukuk*. Brunei LNG issued BND100 million worth of *sukuk* in 2006, but the bond matured in 2007.

In line with Autoriti Monetari Brunei Darussalam's efforts to further develop the domestic capital market, including the *sukuk* market, the Securities Market Order was enacted in June 2013 and its implementing guidelines were issued in February 2015. This regulation included new provisions to facilitate public offerings of *sukuk* and

Figure 29: LCY Sukuk Outstanding in Brunei Darussalam

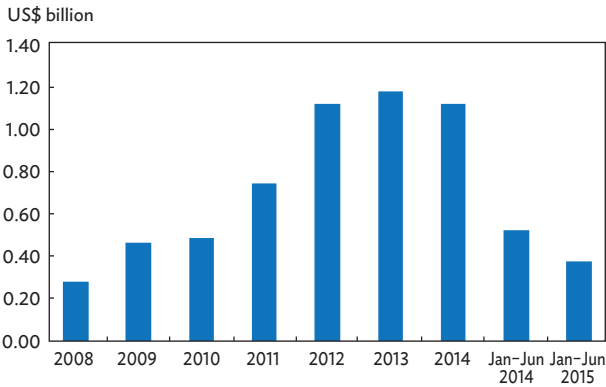


LCY = local currency.

Note: LCY values were converted based on 30 June 2015 currency exchange rates and do not include currency effects.

Source: Autoriti Monetari Brunei Darussalam.

Figure 30: LCY Sukuk Issuance in Brunei Darussalam



LCY = local currency.
 Note: LCY values were converted based on 30 June 2015 currency exchange rates and do not include currency effects.
 Source: Autoriti Monetari Brunei Darussalam.

other *shari'ah*-compliant securities. The legislation is expected to be implemented over the next few years.

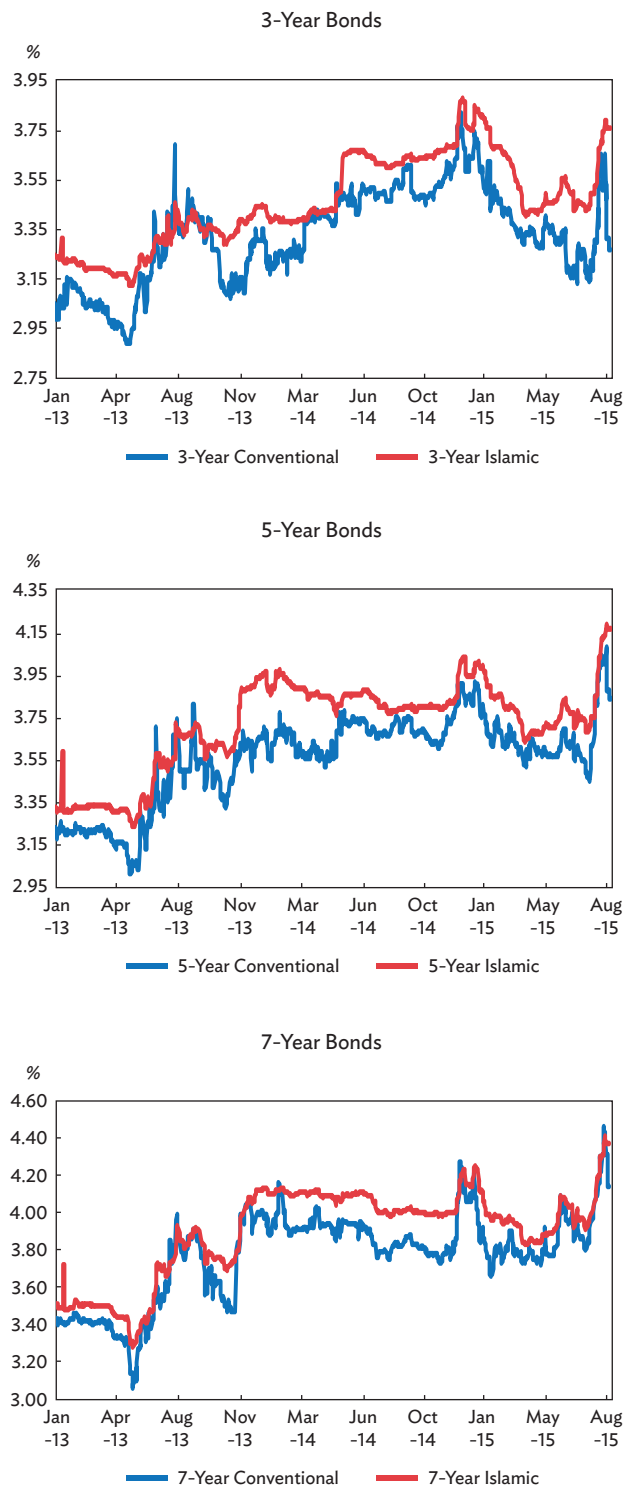
The Government of Brunei Darussalam announced in 2015 that it is looking into issuing longer-dated *sukuk* to extend the maturity of its issuances. This initiative is not just to create a benchmark yield for longer-dated securities, but also to serve as a new funding source for the government as it aims to reduce its reliance on oil and gas revenues. In addition, the government also has plans to broaden the investor base for sovereign *sukuk* as only a handful of domestic commercial banks are currently participating in the issuance of the short-term Sukuk *Al-Ijarah*.

Sukuk Yield Comparisons

As mentioned above, Malaysia has the largest *sukuk* market in the region, and its market is more liquid than Indonesia's. However, *sukuk* still tend to trade at a premium relative to conventional government issues. This is manifested in a liquidity premium, which widens during times of market stress, despite the fact that *sukuk* instruments are collateralized. This suggests that investors are still concerned with the ease of trading *sukuk*.

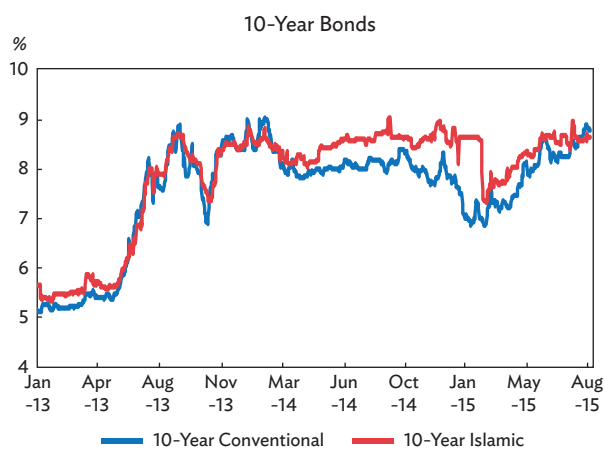
In 2014, yields rose and the spreads between the LCY Malaysian *sukuk* profit rates and those of conventional government bonds widened in anticipation of the impacts on the Malaysian economy of the end of US quantitative easing and low global oil prices (Figure 31).

Figure 31: LCY Malaysian Sukuk Profit Rates vs. Conventional Government Bond Yields



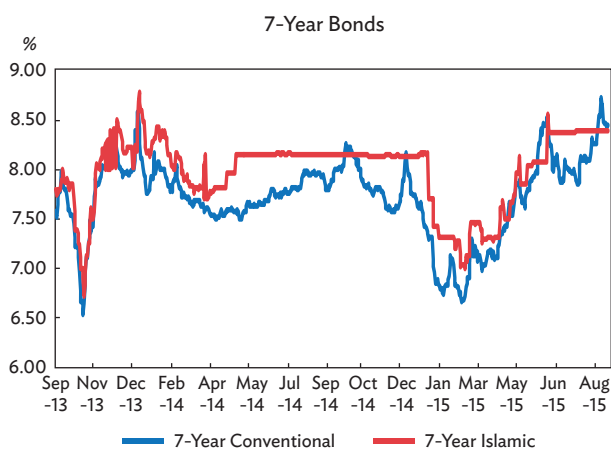
LCY = local currency.
 Note: Data as of 31 August 2015.
 Source: Based on data from Bloomberg LP.

Figure 32: LCY Indonesian Sukuk Profit Rate vs. Conventional Government Bond Yield



LCY = local currency.
 Note: Data as of 31 August 2015.
 Source: Based on data from Bloomberg LP.

Figure 33: LCY Indonesian Sukuk Profit Rate vs. Conventional Government Bond Yield



LCY = local currency.
 Note: Data as of 31 August 2015.
 Source: Based on data from Bloomberg LP.

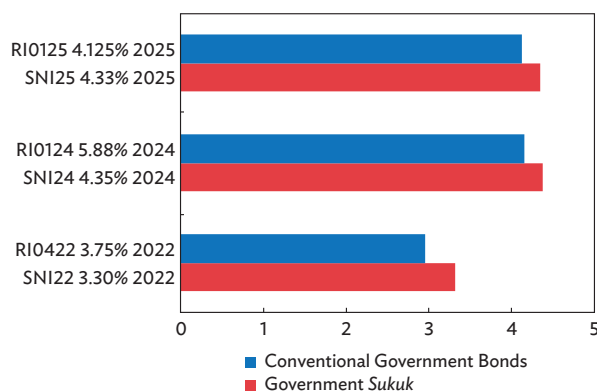
In 2015, spreads narrowed with the addition of Malaysian *sukuk* to Barclay’s *Sukuk* Index before widening in August due to continued concerns regarding low oil prices and the depreciation of the Malaysian ringgit.

In Indonesia, there has been a narrowing of spreads in 2015 for bonds with an original maturity of 10 years (Figure 32), but a widening for bonds with an original maturity of 7 years (Figure 33). The divergence could mean that the LCY *sukuk* market in Indonesia is becoming much less liquid. However, Indonesia’s *sukuk* yields also showed some widening in 2014.

In contrast, the US\$-denominated *sukuk* market of Indonesia is more liquid compared with its LCY counterpart as evidenced by the more consistent pricing of US\$ bonds (Figure 34). In addition, the spread between US\$-denominated *sukuk* and conventional bonds has narrowed over time, indicating that the US\$ *sukuk* market in Indonesia is becoming more developed.

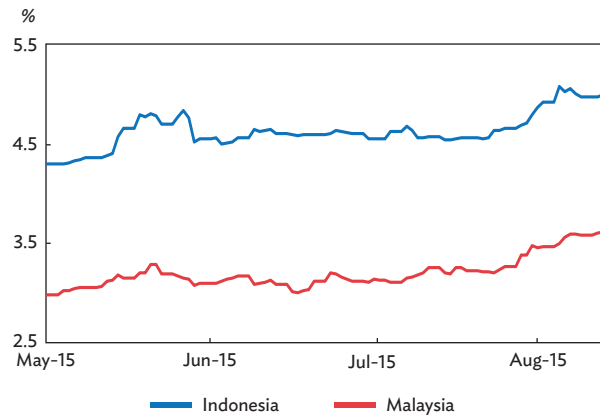
In terms of risk profile, the US\$-denominated markets *sukuk* of Malaysia and Indonesia are highly correlated. The yield comparison of two recently issued Malaysian and Indonesian *sukuk* shows that their yield movements were broadly similar (Figure 35).

Figure 34: Conventional vs. Sukuk 10-Year US\$-Denominated Sovereign Bond Yields in Indonesia



Notes:
 1. Conventional government bond yields refer to yield to maturity at the time the comparable *sukuk* was issued.
 2. For government *sukuk*, coupon rates were used.
 Sources: Directorate General of Budget Financing and Risk Management, Ministry of Finance; and Bloomberg LP.

Figure 35: 10-Year Yields of Global Sovereign Sukuk in Indonesia and Malaysia



Notes:

1. Data as of 31 August 2015.
2. For Indonesia, 10-year global sovereign sukuk was issued in May 2015 and carries a 4.325% rate of return.
3. For Malaysia, 10-year global sovereign sukuk was issued in April 2015 and carries a 3.043% rate of return.

Source: Based on data from Bloomberg LP.