CHAPTER 5

Developments in Islamic Capital Markets

5.1 Introduction

The growth of Islamic capital markets is a direct effect of the growth of the Islamic banking industry. The need for liquidity management for Islamic banks and takaful operators drove a number of countries such as Malaysia, Kuwait and Bahrain to introduce sukuk to facilitate management of assets by Islamic financial institutions. Growth is also attributed to growing awareness of, and demand for, investing in accordance with Shari'a principles. In more recent times, growth is attributed to the globally low interest rates, the weakening US Dollar over the past 25 years, and the sub-prime mortgage crisis in the west prompting investors to seek alternative investments.

The importance of the Islamic capital markets within the conventional financial markets is becoming increasingly clear as evidenced by the move of regulators to establish standards and guidelines. In recent years, international Islamic bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have formulated standards for the Islamic financial services industry. The Islamic capital markets star product is undeniably the sukuk. Most studies show that sukuk remains a major instrument within the suite of Islamic capital market products.

However, even with the impressive growth of the Islamic capital market, questions are being asked as to the inclusivity of the market. Are the products on offer simply to satisfy well-moneyed customers? If this is the case, then is the industry following the original intents and purposes of the Islamic finance? This chapter looks into these issues. After assessing the state of the Islamic capital markets, attention will be given to the development of retail sukuk in Malaysia. This Special Focus section provides the potential of developing an Islamic capital market product that can benefit a wider section of the population. Following this, a proposal for an innovative instrument, esham, which was used by the Ottoman government for well over a century to fund their current accounts, is made. This innovation can increase investment participation. While the industry is progressing, more needs to be done to spread the benefits, and ensure stable and inclusive economic growth.

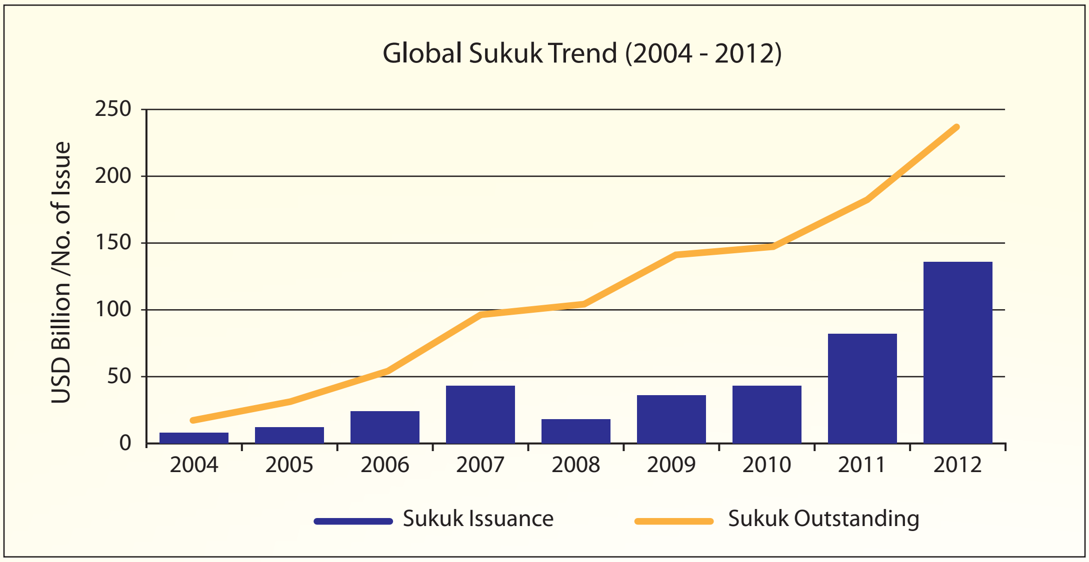
5.2 The sukuk market

Following Mufti Taqi Usmani's criticism of sukuk in 2007 in which he opined that approximately 85% of sukuk are non-compliant, there resulted a significant drop of 50% in the primary sukuk market. After a series of developments and enhancements following his remarks, sukuk has become even more popular for both corporate and sovereign entities to raise funds and to tap into the world's wider investor base. This has certainly opened doors to the international markets, especially for the GCC where most HNWIs in this region are faith-based investors.

The development, in terms of structure and mechanism, has diversified issuer choice in raising funds based on the needs and nature of their businesses. From 1990 to 2012, there have been many exciting innovations made to the underlying sukuk structure. In 2004, Dawama was the first to issue a hybrid sukuk merging murabaha and ijara as the underlying contracts. This paved the way for the first international hybrid sukuk issued by Durrat Al Bahrain in 2005, which combined ijara and istisna.

In quantifying the industry, Kuwait Finance House Research (KFHR) reports that whilst the Islamic finance industry grew at an average rate of 15% - 20% per annum over the past decade to reach approximately USD1.3 trillion in terms of assets, the sukuk industry grew at a compound annual growth rate (CAGR) of 67% to reach above USD230.0 billion outstanding sukuk papers as of 2012, and contributes approximately 14.3% of the global Islamic finance assets. In 2012, there was a total of USD131.2 billion worth of sukuk recorded in the primary market, representing 54% year-over-year growth. This surpasses and dwarfs that of the previous year and represents three times the size of the primary sukuk market pre-global financial crisis. (Figure 1)

Figure 1: Global sukuk trend

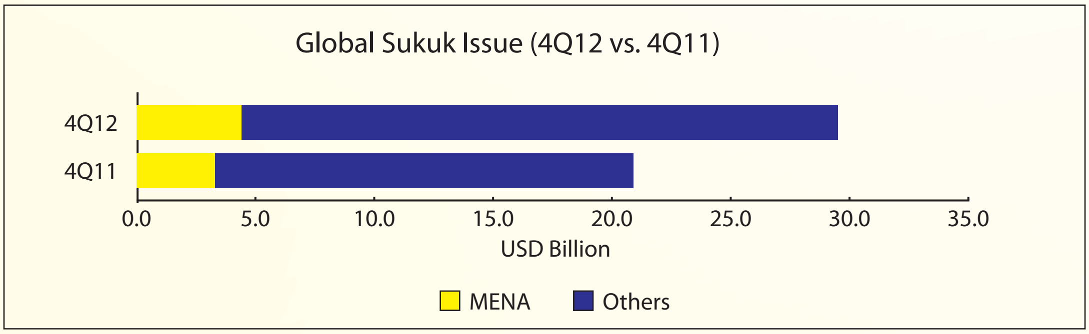


Source: HLISB, KFHR

The MENA region accounted for 15% of global sukuk issues in the fourth quarter 2012, up from 2011 but below the previous quarter levels (Figure 2). In numbers, the MENA region was, in 2012, the domicile for approximately USD24.5 billion worth of sukuk issues (2011: USD19.8 billion). In 4Q12, sukuk worth about USD4.4 billion were issued throughout MENA as compared to the same quarter in 2011 of USD3.3 billion.

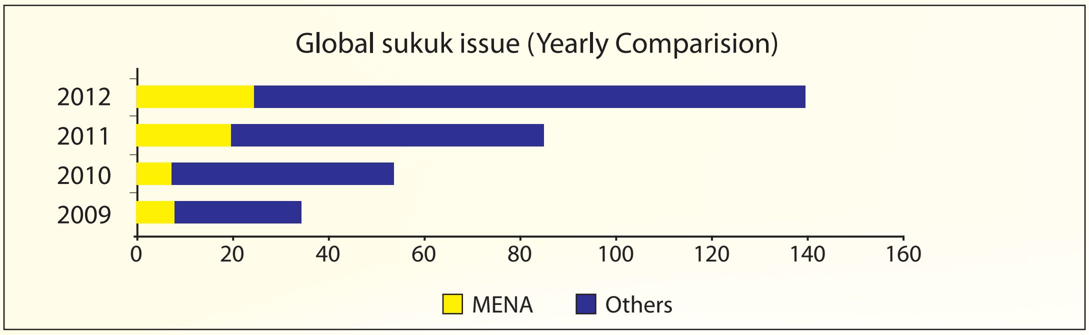
2012, sovereign entity issuances reached USD80 billion, representing 36% increase year-over-year (2011: USD59 billion). Although sovereign papers cover more than 50% of total issuance, they were overshadowed by significant growth in both corporate and government-linked entities which grew by about 92% and 103% to USD37 billion and USD15 billion respectively.

Figure 2: Global sukuk issue (quarterly comparison)



Source: Zawya

Figure 3: Global sukuk issue (yearly comparison)



Source: Zawya

In terms of issuer type, despite the record amount of corporate sukuk placed during the year, sovereign linked entities continue to dominate the market. In

New jurisdictions with debut sukuk issuances in 2012 include Kazakhstan and France. The Development Bank of Kazakhstan initiated the first debut sukuk through its

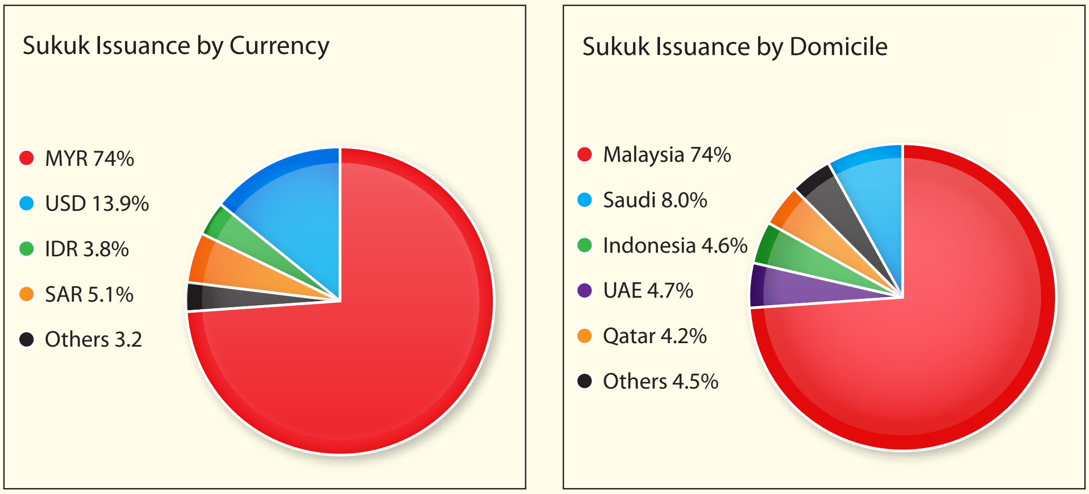
5-year USD76.7 million sukuk murabaha having been issued in Malaysian ringgit. It marked the first paper from the CIS region which could act as a benchmark for subsequent issuances within that country and area. The French sukuk mudaraba was issued by Bibars SAS in Euro-denomination and was worth up to USD700,000 in October 2012.

The future of the industry remains promising. According to estimates by Ernst & Young's Global Islamic Banking Center of Excellence, the global demand for sukuk is forecasted to grow three-fold from USD300 billion to USD900 billion by 2017.

5.4 Developments in the Islamic capital markets

To uphold the integrity of the market and meet the demand of an increasingly sophisticated investor class, there is a need to strengthen the policy and market practices of Islamic capital markets. Development would need to balance the needs of both parties, where, in sukuk cases, issuers are seeking more options and flexibility to raise funds whereas investors are demanding more protection on their investments.

Figure 4: Sukuk Issuance by Currency and Domicile



Source: KFHR

5.3 Other products

Other than sukuk, the Islamic capital markets include Islamic equity, Islamic funds, Islamic real estate investment trusts (REIT), and Islamic exchange-traded funds (ETF). Developments are relatively modest in comparison to sukuk. Focusing on Malaysia, Table 1 provides a useful microcosm of the overall Islamic capital markets. We see that the number of Shari'a compliant securities that have been issued in 2011 and 2012 is significantly more than the amount of unit trust funds, ETFs and REITs in the markets.

5.4.1 Basel III-compliant sukuk

Globally, the market is moving towards issuing Basel III-compliant sukuk which is seen as an exciting opportunity for banks to raise capital. Studies have shown that dealers find the new decree as an occasion for Asian banks to sell their own capital compliant sukuk to attract more diverse investors. Already, Abu Dhabi Islamic Bank's (ADIB) Basel III and Shari'a-compliant perpetual sukuk worth USD1 billion has been issued (November 2012) and achieved a relatively low yield due to the uniqueness of the deal. Malaysian banks are likely to follow given their familiarity and expertise, strong funding base, and good credit ratings.

Table 1: Islamic capital markets in Malaysia

Shari'a-compliant Securities	June 2012	June 2011
No. of securities	825	847
% of total listed securities	89%	89%
Market capitalisation:		
▪ Shari'a-compliant (RM billion)	864	836
▪ Total market (RM billion)	1,368	1,342
% of Islamic securities to local market	63%	62%

Islamic Unit Trust Funds	June 2012	June 2011
No. of launched funds	166	157
Total industry	597	584
Net Asset Value (NAV) (RM billion)		
▪ Islamic UTF	31	26
▪ Total industry	278	250
% to total industry	11%	10%

Equity Market Indices	29 June 2012	30 June 2011
KL Composite Index (KLCI)	1,599.15	1,579.07
FBM Emas Shari'a	11,003.17	10,517.49
FBM Hijrah Shari'a	11,853.05	10,995.91
DJIM Malaysia Titans 25	936.71	891.88

Islamic Exchange-traded Funds	June 2012	June 2011
Islamic ETF	1	1
Total industry	5	5
Net Asset Value (NAV) (RM billion)		
▪ Islamic ETF	0.3	0.6
▪ Total industry	0.93	1.19
% to total industry	32%	50%

Islamic Real Estate Investment Trust	June 2012	June 2011
Islamic REIT	3	3
Total industry	15	14
Market capitalization (RM billion)		
▪ Islamic REIT	3.3	2.5
▪ Total industry	17.9	11.5
% to total industry	18%	22%

Source: Securities Commission (Malaysia)

5.4.2 Covered sukuk

A new type of sukuk, covered sukuk, is expected to offer investors greater security through a structure similar to conventional covered bonds. During the global financial crisis, by providing recourse to a pool of assets when the originator becomes insolvent, covered bonds found a new lease of life in Europe and the United States as investors sought a more liquid and safer haven to invest in.

The structure could be applied to Islamic capital markets in diversifying the product offering if tax and pricing issues could be resolved to the satisfaction of investors. The structure was used for the first time by London-based Gatehouse Bank via private placement in December 2012. The 5-year sukuk ijara issue, worth USD10.4 million, was backed by a property in Basingstoke which the bank acquired in 2011.

The covered sukuk operates in the following way: a purchase undertaking by the bank that gives primary security to sukukholders, while in the case of default they have secondary security on the property acquired. This replicates the structure of covered bonds, where investors are entitled to claim not only issuer assets but also the assets backing the structure, giving them two layers of security.

5.4.3 Retail sukuk

A recent development in the Islamic capital markets is the introduction of retail sukuk. The product has been offered in London, Indonesia, South Africa and few other

countries. Retail sukuk provide a promising avenue as it renders a stable income and is less volatile, but carries the same risks due to the product's very nature.
In Indonesia, investors are given direct access to a larger pool of capital by providing a platform to retail investors. Most retail sukuk were issued by the finance ministry of Indonesia. Indonesia started to issue retail sukuk in 2009 - Standard Chartered in its research noted that 57% out of Rp1.7 trillion were subscribed by the retail investors. Recently, the ministry announced that there will be another issue to be launched in early 2013 with indicative proceeds target of up to Rp15 trillion. Offering 6% profit per annum, the ministry has appointed 25 selling agents, consisting of 16 banks and 9 securities firms. Research shows that the proceeds raised from such issuance will be utilised to support the state budget.

On 1 February 2010, the London Stock Exchange launched an order book for retail bonds. Though the trading service offers access primarily to conventional bonds, it does not restrict the offering of retail-based and traded on the on-screen secondary market. The exchange claimed, other than transparency and well regulated framework, the platform is the first of its kind allowing private investors to trade fixed income securities as easily as they would trade shares.

Malaysia has taken a further step forward by offering the same to retail investors. Prior to implementation, Malaysia only opened the sukuk and bonds market to institutional and corporate clients with substantial investment for initial participation. The limited access to sukuk was indirect and only available through unit trust and exchange-traded funds. The framework for retail sukuk and bonds in Malaysia was developed pursuant to the SC's Capital Market Masterplan 2 to facilitate greater retail participation in the bonds and sukuk market. Under this framework, potential issuers are able to issue retail sukuk or bonds either on the Malaysian exchange (Bursa Malaysia) via its newly developed platform, Exchange-traded Bonds and Sukuk (ETBS) – where the sukuk is available for trading on the exchange or over-the-counter via appointed banks. This would assist issuers in tapping into a larger pool of capital as well as gaining better pricing on their issuances. A recent example is Malaysia's notable sukuk issuance by DanaInfra Nasional Berhad's RM8 billion Islamic medium term notes programme (Figure 4). More information can be found later in the Special Focus section below.

5.4.4 Framework on agro-sukuk

Agro-sukuk is rather a new-fangled avenue for investors. Specifically, this type of sukuk is offered as an option to potential issuers with core businesses engaging in the agricultural-related sector. This indeed will stimulate further development in the Islamic capital and equity markets.

In Malaysia's 2013 Budget, the Prime Minister announced the country's intention to introduce an agro-sukuk framework to the market in the near future. The country's regulator, the Securities Commission (SC), will provide such a framework in order to raise capital to finance agricultural companies and agro-related industries. As encouragement, the Malaysian government proposes that the expenses for the issuance of agro-sukuk be given a double tax deduction for a period of four years effective from 2012.

5.4.5 The possibility of CSR sukuk

A corporate social responsibility sukuk (CSR sukuk), where proceeds are raised to create the funding for priority social sector initiatives and decent causes, is seen as a new opportunity for investors who are in search for a different asset class of sukuk. The CSR sukuk was suggested by Iqbal Khan, the 2012 recipient of the prestigious Royal Award for Islamic Finance.
It can be issued by any endowment, institution or government who has long-term commitment budgeted for CSR activities for the next five to ten years. Due to its budgeted annual commitment, the sukuk will be repaid accordingly and therefore will initiate a good credit rating.

One of the first CSR bond was introduced by the World Bank in 2008. In its efforts to cater to climate change, the development bank issued a bond where the proceeds were directly invested in climate change-related projects. As for a CSR sukuk, there is a long way to go as costs and benefits require evaluation.

5.5 Other developments

Islamic finance, in general, has gained popularity due to its competitiveness. Jurisdictions are keen to establish their own Islamic financial activities via the introduction of Islamic capital market instruments where sukuk will be the most prominent instrument to start with. Many

Figure 4: Summary of DanaInfra's Retail Sukuk Portion

Issuer	:	DanaInfra Nasional Berhad
Guarantor	:	Government of Malaysia
Offer Size	:	RM300 million
Use of proceeds	:	To finance the capital expenditure and operating expenses in relation to the development of the MRT project.
Profit Rate	:	4.00% per annum (semi-annual profit payment)
Minimum amount	:	Minimum subscription of 10 units or RM1,000.00
Maximum amount	:	No limit

Source: DanaInfra Nasional Berhad

countries are exploring opportunities in Islamic finance, and the organisation of forums and seminars throughout the world suggests there is a lot of interest.

5.5.1 ASEAN

ASEAN regulators in January 2013 discussed the possibilities of regional cooperation in the Islamic capital market as part of the ASEAN Capital Market Forum's effort to better integrate the regions' capital market activities. This is expected to boost cross-regional transactions and activities in the Islamic capital market so as to enhance the ASEAN's competitiveness and to achieve greater economies of scale utilising numerous resources across the ASEAN region.

5.5.2 Japan

The Japanese Securitisation Law has been amended to facilitate the issuance of the J-Sukuk. The tax law allows both local and foreign investors to be exempted from tax when it comes to issuing sukuk. Though the market in Japan is new, it is believed that the J-Sukuk may soon become popular for Japanese entities. Although no local entities have made its mark in the J-Sukuk market, Nomura bank has issued one sukuk overseas, proving that local players are taking part in Islamic finance even if the J-Sukuk market itself has proven slow to take-off. On the positive side, amending the tax law has levelled the sukuk playing field with conventional bonds in Japanese capital market.

5.5.3 Maldives

The Maldives Capital Market Development Authority (CDMA) has signed a memorandum of understanding with the Ministry of Islamic Affairs to develop Islamic capital markets activities within the country. In order to promote Islamic financial services within the jurisdiction under one organisation, the country proposes to establish the Maldives Centre for Islamic Capital Market and Finance. In addition, the government has issued MVR150 million (USD9.75 million) sukuk wakala bi al-istithmar papers to facilitate the Shari'a-compliant liquidity management for the country's only Islamic bank, Maldives Islamic Bank. Proceeds raised from the issuance will be used for oil trading activities of Fuel Supplies Maldives, a subsidiary of the government-owned State Trading Organisation. The issuance was divided into three tranches with maturity of 6 months per tranche.

5.6 Challenges ahead

Lack of liquidity in the secondary market has been a concern since the inception of the Islamic capital markets. The behaviour of investors, known for their predilection for buy-to-hold papers to maturity, and the lack of investor diversity are perhaps some of the main reasons for the current deadlock in the secondary market. Notwithstanding the efforts from the central banks, such as the Central Bank of Bahrain and Bank Negara Malaysia, to stimulate the growth of this market through the issuance of short term papers and the establishment of Islamic International Liquidity Management (IILM), the market has yet to truly yield the results of these efforts.
The lack of product supply, especially sukuk papers, and with issuances from highly-rated issuers and sovereigns remaining sparse, sukukholders are holding onto securities until maturity. Investors are then unable to purchase enough papers. These supply and demand imbalances have inhibited trading on the secondary market for fear of not finding other papers of similar credentials and good rating to invest in. Sime Darby's recent USD1.5 billion sukuk issue can be seen as a result of a lack of quality papers in the market as it was oversubscribed by 10 times

Conversely, based on the issuance momentum seen at end of 2012, the global sukuk market is expected to illustrate strong but moderated growth between 20% - 30%, underpinned mainly by weaker than expected global economic growth. The weaker forecast will absolutely shift the appetite of investors, regardless of whether they are corporates or HNWIs, to fixed income based instruments which would render safer investment returns. Sovereign issuances are expected to dominate the market in 2013, similar to 2012. The sukuk market in 2013 will be spurred further by the new jurisdictions that have shown interest in applying Islamic finance and using sukuk. Egypt, Libya, Tunisia, Senegal, and Nigeria are expected to make the necessary regulatory amendments for future issuances.

Last but not least, Malaysia, given the recent growth forecast of above 6% for 2013, has produced a good breadth to the country's investment prospects. More investments are expected to flow into the country and this will increase numbers of projects that could indirectly boost the Islamic capital markets through its diverse fund-raising tools, particularly sukuk. Given its current position as the home of the world's largest sukuk market with various incentives offered, Malaysia will continue to be an Islamic finance hub in years to come.

INCLUSIVITY IN THE CAPITAL MARKETS: Development of Retail Sukuk in Malaysia

Introduction

If Islamic finance is to make a real difference to the global economy, one aspect that it should concern itself is the welfare of the masses. The industry needs to provide financial solutions not just in terms of banking and asset management for HNWIs, but it has to contribute toward the wealth and welfare of ordinary people as well as to bring the "unbankable" or marginalised sector of the society into the mainstream, thus promoting an agenda of financial inclusion.

The discourse on maqasid al-Shari'a or the objectives of Shari'a has often pointed to the apparent weaknesses of the current Islamic finance industry in that it tends to serve the wealthy or those who are already in the mainstream financial sector. Countries like Malaysia, which started its Islamic finance industry in the early 1980s in retail Islamic banking, has managed to create public awareness on the prohibition of riba as well as increase the visibility of Islamic banking on the financial and geographic landscape. Due to the industry's emphasis on Islamic banking at the retail level, Malaysia's Islamic finance industry is probably making greater inroads toward financial inclusion as compared to other countries in Europe and the Gulf where the Islamic finance industry tends to slant towards the capital market and asset management rather than retail banking.

Nevertheless, developments in the capital market are still largely concerned with large institutions and corporations. Malaysia may have the most comprehensive Islamic finance industry in the world, but there are still limited Shari'a compliant investment products in the market at the retail level.

However, glimmers of change are occurring. Retail investors already have access to the bond and sukuk markets via bond and sukuk funds. Moreover, in 2009, Bank Negara Malaysia issued a Bon Simpanan Merdeka, a bond based on Shari'a principles made available to Malaysian citizens who are 56 years and above. The Exchange Traded Bonds and Sukuk (ETBS) forms another financial product that promotes greater financial inclusion by providing an additional asset class for portfolio diversification and increasing direct access to both markets for retail investors.

A more significant development occurred on September 7, 2012, when the SC launched a framework for retail bonds and sukuk. The development of the framework by the SC was seen to provide retail investors direct access to the bonds and sukuk market. The framework was developed pursuant to the SC capital market master Plan 2 to facilitate greater retail participation in the bonds and sukuk market. During the Budget 2013 on 28 September 2012, the Malaysian Prime Minister announced the first ever retail sukuk to be worth RM300 million. This was to be part of the larger RM1.5 billion issue that was to be sold by DanaInfra Nasional Berhad, of which RM 1.2 billion is for institutional investors. The issuance, part of the RM8 billion Islamic commercial papers/Islamic medium-term notes (ICP/IMTN) programme signed in early July, 2012, would see one fifth of it — or RM300 million — being floated as retail sukuk. Before exploring this instrument further, the next section will look at the purported objectives of Islamic finance.

Maqasid and financial inclusion

According to Imam Al-Ghazāli (d.1111) "The objective of the Shari'a is to promote the well-being of all mankind, which lies in safeguarding their faith (dīn), their human self (nafs), their intellect ('aql), their posterity (nasl) and their wealth (māl). Whatever ensures the safeguard of these five serves public interest and is desirable."[1]

Ibn Ashur (1941) proclaims that "the all-purpose principle of Islamic legislation is to preserve the social order of the community and ensure its healthy progress by promoting the well being and righteousness of human beings.[2] Generally, Shari'a is predicated on benefits of the individual and that of the community, and its laws are designed so as to protect these benefits, and facilitate improvement and perfection of conditions on earth. The uppermost objectives of Shari'a rest within the concept of compassion and guidance, that seeks to establish justice, eliminate prejudice and alleviate hardship. It promotes cooperation and mutual support within the family and society at large. This is manifested in the realisation of maslaha (public interest) which Islamic scholars have generally considered to be the all-pervasive value and objective of the Shari'a, and is synonymous with compassion. Maslaha sometimes connotes the same meaning as maqasid, and scholars have used the two terms almost interchangeably.[3] Fundamentally, what Muslim jurists mean by maslaha is the seeking of benefit and the repelling of harm as directed by the Lawgiver or Shari'a.

In the case of the sukuk market, developments, thus far, have not fully been for the public interest since most people – essentially those who have little to no

[1] Chapra, U (2000) "The Future of Economics: An Islamic Perspective." (Leicester, UK: The Islamic Foundation).

[2] Muhamamd Al-Tahir Ibn Ashur "Treatise on Maqasid al Shari'a." trans and annotated by Muhamamd El Tahir ElMisawi (London and Washington: International Institute of Islamic Thoughts, 2006.)

[3] Kader, A. (2003) "Modernity, the principles of public welfare (maslaha) and the end goals of Sharia (Maqasid) in Muslim legal thought." Islam and Christian Muslim Relations, 14, no. 2.

relationship with the financial markets - do not have access to sukuk. Although it could be argued that the rise of sovereign sukuk used to raise funds to finance big infrastructure or other projects can benefit the wider population, the lack of access to sukuk as an asset class for retail investors means that the masses are prevented from making up the investor base and hence do not benefit from the returns of such productive ventures. Limited access to the capital market means that the public do not enjoy greater returns from investing in the capital market and likewise the issuers do not benefit from reduced risk and greater stability of having a wider investor base. The circulation of wealth, and means of wealth creation, that are limited to the wealthy elites is frowned upon in Islam: the Qur'an emphasises wealth distribution "so that the wealth does not circulate only among your rich folk" (Al-Hashar 59:7).

Having an agenda of financial inclusion is consistent with achieving the maqasid al Shari'a of ensuring maslaha, that of repelling harm and providing benefits, for the public. Financial inclusion is a concept that has gained importance since the early 2000s. It has now become a common objective for many governments and central banks in developing nations. The concept initially refers to the delivery of financial services to low income segments of society at affordable costs. During the past decade, the concept of financial inclusion has evolved into four dimensions: easy access to finance for all households and enterprises, sound institutions guided by prudential regulation and supervision, financial and institutional sustainability of financial institutions, and competition between service providers to bring alternatives to customers.

Financial inclusion is a necessary tool for sustaining equitable income distribution in society. It provides an avenue for bringing the savings of the poor into the formal financial intermediation system and channels them into productive investment. For many years, both the conventional and the Islamic system, debt financing dominated the market, and while the public do have access to the capital market, available products remain limited. A large amount of public saving is still in the form of low returns savings or current accounts. Lack of awareness and the reluctance to share higher risks have prevented retail customers from venturing into the higher returns equity market, thus not receiving the oft-repeated profit-loss sharing benefits of the Islamic financial system. In the case of sukuk, the absence of infrastructure and provisions to allow public participation has also prevented such involvement of retail consumers.[4]

The Islamic finance industry cannot promote maslaha unless it makes room for financial inclusion not only in terms of giving the public access to financial and banking facilities, but also by providing greater access to means of investment and wealth creation. This "democratisation of financial investment" means that ordinary people would enjoy higher returns from their savings, and, as financial investment in Islam is tied to the real economy, the public can also invest and profit from various development projects. Islamic finance theory addresses the issue of financial inclusion from two directions: one through promoting risk-sharing contracts and the other through specific instruments of redistribution of the wealth among the society. This differentiates its path of development significantly from the conventional debt-based financial industry. [5]

Structuring Islamic finance products to enhance financial inclusion

Various risk-sharing financing instruments can be structured to enhance financial inclusion. This can include risk sharing instruments including sukuk that can provide much needed financing to SMEs. With the introduction of securitisation, financial institutions would be able to pool their assets and issue marketable securities. In this way, they will share the risks with the market as well as free-up the capital for further mobilisation of micro and SME financing. In addition, redistributive instruments such as zakah, sadaqa, waqf, and qard hasan complement each other in offering a comprehensive approach to eradicating poverty and building a healthy and vibrant economy. Instruments offered by Islam have strong historical roots and have been applied throughout history in various Muslim communities. [6]

The sukuk market can be improved to incorporate more features of financial inclusion by simply enhancing its distribution aspects to include a wider investor base. The approach is rather simple because retail sukuk does not necessarily require a special form of sukuk structure in order for it to be retailed. Any sukuk for that matter can be retailed, however since it involves the public who are less sophisticated in their understanding compared to institutional or corporate investors the contracts have to be fairly simple and straight forward for ordinary people to understand. In addition, since retail investors have less appetite for risk, retail sukuk requires, at least initially, government or third party guarantees in order for it to be successfully taken up by the public. Thus, it is more likely that due to the associated social objectives attached to retail sukuk, we would see most sukuk distributed at retail level coming from sovereigns. In Malaysia, during the first phase, the only eligible issuers are the Malaysian government and any company that are guaranteed by the Malaysian government. This is to ensure that retail investors are secured from risks of totally losing their investment. In the second phase, eligible issuers are expanded to include other listed or unlisted companies and banks but with guarantee facilities that guarantee the principal investment of investors.

Development of retail sukuk in Malaysia

As mentioned above, the first retail sukuk framework was launched by the SC on 7 September 2012. The launch of the first retail Exchange-Traded Bonds/Sukuk (ETBS) was made on 8 Jan 2013 by the Malaysian Prime Minister Datuk Seri Najib Tun Razak with a maiden issuance by DanaInfra Nasional Bhd. The DanaInfra retail sukuk is guaranteed by the Government of Malaysia with 10 year tenure and 4% indicative profit rate. Priced at RM100 each and bundled in lots of 10 for trading, the minimum subscription is RM1,000. This first retail sukuk offer investors an opportunity to invest in the country's key transport infrastructure and receive a return, with the security of a government guarantee, in addition to being part of a diversified investment portfolio. The sukuk was issued to fund the construction of the country's Sungai Buloh-Kajang mass rapid transit (SBK Line) and it has been oversubscribed by 0.61 times, giving a small boost to the funding needs of the project.

[4] Beck, T., and Demirguc-Kunt, A. "Access to Finance: An Unfinished Agenda." The World Bank Economic Review, 2008: 383-396.

[5] Mohieldin, M. , Iqbal Z., Rostom A., and Fu, X. (2009) "The Role of Islamic Finance in Enhancing Financial Inclusion in OIC Countries." 8th International Conference on Islamic Economics and Finance.

[6] ibid

The oversubscription represents RM484.3 million in value from a total of 1,424 applications for the RM300 million retail sukuk offering. According to the Prime Minister, the sukuk represented an unprecedented opportunity for the people of Malaysia to invest in, and profit from, the nation's development.

DanaInfra is a company wholly-owned by the Ministry of Finance that was set up to help raise financing for the country's largest infrastructure project: the mass rapid transit (MRT) projects in the Klang Valley. The establishment of DanaInfra Nasional Berhad was pursuant to the Economic Council's decision on 14 June 2010 after an in-depth review on having an Infrastructure Financing Entity (IFE). Maybank Investment Bank, CIMB Investment Bank, RHB Investment Bank and AmInvestment Bank were appointed to handle DanaInfra's sukuk sale. The infrastructure project forms part of the economic transformation policies by the government of Malaysia. According to government estimates, the project is expected to generate a further RM8bil to RM12billion in Gross National Income (GNI) from spill-over effects. In total, an average of RM21billion GNI per annum will be generated over the next 10 years, creating 130,000 jobs, as well as pushing up the value of property in the vicinity of MRT stations. DanaInfra is expected to sell at least RM6 billion of sukuk in 2013 to finance the MRT project, with a tranche of about RM1.5 billion expected to be issued every quarter.

To encourage companies to issue retail bonds and retail sukuk, the government proposed in the budget 2013 that additional expenses incurred in the issuance of retail bonds and retail sukuk be given a double deduction for a period of four years effective from the year of assessment 2013 to 2016. At the same time, individual investors are also given stamp duty exemption on instruments relating to the transactions of retail bonds and retail sukuk.

After the announcement of the first retail sukuk in the budget 2013, and before the launch of the DanaInfra retail sukuk in January 2013, an exploratory study was conducted by researchers at Universit Teknologi MARA in the city of Shah Alam, a suburb about an hour's drive from Kuala Lumpur. The study was to gauge public knowledge and awareness of retail sukuk and to identify the factors that influence the attitude and possible take up of retail sukuk. The findings show that about 70 % of respondents are moderately aware of sukuk development; however, they are not aware of the opportunities of procuring sukuk. The study reveals the variables factors explaining the attitude and the possible adoption or take up of retail sukuk are consumer awareness, perceived relative advantage, compatibility and uncertainty. These factors point to the need for public education on sukuk as well as on Islamic capital market and investment generally.

The benefits for investors, and hence society at large, is that the retail sukuk is a form of investment, and for an organization, it is a method to raise funds from a larger pool of investors. In Malaysia, the retail sukuk will be introduced in phases to provide retail investors time to gain the necessary understanding and familiarity with investing and trading in sukuk. To begin with, the only eligible issuers are the Malaysian government, and any company with issuances that are guaranteed by the Malaysian government. In both cases, the returns on capital are guaranteed provided the instruments are held to maturity. In the second phase, targeted for January 2013, the market will be opened to listed companies, appointed banks, Cagamas Bhd and unlisted companies with issuances that are guaranteed by Danajamin Nasional Bhd, the Credit Guarantee and Investment Facility or any other eligible issuers. Here, the return on capital is not guaranteed, but the principal will be returned to the investor, unless the issuer defaults.

In terms of risks, sukuk that are issued or guaranteed by the Malaysian Government will have low credit risk, but there will be exposure to market risk such as interest rate risk, and the fluctuation of bonds and sukuk prices. Investors can expect guaranteed returns at a predetermined rate throughout the tenure of the sukuk, and return of capital will be guaranteed if held to maturity. Where sukuk is sold prior to maturity, the principal returned will be dependent on the market price.

The broadening of access to the retail market is supported by an investor protection framework comprising of a robust disclosure regime which includes prospectus and continuous disclosure requirements and checks and balances in the form of a trustee and trust deed, mandatory credit rating for all bonds and sukuk that are offered to the retail market by a registered credit rating agency and investor education initiatives to enhance investor understanding and knowledge of investing in bonds and sukuk market.

Conclusion

Recent developments, especially in developed economies where interest rates are at historically low levels, indicate increasing interest in retail bonds for which ordinary people can participate in relatively low risk fixed income assets that might give them slightly higher returns than fixed deposits or saving accounts. The successful launch and issue of retail sukuk in Malaysia represents a development that would deepen the Islamic capital market in Malaysia and internationally. The double deductions announced in the Malaysian Budget 2013 are expected to enhance the growth of the ETBS market and could even attract foreign issuances out of Malaysia. The listing of the ETBS on Bursa Malaysia provides an additional and cost effective method to raise capital as well as provide both domestic and foreign investors price transparency and flexible access to the stability of the sukuk market.

The funding of mega infrastructure projects such as the MRT project by DanaInfra would consistently contribute towards the growth of the capital market and help to retain Malaysia's place as a leader in sukuk issuances. The first retail sukuk in Malaysia has managed to involve more of the population into the sukuk space, hence providing another avenue for the agenda on financial inclusion. The participation of retail investors in the MRT infrastructure project in addition to institutional and corporate investors has widened the investor base which helps to diversify risks and contribute towards financial stability and sustainability.

How does an Islamic state (or, for that matter, a corporation), borrow a substantial amount of capital from mostly Muslim savers or high net-worth individuals, and fast? In 1774, this was the question which the Ottoman Minister of Finance had to answer urgently. Defeated by the armies of Imperial Russia, Ottomans had to pay a huge war indemnity within a year. Moreover, since the borrowing had to be done by the government of the Caliph, it had to be Shari'a based. [7] The solution found is known as "esham" (plural of sehm, meaning share). It successfully raised about one third of the war indemnity within less than a year and then came to dominate Ottoman public finances for the next century or so.

While this dramatic example refers to sovereign borrowing, esham in our days can also be utilised for corporate borrowing. Actually, the terms "borrowing", and by the same token, "loan" or "bond", may be misleading because esham do not impose redemption obligation upon the borrower. This caveat notwithstanding, these terms will be used in this paper for the sake of clarity.

Modus Operandi

a) Asset

The operation starts with the issuer setting aside an asset yielding a regular annual revenue. The asset is owned and managed by the issuer, who allocates a certain fraction of the annual revenue for esham.

b) Securitisation

This revenue fraction is then securitised into equal shares and offered for sale to the public. Each share authorises its purchaser (the investor) to receive his share of the allocated annual revenue pro rata. This is a fixed amount, which makes it quite attractive to the investor. Why, notwithstanding this feature, esham does not constitute riba, will be discussed below.

c) Duration

Esham does not have a fixed period. With respect to duration, there are usually two kinds of esham: limited for a life time, or perpetual. The investor, who has purchased the sehm share, continues to receive his share of the annual revenue earmarked for the project for as long as he/she lives, or even in perpetuity. In view of the latter, it can be called perpetual bonds or perpetual sukuk, in modern parlance. As a matter of fact, esham differs from both: it is neither a bond, nor a sukuk. It is not a bond because of its specific redemption characteristic. It is not a sukuk either, because unlike most sukuk, it does not have or need an SPV. Consequently, it is considerably simpler than most sukuk and has lower transaction costs. A life-time esham would be issued to a specific person and therefore be a registered share, whereas the perpetual one would be a bearer's share.

d) Pricing

Each sehm share is sold at a certain multiple of the annuity it will yield for the investor. Naturally, a sehm for a life time would be cheaper than a perpetual one. While there is no fixed rule regarding the initial price of a share, present value criteria [8] can be of some relevance with time (t) ranging from 20, with a 20 years maturity, to an indeterminate (t) for an expected life time and perpetuity. Actuarial tables can be used to approximate the expected life time.

When sold in secondary markets by the initial owner, the price of a share fluctuates reflecting supply and demand as well as the reliability of the annuities. Esham can be traded in secondary markets and are fully negotiable. Listed on an exchange, they would behave like participating preferred stocks. Historical examples inform us that a sehm can be traded at 75 percent or at par if the annuities are paid regularly by the issuer over the long run.

e) Yield

Esham is a hybrid fixed income and profit/loss sharing instrument. Fixed returns are paid to the investor in the form of fixed annuities. Profit/loss sharing occurs when it is traded in the stock exchange. Because of the redemption specifics explained below, the annual yield can be benchmarked to LIBOR or it can be set even higher. A reserve account can also be set up to avoid reflecting the losses on investors.

Income from invested asset is channeled to two pools: the first pool is reserved for paying the fixed annuities. The second pool contains the retained earnings, which will be accumulated until maturity (see the next item) and invested in the meantime.

f) Redemption

What makes esham unique is the fact that redemption is at the discretion not of the lender but of the borrower. Put differently, the borrower pays back the principal when he sees fit. This means that the maturity is decided

[7] "Shari'a based" differs from "Shari'a compliant" in that, unlike the latter, it is not borrowed from the conventional system but is evolved from authentic Islamic instruments. On the Islamic as well as possible medieval European origins of esham, see; Murat Cizakca, Islamic Capitalism and Finance: Origins, Evolution and the Future (Cheltenham: Edward Elgar, 2011), pp. 62-66.

[8] Standard Present Value Criterion includes the discount rate which is based on the interest rate. In Islamic finance internal rate of return or the required yield or the opportunity cost of investment are used. For details see; Murat Cizakca, "Tax-Farming and Resource Allocation in Past Islamic Societies", Journal of King Abdulaziz University, Islamic Economics, vol. I, pp. 59-80, 1989. Available at: www.kau.edu.sa/Files/320/Researches/51008_21145.pdf

by the borrower. While this is so, and the borrower may decide to redeem at a certain time in the future, the investor does not have to sell his esham. Thus, the issuer may end up redeeming only those esham whose owners wish to cash.

In the case of perpetual esham, the borrower may not redeem at all. He is, however, obliged to pay the annuity on time every year either for as long as the investor lives or in perpetuity. Providing the issuer does not fail to pay the annuities on time, there is no obligation for redemption. Some current esham derivatives give the option to the issuer to redeem the shares some twenty years after the issuance.

Consequently, esham would be considered not as debt but as equity – a highly advantageous situation regarding the Basel III gearing ratios. Put differently, a company issuing esham, would be able to shore up its capital base without deteriorating its debt/equity ratio.

g) Third party guarantee

If the issuer is a government, certain taxes can be allocated by law to the payment of annuities, or one branch of a government may provide guarantee for the other. The former, of course, would be a far more persuasive alternative. If it is a private corporation, a reliable and trustworthy third party may need to be found. In a recent perpetual sukuk of RM2.5 billion, issued by the Malaysian Airlines (the closest example of a modern esham), third party guarantee has not been provided. Third party guarantee pertains to the fixed annuities only.

h) Relevance for central banks and open market operations

The above mentioned characteristics render esham an ideal instrument for open market operations of central banks in Islamic countries. Currently, these banks utilise commodity murabahas or tawarruqs as their monetary policy instruments. These instruments are subject to Shari'a risks, while esham is not.

The Shari'a perspective

A cash-cash transaction would be considered as riba if the following conditions simultaneously take place:

1) Excess or surplus over and above the loan capital to be returned to the lender.

2) Determination of this surplus in relation to time with a definite date of redemption.

3) Stipulation of this surplus in the loan agreement.

With regard to the life time esham, the uncertainty of the lifespan of the investor eliminates the certainty of the surplus and violates, at once, all three conditions. With regard to the perpetual esham, the lack of a definitive date of redemption and the fact that redemption is at the discretion of the borrower, not the lender, violates the first and the second conditions.

If esham shares are sold by the investor, who possesses them, in secondary markets, the price will be determined by supply and demand, which will render it a true profit or loss instrument.

In view of the above, it is concluded that esham is not usurious. The fact that it was used by the Ottoman Caliphate for more than a century also confirms this conclusion.

Most recent esham derivatives

Recently some new forms of, what the industry insists on calling sukuk, have been issued, which from the perspective of institutional evolution appear to have been derivatives of esham, and not sukuk.

Probably the earliest one was issued in 29th July 2006 for USD800 million by the Saudi company SABIC. This sukuk was similar to esham in that it did not have an SPV structure, a feature preferred by the Saudi authorities. It differed from esham as it had a life span of only 20 years. Moreover, it was structured such that investors would sell their shares after five years. By doing so, they would achieve 100 percent return of the face value and earn a quarterly return during these five years.[9]

Another example is a sukuk issued in June 2012 by Malaysian Airlines advised by Maybank. The first tranche of the junior sukuk amounting to RM1 billion was issued to Kumpulan Wang Amanah Pesara and firm commitments from other parties amounting to RM1.5 billion were also received. Just like esham, this was a perpetual instrument without a maturity date, and it does not obligate Malaysian Airlines to repay the principal. But unlike esham, there is no government or third party guarantee and annuities are not fixed. The instrument is expected to pay 6.9 percent per year profit rate semi-annually, which makes it quite attractive for investors in search of higher returns. From an accounting perspective, this sukuk is considered as equity and does not negatively affect the gearing ratio of the issuer.

Finally, in November 2012, Abu Dhabi Islamic Bank (ADIB) issued a USD1 billion perpetual sukuk, also without a maturity date. ADIB can choose to repay the principal from 2018 onwards, if it so wishes. ADIB has announced that it has issued this perpetual sukuk in order to meet the Tier 1 capital requirement in Basel III. An important feature of this issuance is that private banks catering to individuals were allocated 60 percent. This is in contrast to most regional bond issues, which are bought up by other banks. Thus, a whole new investor base appears to be opening up. It is possible that the HNWIs may be followed by the rising middle classes, a massive demographic phenomenon, of the democratising Islamic countries. [10]

Conclusion

Unlike human beings, institutions do not die! They may linger on for a long time, even centuries, but when circumstances change and there is a need for them they spring into being again. The fact that various esham derivatives are suddenly appearing indicates that, once again, they are needed. There are number of reasons for this.

First, a mighty combination of demography and democratisation in the Middle East, as well as the rest of the Islamic world, is likely to create a totally new investor class: the rising middle classes. This huge group need an instrument that yields fixed returns without violating the Shari`a. Muslims have always needed such instruments. They usually solved the problem by resorting to legal tricks, which obeyed the letter of the Shari'a, but violated its spirit. What makes esham unique is that through its unique redemption structure it obeys not only the letter

[9] http://www.kantakji.com/fiqh/Files/Markets/f142.pdf. Retrieved on Dec. 3rd, 2012.

[10] http://biz.thestar.com.my/news/2012/11/23/business (Retrieved 30/11/12)

but also the spirit of the Shari`a. Esham is not a loan, and where there is no loan, there is no riba.

Second, Basel III has created an urgent need for raising capital without deteriorating the gearing ratios. Esham derivatives, being considered equity and not debt, are ideal for this purpose.

Third, open market operations conducted by Islamic central banks are totally dependent on sukuk. As mentioned above, Mufti Taqi Usmani considered 85 percent of sukuk as Shari'a repugnant. Thus, the central banks are operating at great risk and should urgently diversify their portfolios.

Fourth, there is a huge need for the governments all over the world to raise capital. Esham has already proven that it can help governments in times of dire need. Indeed, it is time tested.