THE EVOLUTION OF THE ISLAMIC CAPITAL MARKET

IN MALAYSIA

Wan Razazila Wan Abdullah *
Faculty of Commerce
Lincoln University
Lincoln 7647
NEW ZEALAND
Tel: +64 3 3218403
Fax:+64 3 3253847
Email: wanabduw@lincoln.ac.nz

Dr Jamal Roudaki
Faculty of Commerce
Lincoln University
Lincoln 7647
NEW ZEALAND
Tel: +64 3 3218865
Fax:+64 3 3253847
Email: jamal.roudaki@lincoln.ac.nz

Murray Clark
Faculty of Commerce
Lincoln University
Lincoln 7647
NEW ZEALAND
Tel: +64 3 3218267
Fax:+64 3 3253847
Email: murray.clark@lincoln.ac.nz

* Corresponding author.

Acknowledgements: The authors wish to acknowledge the helpful comments from two anonymous referees.
ABSTRACT

The Malaysian capital market is unique because the Islamic Capital Market (ICM) runs parallel with the conventional capital market. Two main reasons have been identified to support the emergence of Malaysian ICM, namely the 1997 Asian Financial Crisis, and the liquidity problem that arose because of the availability of surplus funds in the Islamic finance industry. Following the Asian Financial Crisis, the Malaysian government focused on the development of an Islamic Capital Market, especially on product innovations, infrastructure facilities, policy incentives, human capital development and financial market regulations. This paper traces the development of the Malaysian Islamic Capital Market, identifies the relevant regulatory bodies, and the policy initiatives and products that highlight the pioneering achievements accomplished by the formation of an Islamic Capital Market in Malaysia.

Keywords: Islamic Capital Market, Shariah-approved companies, Malaysia
THE EVOLUTION OF THE ISLAMIC CAPITAL MARKET IN MALAYSIA

Introduction

The unique characteristic of Malaysian capital market is that the Islamic and conventional capital markets are running concurrently. The Islamic Capital Market (ICM) is ideally characterised by the absence of interest based transactions, doubtful transactions, and trading of shares in companies that deal in activities or items that are unlawful under Islamic (Shariah) law (Alhabshi, 1994). Besides Islamic banking and takaful (Islamic insurance), the ICM is one of the important and growing segments in Islamic Finance. These segments are receiving increased investors attention because they are experiencing inflows of cash and are providing innovative financial products (Syed Ali, 2008). The development of the Malaysian Islamic Capital Market is remarkable, two main reasons have been identified that support the emergence of this market are the 1997 Asian Financial Crisis, and the liquidity problem that arose because of the availability of surplus funds in the Islamic finance industry (IOSCO, 2004).

The development of the Malaysian ICM has been the result of outstanding efforts and achievements in terms of product innovation and/or regulatory framework. This paper traces the development of the Malaysian Islamic Capital Market, identifies the relevant regulatory bodies, and the policy initiatives and products that highlight the pioneering achievements accomplished by the formation of an Islamic Capital Market in Malaysia. The next section explains the regulatory environment in Malaysia followed by a discussion about the emergence of the Islamic Capital Market. The sections following then discuss the regulatory bodies and the regulatory framework, the Islamic Capital Market products, and Malaysia’s progress towards the establishment of an international hub for an Islamic Capital Market. The final section concludes the paper and brings about recommendations.
The Evolution of Malaysian Regulatory Environment

The main regulatory bodies that govern the Malaysian capital market are Bursa Malaysia Berhad (previously known as the Kuala Lumpur Stock Exchange or KLSE), the Securities Commission, and the Labuan Offshore Financial Services Authority. The scope of jurisdiction for these regulatory bodies encompasses both Islamic and conventional finance matters. Malaysia’s banking and insurance sectors come under the jurisdiction of Bank Negara Malaysia (the central bank of Malaysia) while the capital market is regulated by Securities Commission Malaysia. Matters relating to the off-shore finance industry are regulated by the Labuan Offshore Financial Services Authority. The following sections provide the evolution of these regulatory bodies.

Bursa Malaysia Berhad (BMB)

The first move towards securities trading in Malaysia occurred in 1930 when the Singapore Stockbrokers’ Association was established. However, the first formal organisation for the public trading of securities commenced when the Malayan Stock Exchange was established in 1960 (Bursa Malaysia, 2009). On April 14, 2004, the name ‘Kuala Lumpur Stock Exchange’ was changed to Bursa Malaysia Berhad. Bursa Malaysia operates a fully-integrated exchange, offering the complete range of exchange-related services including trading, clearing, settlement and depository services (Bursa Malaysia, 2009). All listed companies are either on the Main Market or the ACE (access, certainty and efficiency) Market and the main differences between the requirements for listing on the two markets relate to a minimum amount of paid up capital and the profit track record.

Currently, the Malaysian capital market is governed by Capital Markets and Services Act 2007, the Securities Industry (Central Depositories Act) 1991, the Securities Commission Act 1993, the Companies Act 1965, the Offshore Companies Act 1990 and the Labuan Offshore Securities Industry Act 1995. Figure 1 represents the regulatory structure of the Malaysian
capital market, which is ultimately governed by the Ministry of Finance.

Figure 1: Regulatory Structure of Malaysian Capital Market
Source: Bursa Malaysia website 2010

Securities Commission (SC)

The Securities Commission is the sole authority for the regulating and development of the capital market in Malaysia, and was set up under the Securities Commission Act 1993. The Commission reports directly to the Minister of Finance and responsible for the regulation and supervision of the activities of the market institutions (Securities Commission, 2009a). In addition, the Commission is obliged to encourage and promote the development of the securities and futures markets in Malaysia (Securities Commission, 2009a).

Labuan Offshore Financial Services Authority (LOFSA)

Interestingly, the Malaysian capital market also possesses an offshore capital market. The Labuan Offshore Financial Services Authority (LOFSA) is the authority to regulate offshore this capital market, and is assisted by the Labuan International Financial Exchange Inc (LFX), which is a wholly owned subsidiary of Bursa Malaysia Berhad. The LFX is a web-based financial exchange that provides listing and trading facilities for a wide range of financial and non-financial products, including Islamic financial products.
Shariah Advisory Council (SAC)

Part of Malaysia’s pioneering efforts to create an organised and efficient Islamic capital market was the establishment of the Islamic Capital Market Department (ICMD) and the Shariah Advisory Council (SAC) in 1996 (Securities Commission, 2007d). The role of the Shariah Advisory Council is, with the assistance of the ICMD, to advise the Securities Commission on all matters relating to the comprehensive development of the Islamic capital market and to function as a reference centre for all Islamic capital market issues (Securities Commission, 2007d). In addition, the SAC is charged with the analysis of Shariah principles that can be used to introduce new products and services for the Islamic capital market, and to determine the extent to which existing conventional capital market instruments comply with the Shariah principles (Securities Commission, 2007d). The primary sources for development and references of the Shariah principles of Islamic capital market are the Holy Quran and the Sunnah (authentic traditions of Prophet Muhammad, PBUH).

Selection Process for Shariah-Approved Companies

The Shariah Advisory Council also responsible for screening, reviewing and identifying process of listed stock for companies listed and to be listed on Bursa Malaysia for Shariah compliant status. There are two parameters considered in the selection process - qualitative and quantitative parameters.

Qualitative Parameters

Under this stage, focus is placed on the primary activities of a company with regards to goods and services offered (Securities Commission, 2007d). A set of criteria have been formulated for use as basic guidelines in the selection process (Securities Commission, 2008b).

Companies that carry out any non-permissible core activities will not qualify as Shariah compliant. Non-permissible activities encompass: financial services based on riba (interest); maisir (gambling); the manufacture or sale of non-halal products or related products; conventional insurance; certain entertainment activities that are not permitted according to
Shariah; the manufacture or sale of tobacco based products or related products, broking or trading in securities that are not Shariah-approved securities; and other activities that are regarded as not permitted according to Shariah.

For companies with activities comprising both permitted and non-permitted elements, the Shariah Advisory Council considers two additional criteria; the public perception or image of the company must be good and the core activities of the company are important and considered beneficial to Muslims and the country. The non-permitted element must be very small and involves matters which are common and difficult to avoid, are customary and are rights of the non-Muslim community which are accepted by Islam.

**Quantitative Parameters**

The second stage of evaluating Shariah approval requires assessment of relevant quantitative parameters. The Shariah Advisory Council has established several benchmarks in order to determine the tolerable level of mixed contributions from permitted and non-permitted activities, based on reasoning from the source of Shariah by qualified Shariah scholars (Securities Commission, 2007d). The securities of the company will be classified as the Shariah-compliant if the contributions from non-permissible activities do not exceed the following benchmarks:

a) A 5-percent benchmark for activities that are clearly prohibited such as interest, gambling, liquor and pork.

b) A 10-percent benchmark for activities that involve elements that affect most people and are difficult to avoid, such as interest income from fixed deposits in conventional banks, and for tobacco related activities.

c) A 20-percent benchmark for non Shariah-compliant activities such as rental payments from premises that are involved in gambling, sale of liquor etc.
d) A 25-percent benchmark for activities that may affect the Shariah-approved status such as hotel and resort operations, share trading, stock broking and other activities that are not Shariah approved.

Subsequently, the Securities Commission compiles the decisions of the SAC and publishes the list of Shariah-compliant stocks twice a year in April and October. The issuing date was changed in 2007 to May and November in 2007 in order to coordinate with the FTSE Bursa Malaysia EMAS Shariah Index. The list of Shariah-compliant stocks gives investors, especially Muslims, the necessary guidance, opportunity and confidence to select and invest in the listed securities or companies that comply with the Shariah principles (Securities Commission, 2007c). The following figure presents the number of Shariah approved companies on Bursa Malaysia from 1997 to 2009.

![Figure 2: Statistics of Shariah Approved Companies on Bursa Malaysia](source: Securities Commission website, 2010)

From the figure above, it can be seen that when the list was first introduced in 1997, the total number of companies that comply with the criteria was 478, but since then, the number of Shariah-compliant companies has grown steadily to reach 848 companies as at 30 November 2009 – a number that represents 88% of the total number of companies listed on Bursa Malaysia. The list is essential for further growth in the Islamic capital market since it provides
reference and guidance to the investing public, and for the development of the Islamic management industry (Securities Commission, 2007c).

**Emergence of the Islamic Capital Market**

As stated previously, the Malaysian capital market is unique in that the Islamic Capital Market runs concurrently with the conventional capital market. The ICM refers to the market where capital market activities are carried out in the ways that do not conflict with the conscience of Muslims and the religion of Islam. Transactions in the ICM are free from the elements such as interest (riba), gambling (maisir) and ambiguity (gharar) (Securities Commission, 2009b).

The Islamic finance industry in Malaysia has grown tremendously since it emerged in the 1970’s. The growth of the Islamic finance industry in Malaysia can be divided into three phases: Phase 1 (1983-1992) known as the Period of Discovery, Phase 2 (1993-2001) recognised as the Period of Acceptance, and Phase 3 (2002 until today) which is acknowledged as the Period of Strategic Development (Yakcop, 2002). This evolution is presented in Figure 3. The Islamic Capital Market played a relatively minor role in the early stages of the development of the Islamic Financial system in Malaysia. The Initial set-up in 1980 witnessed the introduction of the Islamic Banking Act 1983, the Bank Islam Malaysia in 1983 and the Takaful Act in 1984.
Figure 3: Evolution of Malaysian Islamic Capital Market

There was further significant development in 1990s when more companies and other entities began to source funds from the capital market in order to finance their operations (Securities Commission, 2001b). In 1996, there was a promulgation of the Shariah-approved criteria and the introduction of Shariah-approved securities by the Securities Commission. The promulgation of Sharia-approved criteria led to an increased acceptance of the Islamic Capital Market as an alternative market for capital seekers and providers. Similarly, there was a growing interest in Islamic debt securities as an alternative instrument for investment and financing.

The richness of Islamic financing principles provides issuers with sufficient flexibility to structure a wide range of innovative and competitive Islamic securities (Securities Commission, 2003). From the year 2000 onwards, the market witnessed the development and subsequent issue of a variety of Islamic Capital Market products, encompassing debt or equity securities. The first global corporate Islamic bond was issued in 2002 by Kumpulan Guthrie Bhd and this heralded a starting point in the liberalisation of access to capital markets. In
2004, there was another landmark when the first Ringgit denominated Islamic bonds were issued by the International Finance Corporation (IFC), the private arm of World Bank, which reflects the recognition given to Malaysia as an Islamic Capital Market Centre (Securities Commission, 2004).

Towards the Period of Strategic Development or Developed Market, a comprehensive plan that consists of vision, strategic initiatives and recommendations, was formulated by the Malaysian government. These include among others, the Capital Market Master Plan, the Ninth Malaysian Plan, and the yearly Budgets from 2007 until 2010.

**Capital Market Master Plan**
The Capital Market Master Plan launched in 2001, with six broad objectives, 24 strategic initiatives and 152 recommendations, for the development of an internationally competitive Islamic capital market in Malaysia. The strategic initiatives that were considered necessary to be undertaken in order to achieve this objective are: to facilitate the development of various competitive products and services related to the Islamic capital market; to create an independent market to mobilize Islamic funds effectively; to ensure an appropriate and comprehensive accounting, tax and regulatory framework; and to enhance the international recognition of the Malaysian Islamic capital market (Securities Commission, 2001a). The Malaysian Government incorporated these objectives into the country five-year economic plan and budget bills 2007 -2010.

**Ninth Malaysian Economic Plan**
The Ninth Malaysian five-year Economic Plan was announced in March 2006 by the Prime Minister Datuk Seri Abdullah Ahmad Badawi, and covered the period from 2006 up to 2010. This Plan is a comprehensive blueprint prepared by the Economic Planning Unit (EPU) of the Prime Minister’s Department and the Finance Ministry of Malaysia that further reaffirmed the importance of the Islamic capital market. An important feature of this plan was the
recommendation to make Malaysia a global hub for Islamic capital market products and services (Securities Commission, 2001a). Since then there has been an ongoing effort by the Malaysian Government to position Malaysia as an international Islamic Capital Market by formulating new incentives such as those found in the Budgets presented over the periods 2007 to 2010.

**Budget 2007**

The Supply Bill in the Budget 2007 is presented as an action plan for the mission set out in the ninth Malaysia Plan. Realizing the huge potential of the Malaysian Islamic finance industry, the government announced a series of tax incentives aimed at further developing the Islamic Capital Markets. These tax incentives are summarised in Table 1.

**Table 1: Tax Incentive Framework in the Malaysian 2007 Budget**

<table>
<thead>
<tr>
<th>No.</th>
<th>Capital Market Sector and Participants</th>
<th>Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Islamic Fund and Wealth Management</td>
<td>Local and fund managers located in Malaysia are accorded 100% income tax exemption on their management fee earned for managing foreign funds in accordance with Shariah principles.</td>
</tr>
<tr>
<td>2.</td>
<td>Sukuk (Islamic Bond)</td>
<td>The special purpose vehicle (SPV) set up for Islamic financing is exempted from income tax. The company that establishes the SPV is also given a deduction on the cost of issuance of the Islamic bonds incurred by the SPV. Extension of deduction on expenses for Sukuk until the year of assessment 2010.</td>
</tr>
<tr>
<td>3.</td>
<td>Islamic Stockbroking business</td>
<td>Tax deduction on expenses incurred in establishing an Islamic stockbroking firm.</td>
</tr>
</tbody>
</table>
| 4.  | Real Estate Investment Trusts (REITs) | Receiver of dividends from REITs listed on Bursa Malaysia are taxed at the following rate:  
  - Resident and non-resident individual investors and other local entities are taxed at 15% for five years.  
  - Foreign institutional investors are taxed at 20% for five years.  
  REITs are also exempted from tax on all income provided that at least 90% of their total income is distributed to the investors. |

Source: The 2007 Budget Bill and Securities Commission website 2010
As can be seen from this Table, the Malaysian government is providing focus and incentives in term of a tax incentive framework to all capital market sectors including Islamic Fund and Wealth Management, Sukuk (Islamic Bond), Islamic Stockbroking business and Real Estate Investment Trusts (REITs). To ensure the smooth and effective implementation of national development policies and strategies, it is vital to have an efficient system of tax administration (Abdullah, 2006). Besides offering attractive tax incentives, well developed infrastructure, efficiency in services, large size of investments, there is a need to further diversify capital market products in order to attract local and foreign investors (Abdullah, 2006).

**Budget 2008**

Additional incentive has been introduced in the Budget 2008 to strengthen Malaysia’s position as an international Islamic financial centre. The incentives are summarised in Table 2.

**Table 2:** Special Incentives for the ICM in the 2008 Budget

<table>
<thead>
<tr>
<th>No.</th>
<th>Capital Market Sector and Participants</th>
<th>Initiatives</th>
</tr>
</thead>
</table>
| 1.  | Fund Management Industry              | - Foreign ownership on fund management companies and REITs management will be allowed up to 70%.  
 - Islamic fund management companies are allowed to have 100% foreign ownership & permitted to invest 100% of assets abroad.  
 - A sum of RM7billion will be channelled by the Employees Provident Fund (EPF) to be managed by the Islamic fund management companies.  
 - Income tax exemption on all fees received in respect of Islamic fund management activities, until the assessment year 2016. |
| 2.  | Stockbroking company                   | - Tax incentives for existing stockbroking companies from the Middle East to set up Islamic stockbroking subsidiaries.  
 - Three new stockbroking licences will be issued to leading stockbroking companies which are able to source and intermediate businesses and order flows from the Middle East. |
| 3.  | Non-resident consultants               | - Income tax exemption to non-resident consultants with the required expertise in Islamic finance. |

Source: Securities Commission website 2010
Table 2 illustrates additional incentives introduced by the Malaysian government in order to enhance the emergent Islamic Capital Market in Malaysia. Realizing the significant contribution of the fund management industry, the focus of the incentives contained in the 2008 Budget is on Fund Management companies, stockbroking companies from the Middle East and non-resident consultants regarded as experts in Islamic finance. The rationale is to attract greater investment from the Middle East and therefore increase the flow of funds into Malaysia. Additional incentives were offered in the 2009 Budget, again providing evidence that Malaysia is heading towards becoming a global hub of Islamic capital market.

**Budget 2009**

Further tax incentives aimed at developing the Islamic Capital Market were offered in the 2009 Budget, as summarised in Table 3.

**Table 3: Special Incentives for the ICM in the Malaysian 2009 Budget**

<table>
<thead>
<tr>
<th>No.</th>
<th>Capital Market Sector and Participants</th>
<th>Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Sukuk (Islamic Bond)</td>
<td>Tax exemption for fees and profits earned by institutions undertaking activities such as arranging, underwriting, distributing and trading non-ringgit sukuk (Islamic bonds) issued in Malaysia and distributed outside Malaysia; and profits received by qualified institutions from the trading of non-ringgit sukuk issued in Malaysia.</td>
</tr>
<tr>
<td>2.</td>
<td>International Centre for Education in Islamic Finance (INCEIF)</td>
<td>Double tax deduction for courses conducted by this centre.</td>
</tr>
<tr>
<td>3.</td>
<td>Real Estate Investment Trusts (REITs)</td>
<td>Tax rate on dividends received by foreign institutional investors from Real Estate Investment Trust (REITS) was reduced from 20% to 10%.</td>
</tr>
<tr>
<td>4.</td>
<td>Domestic intermediaries.</td>
<td>Tax exemption on fees received by domestic intermediaries, which have successfully listed foreign companies and foreign investment products on Bursa Malaysia.</td>
</tr>
<tr>
<td>5.</td>
<td>Venture Capital Companies</td>
<td>A five year tax exemption for venture capital companies that invest at least 30% of their funds in start up, early stage financing or seed capital are eligible for.</td>
</tr>
</tbody>
</table>

Source: The Budget Bill 2009 and Securities Commission website 2010
The incentives in the 2009 Budget are quite revealing in the legislators targeted new participants and promote efforts to further diversify and attract more foreign investors to the domestic capital market (Abdullah, 2008). The tax incentives are offered to entice industry players, both local and international to join the market (Securities Commission, 2008a). Consequently, all industry players together with the regulatory bodies shoulder the responsibility to successfully position Malaysia as a global hub for the Islamic capital market.

**Budget 2010**

The Malaysian government provided additional incentives in the 2010 Budget in order to sustain and improve their position as an international Islamic financial and capital market centre, as summarised in Table 4.

**Table 4: Special Incentives for the ICM in the Malaysian 2010 Budget**

<table>
<thead>
<tr>
<th>No.</th>
<th>Capital Market Sector and Participants</th>
<th>Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>International Islamic Financial Centre (MIFC)</td>
<td>The double deduction incentive given on expenses to promote Malaysia as MIFC is extended until the year of assessment 2015.</td>
</tr>
<tr>
<td>2.</td>
<td>Islamic Stock Broking companies</td>
<td>Expenses incurred in the promotion of Malaysia an International Islamic Financial Centre are given incentive.</td>
</tr>
<tr>
<td>3.</td>
<td>Islamic Securities</td>
<td>Expenditure incurred prior to the commencement of an Islamic stock broking company is given an incentive in the form of deduction for the purpose of income tax computation. The same incentive is extended to Islamic securities approved by LOFSA effective from year assessment 2010 to year of assessment 2015.</td>
</tr>
<tr>
<td>4.</td>
<td>Special Purpose Vehicle (SPV)</td>
<td>The tax treatment of SPV solely to channel funds for the purpose of issuance of Islamic securities is also given to SPV established under the Offshore Companies Act 1990 effective from the year assessment 2010.</td>
</tr>
<tr>
<td>5.</td>
<td>Sukuk (Islamic Bond)</td>
<td>The tax exemption on profits derived from the issuance of sukuk approved by the Securities Commission extended to the issuance of sukuk approved by Labuan Offshore Financial Services Authority effective from the year assessment 2010.</td>
</tr>
</tbody>
</table>

Source: The 2010 Budget Bill
The incentives proposed in the 2010 Budget aims to ensure that Malaysia advances significantly in the development of Islamic financial services, to influence the establishment of stockbroking companies, and to persuade the issuance of Islamic securities (Abdul Razak, 2009). As can be seen from this and previous budgets, the Malaysian government has taken many initiatives aimed at becoming the international Islamic hub. Although Malaysia is already recognised as the world’s largest sukuk issuer with USD 94.7 billion, the Malaysian Government provided further incentives in the 2010 Budget to strengthen their achievements to date and to further develop the Islamic capital market in Malaysia.

**Islamic Index**

The Islamic Index is an index that tracks the performance of the Shariah-compliant securities on Bursa Malaysia. The first Islamic equity index was introduced by RHB Unit Trust Management Berhad (a unit trust company that is a subsidiary of RHB Capital Berhad) in May 1996. Subsequently, the Dow Jones Islamic Market Index (DJIM) was launched in February 1999 by Dow Jones and Company, the Kuala Lumpur Shariah Index (KLSI) was launched in April 1999 by Bursa Malaysia, and the FSTE Global Islamic Index Series was launched by the FSTE Group in October 1999. The FBM (FTSE Bursa Malaysia) Shariah Index replaced the KLSI on 22nd January 2007.

All these indices were launched in order to expand participation of investors who are passionate investing in securities approved in accordance to the Islamic law. These indices allow investors to track and benchmark the performance of Shariah-compliant securities, and aid investors make better investments decision (Securities Commission, 2007e). The Shariah indices measure the performance of Islamic equity, and in April 2006, the Dow Jones Citigroup Sukuk Index was launched by Dow Jones Indexes and Citigroup Inc. The objectives for the launching of the Sukuk Index are to educate investors about Sukuk, build awareness of the vehicles, improve market transparency, provide a benchmark and a basis for investments and tradable products (Siddiqui, 2008).
Islamic Financial Market (Bursa Suq Al-Sila’)

Another milestone project to further strengthen Malaysia’s position as an international Islamic financial hub is the Bursa Suq Al-Sila’, a world first commodity trading platform specifically dedicated to facilitate Islamic liquidity management and financing by Islamic banks (Bursa Malaysia, 2010). One notable features of this market is that it is a fully electronic web-based platform that provides industry players with an avenue to undertake multi-commodity and multi-currency trades from all around the world. In essence it integrates the global Islamic financial and capital markets together with the commodity market.

Regulatory Bodies and Regulatory Framework

The development of an Islamic capital market requires an in-depth understanding of the operations of the current capital market and contemporary analyses to fulfil the present day needs of investors, especially Muslims who wish to participate in economic activities in accordance to Shariah principles of Islam (S. G. Abdul Rahman, 2007). Therefore the regulatory bodies play a vital role in the development and operation of the Islamic capital market. The two main regulatory bodies are the (Malaysian) Securities Commission and the Malaysia International Islamic Finance Centre (MIFC).

Malaysia International Islamic Finance Centre (MIFC)

In order to promote Malaysia as a major hub for International Islamic Finance, the country’s financial and market regulators, including the Central Bank of Malaysia, Securities Commission Malaysia (SC), the Labuan Offshore Financial Services Authority (LOFSA) and Bursa Malaysia, together with industry participation from the banking, takaful (Islamic insurance) and capital market sectors, launched the Malaysia International Islamic Financial Centre (MIFC) in August 2006. The focus of this centre is on areas such as: sukuk origination, Islamic fund and wealth management, international Islamic banking, international takaful, and human capital development. The Securities Commission together with other regulators, have played an important role in formulating a facilitative regulatory framework to
strengthen and sustain Malaysia’s position as an international hub for an Islamic Capital Market.

**Regulatory Framework**

In line with its vigorous effort to provide facilitative regulatory environment for the development of the Islamic Capital Market, the Securities Commission introduced the following regulatory framework:

*Guidelines on the Offering of Islamic Securities in July 2004*

These guidelines aimed to facilitate the development of more innovative and sophisticated Islamic financial instruments that meet the requirements of both local and global investors.

*Guidelines for Islamic Real Estate Investment Trusts (REITs) in November 2005*

These guidelines were introduced to facilitate the creation of a new asset class and further develop new Islamic Capital Market products. This effort is another notable effort, making Malaysia the first jurisdiction in the global Islamic financial sector to issue such guidelines (Securities Commission, 2005).

*Guidelines on Islamic Fund Management in December 2007*

These guidelines set out the requirements that must be followed by an Islamic Fund Manager that carries on Islamic Fund Management as a standalone operation, and also compliance requirements for Islamic Fund Management to operate their business under an Islamic window (Securities Commission, 2007a).

*Best Practices Guidelines in Islamic Stockbroking in 2007*

It outlines important areas for operations and compliance aspects of an Islamic stockbroking business whether on full-fledge basis or window basis (Bursa Malaysia Securities Bhd, 2007).

*Guidelines and Best Practices on Islamic Venture Capital in May 2008*
The new guidelines stipulate the minimum requirements for the establishment on an Islamic venture capital and Islamic venture capital management company. In addition, it includes a set of best practices to promote appropriate Islamic standards in the industry.

**Guidelines on Unit Trust Funds in March 2008**

These guidelines set out requirements to be complied with by any person intending to establish a unit trust fund in Malaysia and were revised to set out additional requirements for the appointment of Shariah advisers and define the roles of the Shariah adviser and compliance officer.

On top of a robust and effective regulatory framework, a fine balance between enhancing the growth of the industry and ensuring safeguards to protect investor interest needs to be top priority when designing regulatory framework for the market (A. Abdul Rahman, 2007).

**Islamic Capital Market Products**

Modern Islamic financial products and services are generally developed using two different approaches. The first approach is to identify and modify existing conventional products and services so that they comply with Shariah principles. The second approach is to offer innovative new products and services that involves the application of various Shariah principles (IOSCO, 2004). In Malaysia, both approaches are being used to develop and structure Islamic capital market products that will cater the need of the market (Securities Commission, 2007b). Figure 4 illustrates variety of financial products that are currently offered in the Malaysian Islamic Capital Market.
As can be seen from Figure 4, the Malaysian Islamic capital market products are mainly divided into five categories, being Shariah-compliant securities, Shariah-based Unit Trust Fund, Islamic Exchanged Traded Funds (ETF), Islamic Real Estate Investment Trusts (REITs) and Sukuk (Islamic Bond). There is significant product innovation and sophistication all over the world and Shariah-compliant products have proven to be attractive to Muslim and non-Muslim investors since they offer many investment opportunities, even to non-Islamic institutions (Mahlknecht, 2010).

**Shariah-Compliant Securities**

The most popular products are the Shariah-compliant securities (ordinary shares, warrants and transferable subscription rights) that have been issued by companies that comply with the Islamic criteria promulgated by the Securities Commission. Those companies are known as Shariah-approved companies or Shariah-compliant companies. There are now many such Shariah-compliant securities listed on Bursa Malaysia, enabling investors to diversify their investment portfolio across a range of industries.

From their introduction in 1997, the number of Shariah-compliant securities has almost doubled over the next 13 years, from four hundred and seventy-eight in 1997 to eight hundred and forty-eight at the end of 2009. Figure 5 illustrates the number of Shariah-compliant securities that were listed on Bursa Malaysia from 1997 to 2009.
Shariah-Based Unit Trust Fund

The Shariah-based unit trust funds are collective investment funds that offer investors the opportunity to invest in a diversified portfolio of Shariah-compliant securities and managed by professional managers in accordance with Shariah principles. This enabled both Muslim and non-Muslim investors to invest and participate in Islamic investments that are professionally managed. The Shariah-based unit trust funds have experienced significant growth from two Islamic funds in 1993 to currently more than 150 Islamic funds, which represents 26% of the total industry in Malaysia.

Figure 6 shows the value of Shariah-based Unit Trust Funds in Malaysia from 2001 until 2009. The net assets value (NAV) of Shariah-based Unit Trust Funds at the end of 2009 amounted to RM22.08 billion compared to RM2.42 billion in year 2001. It formed 11.5% of the industry NAV compared to 5.1% in year 2001. Although the size of Shariah-based unit trust funds is small as compared to the overall domestic industry, the Malaysian Shariah-based unit trust funds industry is the world’s largest Islamic trust funds industry (PriceWaterHouseCoopers, 2008).
Figure 6: Value of Shariah-based Unit Trust Funds in Malaysia
Source: Securities Commission Malaysia website 2010

There are three main categories of Shariah-based Unit Trust Funds - Balanced, Sukuk, and Equity. Figure 7 depicts the proportions of the various Shariah-based Unit Trust Funds as at September 2009. In this figure, Equity Funds are the largest Shariah-based unit trust funds in the market. Of the total Shariah-based Unit Trust Funds issued, 65% were Equity Fund, 8% were Balanced Fund, 6% were Sukuk Fund and 21% were others.

Figure 7: Categories of Shariah-based Unit Trust Funds in Malaysia
Source: Securities Commission website 2010

Islamic Exchanged Traded Funds

Islamic Exchanged Traded Funds (ETF) are funds traded on Bursa Malaysia which track indices based on stocks that have been classified as Shariah-compliant listed equities. Among the benefits of investing in ETF are: diversification as ETF invests in a portfolio of
securities, low minimum investment as ETF are traded in board lots, and liquidity as ETF is continuously traded on Bursa Malaysia.

The first Islamic compliance exchange traded fund (ETF) in Asian region was launched in Malaysia in January 2008, known as MyETF Dow Jones Islamic Market Malaysia Titan 25 (MyETF-DJIM25). It can be seen from Figure 8 that, as at December 2009, the net asset value (NAV) of Islamic ETFs has risen significantly from RM482.73 million in 2008 to RM656.6 million in 2009, representing 56% of total industry. It is believed that the launch of this traded fund will boost the country’s aspiration to become an Islamic financial hub, attract foreign funds, and broaden the market (Securities Commission, 2008).

![Figure 8: Value of Islamic Exchanged Traded Funds (ETF) in Malaysia](image_url)

Source: Securities Commission website 2010

**Islamic Real Estate Investment Trusts**

Islamic Real Estate Investment Trusts (REITs) are defined as collective investment vehicles that pool money from investors and buy, manage and sell real estate through Shariah-compliant capital market instruments (Securities Commission, 2006).

There is a combination feature of real estate and trust funds in REITs and it sit between bonds and equitiesVI. In addition, the holder essentially owns a fraction of a pool of real estate and this actually provides a platform for international investors to invest in a particular country’s real property without any difficulties and responsibilities associated with direct ownership of that assets (Securities Commission, 2006). The first REIT was launched by the healthcare
sector, the Al-Aqar KPJ REITs, in 2006 with a fund size of RM180 million. At present, there are 12 REITs being offered in Malaysia, inclusive of three Islamic REITs. Despite their small number, the market capitalisation of Islamic REITS in Malaysia has experienced significant growth from RM180 million for the first introduction to RM1,827 million at the end of 2009. Figure 9 shows the value of Islamic Real Estate Investment Trusts in Malaysia from 2007 to 2009.

![Figure 9: Value of Islamic Real Estate Investments Trusts (REIT) in Malaysia](source)

**Sukuk (Islamic Bond)**

Sukuk is a form of financial note, which represents the value of the asset. The issuance of Islamic bonds require an exchange of a Shariah-compliant underlying asset for a financial consideration through the application of various Shariah principles such as *ijarah, mudharabah, murabahah, musharakah, bai’ bithaman ajil* and *istisna’* (IOSCO, 2004).

In Malaysia, sukuk are issued in both Malaysian Ringgit and foreign currencies. Therefore, this offers a variety of investment opportunities to all investors, local or foreign, and also for local and international entities that seek listing on Bursa Malaysia. Among the five major Islamic Capital Market products, Sukuk is the most preferred choice for corporations to raise funds, the main reasons being the strong demand from fixed income investors, it is competitively priced, and it can be issued without excessive cost (Securities Commission, 2007a).
In Malaysia, the first Sukuk was issued in 1990 by Shell MDS Sdn Bhd, with the value of RM150 million. Figure 10 shows the Malaysian bonds issued since 2000, illustrating the significant size of the Sukuk market in Malaysia as compared to the conventional bonds market. Over the past ten years, Sukuk have proven to be a viable investment option. As at December 2009, the size of Sukuk in Malaysia stood at RM32.3 billion, which reflects an explosive growth rate from RM7.7 billion at the end of 2000. Meanwhile, the size of conventional bonds as at December 2009 was RM29.8 billion, with the market registering an average growth rate from year 2000.

![Figure 10: Values of Islamic and Conventional Bonds in Malaysia](source: Securities Commission website 2010)

The growth in the Sukuk market reflects the commitment and combined efforts of the Malaysian government and regulators, especially with the introduction of innovative and competitive Sukuk structures that appeal to a wide range of investors. The value of the conventional bonds as at December 2009 was RM29.8 billion, which results from an average rate of growth since the year 2000. (Aziz, 2007; PriceWaterHouseCoopers, 2008).

**Value Proposition**

Malaysia becomes a destination of choice because of the competitive advantage or value propositions in a number of fundamental areas needed for an International Islamic centre.
Figure 11 demonstrates ten value propositions posed by the Malaysian Islamic financial market.

As depicted in Figure 7 by the Malaysia International Islamic Finance Centre (MFIC), Malaysia is currently considered to be a strategic location for an Islamic capital market hub due to these ten value propositions. These propositions promote the Malaysian Islamic capital market for the following reasons:

i) Well developed market

Malaysia has placed strong emphasis on the development and expansion of Islamic finance including Islamic Banking, takaful (insurance), Islamic capital market and Islamic money market for more than 30 years. This has resulted in the development of a comprehensive Islamic finance environment that is rich in the diversity of financial institutions, vibrant with continuous product innovation, market activity, and embedded maturity that adds stability and robustness to the whole system (MIFC, 2009b).

ii) Diversity of international and domestic financial institutions

Figure 11: Value Propositions of Malaysia
Source: Malaysia International Islamic Finance Centre website 2010
That there is a diverse and growing community of domestic and international financial institutions and fund managers in Malaysia is undeniable. Much of Malaysia’s notable achievements, such as record setting Islamic bond issuance and other industry ‘firsts’, are due to the participation of these intermediaries. Their in-depth experience and innovative capability and credibility in producing new Islamic products and issuances are internationally recognized (MIFC, 2009b). Figure 12 presents the Islamic Capital Market product innovation and world-first achievements since 1990.
iii) Liberal foreign exchange administration (FEA) rules

The main objective for Malaysia to adopt liberalised foreign exchange administration rules is to enhance its competitiveness and business efficiency while promoting financial and economic stability. This also enables greater trade in foreign currencies whereby foreign Islamic fund management companies are allowed to invest all their assets abroad and to swap domestic currency funding into other currencies (MIFC, 2009b).

iv) A facilitative business environment

A facilitative business environment and framework has been provided in Malaysia that enables efficient delivery channels for the proliferation of foreign Islamic institutions as well as Islamic products and services. This includes a reliable infrastructure platform of the Electronic Trading platform and the Real-time Electronic transfer of Funds and Securities system which enable efficient trading. Further, the existence of an active secondary market generates greater trading activity and grows the depth and liquidity of Islamic products, especially the Islamic bond (MIFC, 2009b).

v) Strategic location

Geographically, Malaysia is located at a strategic position in order to function as a link between the East and West. This ideal location is an advantage to serve and facilitate the cross
flow of funds and greater global economic linkages especially between South East Asia and the Middle East (MIFC, 2009b).

vi) Adoption of global legal and regulatory best practice

The legal framework in Malaysia caters the specific regulation of Islamic Finance. It is being governed by dedicated legislation; the Islamic Banking Act 1983, the Takaful Act 1984 and the Capital Market Services Act 2007. With the rapid growing of Islamic finance industry, the legal and regulatory framework is continuously updated in order to ensure laws are refined to best practices.

vii) Well developed Shariah governance framework

Malaysia posses two dedicated Shariah Advisory Councils in order to govern any matters pertaining to Islamic market (MIFC, 2009b). The Shariah Advisory Council of the Central Bank of Malaysia advises on issues related to Shariah compliance related to the Islamic banking and takaful industry. On the other hand, the Shariah Advisory Council of the Securities Commission Malaysia advises on issues related to the operations of the ICM as well as providing guidance and advice to investors, government and industry. The establishment of these two Shariah Advisory Councils is a world first at the regulatory level (Anwar, 2007).

viii) Wide range of innovative Islamic investment products

Malaysia has taken an initiative to cultivate the growth of various innovative Islamic finance products in either the banking sector or the Islamic Capital Market to ensure participation from local or foreign market players (MIFC, 2009b). At present, a holistic range of innovative Islamic capital market products from equities to debt securities across all sectors and industries are being offered by Bursa Malaysia. Strategic differentiation in identifying, designing to produce products and services that customers perceive as being different in ways, that are important to them is the key to sustainability in this market (Anwar, 2008).
ix) Tax neutrality

Malaysia has introduced a very conducive tax environment for the development and operation of the Islamic Capital Market. This environment provides a competitive advantage and spurs the development of Islamic Finance. Anwar (2007) claims that a tax neutral environment is considered to be a vital tool in facilitating innovation and the promotion of Islamic financial products. If such an environment was not present, Islamic transactions, which by their nature involves the execution of numerous underlying contracts, will be very costly and the development of new products will be slow.

x) Comprehensive human capital

Human capital is also a vital element to ensure the expansion of an Islamic Capital Market. It is a primary challenge for Malaysia to ‘build’ a new generation of innovators, regulators, intermediaries and risk managers with the appropriate blend of financial and Shariah knowledge, together with expertise in capital markets (MIFC, 2009a). An appropriate infrastructure is an essential ingredient for the development of intellectual capital, including meeting the education needs of all level of Islamic finance practitioners. In addition to higher learning institutions currently available, Malaysia has established the Islamic Banking and Finance Institute Malaysia, the International Centre for Leadership in Finance, and the International Centre for Education in Islamic Finance. These institutions offer short-term training courses together with long-term certification and post-graduate programmes in Islamic finance. The latest initiative to create a pool of human capital to facilitate the development of Islamic capital market is the Islamic Capital Market Graduate Training Scheme which is jointly developed and introduced by the Securities Industry Development Corporation and Securities Commission Malaysia in March 2009 (SIDC, 2010).
Conclusion and Recommendations

The Islamic Capital Market in Malaysia has grown rapidly and successfully. As compared to other Muslim countries, Malaysia offers a superior infrastructure for and provides on-going government support that provides impetus for the continued growth of the Malaysian Islamic Capital Market. The leadership and support provided by the government through the facilitation of policies and incentives has ensured the successful development of the Islamic Capital Market. A range of incentives have been provided through the annual Budgets from 2007 to 2010 that are intended to encourage and facilitate local and foreign participation in the Malaysian Islamic capital market. These Government initiatives have been substantial. Malaysia International Islamic Finance Centre value prepositions provide a unique environment for development and expansion an internationally recognized Islamic financial market. Perspectives such as product innovation, infrastructural facilities, policy incentives, human capital development, liberalisation and regulatory frameworks, have all been focussed on encouraging the development of the Islamic Capital Market. Regulatory bodies and market players have all been involved to ensure the successful attainment of an international hub for an Islamic Capital Market in Malaysia.

To further ensure the success of the development, especially towards the government desire as an international Islamic Capital Market hub, several issues should be considered. Since its products and services have been accepted and demanded worldwide, the international harmonization of the regulatory framework, standards and practices are needed to enhance cross-border linkages. A comprehensive, competitive and wider range of products innovation is also essential to cater the different risk-return requirements of investors. In addition, tax legislation and incentives should be able to cater all types of Islamic products and services. Extensive promotion and awareness at domestic and international level regarding investment opportunity is important to enhance public knowledge, understanding and activities in this
market. Continuous government strategies formulation and effective implementation as well as supports from all market players are vital towards this goal.

This paper tracks the development of the Islamic Capital Market in Malaysia. In order to critically review the success of this development, further empirical studies with financial data is needed. It is suggested that future studies investigate the Islamic Capital Market from all angles, such as new product innovation, performance, branding and pricing, including comparisons with conventional capital markets. It is hoped, however, that this paper will provide a platform from which future research can be launched.
Notes:

i The LOFSA website (http://www.lofsa.gov.my) provides excellent information about this organisation.

ii Further information regarding this exchange can be referred to its website (http://www.lfx.com.my).

iii Islamic Fund Management can be carried out together with conventional fund management business.

iv The others are money market, structured, feeder, fixed income, mixed and structured funds

v The structure of Islamic ETF is similar like a unit trust but it is entirely a different product as it is tradable instantaneously on the Bursa Malaysia like equity during the usual trading hours.

vi Investment in REITs will give returns generated from rental income plus any capital appreciation that comes from holding the real estate assets over an investment period. The unit holders of REITS will receive returns in form of dividend and capital gain.

vii Ijarah (leasing contract), mudharabah (business venture contract: profit sharing), musharakah (business venture partnership: profit and loss sharing), bai’ bithaman ajil (assets financing contract: deferred payment sale), istisna (progressive sale) are the Islamic principle used for a similar transaction in conventional market.
References


