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FEATURE

The Sukuk market performance in Malaysia

The increasing awareness of Sukuk has made the Malaysian Sukuk market a viable source of capital formation for eligible issuers. MEOR AMRI MEOR AYOB shares his insights.

The growth of the Malaysian bond market can be traced back to the 1970s, when the government started issuing bonds to meet the massive funding needs for the country's development. By the mid-1980s, the private sector had assumed a more important role in the strategic development of the Malaysian economy, with the aim of making it the main driver of growth as well as finance. During that period, the corporate sector relied heavily on bank loans, which in turn prompted the government to pursue the development of the corporate bond market as a key strategic priority.

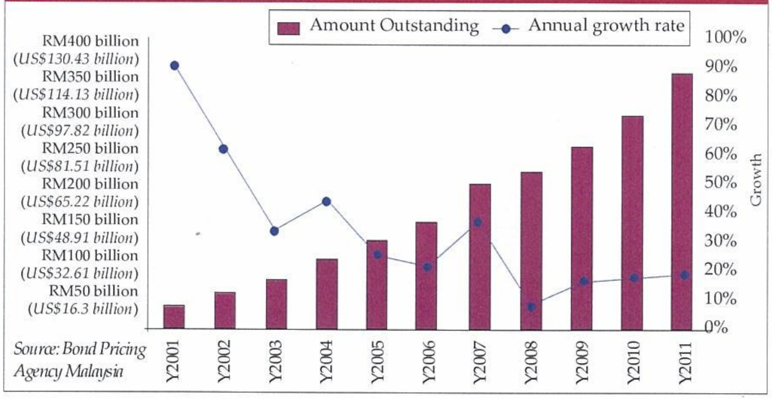
The regulatory push to mould Malaysia into a global hub for the development of Islamic finance was also important plus for the bond market. On the supply side, the issuance of Sukuk in terms of innovativeness and volume has been equally matched by growth on the demand side. The issuance of new licenses for Islamic financial institutions and the rising number of dedicated Islamic funds all point to a bright future for the Malaysian bond market.

Historical perspective

The Malaysian bond market can be characterized as being in a developing phase. High growth rates have been its hallmark, attributable to increasing recognition of the local bond market as a viable alternative for capital formation. Borrowers can have substantial influence over the structure of a proposed bond issue. Coupled with the vast number of potential investors with varying risk appetites, this has effectively fuelled growth. The push by financial institutions to re-prioritize lending activities to the retail sector after the regional crisis of the late 1990s has also accelerated market disintermediation, with corporate borrowers moving away from the banking sector to the bond market.

The Malaysian Sukuk market continues to expand. The creation of a number of Islamic financial institutions and the increasing awareness of Sukuk as alternative asset class have made the Malaysian Sukuk market a viable source of capital formation for eligible issuers. This pull factor on the demand side provides a powerful incentive for a build-up on the supply side. Innovative Sukuk structures incorporating one or more of the standard Islamic financing contracts are continuously being developed and introduced to the market. This conducive environment will elevate the Sukuk market to higher levels, with the trend expected to be maintained in the foreseeable future.

Graph 1: Graph of Sukuk outstanding at the end of the year in RM billion (US$)



Source: Bond Pricing Agency Malaysia

> ***"The regulatory push to mould Malaysia into a global hub for the development of Islamic finance was also important plus for the bond market"***

The trends in outstanding quantities and growth of the Sukuk market over the last 11 years are depicted in chart 1. As illustrated, the Malaysian Sukuk market has been enjoying healthy annual growth rates. For the last 11 years, the lowest annual growth rate ever registered by the Malaysian Sukuk market was in 2008 at just 7.6%. Apart from that year, every other year has seen double digit growth.

Despite the global impact of the fallout from the US subprime mortgage crisis and the Eurozone sovereign debt crisis, their effect on the growth performance of the local Sukuk market has not been significant. The Malaysian Sukuk market did not suffer much since most of the Sukuk issued were for local infrastructure projects. A similar trend for the next few years is likely.

Market infrastructure

The Malaysian Sukuk market would not have reached this level without having a strong market infrastructure in place. The concept of Sukuk in Malaysia is embedded in the Islamic banking and financial system. It began with the birth of the Pilgrimage Fund in 1973; the first Islamic financial institution in Malaysia. A decade later, with the enactment of the Islamic Banking Act 1983, Bank Islam Malaysia became the first fully-fledged Islamic commercial bank in Malaysia. In 1993, the government took another bold step and introduced the interest-free banking unit (IBU), an Islamic window within the existing commercial banks. The IBU allows for the parallel existence of conventional and Islamic banking systems within a bank.

Other infrastructure systems set up to support Islamic banking included the

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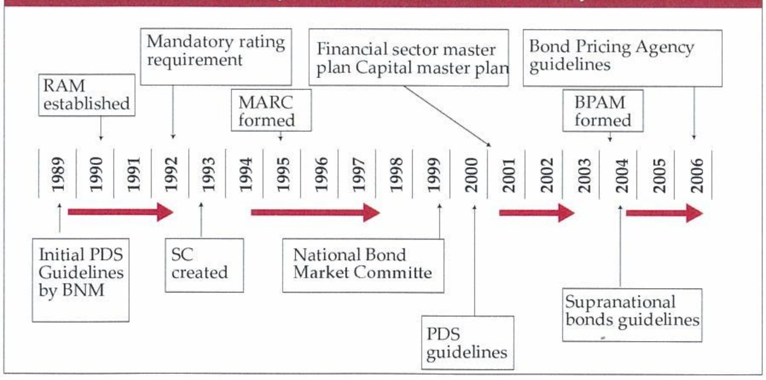
Chart 2: Evolution of the Malaysian bond and Sukuk markets — Key milestones



Sukuk financing and Islamic Interbank money market. The Islamic money market was established in 1994 as the final major requirement for a complete Islamic banking system. It currently serves as a place to trade Islamic financial instruments. In addition, a National Shariah Council was established: a single source of reference for advice on the legality and compliance of Islamic financial instrument transactions to Shariah law, which streamlined the development process.

A number of other important market infrastructures have also been established in the last two decades. Chart 2 shows an illustration of the establishment timeline for key market infrastructures in Malaysia.

Sustaining such growth requires a very good legal as well as price discovery mechanism to enable market participants to be well informed of valuation levels and their rights. In this regard, Malaysia has in place a very good legal framework which has shown its impartiality as well as its fairness. However, the issue of valuation remains a very grey area. This factor is important as only with a strong valuation regime in place can one confidently assess the performance of the Malaysian Sukuk market.

In marking-to-market using market price, the last transacted price of the instrument is taken. Market price is reliable only in an efficient market where information infrastructures are established and liquidity is sufficient. In the bond and Sukuk markets, less than 1% of bonds are traded on a daily basis. Furthermore, bonds and Sukuk that are traded may not encounter their next trade for several weeks or months. Hence the last traded price may no longer reflect the bond's true value as certain pricing factors may have altered, such as interest rates and credit environment.

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Due to the low level of liquidity in the bond and Sukuk markets compared to the equity market, the ability for players to obtain market prices is extremely difficult. Moreover the 'non-independence' of traditional sources of bond and Sukuk prices in Malaysia, and the lack of comprehensive rules and regulations regarding the origination and usage of generated bond and Sukuk prices, creates a situation of information asymmetry between market players. Despite the market growing to a substantial size, the ability of market players to obtain independent pricing as well as comparing and evaluating th portfolio performance of fund managers, is close to impossible.

To eliminate this impediment to the bond and Sukuk markets, the Securities Commission Malaysia created a new capital market infrastructure: the Bond Pricing Agency concept.

Since the Bond Pricing Agency Malaysia (BPA Malaysia) was established in 2004, the company has provided daily valuation for every bond and Sukuk traded in Malaysia. With eight years of data, BPA Malaysia is able to present data series as well as design a set of indicators that can effectively show the performance level of a portfolio of bonds and Sukuk. With this data, for the first time, performance benchmarking becomes possible.

Performance benchmarking for the Malaysian Sukuk market

In late 2008, BPA Malaysia began to publish a set of bond and Sukuk indices. In recognition of the quality of the product, in October 2011 Thomson Reuters came on board to co-brand this set of 108 indices, out of which there are 36 Thomson Reuters-BPA Malaysia Sukuk Indices, 36 Thomson Reuters-BPA Malaysia Bond Indices and 36 Thomson Reuters-BPA Malaysia All Bond and Sukuk Indices.

As a performance benchmark, it is able to track the impact of the various international and local events. For reference, chart 3 is a performance graph

Chart 5: Simple average returns as of the 28th February 2012

Period	All Bonds	Government Sukuk	Corporate Sukuk
1 Month	0.63%	0.55%	0.83%
3 Months	1.84%	1.82%	1.99%
6 Months	2.60%	2.69%	2.72%
12 Months	5.96%	5.53%	6.94%

Source: Bond Pricing Agency Malaysia and Thomson Reuters

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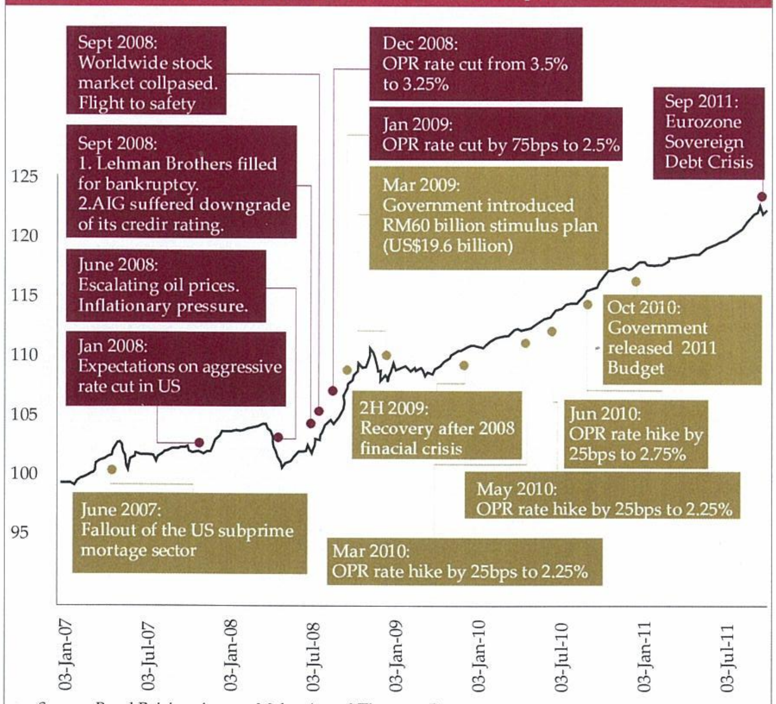
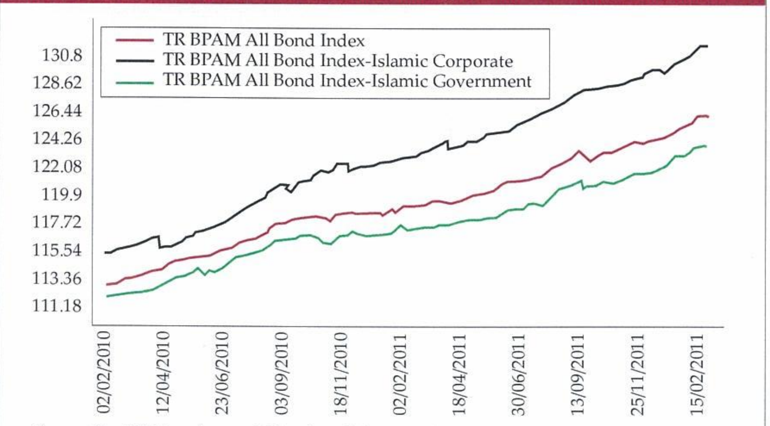
Chart 3: Events tracking via the TR-BPAM Sukuk Index Graph



Source: Bond Pricing Agency Malaysia and Thomson Reuters

Chart 4: Comparison between TR BPAM All Bond, Islamic-government and Islamic-corporate indices



Source: Bond Pricing Agency Malaysia and Thomson Reuters

of the TR-BPAM All Bond Islamic Index as well key events that have affected the movement of the graph across time. As shown in the graph, significant economic events both international as well as local have had an effect on the performance of the Malaysian Sukuk market, at varying degrees. Major equity market events such as the worldwide collapse of the stock market in the later part of 2008 also appear to have had a significant impact to the Sukuk market. This index has consistently tracked events influencing the Malaysian Sukuk market.

A further breakdown of specific Sukuk classes such as government and corporate Sukuk markets yield the statistics shown in chart 4. A number of interesting observations can be found from the performance statistics.

Chart 5 is a table of the simple average returns of the three different portfolios segregated in four distinctive periods.

At the reference date of the 28th February 2012, the corporate Sukuk portfolio recorded the best returns for all period buckets. The corporate Sukuk portfolio outperformed the government Sukuk portfolio at every period bucket. The government Sukuk portfolio recorded a higher return compared to the all bond (and Sukuk) portfolio in the six- month period bucket.

These results are not only intuitive but also very revealing.

The adage 'high risk, high return' is very much evident in the statistics. Since corporate issuers are riskier compared to government risk, it make sense for corporate Sukuk portfolios to register higher returns compared to government Sukuk portfolios. Another interesting observation is the performance of the government Sukuk portfolio compared to the all bond portfolio at the six-month period bucket. For the government Sukuk portfolio to outperform the all bond portfolio, it would imply the conventional bond portfolio must have performed worst to bring the average down.

Conclusion

To sustain a growing and vibrant Sukuk market, a number of key infrastructures must be put in place. Increasing the efficiency and ease for issuers as well as investors in Sukuk products and services will help to promote the viability of the market as a source for capital raising as well as an investment opportunity. However, an efficient market can only be attained if valuation can be easily ascertained and performance benchmarking is made available. This factor alone will introduce the necessary ingredient to promote the market transparency that is naturally available in equity markets.

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