Development of Sukuk Ijarah in Malaysia

Mohd Yahya Mohd Hussin*  
Fidlizan Muhammad*  
Salwa Amirah Awang**  
Ahmad Azam Sulaiman@Mohamad***

Abstract

Sukuk Ijarah is one of the alternative instruments in Islamic finance which is frequently offered and received encouraging response in the Malaysian capital market. It plays the role as the source of the financing fund and capital liquidity for the purpose of economic growth. This scenario of Sukuk Ijarah development owes to the tax incentive given by the government and the acceptance among international investors toward the issuance of sukuk based on equity. This positive development of Sukuk Ijarah has indirectly expanded the Shariah compliant investment activity in Malaysia. Besides that, the role of Shariah Advisory Council (SAC) of Security Commission (SC) in preparing guidelines for people to be involved with Islamic investment field has encouraged the further growth of Islamic Capital Market in Malaysia especially for Islamic Sukuk market.

Keywords: Sukuk, al-Ijarah, Islamic Capital Market

1. Introduction

Economic growth of a country relies on an efficient and effective capital market. The existence of Islamic Capital Market which moves in parallel with the conventional capital market in Malaysia contributes to the rapid economic development of the country. Indirectly, this has expanded economic activities based on Shariah. Eventhough the Islamic Capital Market uses the same market facility as the conventional, but the two have quite a different component and activity (Securities Industry Development Centre (SIDC), 2002).

Obiyathulla Ismath Bacha (2002) explains that the Islamic Capital Market is formed and structured based on five main operational principles that is to prevent practice of usury, share risks, avoid events of speculation, equalize the aqd with the subjected

* Lecturer, Department of Economics, Faculty of Management & Economics, Universiti Pendidikan Sultan Idris, Tanjong Malim, Perak.
** Lecturer, Department of General Studies, Politeknik Sultan Azlan Shah, Behrang Stesen, Perak
*** Lecturer, Department of Syariah and Economics, Academy of Islamic Studies, Universiti Malaya, Kuala Lumpur
contract and activities carried out must be legal from the Shariah perspective. In brief, Islamic Capital Market refers to a market in which activities are done through ways that are not contradicting with the principles of muslims and Islam.

In accordance to the increase of interest in the use of Islamic products, sukuk is identified as an alternative instrument for financing and investment. It comprises of Islamic government debt security and Islamic corporate debt security. Sukuk market becomes the prime source for the financing need toward productive investment activity. While for investors, it offers potential for diversing the class of their new investment asset.

Growing interest in Sukuk market can be traced in 1983 when Malaysian Government launched a government bond known as Government Investment Certificate (SPK) based on the concept of Qard al-Hasan. The purchase of SPK by the public was considered as loan for the government to be spent on development expenses (Suruhanjaya Sekuriti, 2002). In November 1999, Bank Negara Malaysia (BNM) issued the second series of Malaysian Saving Bond (BSM02) for pensioners in RM 2 billion whereby RM 1 billion was issued based on the concept of Bai’ al-Inah (Bank Negara Malaysia, 1999).

Another important development in Sukuk market was recorded when Free Interest Private Debt Security known as CagamasMudharabah Bond was launched in May 1993 by Cagamas Berhad using the concept of Mudharabah. Its purpose was to finance the Islamic Housing Loan from institutions that provided Islamic Housing Finance for their customers with the value of RM 30 million (Suruhanjaya Sekuriti, 2002).

Generally, the growth in Islamic Capital Market Industry especially for sukuk succeeds the variation of Islamic Investment Instruments and drives the development of Islamic capital market in Malaysia. This can be achieved through the role of Shariah Advisory Board (MPS) of Security Commission which provides guideline for Islamic investment that becomes the main source of reference for investors and fund managers to ensure that Muslims can participate in investment without hesitation in the Malaysian Islamic Capital Market especially in Sukuk (Mohd Yahya et al, 2009).

2. The concept of Sukuk

Sukuk is an Arabic word which is the plural for the word sakk that means financial certificate. Sukuk in the context of Islamic capital market refers to a process of securitizing and is known as Islamic bond. Security Commission (2006) explains sukuk as a financial document in which its value is based on property while Hailani
and Sanep (2009) define sukuk as a certificate that describes a right of participation over an asset.

Therefore, sukuk should be based on physical items that have concrete value. This is because the sukuk certificate per se is solely a paper contract and with that it has no intrinsic value (Saiful Azhar Rosly, 1997). Besides that, Shamsiah and Nor Fahimah (2009) state that the parties involved in the structuring or issuance of sukuk must consider the rules drawn by the Security Commission related to base asset\(^1\), price of sukuk asset\(^2\) and the use of fund gained from the issuance of sukuk\(^3\). All these are vital in ensuring the issued sukuk conforms the Shariah requirement.

Apart from that, the most common uses of sukuk can be named as project specific, asset-specific, and balance sheet specific (Shariq Nisar, 2007):

**Project-specific Sukuk**

Under this category money is collected via sukuk for specific project. For example, the Government of Qatar in 2003 issued Qatar Global sukuk to assemble funds for the construction of hospital in Doha (Hamad Medical City (HMC)).

**Assets-specific Sukuk**

Under this category, the funds are mobilized by selling the beneficiary right of the assets to the investors. For instance, Ijara sukuk Trust Certificates (TCs) worth US$ 600 million issued by the Government of Malaysia in 2002.

**Balance Sheet-specific Sukuk**

An instance of the balance sheet specific use of sukuk funds is the Islamic Development Bank (IDB) sukuk issued to finance a variety of projects of the member countries. The IDB made its entrance resource mobilization from the international capital market by issuing five-year sukuk worth US$ 400 million in 2003.

To date, there are a few types of Sukuk issuance that apply different Shariah principles. The categorization of Sukuk according to nature of contract can be divided

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\(^1\) MPS decides that the asset benchmarking used in the structuring of sukuk must be Shariah compliant. Thus, any assets that do not fulfil this pre-requisite cannot be considered as base asset.

\(^2\) MPS concludes that the buying price for a benchmarking asset should i) if it is purchased at more than the market price, it must not exceed one and third quarter of the market price and ii) if the asset is purchased at a discounted rate, the buying price must not less than 0.67 (two third) of the market price.

\(^3\) MPS rules out that the fund gained from the issuance of sukuk must be used for only Shariah compliant purposes.
into three categories which are sukuk based on sale (Sukuk al-Murabahah, al-Istisna’ dan Salam), based on equity (Sukuk al-Mudharabah dan al-Musyarakah) and based on rental (Sukuk al-Ijarah).

If it is viewed from the aspect of base asset nature, sukuk can be divided into two which are sukuk based on debt (Sukuk al-Murabahah, al-Istisna’ dan Salam) and based on equity (Sukuk al-Mudharabah, al-Musyarakah dan al-Ijarah). Nevertheless, there are other kinds of sukuk practiced in the activity of financing although it is less popular which are sukuk al-Wakalah, Bay bithaman Ajil, al-Muzaraah, al-Musaqa and many more.

According to Hailani and Sanep (2009), Sukuk al-Ijarah is the most accepted sukuk among the Islamic scholars and the most popularly applied in the project financing. Hence, the sukuk structured with only the principle of al-Ijarah will be discussed in this article.

3. Sukuk al-Ijarah

Security Commission (2006) enlights that the principle of Ijarah or rental is a contract based on benefit between the lessee and the lessor (the asset owner) when the rental rate and rental duration are specified during the contract. Meanwhile, the ownership right on the asset is preserved to the asset owner (Muhammad al-Bashir, 2001). Through this principle, the company which issues the sukuk will sell its asset (commonly in the form of equipment, building or machine) to the loaner by asset purchase contract. The loaner will then rent the purchased asset to the company using the contract of ijarah. The payment of rent by the company will be made through the issuance of sukuk.

Hailani and Sanep (2009) opinionate that sukuk al-Ijarah is a sukuk structured with the concept of rental together with the endowment of right to the lessee to purchase the rented assets on the final date of rental. This sukuk is issued by applying the contract of Ijarah among the Sukuk issuer and the investor. However, the implementation of sukuk involves the sale and purchase contract at the initial stage. With that, sukuk al-Ijarah applies the contract of sale and purchase and the contract of al-Ijarah altogether. Sukuk issued by using this principle represents each unit of sukuk with one part of physical asset. Thus, the loaner is able to sell it in the secondary market without any restriction domestically or internationally.

This is in the contrary with the principle of al-murabahah and al-Bay Bithaman Ajil that will produce certificate of debt (Syahadah al-Dayn) and the debt of sale and purchase (Bay al-Dayn) that only negotiable in Malaysia based on the specified rules
(Abdulkader Thomas, 2007). In addition, the principle of Bay al-Dayn receives opposition from some of the scholars from the middle east (Kamaruzaman et.al, 2004).

4. Types of Sukuk Ijarah in Malaysia

Sukuk al-Ijarah is the sukuk that usually attracts the interest of investors. In Malaysia there are two types of sukuk al-Ijarah issuance which are sukuk issued by the government and another one issued by the private. There are only two types of sukuk issued by the government applying the principles of al-Ijarah which are Malaysia Global Sukuk and BNM Ijarah Sukuk. While, for sukuk issued by the private, there are various principles that have been applied. For example, the principles of al-Ijarah Thumma al-Bay is adopted by Sukuk Ijarah DRIR Management, al-Ijarah Muntahiyah bi Tamlik (Islamic Finance Bulletin, 2008)\(^4\) is applied by Sukuk Ingress and ample Zone, al-Ijarah Mausufah fi Zimmah (AAOIFI, 2003: 299) is used by Sukuk Ijarah Projek Lintasan Shah Alam (PLSA) and the principle of rental and re-rental (AAOIFI, 2003: 298) is practiced by Sukuk al-Aqar Capital.

The diversity of sukuk al-Ijarah structure issued by the private sector aims to reduce the risk of violation of rent payment and repurchase of asset at the end of rental period. Besides that, usually the issuance of sukuk al-Ijarah actually has multiple purposes such as for the purpose of financing and liquidity (Sudin Haron, 2007). The issuance of sukuk al-Ijarah purposively for financing is done when the company that is in need of specific assets cannot afford to buy these assets, thus the company through the Special Purpose Vehicle (SPV) will issue Sukuk Ijarah to collect fund from the investors and act on behalf of their names, to buy the needed assets in cash from the manufacturer or seller, and later rent them to the company. The company will pay rent to the investors through SPV based on agreement and purchase these assets at the maturity period based on options.

The issuance of sukuk al-Ijarah for the purpose of liquidity occurs when the company requires fund for its working capital or as turnover capital. In this situation, the company will select valuable property like the owned building or factory, and then

\(^4\) Generally, the concept of sukuk al-Ijarah thumma al-Bay and al-i jarah muntahiyah bitamlk is the same. The difference is found in sukuk al-Ijarah tumma al-Bay, where the original asset owner can purchase or recall the asser before the maturity period whereas in al-Ijarah muntahiyah bitamlk, the transfer of asset ownership can be done through several ways: 1) purchase at market price (prior maturity period), 2) through last payment (at the end of maturity period), 3) through the amount of minimal payment (at the end of maturity period) and 4) as a gift (at the end of maturity period)).
sell them to investors by SPV. If the value of a property is not large enough, it can be combined with other kinds of asset. For instance, the building can be combined with the value of land and machinery. This group of property is then sold collectively to investors via SPV. The investors will pay in cash to the company SPV and later, the SPV that represents the investors will make an agreement to rent the property to the company. At this time, the liability is born by the company that pays the rent to the investors. The liability to pay the rent can be securitized by SPV in which the promise to pay the monthly rent will be made in the form of sukuk and surrendered to the investors. This Sukuk can be kept or resold in the secondary market by the investors.

5. Mechanism of Sukuk al-Ijarah Issuance

Every issued sukuk must be based on asset. It is to avoid usury. The process of sukuk issuance can be divided into two methods which are to involve the SPV as the mediating body and vice versa. The issuance of sukuk with SPV involvement generally comprises six steps while the issuance without SPV involvement only consists of three steps (Hailani dan Sanep, 2009). Nonetheless, the current practice in the issuance of sukuk usually involves SPV. Based on figure 1, there are six steps in sukuk Ijarah issuance which are:

1) The asset owner will identify the asset or project to be the base asset.

2) The asset owner will sell the asset or project to SPV to be worked on by basing on the sale and purchase contract.

3) Sukuk Ijarah issued by SPV to collect fund from investors and it is given as a proof of possession and a contract of rent payment which is negotiable in the secondary market.

4) SPV will conduct business with the original owner or the third party for the rental matters based on initial agreement.

5) The rental profit gained by SPV will be divided as capital revenue for investors.

6) After the period of maturity, SPV will execute the process of reselling that requires the original owner or the tenant to buy the asset for the purpose of sukuk certificate redemption.


Parallel to the increasing interest in the use of Islamic product, sukuk has been identified as an alternative instrument for financing and investment. It consists of
Islamic government debt security and Islamic corporate debt security (Security Commission, 2002). Malaysia issued around 60 percent of global sukuk value worth about AS$100 billion (Berita Harian, 13 May 2008). Sukuk market becomes the important source for the need of productive investment activity financing while for the investor, it provides a potential for diversing the class of their new investment asset.

Figure 1: The Issuance of Sukuk al-Ijarah by Using SPV

Source: Modified from Hailani and Sanep (2009)

In Malaysia, the first sukuk ijarah was issued by Segari Energy Ventures Sdn Bhd on 30 September 1997 with the value of RM 521.5 million and 4 times of repayment to the holders which were on 31 March 2002 with RM 116 million, and RM 124.5 million, RM 157 million and RM 124 million on 31 March 2003, 31 March 2004 and 31 March 2005 respectively (Sudin Haron, 2007).

In December 2000, Kumpulan Guthrie Berhad (Guthrie) was granted a RM 1.5 billion (US$400 million) Al-Ijara Al-Muntahiyah Bit-Tamik by a consortium of banks. The original facility was raised to re-finance Guthrie’s acquisition of a palm oil plantation in the Republic of Indonesia. The consortium was then invited to participate as the underwriter/primary subscriber of the Sukuk Transaction (Shariq Nasir, 2007).

Malaysia Global Sukuk that adapted the principle of al-Ijarah was the first sukuk Ijarah issued by the government in July 2002 with the value of USD 600 million and
maturity in 2007. It was based on property asset traded in the international market. Its purpose was to expand the nation’s Islamic financial instrument and to generate the liberalization of Islamic capital market (Ali Arsalan Tariq, 2004).

Since then, a few sukuk were issued by the public and private sectors to finance the need of their long term financing that based on equity including the concept of al-Ijarah.

Table 1: Number of Sukuk Approved By The Security Commission

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Sukuk</th>
<th>Number of conventional Bond</th>
<th>Overall Total of Sukuk and Bond</th>
<th>Size of Sukuk Issuance (RM Bilion)</th>
<th>Size of Conventional Bond Issuance (RM Bilion)</th>
<th>% of the overall value of the approved bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>35</td>
<td>79</td>
<td>114</td>
<td>19.0</td>
<td>26.6</td>
<td>41.5</td>
</tr>
<tr>
<td>2002</td>
<td>34</td>
<td>137</td>
<td>171</td>
<td>17.6</td>
<td>38.41</td>
<td>31</td>
</tr>
<tr>
<td>2003</td>
<td>31</td>
<td>87</td>
<td>118</td>
<td>12.0</td>
<td>35.3</td>
<td>25</td>
</tr>
<tr>
<td>2004</td>
<td>49</td>
<td>75</td>
<td>124</td>
<td>15.16</td>
<td>32.68</td>
<td>31.7</td>
</tr>
<tr>
<td>2005</td>
<td>77</td>
<td>49</td>
<td>126</td>
<td>43.32</td>
<td>17.34</td>
<td>71.4</td>
</tr>
<tr>
<td>2006</td>
<td>64</td>
<td>52</td>
<td>116</td>
<td>42.02</td>
<td>33.81</td>
<td>55.4</td>
</tr>
<tr>
<td>2007</td>
<td>59</td>
<td>61</td>
<td>120</td>
<td>121.3</td>
<td>37.5</td>
<td>76.4</td>
</tr>
<tr>
<td>2008</td>
<td>47</td>
<td>52</td>
<td>99</td>
<td>43.2</td>
<td>96.7</td>
<td>30.9</td>
</tr>
<tr>
<td>2009</td>
<td>11</td>
<td>23</td>
<td>34</td>
<td>34.0</td>
<td>23.5</td>
<td>59.1</td>
</tr>
</tbody>
</table>

Source: (Security Commission, Annual Report, Multiple Years)

By basing on Table 1, generally it was found that the value of sukuk issuance in Malaysia was increasing from year to year from RM 19 bilion in 2001 to RM 34 bilion pada in 2009. The largest increase was recorded in 2007 in which the value of sukuk achieved RM 121.3 bilion which was an increase of RM 79.28 bilion from the previous year. However, in 2008, the value of sukuk experienced a major decrease with RM 78.1 bilion.

During 2001 until 2004, it was discovered that the size value of sukuk issuance was only between RM 12 bilion to RM 19 bilion that represented a market domination of 41.5 percent. Furthermore, in 2005 demonstrated an increase of sukuk issuance value with RM 43.32 bilion compared to RM 15.16 bilion in the previous year that signalled to a market domination of 71.4 percent from the total overall of approved in Malaysia.
Meanwhile in 2006, the Security Commission approved 116 of issued bond and sukuk that worth RM75.83 bilion. From the number, 64 was made of sukuk with the value of RM42.02 bilion. This value delineated 55.4 percent of the new approved bond. In 2007, the Security Commission passed the issuance of 120 bond with RM158.8 bilion. From that figure, 59 was from sukuk issuance that worth RM121.3 bilion. This value symbolized 76.4 percent of newly issued and approved bond. Based on the number of approved sukuk by the Security Commission, it showed that the flow of loan financing was more focused on sukuk compared to conventional bond in which since 2005, more than 55 percent of new bond that was approved annually comprised of sukuk.

But in 2008 the number of issued sukuk was smaller compared to conventional bond whereby from the overall total of 99 issuance, only 47 was sukuk issuance and another 52 was conventional bond. The value of the approved sukuk was 43.2 bilion that represented only 30.9 percent of the overall value of the approved bond.

In 2009, the number of issued sukuk was only 11 issuance compared to bond that was 23. The issued sukuk had 59.1 percent of capital market value of RM34 bilion. This exhibited that although the number of its issuance was smaller but its value was greater. Thus it was an indication that sukuk instrument was accepted by investors in Malaysia and at international.

Table 2: The Percentage of Sukuk al-Ijarah According to the Capital Market Value and the Number of Issued Sukuk.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of Capital Market (%)</th>
<th>Number of Issued Sukuk (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>8</td>
<td>15</td>
</tr>
<tr>
<td>2004</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2005</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>2006</td>
<td>3</td>
<td>17</td>
</tr>
<tr>
<td>2007</td>
<td>4</td>
<td>19</td>
</tr>
<tr>
<td>2008</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2009</td>
<td>8</td>
<td>20</td>
</tr>
</tbody>
</table>

Source: *(Islamic Finance Bulletin & Sukuk Focus, Variety of Publishing)*
According to Table 2, it was found that the issued sukuk using the principle of al-Ijarah can be categorized into two which are based on capital market value and also the number of issued sukuk. From the aspect of capital market value, the issued sukuk adopted the principle of al-Ijarah only dominated the value of sukuk capital market by not more than 9 percent. This could be proven by the highest percentage value recorded in 2003 and 2009 with 8 percent respectively while in 2004 noted the lowest percentage with only 1 percent.

Form the aspect of the issued sukuk number that applied the principle of al-Ijarah, it was discovered that its domination was not more than 20 percent when the highest percentage of 20 percent was attained in 2008 and 2009 while in 2004, the lowest percentage of 2 percent was recorded from the total overall number of the issued sukuk. The issuance of sukuk based on the concept of al-Ijarah was low in 2004 from the aspect of capital market value and also the total number because in that year the issuance of sukuk was more focused on the concept of debt or sale such as al-Murabahah, Bay bithaman Ajil as well as al-Itisna’ (Mohd Yahya et al, 2009).

Other than that, beginning from the year of 2005, it was found that there has been an innovation in the structuring of sukuk in which the issuance of sukuk has currently tended to the principles that based on equity al-Musyarakah, al-Mudharabah and also al-Ijarah. According to Mohd Yahya et al (2009), the combination of sukuk issuance that based on equity majored more than 65 percent of the capital market value total and also the number of issued sukuk from 2006 until 2008. Meanwhile in 2009, the issuance of sukuk based on the concept of ijarah populated 20 percent of the issued sukuk total number and from the aspect of sukuk capital market, the concept of Ijarah overpowered by 8 percent. To Abdulkader Thomas (2007), the issuance of sukuk based on ijarah concept was the second largest contributor after Sukuk al-Musyarakah in the world with the domination of 18.29 percent in 2006.

In relation to that, there are a few overviews regarding the factors for the growth of Sukuk Issuance based on equity especially the ijarah concept in Malaysia. Among them is because the issuer tends to apply the principle of Ijarah for motivation given by the government that rules out any sukuk that is issued by using the principles of al-Ijarah, al-Musyarakah, al-Mudharabah and al-Itisna’ is entitled for tax incentive that is the reduction of sukuk issuance expenditure cost (RAM, 2010).

Besides that, most of the capital loaners are middle eastern investors. Therefore, the issuance of sukuk based on the concept of al-Ijarah suits their understanding and culture that their investment tendency is more towards the method of sukuk issuance based on equity. Apart from that, sukuk Ijarah is universally negotiable be it in
Development of Sukuk Ijarah in Malaysia

Malaysia or the world itself (Abdulkader Thomas, 2007). This indirectly evidences that the issuance of sukuk through the concept of Ijarah has diversified the structuring of sukuk and then it is able to drive the development of Islamic capital market industry in Malaysia and also in the world.

7. Conclusion

In general, the development of sukuk market in Malaysia is mostly dominated by the issuance of sukuk based on equity such as al-Musyarakah, al-Mudharabah and also al-Ijarah. The issuance of Sukuk Ijarah has been popularly applied by the government and the private sector in ensuring the continuation of economic growth and the upgrading of Islamic financial liberalisation. This development is also influenced by the demand factor from foreign investors especially from the middle east countries towards equity based sukuk instrument as well as the tax incentive endowed by the government in the issuance of sukuk ijarah. All in all, the diversity in issuing the sukuk that based on equity or debt has become the main core of Islamic capital market development with sukuk market domination of 60 percent in Malaysian bond market capitalization. This condition has indirectly made Malaysia as a hub that is capable of providing profitable investment opportunity and competitive towards investors in the world besides from being compliant to Shariah requirement.

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