Islamic Financial and Capital Markets

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# Chapter 1: Overview of Islamic Finance and Markets

5

- Chapter Introduction
- Fundamentals of Islamic Finance
- \textit{Shar\'i}ah Principles for Financial Products and Services
- \textit{Shar\'i}ah Principles for Equity Financing
- \textit{Shar\'i}ah Principles for Debt-financing
- The Evolution of Islamic Capital Markets
- Structural Issues in Islamic Equity Markets
- Operational Issues for Islamic Equity Markets
- Islamic Investment Funds
- Types of Islamic Investment Funds
- Types of Islamic Equity Funds
- Screening and Purifying Funds for \textit{Shar\'i}ah-Compliance
- Two Types of Financial Instruments

# Chapter 2: Overview of Advanced Islamic Instruments and Markets

19

- Chapter Introduction
- Investment \textit{Sukuk}
- Islamic Financial Markets and \textit{Sukuk}
- Trading Islamic Financial Instruments
- Islamic Stockbroking Services
- Islamic Inter-Bank Money Market (IIMM)
- Islamic Forward Markets
- Islamic Foreign Exchange Markets
- Derivatives in Islamic Finance
- Major Issues with Derivatives

# Chapter 3 - Islamic Capital Market Products

27

- Chapter Introduction
- Choosing Stocks for Islamic Equity Funds
- Choosing Stocks for Islamic Equity Funds (Contd.)
- Growth of Islamic Equity Funds
- Challenges for Islamic Equity Funds
- Islamic Commodity Funds
- Real Estate Investment Trusts (REITS)
- Types of REITs
- REIT Structures
- Hedge Funds and Islamic Finance

# Chapter 4 - Challenges to the Growth of Islamic Financial Markets

37

- Chapter Introduction
Need for a Regulatory and Legislative Framework

Customising Regulatory and Legislative Frameworks

Market Structure and Practices

Use of Incentives to Promote Growth

Development of Supporting Institutions

The Use of Financial Engineering

Use of Training and Interaction to Promote Growth

Bibliography
Chapter 1: Overview of Islamic Finance and Markets

Chapter Introduction

Overview of Islamic Finance and Markets.

The Islamic financial system comprises all financial market operations and transactions that are based on the \textit{Sharī'ah}, the Islamic code of laws and ethics.

Islam prescribes certain financial activities and prohibits others. Muslim investors generally practice Islamic financial principles, but others may find the ethics of it attractive.

Modern Islamic products and services can be developed:

- By identifying all existing conventional practices that will be acceptable to Islam and
- By removing non-\textit{Sharī'ah}-compliant elements from conventional products and services and by innovating and developing new products that comply with the \textit{Sharī'ah}.

The Islamic capital market is similar to the conventional market, but it will have to work on a different set of principles. For example, Islamic markets function without interest rates.

In general, Islamic finance is asset based and therefore, fund based activity is more suitable for Islamic financial institutions than conventional financing.

The challenge before Islamic markets is that debt is not acceptable to Islam. Again, any stock must be \textit{Sharī'ah}-compliant if it must be accepted by Islam.

The Islamic investment funds, Islamic equity funds and the need for screening and purifying will be covered later in this chapter.


On completing this chapter, you will be able to:

- Explain the \textit{Sharī'ah}'s legal maxim towards commercial transactions and the four major prohibitions,
- Explain the impact of the \textit{Sharī'ah}'s principles on Islamic finance and the basic nature of Islamic equity and debt financing,
- Explain the \textit{Sharī'ah}'s principles from which equity financing contracts of Islamic finance have been derived,
- Explain the \textit{Sharī'ah}'s principles from which debt financing contracts of Islamic finance have been derived,
• Describe the evolution of Islamic equity and debt markets since the second half of the twentieth century,
• Describe the need for screening stocks for investment by Islamic equity funds and the process of ensuring the returns are compliant with Shari'ah guidelines,
• Describe the basic nature of the Islamic investment fund business,
• Describe the five types of Islamic investment funds,
• Describe the four types of Islamic equity funds,
• Describe the nature and evolution of Islamic stockbroking services and
• Distinguish between the two types of financial instruments based on return.

**Fundamentals of Islamic Finance**

Islamic commercial law is called *Fiqh al-Mu'amalah* and it is based on the tenets of equitable distribution, social justice and fairness, described in the *Shari'ah*.

*Shari'ah* guidelines with respect to commercial transactions are that, “they are permissible unless there is a clear prohibition”.

So, a transaction is *Shari'ah*-compliant if elements clearly prohibited by the *Shari'ah* are removed.

The four elements clearly prohibited by the *Shari'ah* are:

- **Ribâ**
- **Gharar**
- **Maisir**
- Non-*halal* food and drinks and immoral activities.

**Ribâ**

The literal meaning of *Ribâ* is ‘excess’ and it refers to any increase or excess that one party in a transaction gets at the expense of the other party.

Through the following verses, the Holy Qur’ān asserts that trade is lawful, but *Ribâ* or usury is not.

Verse two hundred and seventy five of the *Surah Al-Baqarah* of the Holy Qur’ān says this: Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But *Allāh* has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with *Allāh*. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein.”
The *Surah An-Nisâ’*, in verse twenty nine, provides this guidance: O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, *Allâh* is to you ever Merciful.

The *Sharî'ah* identifies two types of *Ribâ* – *Ribâ Qurudh* and *Ribâ Buyu*.

The prohibition of *Ribâ Qurudh* is specific to usury and loan transactions where, a rate of return is assured according to the maturity and amount of the principal, whether or not the investment has been successful.

However, the *Sharî'ah* allows loans to be given and taken for social welfare and short-term needs, provided the amount returned is the same as that borrowed. This type of loan is called *al-Qardh al-Hasan*. The borrower is also within his rights to pay back a greater amount, provided it was not determined at the time of the contract.

The *Ribâ Buyu* applies to the sale and purchase of six *Ribâ* commodities – gold, silver, dates, barley, wheat and salt.

Trading in *Ribâ* commodities is governed by the following conditions:

- When trading happens in the same group and kind of commodity, that is, gold for gold or dates for dates, their value should be exactly equivalent and delivery should be prompt.
- When trading happens in the same group but different kind of commodity, such as wheat for barley, promptness of delivery is not a must.
- When trading happens in different commodities with different groups or kinds of commodities, such as wheat for gold, there are no conditions. The *Sharî'ah* allows for free trade even if there is inequality.

The *Sharî'ah* supports entrepreneurship and profit-earning, provided there is no inequality. Interest is seen as a cost that accrues even if there are business losses and therefore, considered as unfair.

*Gharar*

The *Sharî'ah* prohibits activities that have elements of *Gharar* or uncertainty.

The term *Gharar* covers uncertainty, ambiguity and deception of the buyer. Uncertainty can affect the price and delivery of goods.

The *Sharî'ah* acknowledges that *Gharar* cannot be completely eliminated from the market and allows for some uncertainty provided it is not excessive in the contract.

The *Sharî'ah* prohibits *Gharar* in commercial transactions. For example, *Sharî'ah* scholars refuse to accept conventional insurance because a policy holder pays a
premium expecting a certain amount in case of emergency, but there is no guarantee or certainty about that amount.

**Maisir**

*Maisir* or *Qimar* means gambling in Arabic. It refers to any activity where two parties risk a loss and the loss of one means the gain of the other.

Islam prohibits gambling because it distracts people from productive activities and creates wealth without effort.

The holy Qur’ān and the traditions of the Prophet (peace be upon him) prohibit unearned income, or *Al-Maisir*, such as from games of chance. Speculation always involves a risky attempt at earning greater profit. While all business decisions are speculative to some extent, the lack of relevant information and conditions of excessive uncertainty make business speculation closely related.

Any activity related to the gambling industry is strictly prohibited, including investing, partnering or participating.

**Non-halal products and services**

Islam forbids the use of alcoholic and non-permissible foods such as pork.

Activities such as pornography, prostitution and other immoral entertainment are strictly prohibited. Any related activities such as creating, marketing, processing and selling such products are forbidden too.

Companies involved in any of these activities will not be deemed as *Shari‘ah*-compliant.

**Shari‘ah Principles for Financial Products and Services**

Modern Islamic finance has emerged from Islamic banking. In accordance with the *Shari‘ah*, the banks charged no interest.

In the last decade, a number of new financial products, insurance products and other financial services have been introduced in accordance with the principles of the *Shari‘ah*.

*Shari‘ah*-compliant products have been developed for equity and debt securitisation and are being studied for derivatives.

Rules in accordance with Islamic tenets have also been put in place for banking, broking and investment and advisory services.
Equity financing is a significant part of Islamic financing. This is usually done through profit-sharing agreements called *Uqud Al-Isytirak*.

The two types of equity financing instruments are:
- The *Mudarabah* or profit-sharing
- The *Musharakah* or profit and loss sharing

Debt-financing, on the other hand, is traditionally interest-based and therefore, not *Sharī'ah*-compliant.

In Islam, debt financing is accomplished by making an existing asset the subject of a sale or purchase contract. Such a contract is called *Uqud Al-Mu’awadat*.

The common Islamic debt instruments are:
- The *Murabahah*, which is trade with mark-up or cost plus.
- *Ijarah* or lease contracts
- *Bai‘ al-Salam* or advance purchase
- *Istisna’a* or purchase order

In *Ijarah*, the *Sharī'ah* recognizes two types of leasing—operating lease and finance lease.

**Sharī'ah Principles for Equity Financing**

Islamic equity financing accounts for a large proportion of capital market transactions.

The *Sharī'ah* recognizes equity financing as long as it follows the principle of equitable sharing and fairness.

The *Sharī'ah* recognizes two types of equity financing:
- *Mudarabah* and
- *Musharakah*

**Mudarabah**

A *Mudarabah* contract is a partnership between the owner of capital and an entrepreneur.

The owner of the capital only invests in the project. The management of the capital and the project is the entrepreneur’s responsibility.
In the event of the project making a profit, the owner of capital cannot claim a fixed portion of the profit. Instead, he can take his share based on the pre-agreed ratio of profit sharing.

In the event of a loss, the entrepreneur is not expected to bear the loss. The loss is to be borne entirely by the owner of the capital, unless he can prove that the loss was due to the negligence of the entrepreneur.

The *Sharī'ah* also provides a two-tier *Mudarabah* contract. In the first tier, the owner of capital provides funds to an Islamic financial institution or IFI.

In the second tier, the Islamic financial institution provides that capital to an entrepreneur to invest in a project.

In this arrangement, the Islamic financial institution plays the role of an intermediary between the owner of capital and the entrepreneur.

**Musharakah**

The *Musharakah* is like a joint venture, between an investor and an entrepreneur. Both parties contribute capital, technical and managerial expertise and assets to the venture.

Both parties share the risks as well as the profits in some proportion agreed to at the time of the contract.

In addition, the *Sharī'ah* provides a ‘diminishing *Musharakah*’ or ‘*Musharakah Mutanaqisah*’, where the financial institution and the entrepreneur have joint ownership of the asset. The entrepreneur pays the investor over a period of time, eventually buying out the entire stake in the venture.

**Sharī'ah Principles for Debt-financing**

Islamic debt financing is different from conventional debt financing.

In Islamic debt financing, there must be an asset that is the subject of a transaction.

The *Sharī'ah* permits five types of debt financing contracts:

- *Murabahah*
- *Bai‘ Bithaman Ajil*
- *Bai‘ al-Salam*
- *Ijarah*
- *Istisna’a*

**Murabahah**
The *Murabahah* is a short-term financing option where the buyer and the seller of an asset agree on a price that is marked up over the initial cost price of the seller. Both parties are aware of the actual price and the mark up and agree upon it. The price is paid in cash or in instalments, as per the agreement between the parties. The financier agrees to buy the commodity for selling back to the client at a premium.

**Bai’ Bithaman Ajil**

The *Bai’ Bithaman Ajil* is very similar to the *Murabahah* contract in terms of the financier promising to buy an asset to resell to a client at a marked up price.

The only difference here is that the seller is not obliged to reveal his profit to the buyer. This contract is generally used for long-term financing.

**Bai’ al-Salam**

The *Bai’ al-Salam* is an advance purchase contract. Under this contract, the buyer pays cash for an asset, but its delivery is scheduled for a later date that is fixed at the time of the contract.

Modern Islamic finance permits parallel *Salam* or back-to-back *Salam*, in which the buyer in one *Salam* can be the seller in another *Salam* for similar assets.

The only condition is that each *Salam* must be treated as an independent contract.

**Istisna’a**

The *Istisna’a* is a purchase order where an order is placed for the creation or manufacture of an asset matching the specifications set in the contract.

It resembles the *Bai’ al-Salam*, but there is no need for an advance payment. This contract is used for things that are generally made to order.

The *Shari’ah* also permits parallel *Istisna’a* or back-to-back *Istisna’a*, in which the financier will act as a contractor in one *Istisna’a* and a customer in another *Istisna’a*. Each *Istisna’a* contract must be treated as an independent one.

**Ijarah**

*Ijarah* or lease financing is useful in contracts that involve leasing equipment for projects.

It is the *Manfaah* or the right to use an asset or equipment.
The lessor of equipment or asset enters into a contract with the lessee for a fixed period of time.

There are variations to the Ijarah that permit the lessee to pay a rental for a fixed period, a part of which will go towards the purchase of the asset itself.

This is called Islamic hire-purchase or Ijarah Thumma Bai.

This agreement is also commonly referred to as Ijarah Wa Iqtina or Ijarah Muntahiyah Bi Tamlik.

The Evolution of Islamic Capital Markets

The development of a Sharī‘ah-compliant capital market is the result of the natural growth of economies of Islamic nations that needed a variety of products, including those that were elements of conventional economics, such as stocks and bonds.

The need to provide liquidity to Islamic banks and takaful operators forced Islamic governments to come up with Sharī‘ah-compliant ways to access markets, issue equities and bonds.

Today, Islamic capital markets offer a range of products and services, including Sharī‘ah-compliant stocks, Islamic bonds, Islamic funds and Islamic risk management products.

Services such project financing, stockbroking and venture capital have all been reinvented to comply with Islamic tenets while fulfilling their purposes.

Debt Market

The first successful issue of bonds by an Islamic country was achieved in 1983 by Malaysia. The government issued the Government Investment Issue or GII. The purpose of this issue was to enable the management of assets of Islamic banks.

The GII is designed around the Islamic principle of al-Qardh al-Hasan which means ‘benevolent loan’ which carry no interest. However, this also meant that they could not be traded in the market. The nature of the GII has now been changed to Bai’ al-‘Inah so that it may be traded in the secondary market.

Kuwait too has issued bonds to raise funds for purchasing properties owned by nationals of countries other than the Gulf Co-operation Council.

Iran too has issued participation bonds based on the principle of Mudarabah.
The success of these initiatives in the Islamic debt market has made them popular, with more countries beginning to opt for them.

**Equities Market**

Like in the debt market, the first steps towards an Islamic equities market was taken by Malaysia Bhd, when the Bank Islam Malaysia identified a list of *Sharī‘ah*-compliant stocks in 1983.

The *Sharī‘ah* lists a set of criteria which are used to determine which stocks are compliant with Islamic tenets.

In 1997, the Securities Commission of Malaysia published a list of *Sharī‘ah*-compliant stocks.

The first Islamic equities index was introduced by RHB Unit Trust Management Bhd of Malaysia in 1996.

Since then, several other indices have been launched, including the Dow Jones Islamic Market Index or DJIM, the Kuala Lumpur *Sharī‘ah* Index or KLSI, the FTSE Global Islamic Index Series, S&P 500 *Sharī‘ah* and S&P BMI *Sharī‘ah* group of indices.

The first Islamic investment fund was the Amana Income Fund set up in 1986 in the United States by the North American Islamic Trust or NAIT.

The Dallah Al Baraka group has set up two companies called Al-Tawfeek and Al-Amin, which have launched multiple Islamic investment funds focussing on a range of sectors including real estate and equities.

**Structural Issues in Islamic Equity Markets**

An Islamic economy can function well only if there are vibrant markets. However, the Islamic economic system does not yet have a formal model for a stock market that is *Sharī‘ah*-compliant.

Some elements of a conventional market cannot be part of an Islamic stock market. Those structural elements must be altered or changed to suit a *Sharī‘ah*-compliant market.

**Limited Liability**

The issue of limited liability is tricky since it cannot be directly explained in Islam.
Limited liability means that the company in question is a corporation and has a legal personality. There is no clarity on how to deal with a `legal person.’

Although some *Sharī'ah* scholars have accepted the principle of limited liability, most scholars say it goes against Islam. Therefore, Islamic equity funds invest mostly in public limited companies.

*Fiqh* scholars must study and derive the role of a legal entity in Islam and whether the corporation can be treated as a partnership like the *Musharakah* and how to address the possibility of insolvency of the limited company.

**Contractual Structure of Equity Stock**

An important issue that must be resolved is how does Islam view joint stock companies? What kind of partnership would be the most appropriate to describe this kind of holding?

The *Sharī'ah* recognizes two kinds of *Musharakah* partnerships; the *Musharakah Mulk* and the *Musharakah Aqed*.

The *Musharakah Mulk* makes the partner the owner of a specific asset. The *Musharakah Aqed*, on the other hand, gives the partner ownership over the value of the asset and not the asset itself.

The question is – are stocks to be categorized under *Musharakah Mulk* or under *Musharakah Aqed*?

In practice, the joint stock company is considered as a new kind of *Musharakah*, which is a combination of the two. Under this, trading in stock is classified under *Musharakah Mulk* and the operations and shareholder rights issues are treated under *Musharakah Aqed*.

There is, however, no agreement and no formal classification for the joint stock company.

**Negotiability and Tradability**

The negotiability and tradability of stocks and their transferability from buyers to sellers in the primary and secondary markets is the most important issue.

While the *Sharī'ah* permits trading in goods and services, it prohibits trading in financial interests because it may cause the discreet charging of a *Ribā*, which is not allowed in Islam.

The *Sharī'ah* does not allow trading in *Dayn* or debt, currency or any other monetary unit or future rights.

Shares of a company that holds all its assets in a liquid form cannot be traded. Some portion of its assets must be in some other form, according to the *Sharī'ah*.

This also means that a company that functions as a financial intermediary cannot be held as a public company.
Operational Issues for Islamic Equity Markets

In addition to the difficulties at the structural level, there are operational constraints that make it difficult for conventional market mechanisms to function in an Islamic economy. These must be resolved for the success of the Islamic capital market.

Margin Accounts
The first issue that must be considered is the practice of margin accounts to purchase stock.

Margin accounts are used to purchase stock using leverage and borrowed funds for an interest. This violates the Shari'ah’s no-debt principle.

The use of leverage will directly remove a number of players in the stock market. This, in turn, will affect liquidity in the market and raise transaction costs, causing general inefficiency.

Speculative Trading
Speculation is an inherent part of stock market trading, but is prohibited by Islam which treats speculation as the basis for activities like gambling. While Islam does not specifically bar speculation, it prohibits activities that might result in speculation, such as borrowing funds at an interest.

Some scholars have, however, differentiated between speculation and calculated risk-taking.

Their suggestions for remedial measures include, a tax structure linked to the holding period of investment, regulation to control institutional investors who tend to drive the prices up and down, regulation of pricing and more transparency in the market.

It is also important to understand the benefits of speculators in bringing in liquidity and efficiency.

In general, Islam forbids over pricing. It considers Ghubn, or the difference between the transaction price of a commodity and its fair price, to be unethical. A small change in price is alright, but over pricing is not.

Short selling
Islam does not recognize a transaction in which a seller is selling something that he does not have.

So, in an Islamic market, it is not possible to trade a borrowed financial claim.

Short-selling of stocks will, therefore, be considered unlawful.

This can affect arbitrage opportunities in the market and hamper price discovery of securities.
Islamic Investment Funds

When a group of investors pool their resources into a fund and purchase stock collectively, it becomes necessary to manage that fund. This activity is called fund management. Usually a manager takes care of the pooled resources. The investors come together because they may not be able to individually buy the stock.

Fund management services are offered by both commercial and investment banks. Today, the number of investment banks offering these services is more.

Since Islamic finance is asset-based, fund management is likely to be a better business option for Islamic financial institutions or IFIs than commercial banking.

Around 150 Islamic mutual funds offering Shari’ah-compliant products in the low risk/moderate return, balanced risk/return and high risk/high return categories are operating in Saudi Arabia, Bahrain, Kuwait, Qatar, Pakistan, Malaysia, Singapore, Germany, the U.S., U.K. and Ireland. Many of these are equity funds while a few of them are into real estate, hybrid funds or takaful funds.

Fund management is possible on a Mudarabah basis or on an agency basis. In the former case, the manager or Mudarib gets an agreed share of the realised profit. In the case of an agency, the manager is paid a fee or some part of the net asset value of the fund.

Types of Islamic Investment Funds

Islamic investment funds can be categorised as equity funds, Ijarah funds, commodity funds, Murabahah funds and mixed funds on the basis of their use and type of returns, according to Seif (1996).

Funds from each of them are used differently.

Proceeds of the equity funds are invested in the shares of joint stock companies and any returns as capital gains or dividends are paid back to the shareholders on a pro-rata basis.

Ijarah funds are used to purchase assets that can be leased. The lease income is divided among the fund’s subscribers. Ijarah Sukuk can be traded in the secondary market and the new buyer acquires all the rights and obligations of the seller.

Commodity funds are used to purchase commodities for resale. The profits are distributed among subscribers.

Murabahah funds are closed-end funds that cannot be resold in the secondary market. This is because an Islamic bank has no tangible assets. Closed-end funds are described in Chapter 11 of Course 1.

Mixed funds are used to purchase a mix of assets such as equities and commodities and assets for leasing. Mixed funds can be traded only if fifty one per cent of their assets are tangible and the remaining are intangible, according to Seif (1996).
Types of Islamic Equity Funds

Islamic equity funds differ from conventional equity funds because the Islamic funds have to offer a pro rata profit earned by the fund. Conventional funds, on the other hand, offer a fixed return linked to the face value of the shares.

Islamic equity funds can, therefore, offer no guarantee on either the principal or the profit.

Islamic equity funds have broadly been classified into categories depending upon the risk profile of the investors and asset management by the fund.

Regular Income funds

Regular Income funds aim to earn profits through the dividends of companies they have invested in. These funds generally provide a regular income stream for their investors. Typically such funds are popular with elderly and retired people.

Capital Gain funds

Capital gain funds attempt to earn profits from the frequent purchase and sale of Sharī'ah-compliant stocks. It is possible to manage the funds carefully and provide a moderately steady income to the investors.

Aggressive funds

Aggressive funds aim to yield maximum profits for their investors. Therefore, they invest in high risk/high return stocks. They choose their investors carefully because chances of loss are very high.

Balanced Funds

Balanced funds look for a balance between risk and returns. Typically, these funds pick low risk stocks so that they can offer their investors a steady income. They use the capital proactive approach.

Screening and Purifying Funds for Sharī‘ah-Compliance

Islamic equity funds are permitted to purchase only Sharī‘ah-compliant stocks.

IFIs have Sharī‘ah boards that will determine which stocks are Sharī‘ah-compliant and which ones are not.

The boards arrive at a tolerance level for screening and clearing stocks for compliance and it may be different for different markets.

In 1983, the Bank Islam Malaysia Bhd was the first to undertake screening of stocks for Sharī‘ah compliance. Since 1997, this process has been undertaken by the Securities Commission of Malaysia twice a year..

Indices of Sharī‘ah compliant companies include the Dow Jones Islamic Market Index or DJIMI, the Financial Times Stock Exchange Global Islamic Index or FTSE-GII, the Kuala Lumpur Sharī‘ah Index or KLSI and the DJIM Turkey Index.
For a stock to be *Sharī’ah*-compliant, the equity investment in it should be in the nature of a partnership called *Musharakah*.

More importantly, the stock should not be of a company that is involved in any of the activities prohibited by Islam, such as, alcohol, gambling, pornography, pork products, and conventional financial services. Related industries such as entertainment, hotel and hospitality might also fall within this list, depending upon how each economy defines and interprets the *Sharī’ah*.

In certain countries, financial criteria are used to determine whether a stock is *Sharī’ah* compliant. The criteria used include debt-equity ratio, cash and interest bearing securities-equity ratio and the cash-asset ratio.

Another approach is to cleanse or ‘purify’ tainted stocks. The individual investors take on the burden of purification sometimes lies with, though some Islamic funds do this on behalf of some of their investors. For example, if there some part of a company’s income coming from prohibited activities, the proportion of that income must be given for charity.

The screening and purification of *Sharī’ah*-compliant stocks can be done by the government, as in Malaysia, or by private sector, as in the Middle East and India.

**Two Types of Financial Instruments**

There are a number of financial instruments operating in the Islamic financial world and a majority of them are equity instruments.

They are categorised based on the nature and flow of returns that they offer to investors.

**Quasi fixed/Fixed returns**

Quasi-fixed or fixed-income securities offer investors a steady, fixed income stream. This is suitable for low-risk investors and senior citizens. This income eventually mobilises funds for the banking system.

For this, banks can securitise or sell assets or certificates of deposits against funds from *Ijarah, Iistisna’a* and *Murabahah* contracts.

**Variable Returns**

Variable return securities or *Shirikah*-based securities offer investors a variable stream of income that will depend upon the strength of the company or its projects. This return is suitable for high-risk investors looking for big returns.

For this, banks can securitise *Mudarabah* and *Musharakah* funds in their portfolio.
Chapter 2: Overview of Advanced Islamic Instruments and Markets

Chapter Introduction

Overview of Advanced Islamic Instruments and Markets.

In recent past, Sukuk and securitisation have become prominent modes in Islamic banking and finance. Local currency instruments and Sukuk investment based on modes other than Shirkah have been issued since 1992. The first dollar-denominated Sukuk of USD 600 million was offered in Malaysia in 2002. Since then, Sukuk issuance by sovereign and corporate entities across the globe has been on the rise.

The Islamic money market functions according to the Shari'ah’s rules and the main instruments are based on equity contracts, not on guarantees of fixed income. Due to their Shari'ah-compliant nature, Sukuk provides an alternative to conventional fixed income securities issued for funding large developmental and capital expenditures of the big entities. It facilitates International Financial Institutions or IFIs and investors to balance liquidity with profitability.

The Islamic inter-bank funds market functions on the Mudarabah principle or sale and purchase of instruments according to the Shari'ah rules.

The types of Islamic finance forward market are:

- Salam-based forward market,
- Istisna’a-based forward market and
- Ju’alah-based forward market.
A foreign exchange market can function in the Islamic financial structure by adhering to Shari'ah. IFIs can engage in direct placement or investment in Shari’ah-compliant foreign exchange denominated securities.

Derivatives are complex, high-risk contracts valued at trillions of dollars globally.

An option contract grants the right, without obliging the buyer, to enter into an underlying contract of exchange on or before the specified future date. This makes the contract non-Shari’ah-compliant.

To learn more about Sukuk, refer to Usmani (2008).

On completing this chapter, you will be able to:

- Explain the concept of Sukuk and the types of Sukuk that can be issued,
- Explain how Sukuk may be priced in Islamic markets and the types of markets in which it may be used,
- Identify the types of financial instruments that can be traded in Islamic financial markets and the rules for trading,
- Explain how the Islamic inter-bank money market works,
- Describe the three types of Islamic forward markets,
- Describe the nature of and conditions in which an Islamic foreign exchange market may operate,
- Describe the nature of derivatives and the restrictions in Islamic finance and
- Describe the challenges and controversies about derivatives.

**Investment Sukuk**

In the Middle Ages, Islamic communities used Sukuk as ‘papers’ to represent financial commitments made in trade and other economic transactions. Sukuk structures found in modern Islamic finance are similar to the conventional finance idea of securitisation.

In securitisation, asset ownership transfers to investors through documents such as certificates, Sukuk or other instruments reflecting the proportionate value owned by them of the relevant assets.

Investment Sukuk differ from shares of joint stock companies. Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets of particular projects or specific investment activity, usufruct and services.

The types of Sukuk are Shirkah, Ijarah, Salam and Istisna’a.
According to the basic principles of the *Sharī'ah*, investment *Sukuk* should be structured on the *Mudarabah* principle. Whereas, business can be conducted through participatory or fixed-return modes/instruments.

Note that in practice, only a few *Sukuk* issues are based on *Mudarabah* contracts. *Ijarah* based *Sukuk* are used more often.

Therefore, the rate of return on *Sukuk* is variable, if participatory modes are used and is quasi-fixed, if the modes offer a fixed return. *Sukuk* can be converted into a fixed-return *Sukuk* through a third-party guarantee.

*Sukuk* is covered in detail in Course 1: Islamic Financial System and also in the later chapters of this course.

**Islamic Financial Markets and Sukuk**

A financial market can be divided into primary and secondary markets. A primary market deals with the issue of new securities. The issuer of the securities receives the returns of a sale. Primary market operates on the basis of shares, redeemable equity capital, *Mudarabah/Musharakah* certificates or *Sukuk* representing ownership of leased assets or debt instruments. A secondary market deals with the trading of previously issued financial instruments.

The price of *Sukuk* in the primary market is determined by calculating the weighted average of the bids received for the premium to be offered over the benchmark. Whereas, the price of *Sukuk* in secondary market depends upon the nature of security being traded.

In Islamic finance, pure debt securities do not have a secondary market in principle. However, there could be securitisation of debts resulting from real trading transactions when they are combined with other assets representing ownership in real assets.

All equity or participatory instruments have a secondary market because they represent ownership in assets of the companies.

*Sukuk* can be issued by governments, corporations, banking and non-banking financial institutions and business and industrial entities.

Markets in the Islamic financial system are based on the principles of relevant contracts. These markets are:
• Equity or stock markets,
• Nongovernmental securities markets,
• Government and municipal securities market,
• Commodity futures market,
• Inter-bank money market and
• Foreign exchange market.

Trading Islamic Financial Instruments

Islamic financial instruments traded in Islamic financial markets include *Sharî'ah* compliant stocks, *Mudarabah/Musharakah* certificates, units of open- or close-ended mutual funds and investment *Sukuk*. The income for the *Sharî'ah*-compliant stocks is derived from dividends and capital gains, whereas for the rest three, it is derived from buying, selling and receiving returns from the underlying businesses and assets.

**Stocks, securities, certificates and *Sukuk* can be traded only if they comply with the following *Sharî'ah* rules:**

- Instruments representing physical assets and *usufructs* are negotiable at market prices.
- Instruments representing debts and money are negotiable under the rules of *Hawalah* and *Bai' al-Sarf*, respectively.
- Instruments representing different categories are subject to the rules relating to the dominant category. For example, if cash and debts dominate, then *Bai' al Sarf* applies. Whereas, if real/physical assets and *usufructs* dominate, trading is based on the market price.

Islamic Stockbroking Services

Islamic and conventional stockbroking firms function within the same institutional and regulatory framework, except that the activities of Islamic services comply with *Sharî'ah* principles. For example, the services involve only in originating, trading and distributing of *Sharî'ah*-compliant stocks. They also offer margin financing facilities.

A few conventional stockbroking companies offer Islamic stockbroking through ‘Islamic windows’. However, the accounts of Islamic stockbroking services are separated from the firm’s conventional stockbroking operations.

Many financial services companies now provide a broad portfolio of services to customers through modern technology and skilled staff. The services offered are as follows:

- Maintaining and updating shareholder records,
- Arranging bulk mailing to investors for annual general meetings,
- Distributing share certificates after stock splits and/or increase in capital,
- Providing secure Internet trading, SMS and mobile GPRS trading and automated phone trading,
• Arranging dedicated call centres for one-to-one service and
• Offering GCC and international shares service and multi-channel services.

Stockbroking service is also provided through the bank’s website. The website provides up-to-date stock quotations, information about market and industry prospects and company-specific information. Customers can analyse the information using the support analytical tools available on the website.

The Islamic bank also executes customer orders through its website. Such stockbroking is conducted using the Murabaha sale, which is a Shari'ah-nominate mechanism.

The shares of a legal company may be traded through Murabaha. A company’s shares reflect the holder’s proportionate ownership in the assets of the company, which can be sold for profit. However, the seller must first obtain the shares with all their rights and obligations, before selling them to his client. An arrangement to buy back the shares after sale or selling the shares without actual possession is prohibited.

Islamic Inter-Bank Money Market (IIMM)

Islamic inter-bank money market or IIMM functions on the Mudarabah principle or sale and purchase of instruments according to the Shari'ah rules. A Mudarabah based regular market is dominant in Malaysia. In other countries, banks invest their surplus funds with other banks for about a week.

Bank Negara Malaysia or BNM issued guidelines on IIMM in December 1993. IIMM was later introduced in Malaysia in January, 1994 to provide a ready pool of short-term investment avenues. IIMM allows the participation of Islamic banks, commercial banks, merchant banks, eligible finance companies and discount houses.

To learn more, refer to Islamic Financial Services Board (2008).

IIMM involves inter-bank trading of Islamic financial instruments and Mudarabah inter-bank investments (MII).

In Mudarabah inter-bank investments, a deficit Islamic banking institution known as investee bank can obtain investment from a surplus Islamic banking institution known as investor bank based on the Mudarabah principle. The investment period is up to one year. The rate of return depends on the “rate of gross profit prior to the distribution for investments of one year of the investee bank.” However, the profit-sharing ratio between the two parties is negotiable.
In the recent past, *Ijarah*-based negotiable Islamic money instruments have been developed. Islamic banks can engage in trading of *Ijarah*-based instruments for liquidity management adhering to the *Sharī'ah* rules.

**Islamic Forward Markets**

The three types of forward market considered in the framework of Islamic finance are:

- *Salam*-based forward market for products and commodities possessing a regular market,
- *Istisna’a*-based forward market for infrastructural and developmental projects and
- *Ju’alah*-based forward market for service-based activities.

There are few restrictions for the *Salam*-based forward market from the point of view of future trading. They are:

- Delivery of goods is compulsory.
- Unlike the contemporary future market, it is forbidden to resell a *Salam* commodity before it is received. However, Parallel *Salam* of the same goods, for the same date of delivery, is allowed.
- Unlike the contemporary future market, *Salam* contract requires advance payment.

There are some restrictions in the *Istisna’a* and *Ju’alah* markets too. They are:

- A contract will end only after the delivery of goods.
- An *Istisna’a* contract can be made only for special commodities that are produced as per the defined specifications and are not available in the market.
- A *Ju’alah* contract is applicable only to services and not physical goods.

Price of the contracts will be decided based on the competitive bids and offers made by traders.

For an Islamic futures exchange, a bidding to purchase means commitment towards advance payment. There is also a need to determine a time interval for quoting the new price. Whereas, in a conventional futures market, new prices can be offered at any point of time.

Let’s now learn about the differences between an *Istisna’a*-based futures market and a *Salam*-based futures market.

- Unlike *Salam*-based futures market, *Istisna’a*-based futures market involves long-term transactions. Therefore, it will require a different legal institutional framework. For a significant futures market, particularly for the development of resource mobilization, a long-term *Istisna’a*-based futures contract will suffice.
- Prices of *Istisna’a*-based futures contract may not widely fluctuate over the short term, as expected in the *Salam*-based futures market. This makes the *Istisna’a*-based futures market useful for small savers who are concerned in protecting their real savings value. These contracts allow them to index their savings with inflation.
Islamic Foreign Exchange Markets

A foreign exchange market can function in the Islamic financial market by paying attention to the limitations set by the *Sharī'ah*. IFIs engages in direct placement or investment in *Sharī'ah*-compliant foreign exchange denominated securities such as Solidity Trust Certificates issued by Islamic Development Bank or IDB and many other *Sukuk*.

A foreign currency forward cover facility is also available in the present Islamic financial structure. The forward cover is permitted if the following conditions exist:

- Foreign currency is required for genuine trade or payment activities. This need should be documented to prevent the use of the forward cover for speculation. Therefore, this is not suitable for money changers or forex dealers who rely on book-out transactions.

- The forward cover should be a formal promise to sell or purchase, not a sale and purchase agreement. This implies the sale or purchase take place simultaneously at the pre-defined time at the rate agreed upon initially at the time of the promise to sell or purchase.

- Though the price of foreign currency can be fixed in terms of local currency, the forward cover fee cannot be obtained. However, the bank can demand an amount in advance through earnest money i.e., *Hamish Jiddiyah*, against foreign currency promised to be purchased or sold on a future date. If the promisor fails to honor the promise at the agreed time, the bank can claim the differential amount from the earnest money.

Derivatives in Islamic Finance

Derivatives are complex and risky contracts based on the anticipated performance of the relevant underlying assets. Conventional options, swaps and futures stem are collectively known as derivatives.

Conventional options grant rights but do not oblige the investor to buy or sell. The nominal size of an option is the volume of the underlying asset that the option holder may trade at strike price. Strike price is the price at which the option holder may trade on the underlying asset by exercising the option.
If the price changes favourably, the holder may exercise the option and the transaction of the asset is done at the promised price.

If the price moves unfavourably, the buyer of the option will lose if the transaction of the asset is done at an agreed price. Whereas, according to Sharī'ah, delivery of the asset has to happen according to the sale contract without regard to the price change. Also, because an option contract grants the right but does not oblige the holder to enter into an underlying contract of exchange on or before a specified future date, the contract is not compliant with the Sharī'ah.

Few scholars have discussed about the possibility of put and call options in legitimate goods and stocks on the basis of ‘Arbūn and reverse ‘Arbūn. Al Sanhuri contended that reverse ‘Arbūn, which could validate put options, is in accordance with Islamic principles. Whereas, Shaikh Al Dharir rejected the concept of reverse ‘Arbūn because such a clause is discussed under secular legislation and not under Islamic legal works in some countries.

Hayes (1998) concluded that there are no effective derivates of Islamic debt contracts that mirror conventional contracts for hedging risk and leveraging. All scholars agree that options relating to currencies, interest rates and stock indices do not have any place in Islamic finance.

**Major Issues with Derivatives**

According to the institutions dealing with derivatives and hedge funds, the diversity of hedging products protects clients against market volatility and provides avenue for risk management. Whereas, volatility is actually caused when derivatives are traded and the clients are not sold anything.

Buffet (2003) remarked that derivatives are a financial weapon of mass destruction due to opaque pricing and accounting policies in swaps, options and other complex products. The macroeconomic arguments for derivatives are unconvincing. Derivatives minimise risks which do not need to exist. The financial system should be structured in such a way that volatility is reduced and people engage in productive activities rather than unproductive ones.

The derivatives market can cause the financial system to break down significantly. Due to the high degree of leverage of option contracts, even a single huge unexpected shift in market prices may lead to the collapse of major financial institutions.

Liabilities can never be completely hedged. Some traders prefer not to hedge their options portfolios because hedging restricts high returns.
The degree of risk that can be incurred by hedging was illustrated by the collapse of Long Term Capital Management based in the United States.

The challenge is to move quickly to prevent possible failings. Collateralised debt obligations (CDOs), a sophisticated type of derivative, are used to exploit differences in credit ratings.

Under this type of arrangement, loans and debt securities to be paid by several companies are gathered in a pool. Then, new securities are created and categorised into at least three levels of risk.

When any company in the pool defaults, equity tranche suffers the initial loss. If equity tranche fails to bear the losses, mezzanine tranche suffers. The third and the most barricaded level, senior tranche, is safe until the collective pool suffers major losses.

As few as two defaults among 100 companies can ruin the equity tranche.

In the past, major losses have ruined the equity and mezzanine tranches of many CDOs. Even senior tranches have been downgraded because losses may reach them. Thus, CDOs are not allowed in Islamic finance as they represent absolute risk and exploitation.

Chapter 3 - Islamic Capital Market Products

Chapter Introduction

Islamic Capital Market Products.

Islamic capital markets only recognise financial products that are compliant with Islamic rules and regulations. These products include Islamic equity funds, commodity funds and shares of Shari'ah-compliant companies, shares of real estate investment trusts, or REITs. Sukuk is also an important product in the Islamic capital markets. To be a successful player in any Islamic capital market, the fund manager should know about the distinguishing features and benefits of these products.
Like conventional equity funds, Islamic equity funds also contain a portfolio of stocks. Fund managers for both types of equity funds consider their financial objectives when selecting stocks to build portfolios. However, in the case of Islamic equity funds, fund managers have to consider one special criterion. They have to ensure that they select only stocks that meet guidelines defined by the *Sharī'ah*.

Islamic commodity funds invest money collected from investors into commodities approved by Islamic law. They later sell these commodities at a profit and distribute the profit among investors.

Like Islamic commodity funds, shares of REITs can also conform to Islamic guidelines. A REIT is a firm that invests in income-creating real estate, such as residential apartments and shopping centres. Experts classify REITs into various types and select a REIT based on its organisational structure.

IFIs can customise most products used by conventional capital markets for use in Islamic capital market. However, investors should always avoid hedge funds. Although these funds can be customised to invest only in areas approved by the *Sharī'ah*, the principles hedge-fund managers use to make profit do not comply with *Sharī'ah* guidelines.

Unlike other products, which need to be customised, *Sukuk* was developed exclusively for Islamic capital markets. It originated in Malaysia as a contract between investors and owners of assets. The investors agree to buy assets for cash with the guarantee that they can sell these assets back to the original owners later, at an agreed upon profit.

*Sukuk* are discussed in detail in Chapters 6 to 10 of this course.

On completing this chapter, you will be able to:
- Explain the process and criteria used for choosing stocks for Islamic equity funds,
- Summarise the growth of Islamic equity funds,
- Describe the challenges for growth of Islamic equity funds,
- Explain the nature of Islamic commodity funds,
- Describe the nature of real estate investment trusts, or REITs, tax related aspects, decision makers and types of property invested in,
- Describe various types of REITs,
- Distinguish among the three REIT structures and
- Explain the objectives of and concerns related to hedge funds.

**Choosing Stocks for Islamic Equity Funds**

Among conventional equity funds, Islamic equity funds bear a resemblance to Socially Responsible Investment or SRI equity mutual funds. The stocks for SRI funds are also selected according to specialised criteria, just as the stocks for Islamic equity funds are selected based on their conformity to the *Sharī'ah*.

To build the portfolio for an Islamic equity fund, managers need to follow two steps.

Let us briefly discuss these steps.
Screening
During screening, managers identify all stocks that meet the fund’s financial objectives. Then, from those stocks, they select those companies that conduct businesses according to *Sharī'ah* guidelines.

Filtering
Filtering enables managers to further narrow down their choice of stocks by applying additional selection criteria. Many of these criteria are based on rules specified by the *Sharī'ah* about how a company should raise its capital and obtain finance. For example, the *Sharī'ah* disapproves of companies that use debt-based capital. Fund managers can use these rules as filtering criteria to finally obtain a portfolio of stocks that are completely *Sharī'ah*-compliant.

However, filtering rules are not as stringent as the screening rules. It is up to each fund manager’s discretion what filtering rules they apply and to what extent.

Choosing Stocks for Islamic Equity Funds (Contd.)
Usually, the screening and filtering criteria are based on certain common factors. Managers can be sure of building a portfolio compatible with the requirements of Islamic capital markets if they consider these factors when screening and filtering stocks.

Let us now discuss these factors.
Business Dealings

The main purpose of screening is to select the stocks of companies whose business dealings are approved by the Shari'ah. This means that you can reject the stocks of companies that:

- Manufacture, sell or distribute pork products,
- Manufacture, sell or distribute alcohol,
- Run gambling networks,
- Run night clubs,
- Run casinos,
- Develop or distribute pornography or
- Run conventional banking and insurance endeavours, which earn most of their profit through interest from debt-based securities.

Debt Financing

Islamic capital markets aim to eventually eliminate debt-based financing. However, currently, they allow partial use of this type of financing. Therefore, source of financing is one of the important factors that help define filtering criteria.

Fund managers can select stocks of companies that raise certain percentage of their capital through debt-based financing. This percentage depends on the degree to which the fund managers want to conform to the Shari'ah. Most fund managers allow the use of up to 33 percent debt-based financing. That is, they allow a maximum of 33 percent debt-to-equity ratio.

Most Shari'ah scholars are lenient regarding the partial use of debt-based financing. Even so, they mandate that all shareholders should actively participate in the bid to eliminate this type of financing. One step in this direction, according to the scholars, is to vocally denounce its use.

Interest Income

Like debt financing, interest income is also a factor that helps define filtering criteria.

Any interest that a company earns through cash invested in debt-based securities is considered part of its income. However, Shari'ah scholars disapprove this type of income. They mandate that fund managers should reject the stocks of companies that earn a major part of their income through interest on debt-based securities.

The scholars are lenient, however, if this interest is a miniscule portion of a company’s total income. In this case, fund managers can include the stocks of this company in their portfolio. However, Muslim people who buy these stocks need to take two actions to show that they do not endorse the means through which the company earns its income. They need to:

- Vocally denounce such income, especially at the company’s annual general meeting and
- Purify any dividends they earn through the stocks. To do this, they can donate a part of the dividends to charity. This part should be proportional to the
income the company earned through interest. For example, if the company earned 10 percent of its income through interest, the stockholders should donate 10 percent of their dividend income.

**Assets**

Fund managers can also consider the assets of a company as a factor when defining filtering criteria. During filtering, they can reject the stocks of companies that possess only liquid assets.

According to Islamic principles, liquid assets represent cash, which companies can sell and purchase only at face value and not at market value. Therefore, any profit earned through trading of shares of these companies is not approved by the *Sharī'ah*. This is analogous to selling a bond with a promise to pay the face value plus interest or issuing a zero coupon bond at a discounted value.

However, profits earned through the trading of shares of companies that have illiquid assets are approved. That is why *Sharī'ah* scholars pronounce a company fit for Islamic capital markets only if a portion of the company’s assets are illiquid. Most fund managers set this portion at a maximum of 33 percent of the entire assets of a company.

**Stock**

Another factor that fund managers can consider when defining filtering criteria for their portfolios is the type of stock.

*Sharī'ah* scholars approve only ordinary stock, which gives shareholders undivided ownership in a company. This type of stock does not guarantee a definite return and vests both a company and its shareholders with the same liability. In contrast, stocks such as preferred stocks and warrants guarantee a definite return to shareholders. In addition, they vest little or no liability with the shareholders. Therefore, *Sharī'ah* scholars disapprove these stocks.

**Growth of Islamic Equity Funds**

Today, widespread privatisation in Islamic countries has led to an increase in the promotion and sale of Islamic equity funds. For example, in countries such as Malaysia, Indonesia, Pakistan and Iran, many new *Sharī'ah*-compliant infrastructure projects have been set up. This has created an opportunity for fund managers to include a wider variety of stocks in the portfolios of Islamic equity funds. As a result, more investors are now attracted to these funds.

In Malaysia, more than 50 percent of the stocks listed on the Kuala Lumpur Stock Exchange, or KLSE, are *Sharī'ah* compliant. This is primarily because of the initiatives the Malaysian government has taken to standardise and promote such stocks. For
instance, the government has appointed a centrally controlled body – the Shari‘ah Advisory Council, or SAC – to monitor stock listings. The SAC works in association with other Malaysian regulatory bodies, and twice a year, it screens all stocks listed on the KLSE for Shari‘ah compliance. Details about all Shari‘ah-compliant stocks that SAC identifies are then published by the Securities Commission of Malaysia.

After recognising the impact of Islamic equity funds, many share-market regulators worldwide have also introduced exclusive indices for Shari‘ah-compliant stocks. For example, the Dow Jones Company introduced the Dow Jones Islamic Market Index, commonly known as DJIMI, in February 1999. Later in the same year, Bursa Malaysia set up the Kuala Lumpur Shari‘ah Index, or KLSI, and the Financial Times Stock Exchange, or FTSE, Group set up the FTSE Global Islamic Index Series.

**Note:** For detailed information about DJIMI, you can refer to Chapter 2 of this course.

Each Islamic index has some distinguishing characteristics. For example, DJIMI lists only the stocks that investors from anywhere in the world can buy. KLSI does not impose this restriction. The screening and filtering processes used by DJIMI and KLSI are also different. When determining debt or liquidity levels of stocks, DJIMI considers ratios derived from both the income statement and balance sheet. In contrast, KLSI determines the debt or liquidity levels based on the ratios derived from the income statement only.

Let us now discuss the screening and filtering processes used by DJIMI.

**Screening**

The DJIMI screening process involves identifying and rejecting stocks of companies that indulge in businesses that violate Shari‘ah norms. This process is based on the guidelines specified by the DJIMI Shari‘ah Supervisory Board. According to this board, the following businesses violate Shari‘ah norms:

- Businesses that deal in alcohol,
- Businesses that deal in pork products,
- Business that provide conventional financial services, such as conventional banks and insurance companies,
- Business that deal in tobacco,
- Organisations that manufacture or sell weapons,
- Hotels, casinos, and similar businesses and
- Music and film-making industries, including businesses that deal in pornography.

**Filtering**
During the filtering process, some more stocks obtained at the end of the DJIMI screening process are rejected. This rejection is based on the following financial ratios:

- **Debt to Assets**: To calculate this ratio for a company, determine the total debt for the company as the sum of the short-term and long-term debt and the current portion of the long-term debt. Then, divide the total debt by the trailing 12-month average market capitalisation. If the value obtained equals or exceeds 33 percent, you can reject the stocks of that company.

- **Liquid Assets to Total Assets**:

  To calculate this ratio for a company, calculate the total of cash and interest-bearing securities for that company. Then, divide the total by the trailing 12-month average market capitalisation. If the value obtained equals or exceeds 33 percent, you can reject the stocks of that company.

- **Receivables to Assets**:

  Finally, the stocks obtained at the end of the filtering process are listed on DJIMI. To calculate this ratio for a company, calculate the accounts receivables for the company as the sum of the current receivables and the long-term receivables. Then, divide the accounts receivables by the total value of the company’s assets. If the value obtained equals or exceeds 33 percent, you can reject the stocks of that company.

### Challenges for Islamic Equity Funds

Islamic equity funds have potential for further growth and wider availability. However, there are various challenges that hamper their growth, and they include the following:

- Many *Sharī'ah*-compliant stocks are financially weak.
- Many companies don’t list themselves on Islamic stock indices, perhaps because of a lack of confidence in the prevailing market conditions. Therefore, the number of stocks traded at Islamic stock exchanges is relatively small as compared to conventional stock exchanges.
- Even if fund managers consider stocks from the conventional stock exchanges, the screening and filtering processes can narrow down their options to build a sound portfolio that diversifies risks. There is very little variety in the types of stocks available because most *Sharī'ah*-compliant companies indulge in similar types of businesses.
- Many listed, *Sharī'ah*-compliant companies are monopolised by insiders and allow limited scope for outsiders to make profit.
- Brokers or a group of people who consider their own interests more important than social welfare manage many stock exchanges.
- Liquidity in Islamic capital markets depends on the few stocks that are listed on Islamic stock exchanges. This is not an ideal situation because brokers and malicious investors can manipulate these stocks for their own benefit.
- The investor base is still not at par with that of conventional capital markets and very few new investors venture into Islamic capital markets.
- Fund managers often have to reject many high-value, financially strong funds only because the corresponding companies have high debt-to-equity ratios. This can be avoided if Islamic countries give viable opportunities to these companies to reduce their debt-based financing and liquid assets.
- The financial ratios for a company depend on market conditions and can fluctuate over time. Therefore, a stock that passes the filtering process during one period might not during another. This can negatively affect the diversity benefits offered by the portfolio that contained the stock. The fund manager can use another stock as a replacement during the lean periods. However, this
task can be time-consuming and incur additional transaction costs. Also, there is a chance that similar stocks are unavailable during that period.

- Even if fund managers include Shari'ah-compliant stocks in their portfolios, they themselves can indulge in practices prohibited by the Shari'ah. For example, they can short sell and perform margin account maintenance. There is a need for Shari'ah scholars to define standard, Shari'ah-compliant practices for fund managers as well.

**Islamic Commodity Funds**

Unlike Islamic equity funds, Islamic commodity funds invest only in commodities. Also, any profit these funds generate through the sale of commodities is distributed among investors in proportion to their investments.

Various Shari'ah guidelines apply to Islamic commodity funds. These are:

- Do not short sell.
- Do not undertake a forward sales contract. Two exceptions are Bai’ Salam and Istisna’a contracts.
- Do not deal in commodities such as pork products and alcohol.

**Real Estate Investment Trusts (REITS)**

REITs are companies that own and, often, operate income-creating real estate. Some REITs even offer financing for real estate. These days, many REITs are listed on major stock indices, and most REIT shares are publicly traded.

By buying shares of a REIT, investors can diversify their portfolios and, thus, reduce risks. They also get a chance to profit from commercial and residential real estate businesses that they don't own. The investors – or shareholders – of a REIT have some control over its management as well. They can elect its board of directors, also known as trustees.

A REIT’s directors can elect subordinate management personnel, who actually run the REIT’s business. However, the directors take major investment-related decisions and so are directly accountable to the investors.

Let’s look at two aspects related to REITs.

**Tax Liability**

A REIT can deduct its shareholders’ dividends from its corporate taxable income. In fact, to be considered as a REIT, a company has to distribute at least 90 percent of its taxable income to its shareholders every year. However, the company cannot pass on its tax losses to the shareholders.

Most REITs pay all their taxable income to their shareholders, and as a result, they save on corporate tax.
Types of Investments

The types of investments a REIT can make depend on:

- Property type,
- Industry or
- Geography.

Most REITs invest in various property types, such as residential apartments, hotels, warehouses, self-storage facilities, hospitals, shopping centres, factory-outlet stores and offices.

However, some REITs focus on only one property type. For example, a REIT can own, operate or finance only shopping malls or warehouses.

There are also REITs that focus solely on a particular industry, such as the healthcare industry. For example, a REIT can invest only in healthcare facilities, including acute care centres, rehabilitation and psychiatric hospitals, medical office buildings, nursing homes and assisted living centres.

A REIT can also restrict its operations based on geography. For example, a REIT can own, operate or finance real estate within specific regions or countries or anywhere in the world.

Types of REITs

Experts categorise REITs according to two criteria:

- Whether they own real estate or lend to real estate companies and
- Whether they are private or publicly listed

Let us find out more about these criteria and the corresponding REIT categories.

Own or Lend

Using their styles of business – ownership and lending – as criteria, you can classify REITs into three types.

- **Equity REITs** own and operate properties that generate income and engage in diverse real estate activities, such as leasing and development of residential apartments and office buildings. Unlike real estate companies, equity REITs purchase and develop properties to build their own portfolios. They do not aim to resell the properties later, at a profit.
- **Mortgage REITs** finance owners and operators of properties directly or offer credit indirectly by buying loans or mortgage-backed securities.
- **Hybrid REITs** provide dual services – they own property and provide finance to real estate owners and operators as well.
**Note:** Equity REITs are *Sharī'ah*-compliant but mortgage and hybrid REITs are not. This is because mortgage and hybrid REITs indulge in *Ribâ*-based activities. That is, they earn income through interest.

**Public or Private**
Most REITs are public – they are listed on stock markets and some may be included in *Sharī'ah*-compliant indices. However, public listing is not a prerequisite.

Some REITs are kept private. They are neither listed on stock indices nor traded over-the-counter.

Private REITs are of three types:
- **Institutional REITs**: These REITs target investors who can invest large sums of money – typically, in millions or billions.
- **Syndicated REITs**: Owners of syndicated REITs sell shares in these REITs only through financial consultants. These consultants may offer the REIT shares to investors as part of a package containing various types of financial products.
- **Incubator REITs**: These REITs are still rudimentary but have the potential of going public in the future. Therefore, venture capitalists often fund these REITs.

**REIT Structures**
REIT structures are of three types - Traditional, UpREIT and DownREIT.

Let us discuss these types.

**Traditional REIT**
A REIT based on the traditional REIT structure owns its assets directly, not through an operating partnership.

**UpREIT**
An UpREIT represents a collaborative venture between a REIT and the members of an external partnership. This venture is known as operating partnership. In this partnership, the REIT contributes only cash and the partners contribute properties from their external partnership. The REIT itself does not own or operate any properties.

Both the REIT and the partners receive stakes – or units – in the operating partnership, in proportion to their respective contributions. Usually, the REIT is the majority owner – it owns the larger share of units in the operating partnership.

Typically, a year after the operating partnership was formed, the partners can exchange their units for cash or for shares of the REIT. Either the REIT or the operating
partnership has to grant permission for this, depending on previously agreed upon rules.

**DownREIT**
Like an UpREIT, a DownREIT also represents an operating partnership between a REIT and external entities. However, in a DownREIT, the REIT can also own and operate assets independently. These assets are considered separate from those of the operating partnership.

**Hedge Funds and Islamic Finance**
Hedge funds are investment pools managed by a portfolio manager. Hedge funds can trade frequently and take the maximum possible risks. They invest in almost any type of stock, sell short, use options and futures and buy stakes in illiquid securities, such as real estate and collectables. Many of these characteristics, such as short selling, make hedge funds unsuitable for Islamic capital markets.

Hedge funds do not conform to standard trading practices and guidelines defined by regulatory authorities. They also involve a greater risk than other funds. Therefore, most regulatory authorities discourage average investors from investing in hedge funds. For example, the Securities and Exchange Commission, or SEC, of the US bars anyone with a net worth of less than a million US dollars from investing in hedge funds. It also disallows hedge funds to advertise their business.

Therefore, we can say that hedge funds are privately-traded funds and are suitable for investors who are very strong financially and have a high risk appetite. In addition, they mainly compete with traditional mutual funds and try to surpass them by using techniques such as short selling, derivative investing and arbitrage.

To learn more about hedge funds, refer to Chapter 12 of the course *Islamic Financial System.*

**Chapter 4 - Challenges to the Growth of Islamic Financial Markets**

**Chapter Introduction**

**Challenges to the Growth of Islamic Financial Markets.**

Islamic capital markets are very new and are still evolving. In contrast, conventional capital markets have reached an advanced stage of maturity, which is the result of years of trial and error and innovation. Now, these markets have established various reliable guidelines, processes and procedures that can help to further enhance their growth and minimise risks.
Therefore, the Islamic capital markets can use conventional capital markets as models and emulate aspects such as transparency, market discipline and technology acceptance. By doing so, the Islamic capital markets can accelerate their development and quickly get on a par with the conventional markets.

However, the Islamic capital markets should also be prepared to handle the inevitable challenges that any conventional capital market faces. These challenges are mainly the result of factors such as the:

- State of the existing regulatory and legislative framework,
- Microstructure of the market, market practices and the range of products the market covers,
- Design of the incentive and corporate governance systems,
- Culture of listed companies, brokers and investors,
- Absence or restricted use of reliable supporting institutions, which can help define market standards and benchmarks for performance evaluation and
- Degree of integration with external markets.

The Islamic capital markets also face the additional challenge of establishing guidelines that conform to the *Sharī'ah*. As a functionary in Islamic capital markets, you can play an important role in promoting the growth of these markets. Therefore, you should be aware of the challenges they face and how you can counter them.

On completing this chapter, you will be able to:

- Explain the importance of a sound regulatory and legislative framework for development of capital markets,
- Describe three aspects that countries should consider when customising regulatory and legislative frameworks for Islamic capital markets,
- Explain the issues with respect to market structure and practices that hold back Islamic capital markets,
- Identify the kinds of incentives that regulators can provide for investment in Islamic capital markets,
- Describe how industry associations, rating agencies and standards-setting agencies can help promote the development of Islamic capital markets,
- Explain how financial engineering can help develop new Islamic financial products and capital markets and
- Explain how to encourage training and interaction between markets to promote the growth of Islamic capital markets.

**Need for a Regulatory and Legislative Framework**

A regulatory and legislative framework can help instil and maintain investors’ confidence in a capital market.

This framework defines the rights of all types of investors – for example, individuals, partnerships, intra-country investors and inter-country investors.

It also specifies guidelines to resolve disputes between investors and companies and protect and prioritise the investors’ rights.
Therefore, every capital market requires a sound regulatory and legislative framework. For Islamic capital markets, this framework needs to fulfil one additional criteria – it has to be *Sharī'ah* compliant.

Most Islamic countries still lack sound regulatory and legislative frameworks for Islamic capital markets. Therefore, they improvise and apply local regulations and laws to these capital markets as well.

This improvisation is based on the requirements of individual transactions – for example, when a government body needs to make an Ijarah Sukuk transaction. Any Ijarah Sukuk transaction is based on the leasing of operating assets, and this type of leasing is *Sharī'ah* compliant.

However, in some Islamic countries, the local regulations and laws might disallow government bodies to lease operating assets.

Therefore, every time a government body has to make an Ijarah Sukuk transaction, the concerned legislative body has to pass a directive to amend or even ignore the local regulations and laws for that particular transaction. This is not a good practice and can create technical and legal ambiguities.

To avoid this, Islamic countries should define regulatory and legislative frameworks that conform to the requirements of Islamic capital markets.

**Customising Regulatory and Legislative Frameworks**

When customising regulatory and legislative frameworks for Islamic capital markets, Islamic countries should consider three aspects.

Let us discuss these aspects.

**Standardisation**

All Islamic countries should standardise their legislative frameworks. This can ensure that each country’s framework meets *Sharī'ah* norms and is consistent with the other countries’ frameworks regarding the types of financial products it endorses.

Consistency is important because even in Islamic countries, local laws can be in accordance with conventional legal systems. If these laws are used in their original formats to control Islamic capital markets, ambiguities and inconsistencies can result.

For example, the laws of one Islamic country might allow the issue of Islamic financial product on the market whereas the laws of another Islamic country might disallow this. Taking steps to improvise or overrule local laws for individual transactions can also lead to ambiguities and can prove costly.

Standardisation can prevent ambiguities and inconsistencies across Islamic capital markets and help minimise legal expenses.

**Dispute Resolution**

Dispute resolution is an important aspect. Islamic countries should ensure that the guidelines and procedures for resolving disputes regarding Islamic financial products are included in the existing dispute-resolution system for conventional products after some modification.
This action can preclude any confusion that two different systems for dispute resolution might create. In addition, it can help save the money and efforts required to maintain a separate dispute-resolution system for Islamic financial products.

The action can also enhance investors’ confidence in the Islamic capital markets – the investors can expect the same treatment from these markets as from conventional markets, which are considered investor friendly.

**Strengthening**

Regulatory guidelines can help promote the development of Islamic capital markets. However, very few Islamic capital markets strictly follow these guidelines. This is because of the absence of strong regulatory frameworks and agencies.

To reverse this trend, Islamic countries should strengthen their regulatory frameworks by ensuring that all Islamic capital markets strictly apply them.

To ensure strict application, Islamic countries should set up powerful, independent and trustworthy regulatory agencies and their affiliates – they should create these agencies if they do not already exist. Then, they should empower these agencies to audit capital markets and enforce the regulatory frameworks.
Market Structure and Practices

A favourable market structure and Shari’ah market practices can help promote the growth of an Islamic capital market. Two ways to set up the desired structure and practices are:

- Enforcing compliance with Shari’ah requirements and
- Allowing the inclusion of foreign Islamic securities in the market.

There is also a need to inculcate trust among foreign investors about the market. Many brokers and vested interests in Islamic capital markets indulge in practices such as short selling and margin account maintenance.

These practices are disapproved by Shari’ah scholars and can discourage Muslim investors.

Therefore, regulatory agencies should empower Shari’ah boards to frequently audit market practices of companies. They should also set up a procedure to define and standardise market practices according to Shari’ah requirements. For example, they can standardise existing market practices regarding commodities funds to allow investment only in companies that deal in Shari’ah-compliant commodities, such as pens, food grains and bicycles.

To enhance and expedite its growth, an Islamic capital market needs to diversify. That is, it needs to attract borrowers from multiple Islamic countries and gain access to liquid markets in those countries. Therefore, the regulatory agency for each Islamic capital market should encourage foreign countries to list Islamic securities on the market.

To ensure this, the agency can launch advertisement campaigns and give rebates and incentives to the foreign countries.

Most foreign investors lack confidence in and are reluctant to invest in Islamic capital markets. This is primarily because Islamic capital markets often lack transparency and expose participants to wrong market practices.

Examples of these practices include:

- Price manipulation,
- Front running,
- Insider trading and
- Blank selling.

To kindle trust in the Islamic capital markets, regulatory agencies should enforce transparency in the issuance and trading of securities. In addition, they should outlaw wrong market practices and conduct regular audits to identify the people who indulge in these practices. They should then penalise these people and set up rules that can discourage anyone from indulging in these practices in the future.
Use of Incentives to Promote Growth

Currently, the issue and trade of Islamic financial products costs more in Islamic capital markets than in conventional capital markets. This can discourage potential investors from participating in the Islamic capital markets.

Therefore, the policy makers involved in promoting the growth of these markets need to work towards reducing the operating costs. They need to ensure that the operating costs are equivalent to, if not less than, the operating costs in conventional capital markets.

One of the main reasons for higher operating costs in some Islamic capital markets is the tax framework for these markets.

In these countries, this framework is more demanding on investors than the tax framework for any conventional capital market. For example, in Islamic capital markets, investors in real estate and other underlying assets end up paying more to their governments in the form of a higher percentage of capital gains tax and income tax and double stamp duty.

Therefore, policy makers should restructure the tax framework in Islamic capital markets. The purpose of this restructuring should be to clearly define each rule and guideline, remove ambiguities and disparities and make tax structures more investor friendly.

To begin with, the policy makers can waive additional stamp duties and other additional expenses the investors have to incur in Islamic capital markets.

The policy makers should also offer incentives to attract retail investors from around the globe. In addition, they should allow foreign retail investors to buy and sell through Internet banking. To encourage this, the policy makers should waive unnecessary and time-consuming bureaucratic procedures and checks for foreign investors.

In addition to attracting retail investors, it is important to encourage business and financial institutions to participate in Islamic capital markets. Therefore, policy makers should provide tax breaks to these institutions as well.

An example of a tax break is tax deductions on dividend payments for Sukuk and other Islamic transactions. Another example is tax deductions on the research and development expenses incurred to create a viable Islamic financial product.

A few countries have already formalised tax breaks and incentives for Islamic capital markets. For example, in 2003, the United Kingdom, or UK, government waived the additional stamp duty that was applicable to Islamic mortgages.

A year later, the Malaysian government announced that all transactions in its Islamic capital markets would have the same tax structures and incentives as transactions in conventional capital markets.

Other countries also need to introduce similar schemes for Islamic financial products.
Development of Supporting Institutions

taking steps that directly promote the growth of Islamic capital markets, governments should help to develop supporting institutions such as industry associations, rating agencies and standards-setting agencies. These institutions can play a key role in promoting the growth of Islamic capital markets.

Broadly speaking, an industry association is a front through which investors, business institutions and conventional financial institutions can collaborate. The main purpose of an industry association is to promote the development and trading of new Islamic financial products.

A rating agency, in contrast, is an independent body that evaluates, rates and predicts the future performance of Islamic financial institutions and products.

A standards-setting agency helps set standards and best practices for Islamic capital markets. These standards and best practices are aligned with the risks that are unique to Islamic financial products.

Many countries have successfully set up supporting institutions for their Islamic capital markets.

Let us learn about the specific roles of some of these institutions.

**IIFM**

The International Islamic Financial Market, or IIFM, is an industry association that was set up in Bahrain in November 2001 and became operational on April 1, 2002. It is a front for at least 265 Islamic banks and financial institutions from around the globe. One of the main aims of the IIFM is to enable the listing and acceptance of Islamic financial products on stock exchanges worldwide.

To achieve this aim, the IIFM board of directors established the Global Sharī‘ah Supervisory Committee, or GSSC, during the first decade of the 21st century. The GSSC helps review and certify new Islamic financial products. It also helps formulate guidelines for new financial products and advises on how they can be made Sharī‘ah compliant.

Through the GSSC, the IIFM has already certified global Islamic bonds issued by Bahrain and other countries, such as Qatar and Malaysia. It has also certified global Islamic bonds issued by the Islamic Development Bank, or IDB.

Like the GSSC, the Liquidity Management Centre, or LMC, is also a subsidiary of the IIFM. The LMC was set up in Bahrain in February 2002 to help Islamic financial institutions deploy their surplus liquidity effectively. The LMC helps consolidate the assets of various governments and business and financial institutions and issue them as Sukuk. Islamic financial institutions can use their surplus cash reserves to buy these Sukuk. Because these Sukuk are part of a secondary market, the financial institutions receive competitive returns even on short-term investments.

**IIRA**

The International Islamic Rating Agency, or IIRA, is, as its name indicates, a rating agency. It was established in Bahrain in October 2002 by the IDB. In addition to
performing regular rating tasks, the IIRA assesses Islamic financial institutions and products for *Sharī'ah* compliance. The IIRA is also responsible for releasing a set of rating standards. These standards mainly help to check whether Islamic financial institutions and their products satisfactorily comply with the *Sharī'ah*.

All the findings of the IIRA, along with their chronologies, are available to the public.

**IFSB**

The Islamic Financial Services Board, or IFSB, is a standards-setting agency that was established in Kuala Lumpur, Malaysia, in November 2002. It is an association of central banks, monetary authorities and regulatory and supervisory bodies for Islamic capital markets and financial institutions.

The IFSB collaborates with other standards-setting agencies and conducts training and research about risk management. It also provides technical assistance to institutions regarding risk management.

In 2005, the IFSB released capital adequacy and risk management standards for Islamic financial institutions. These standards specify how financial institutions should identify, classify, measure and report risks. The IFSB is also involved in developing standards for corporate governance, transparency and market discipline.

**AAOIFI**

Sometimes, conventional accounting standards cannot accurately depict the state of Islamic financial transactions. For instance, you cannot depict a *Mudarabah* transaction on either the debit or the credit side of a standard balance sheet. You can only categorise this transaction as an investment account, and so, you need to add a new column to the balance sheet for *Mudarabah* transactions and other similar transactions.

Considering these special accounting needs of Islamic financial transactions, the IDB set up the Accounting and Auditing Organisation for Islamic Financial Institutions, or AAOIFI, in Bahrain in March 1991. The AAOIFI is an autonomous, not-for-profit organisation that defines standards for accounting, auditing, governance and ethics for Islamic financial institutions globally. The standards developed by the AAOIFI take into account both *Sharī'ah* principles and international standards and practices.

The AAOIFI also works to ensure that the *Sharī'ah* supervisory boards of all Islamic financial institutions are aligned in their interpretation and use of *Sharī'ah* standards. So it also prepares, issues and interprets *Sharī'ah* standards for Islamic financial institutions. The *Sharī'ah* standards it has issued to date for Islamic transactions such as *Mudarabah*, *Bai' al-Salam* and *Istisna'a* have already been adopted by many Islamic financial institutions worldwide.

The governments of many Islamic countries have recognised and adopted the standards defined by the AAOIFI. In addition, a few government agencies have used AAOIFI standards as their guides to define their own accounting and auditing standards.
The Use of Financial Engineering

It’s a fact that financial engineering played a major role in the success of the conventional capital markets. Islamic capital markets can also emulate this positive aspect and carefully engineer their financial products to enjoy long-term growth.

A few financially engineered products are already being used in Islamic capital markets. Sukuk is an example of this type of product. However, there is a need to aggressively employ financial engineering to further develop areas such as:

- Money markets,
- Intra-bank markets and
- Securitisation

Money markets provide short-term liquidity while capital markets focus on meeting needs for long-term capital.

Securitisation helps satisfy the long-term needs of capital markets. It is a means to pool and repackage financial assets and then sell them to investors, and so it can generate both long-term and short-term cash reserves.

Examples of financial engineering are discussed in detail in Chapter 5 of this course.

Use of Training and Interaction to Promote Growth

Professionals who manage Islamic capital markets require cross-domain expertise. They need to have advanced technical knowledge about these markets as well as conventional capital markets. That is, they require detailed knowledge of principles, practices and laws related to finance, accounting and taxation. They also require in-depth knowledge of Shari'ah principles.

There is still a dearth of such professionals, and this has led to a slow pace of research and development in Islamic capital markets. Therefore, the range of products and services available in these markets is also very limited.

To grow at a faster pace and equal or even surpass the conventional capital markets, Islamic capital markets need a large pool of trained professionals. Some of the ways to increase the existing pool are:

- Encouraging training providers and financial and business institutions worldwide to collaborate extensively and develop and conduct training programs that focus on Islamic capital markets;
- Encouraging greater interaction between Shari'ah scholars and market professionals and
- Funding research on Islamic finance generously.
- It is also necessary to encourage greater interaction between primary and secondary markets. To do this, authorities should design contracts that can be sold and purchased internationally across regions and markets.
In addition, they should foster ties between the different schools of thoughts about Islamic finance that currently exist. This will enable stakeholders to work in agreement and, thereby, expedite the growth of Islamic capital markets.
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