Islamic Financial and Capital Markets

Power Point

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Table of Contents

Chapter 1

Chapter Introduction

Overview of Islamic Finance and Markets. The Islamic financial system comprises financial market operations and transactions based on the *Sharī'ah*. Islam prescribes certain financial activities and prohibits others.

Modern Islamic products and services can be developed by:

1. Identifying existing conventional practices that will be acceptable to Islam.

2. Modifying and removing non-*Sharī'ah*-compliant elements from conventional products and services.

3. Innovating and developing new products that are in line with the *Sharī'ah*.

Islamic markets are similar to conventional markets, but operate without interest rates. Islamic markets are different from conventional markets, because Islamic modes of finance rely on risk sharing and operate without interest rates.

In general, Islamic finance is asset based. So, fund based activity is more suitable for Islamic financial institutions than conventional financing. The challenge is that debt is not acceptable to Islam. Equity stock too must be *Sharī'ah*-compliant. To learn more, refer to: Towards an Islamic Financial Market, Research Paper 45, IRTI-IDB (1997), by Prof. Ahmad Ausaf.

Learning Objectives

On completing this chapter, you will be able to:

- Explain the *Sharī'ah*'s legal maxim towards commercial transactions and the four major prohibitions.
- Explain the impact of the *Sharī'ah*'s principles on Islamic finance and the basic nature of Islamic equity and debt financing.
- Explain the *Sharī'ah*'s principles from which equity financing contracts of Islamic finance have been derived.
- Explain the *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 *Sharī'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.
- Distinguish between the two types of financial instruments based on return.

Fundamentals of Islamic Finance

Key points of Islamic commercial law (*Fiqh al-mu'amalat*):

- Equitable distribution
- Social justice
- Fairness

Commercial transactions are permissible unless prohibited. Elements prohibited by *Sharī'ah* are:

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

Ribâ

Ribâ means excess. In a transaction, one party gains an excess (*Ribâ*) while the other loses. The Holy Qur'ān asserts that trade is lawful, but *Ribâ* (usury) is not.

- Surah Al-Baqarah (2:275)
- Surah An-Nisâ' (4:29)

Two types of *Ribâ* are:

- *Ribâ* Qurudh
- *Ribâ* Buyu

Ribâ Qurudh is specific to loan transactions where a rate of return is assured irrespective of the outcome of the investment. *Sharī'ah* permits only Qardh Hasan, loans for social welfare and short-term needs. The exact amount borrowed must be returned. Choice to pay more lies with the borrower. *Ribâ* Buyu is applicable on sale of six *Ribâ*'s commodities:

- Gold
- Silver
- Dates
- Barley
- Wheat
- Salt

Terms of trading in *Ribâ*'s commodities are: When trading in commodities of the same group and kind (gold for gold), their values are equivalent and delivery should be prompt. When trading in the same group but different commodity (wheat for barley), delivery is not a pre-condition. When trading in different groups and different kinds of commodities, *Sharī'ah* allows free trade. *Sharī'ah* supports entrepreneurship and profit-earning, provided there is equality. Interest is a cost to be borne even when business fails and hence prohibited.

Gharar

Sharī'ah prohibits *Gharar*. *Gharar* means:

- Uncertainty
- Ambiguity
- Deception of buyer

Gharar can affect price and delivery of commodities. *Sharī'ah* provides a limited level of *Gharar,* but prohibits it in large commercial transactions.

Maisir

Maisir (gambling) is an activity where the gain of one party means the loss of another. *Sharī'ah* prohibits M*aisir* because it:

- Distracts people from productive activities
- Creates wealth without effort

The holy *Qur'ān* prohibits unearned income through speculation. Speculation involves risky attempts to earning greater profit. Taking risks without adequate information and in conditions of uncertainty brings speculation in business. *Sharī'ah* prohibits investing, participating or partnering in the gambling industry.

Non-*halal* products and services

Islam prohibits:

- Use of alcohol
- Foods such as pork
- Pornography
- Prostitution
- Immoral entertainment

Sharī'ah forbids creating, marketing, processing and selling such products. Companies involved in these areas are not considered as *Sharī'ah*-compliant.

Sharī'ah Principles for Financial Products and Services

Modern Islamic finance emerged from Islamic banking. Islamic banking follows an interest-free system. A number of *Sharī'ah*-compliant Islamic financial products are developed in the following areas:

- Equity
- Debt
- Securitisation

- Structured products
- Derivatives

Rules have been put in place for:

- Banking
- Broking
- Investment
- Advisory services

Equity financing is a major part of Islamic financing. Financing is done through Uqud al-Isytirak. Types of equity financing instruments are:

- *Mudarabah* (profit-sharing)
- *Musharakah* (profit and loss sharing)

Debt financing is interest-based and *Sharī'ah* non-compliant. Islamic debt financing is done through a contract called Uqud al–Mu'awadat under which an asset is sold or bought. Islamic debt instruments are:

- *Murabaha*h (Trade with mark-up costs)
- *Ijarah* (lease contracts)
- *Bai' al*-*Salam* (advance purchase)
- *Istisna*'*a* (purchase order)

The *Sharī'ah* accepts two lease agreements–operating lease and finance lease.

***Sharī'ah* Principles for Equity Financing**

Balance sheets can be presented in two ways:

- According to Maturity profiles
- According to Functionality

Functionality-based view is more popular.

Maturity-based view is important – it provides information about institutional exposure.

On the Liabilities side, Islamic banks follow the two-window approach:

- One – demand deposits window
- Two – special investment accounts

Depositors choose the window. Special investment accounts are not a liability in Islamic banks. Investors are partners. Investment accounts are liability in conventional banks. Special or restricted accounts are often shown as off-balance sheet transactions.

A 100 per cent reserve is specified for demand deposits (*Amanah*) because:

- Deposits must be returned at par value.
- There is no increment in value of the funds.

Special accounts are meant for investment. Depositors are aware of risk when they invest. Investors are sources of funds *(Rab al-māl).* The bank acts as agent *(Mudarib).*Profits from special investment are assets, not liabilities. Investors share profits and losses. Restricted profit-and-loss sharing *Musharakah* accounts are also offered for high net worth individuals. Greater choice of instruments is available on the Assets side. For short-term: trade financing and financial claims from a sales contract (*Mudarabah/salaam*) For medium-term: leasing (*Ijarah*) and manufacturing contracts (*Istisna'a*) For long-term: *Musharakah* partnerships

Islamic bank can form a syndicate with other institutions to provide medium and long-term capital. How it works:

- The bank appoints external entrepreneur as agent.
- The bank acts as principal.

Islamic banks also provide:

- Customised services.
- Guarantees.
- Underwriting services.

Financing Instruments in Islamic Finance

Equity financing is a major part of the Islamic capital market. *Sharī'ah* accepts equity financing if it is equitable and fair. It recognises two types:

- *Mudarabah*
- *Musharakah*

Mudarabah

Features of a *Mudarabah* contract:

- It is a partnership between the owner of capital and an entrepreneur.
- Owner of capital only invests money.
- Entrepreneur has complete control over project and money management.
- Profits strictly shared as per terms of contract.
- Loss borne entirely by owner of capital, unless entrepreneur's negligence is proven.

Features of a two-tier *Mudarabah* contract:

- Tier one: owner of capital provides funds to IFI.
- Tier two: IFI funds entrepreneur.
- IFI acts as a financial intermediary.

Musharakah

Features of the *Musharakah*:

- It is a joint venture between investor and entrepreneur.
- Both parties provide capital, expertise and assets.
- Both parties share risks and profits agreed to in the contract.

Features of the diminishing *Musharakah*:

- Financial institution and entrepreneur have joint ownership of asset.
- Entrepreneur pays the FI for a period of time, buying out the stake completely.

***Sharī'ah* Principles for Debt Financing**

Debt financing in Islam requires an asset as the subject of a transaction. *Sharī'ah* permits five types:

- *Murabahah*
- *Bai' Bithaman Ajil*
- *Bai' al-Salam*
- *Ijarah*
- *Istisna'a*

Murabahah

Features of the *Murabahah* contract:

- It is a short-term financing instrument.
- The buyer and seller agree on a markup in the price over cost price, with both parties being aware of the cost price and the mark up.
- The price is paid in cash or in installments.
- The financier agrees to buy the commodity for resale to client at a higher price.

Bai' Bithaman Ajil

Features of the *Bai' Bithaman Ajil*:

- Similar to *Murabahah* in nature
- Used for long-term funding
- Seller need not disclose profit margin

Bai' al-Salam

Features of *Bai' al-Salam:*

- It is an advance purchase contract.
- The buyer pays cash for an asset.
- The commodity is delivered at a later date specified in the contract.
- Modern Islamic finance permits parallel *Salam* or back-to-back *Salam* contracts.

Istisna'a

Features of *Istisna'a*:

- It is a purchase order for an asset.
- The asset must be created according to specifications laid down in the contract.

- It is similar to *Bai' al-Salam*, but needs no advance payment.

The Sharī'*ah* permits parallel or back-to-back *Istisna'a, in which* the financier will act as a contractor in one *Istisna'a* and as a customer in another *Istisna'a*.

Ijarah

Features of *Ijarah*:

- It refers to lease financing.
- It is the right to use equipment.
- The lessor and lessee of equipment enter into a contract for a fixed period.

Ijarah Thumma, where a part of the rental goes towards ownership of the asset, is also accepted.

The Evolution of Islamic Capital Markets

The growth of the Islamic economy made it necessary to adapt conventional products to conform to the *Sharī'ah*. The need for liquidity forced Islamic governments to find ways to access capital markets. Islamic capital markets offer:

- *Sharī'ah*-compliant stocks
- Islamic bonds
- Islamic funds
- Islamic risk management products

Islamic markets also offer the following services:

- Project financing
- Stockbroking
- Venture capital

Debt Market

The first Islamic bonds were issued in 1983 in Malaysia. The Government Investment Issue (GII) was launched to enable the management of assets of Islamic banks. The nature of GII has been changed from *Qardh Hasan* to *bai'ai'-Inah* so that it may be traded in the secondary market. Other Islamic countries such as Kuwait and Iran have also started issuing bonds.

Equities Market

The first step towards Islamic Equities market was taken by Bank Islam Malaysia Bhd in 1983. The bank identified a list of *Sharī'ah*-compliant stocks based on the set of criteria listed by the *Sharī'ah*. The first Islamic equities index was launched by RHB Unit Trust Management Bhd in 1996.

Other indices in use today include:

- Dow Jones Islamic Market Index (DJIM) and its associated national indices
- Kuala Lumpur *Sharī'ah* Index (KLSI)
- FTSE Global Islamic Index Series
- S&P 500 *Sharī'ah* and S&P BMI *Sharī'ah* group of indices

The first Islamic investment was set up in 1986 in the U.S. The Dallah Al Baraka group has two companies that have a number of Islamic investment funds operating in a range of sectors including real estate and stocks.

Structural Issues in Islamic Equity Markets

A stock market is necessary for any modern economy. There is no formal Islamic stock market. Elements of the conventional market must be modified to evolve a *Sharī'ah*-compliant capital market. Structural elements that must be modified in line with the *Sharī'ah* are:

- Limited liability
- Contractual structure of equity stock
- Negotiability and Tradability

Limited Liability

Limited liability implies that a corporation is a legal entity. In Islam there is no concept of `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 derive the role of a legal person in Islam and study if it can be treated like a *Musharakah* partnership.

Contractual Structure of Equity Stock

Islam's view on joint stock companies has the following key points: *Sharī'ah* recognises *Musharakah Mulk* and *Musharakah Aqed. Musharakah Mulk* gives a partner ownership of a specific asset. *Musharakah Aqed* gives the partner ownership over the value of the asset and not the asset. The joint stock company is a combination of both. As per Islamic tenets, trading of such stock falls under *Musharakah Mulk*, whereas operations and shareholder rights falls under *Musharakah Aqed*.

Negotiability and Tradability

Negotiability, tradability and transferability of stocks is critical to market functioning. Issues that must be addressed are that: The *Sharī'ah* prohibits trading in financial interests because it might lead to the charging of a *Ribâ*. It also forbids *Dayn* (debt) or trading in any other monetary unit. It forbids the trading of stock that is held completely in the liquid form, making it impossible for financial intermediaries to issue shares.

Operational Issues for Islamic Equity Markets

Conventional market mechanisms face operational difficulties in Islamic markets and must be resolved.

Margin Accounts

The practice of using margin accounts to purchase stock cannot be used in an Islamic market because:

- These accounts borrow funds at an interest, a concept that violates *Sharī'ah*.
- Leveraging funds will force market players out, affecting the general liquidity of the market.

Speculative Trading

Speculation in the markets is an issue because:

- Islam prohibits speculation as it treats speculation as the basis for gambling.
- It also prohibits activities that might lead to speculation.

There is a distinction drawn between speculation and calculated risk-taking. Possible remedies include:

- Tax reforms
- Regulation of institutional investors
- Regulation of pricing
- Transparency in markets

Speculators can benefit market by bringing in liquidity and efficiency. Islam forbids *Ghubn* as unethical.

Short Selling

Islam does not permit short selling. Islamic market does not allow trading of borrowed financial claims. This can affect arbitrage and price discovery in the market.

Islamic Investment Funds

Investors, who form a group to invest collectively in stocks, form a fund. Usually a manager takes care of the fund. Fund management can be offered by commercial and investment banks. There are more investment banks offering the service. Islamic finance is asset-based and suitable for fund management. IFIs are better suited for fund management than commercial banking. There are 150 Islamic mutual funds operating in Saudi Arabia, Bahrain, Kuwait, Qatar, Pakistan, Malaysia, Singapore, Germany, the U.S., U.K. and Ireland. They offer all categories of investment in equities and real estate.

The categories of returns are:

- Low risk/moderate return
- Balanced risk/balanced return
- High risk/high return

Fund management can be done in two ways:

- *Mudarabah* – the manager gets a pre-agreed share of the realised profit.
- Agency – the manager is paid a fee or a part of the net asset value of the fund.

Types of Islamic Investment Funds

Islamic Investment funds are categorised according to their use and type of returns. Equity funds are used to purchase shares of joint stock companies. Returns as dividends are distributed to shareholders. *Ijarah* funds are used to buy assets for leasing. Rental income is distributed among subscribers. *Ijarah Sukuk* can be traded in the secondary market. Commodity funds are used to buy commodities for resale. Profits are distributed to subscribers. *Murabaha*h funds are close ended and cannot be resold in the secondary market. Mixed funds are used to buy a mix of assets such as equities and commodities and assets for leasing. They can be traded if 51 per cent of their assets are tangible.

Types of Islamic Equity Funds

Islamic funds vs. conventional funds:

- Islamic funds must offer pro rata profit; conventional funds offer a fixed return on the face value of shares.
- Islamic funds can offer no guarantee on returns, while conventional funds can.
- Islamic funds are classified on the basis of risk profile of investors.

Regular Income Funds

Features of regular income funds:

- Aim to earn profits through dividends of investee companies
- Provide regular income stream to investors
- Are popular with elderly/retired people

Capital Gain Funds

Features of capital gain funds:

- Aim to earn profits from trading in stocks
- Provide moderately steady income to investors

Aggressive Funds

Features of aggressive funds:

- Aim to yield maximum profits for investors
- Invest in high risk/high return stocks
- Choose only investors who can also bear losses

Balanced Funds

Features of balanced funds:

- Try to balance between risk and returns
- Invest in low-risk stocks
- Offer steady income to investors
- Use the capital proactive approach

Screening and Purifying Funds for *Sharī'ah*-Compliance

Islamic equity funds must screen stocks for *Sharī'ah*-compliance. IFIs have *Sharī'ah* boards to conduct a screening. Boards evolve a level of tolerance for screening. The tolerance is different for different markets.

First screening was conducted by the Bank Islam Malaysia Bhd in 1983. The procedure was streamlined by Securities Commission of Malaysia in 1997.

Other *Sharī'ah*-compliant indices are:

- Dow Jones Islamic Market Index (DJIMI)
- Financial Times Stock Exchange Global Islamic Index (FTSE-GII)
- Kuala Lumpur *Sharī'ah* Index (KLSI)
- S&P 500 *Sharī'ah* and S&P BMI *Sharī'ah* group of indices

Conditions for *Sharī'ah*-compliance:

- Equity investment in the company should be a *Musharakah* partnership.
- Company should not be involved in activities prohibited by Islam.
- Company should have nothing to do with any industry prohibited by Islam.

Financial criteria for screening stock:

- Debt-equity ratio
- Cash and interest bearing securities–equity ratio
- Cash-asset ratio

Another approach is to purify the stock. Purification can be done by individuals or by funds. Proportion of income from a prohibited activity must be given away to charity.

Screening and purification can be done by:

- The government
- The private sector

Two Types of Financial Instruments

Majority of Islamic financial instruments are equity instruments. They are categorized on the basis of returns to investors.

Quasi fixed/Fixed returns

Features of quasi fixed/fixed returns:

- Offer investors steady, fixed income stream.
- Suitable for low-risk investors/senior citizens.
- Useful to mobilise funds for banking.
- Banks can securitise *Ijarah, Istisna'a* and *Murabaha* contracts for this portfolio.

Variable Returns

Features of variable (*Shirkah*) return securities:

- Offer investors variable income stream.
- Based on the strength of the projects.
- Suitable for high-risk investors.
- Banks can securitise *Mudarabah* and *Musharakah* funds for this portfolio.

Key Terms

Bai' al'-Inah

Bai' al-Dayn

Ijarah

Ijarah Sukuk

Istisna'a

Maisir or Qimar

Mudarabah

Mudarabah Sukuk

Musharakah

Musharakah Sukuk

Murabahah

Qard or Qard al-Hasan

Ribâ

Ribâ Buyu

Ribâ Qurudh

Salam or Bai' al-Salam

Sharī'ah

Shirkah

Sukuk

Uqud Al –Mu'awadat

Uqud Al-Isyitirak

Takaful

Tabarru

Tawarruq

Chapter 2

Chapter Introduction

Overview of Advanced Islamic Instruments and Markets. Islamic banking and finance has gained momentum in the areas of *Sukuk* and securitisation. Local currency instruments/*Sukuk* investments 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. *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 (IFI) and investors to balance liquidity with profitability. Islamic inter-bank funds market functions on the *Mudarabah* principle or sale and purchase of instruments according to the *Sharī'ah* rules.

Types of Islamic finance forward market:

- *Salam*-based forward market
- *Istisna'a*-based forward market
- *Ju'alah*-based forward market

A foreign exchange market can function in the Islamic financial structure by adhering to *Sharī'ah*. IFIs can engage in direct placement or investment in *Sharī'ah*-compliant foreign exchange denominated securities. Derivatives are complex and risky contracts with a market value of trillions of dollars around the world. An option contract confers the right but not the obligation to enter into an underlying contract of exchange on or before the specified future date. This makes the contract non-*Sharī'ah*-compliant.

Learning Objectives

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.
- Describe the challenges and controversies about derivatives.

Investment *Sukuk*

Sukuk were used as 'papers' to represent financial commitments that originate from trade and other commercial activities. *Sukuk* structures found in modern Islamic finance are similar to the conventional concept of securitisation. 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.

Types of *Sukuk*:

- *Shirkah*
- *Ijarah*
- *Salam*
- *Istisna'a*

As per the basic rules of *Sharī'ah*:

- Investment *Sukuk* should be structured on the *Mudarabah* or the *Ijarah* principle.
- Business can be conducted through participatory or fixed-return modes/instruments.

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

The rate of return on *Sukuk* is:

- Variable, if the modes are participatory
- Quasi-fixed, if the modes have 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 Markets and *Sukuk*

A primary market deals with the issue of new securities. The issuer of the securities receives the returns of a sale. A primary market operates on the basis of:

- Shares.
- Redeemable equity capital.
- *Mudarabah*/*Musharakah* certificates.
- *Sukuk*.

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. The price of *Sukuk* in secondary market depends upon the nature of security being traded. Pure debt securities do not have a secondary market in principle. 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.
- Business/industrial entities.

Markets in the Islamic financial system are based on the principles of relevant contracts and include:

- Equity/stock markets.
- Nongovernmental securities markets.
- Government and municipal securities market.
- Commodity futures market.
- Inter-bank money market.
- Foreign exchange market.

Trading Islamic Financial Instruments

Islamic financial instruments traded in Islamic markets include:

- *Sharī'ah* compliant stocks
- *Mudarabah*/*Musharakah* certificates
- Units of open- or close-ended mutual funds
- Investment *Sukuk*

The income for the *Sharī'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.

Rules for trading stocks/securities/certificates/*Sukuk*:

- 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*.
- Instruments representing different categories are subject to the rules relating to the dominant category.

Islamic Stockbroking Services

Islamic stockbroking services:

- Operate within the same institutional and regulatory framework as conventional stockbroking services.
- Comply with *Sharī'ah* principles.

Accounts of Islamic stockbroking services are segregated from the company's conventional stockbroking operations.

One of the leading financial services companies provides unique and wide range of services to its clients through modern technology and skilled staff. The services offered are as follows:

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

Stockbroking service is also provided through the bank's website. The Islamic bank also executes orders placed by its customer through its website. Such stockbroking is undertaken using the *Sharī'ah*-nominate mechanism of *Murabaha* sale. Shares of a lawful company may be sold or purchased on *Murabaha* basis. However, the seller must first acquire the shares with all their rights and obligations, and then only sell them to his client.

Islamic Inter-Bank Money Market (IIMM)

Islamic inter-bank money market (IIMM) functions on the *Mudarabah* principle or sale and purchase of instruments according to *Sharī'ah* rules. Bank Negara Malaysia (BNM) issued guidelines on IIMM in December 1993.

IIMM was introduced in Malaysia in January, 1994 to provide a ready source of short-term investment outlets. IIMM involves:

- Inter-bank trading of Islamic financial instruments
- *Mudarabah* inter-bank investments (MII)

In *Mudarabah* inter-bank investments, a deficit Islamic banking institution (investee bank) can obtain investment from a surplus Islamic banking institution (investor bank) based on the *Mudarabah* principle. The investment period is till 12 months. The return rate depends on the rate of gross profit prior to distribution for investments of one year of the investee bank. However, the profit-sharing ratio between the two parties is negotiable.

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.
- *Ju'alah*-based forward market for service-based activities.

Restrictions in *Salam*-based forward market include:

- Delivery of goods is compulsory.
- It is forbidden to resell a *Salam* commodity before it is received.
- *Salam* contract requires advance payment.

Restrictions in *Istisna'a* and *Ju'alah* markets include:

- 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.
- 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. In a conventional futures market, new prices can be offered at any point of time.

Differences between *Istisna'a*-based and *Salam*-based futures markets:

- *Istisna'a*- based futures market involves long-term transactions and therefore, will require a different legal institutional framework.
- Prices of *Istisna'a*-based futures contract may not widely fluctuate over the short-term, as expected in the *Salam*-based futures market.

Islamic Foreign Exchange Markets

A foreign exchange market can function in the Islamic financial structure by paying attention to the limitations set by the *Sharī'ah*. IFIs engage in direct placement or investment in *Sharī'ah*-compliant foreign exchange denominated securities such as Solidity Trust Certificates issued by Islamic Development Bank (IDB) in 2003 and many other *Sukuk*.

Foreign currency forward cover facility is permissible subject to the following conditions:

- Foreign currency is needed for genuine trade or payment transactions. This should be supported by appropriate documents.
- Forward cover should be a formal 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.

Derivatives in Islamic Finance

Derivatives are complex and risky contracts derived from the expected performance of the respective underlying assets. Conventional options, swaps and futures stem are collectively known as derivatives. Conventional options grant rights but not liabilities. Strike price is the price at which the option holder may trade on the underlying asset by implementing the option.

- If the price changes favourably, the option is implemented and the transaction of the asset done at the agreed price.
- If the price moves unfavourably, the buyer of the option abandons it.

There is a possibility of put and call options in legitimate goods and stocks on the basis of *'Arbūn* and reverse *'Arbūn*. A prominent financial market leader concluded that there are no effective derivatives of Islamic debt contracts, which replicate conventional risk-hedging and leveraging contracts. 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

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. One of the world's most prominent financial market leaders remarked derivatives as 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:

- It does not suffer from continuing volatility.
- People should work in productive pursuits rather than unproductive ones.

Due to the high degree of leverage of option contracts, a large unpredictable market move in prices may lead to the collapse of major financial institutions. Liabilities cannot be perfectly hedged. Few traders prefer not to hedge their option portfolios. This is because hedging would limit high returns. The degree of risk that can be incurred by hedging was expressed by Long Term Capital Management based in the United States. Collateralised debt obligations (CDOs), a sophisticated type of derivative, are used to exploit differences in credit ratings.

Level of Risk:

- Equity tranche: Suffers first loss
- Mezzanine tranche: Suffers loss if equity tranche fails
- Senior tranche: Safe until the collective pool suffers severe losses

Key Terms

Bai' al'-Inah

Bai' al-Dayn

Bai' al-Sarf

Hawalah

Hamish Jiddiyah

Ijarah

Ijarah Sukuk

Istisna'a

Ju'alah

Maisir or Qimar

Mudarabah

Mudarabah Sukuk

Musharakah

Musharakah Sukuk

Murabahah

Qard or Qard al-Hasan

Ribâ

Ribâ Buyu

Ribâ Qurudh

Salam or Bai' al-Salam

Sharī'ah

Shirkah

Sukuk

Uqud Al –Mu'awadat

Uqud Al-Isyitirak

Takaful

Tabarru

Tawarruq

Chapter 3

Chapter Introduction

Islamic Capital Market Products. Islamic capital markets recognise:

- Islamic equity funds
- Islamic commodity funds
- Islamic real estate investment trust (REIT) funds
- *Sukuk*

Islamic equity funds:

- Contain a portfolio of stocks.
- Meet guidelines defined by the *Sharī'ah*.
- Islamic commodity funds:
- Invest in commodities approved by Islamic law.
- Sell commodities at a profit.
- Distribute profits among investors.

REITs:

- Are companies that invest in income-creating real estate.
- Can be classified into various types.
- Can be selected based on their organisational structures.

Sukuk:

- Is exclusive to Islamic capital markets and originated in Malaysia.
- Is a contract that allows investors to purchase assets and then sell them back later at a profit.

Learning Objectives

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 (REIT), tax related aspects, decision makers, and types of property invested in.
- Describe various types of REITs.
- Distinguish among the three REIT structures.
- Explain the objectives of and concerns related to hedge funds.

Choosing Stocks for Islamic Equity Funds

Islamic equity funds resemble Socially Responsible Investment (SRI) funds. SRI stocks are also selected according to special criteria. When building the portfolio for an Islamic equity fund, you follow two steps. Let us briefly discuss these steps.

Screening

During screening, you:

1. Identify all stocks that meet your financial objectives.

2. Select the stocks of companies that conduct business according to *Sharī'ah* guidelines.

Filtering

Filtering:

- Enables you to narrow down your choice of stocks by applying additional criteria.
- Is mainly based on rules specified by the *Sharī'ah* about how a company should raise its capital and obtain finance.
- Can help to obtain a portfolio of stocks that are completely *Sharī'ah*-compliant.
- Depends on the discretion of fund managers. They have the freedom to decide which rules to apply and to what extent.

Choosing Stocks for Islamic Equity Funds (Contd.)

Each Islamic country can enforce its own set of screening criteria. Usually, screening and filtering criteria are based on certain common factors. Let us now discuss these factors.

Business Dealings

When screening stocks, you should select only the stocks of companies that have *Sharī'ah*-approved business dealings.

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.
- Run conventional banking and insurance endeavours.

Debt Financing

Islamic capital markets aim to eliminate debt-based financing in the future. Currently, they allow its partial use. Therefore, financing is one of the important factors that help define filtering criteria.

Fund managers can select stocks of companies that raise a certain percentage of their capital through debt-based financing. This percentage:

- Depends on the degree to which they want to conform to the *Sharī'ah*.
- Is at most 33% of equity.

Sharī'ah scholars:

- Mandate that all shareholders should actively participate in the bid to eliminate this debt-based financing.

- Recommend vocal denouncing of debt-based financing as a step towards its elimination.

Interest Income

Interest income helps define filtering criteria. The interest a company earns through debt-based securities is disapproved of by *Sharī'ah* scholars.

The scholars mandate that fund managers should:

- Reject the stocks of companies that earn a major part of their income through interest on debt-based securities.
- Consider the stocks of companies that earn only a miniscule portion of their income through interest on debt-based securities.

Muslim investors, even if they buy the stock of any such company, should clarify that they do not endorse the company's means of earning its income. They need to:

- Vocally denounce such income.
- Purify the dividend by donating a part of it to charity.

Assets

Assets also help define filtering criteria. Fund managers can filter out the stocks of companies that possess only liquid assets.

Liquid assets represent cash, which can be traded only at face value. That's why:

- *Sharī'ah* scholars mandate that a portion of each company's assets should be illiquid.
- Most fund managers set this portion at a maximum of 33% of the entire assets of a company.

Stock

Another factor that helps define filtering criteria is the type of stock.

Sharī'ah scholars approve only ordinary stock, which:

- Gives shareholders undivided ownership in a company.
- Does not guarantee a definite return.
- Vests both a company and its shareholders with the same liability.

The scholars disapprove preferred stocks and warrants, which:

- Guarantee a definite return to shareholders.
- Vest little or no liability with the shareholders.

Growth of Islamic Equity Funds

Widespread privatisation in Islamic countries has lead to increased promotion and sale of Islamic equity funds. Fund managers can now include a wider variety of stocks in the portfolios of Islamic equity funds. As a result, more investors are attracted to Islamic equity funds. In Malaysia, more than 50% of stocks listed on the Kuala Lumpur Stock Exchange (KLSE) are *Sharī'ah*-compliant. A centrally controlled body – the *Sharī'ah* Advisory Council, or SAC – monitors the stocks listed on the KLSE.

The SAC:

- Works in association with other Malaysian regulatory bodies.
- Screens all stocks listed on the KLSE for *Sharī'ah* compliance twice a year.

Details about all *Sharī'ah*-compliant stocks are published by the Securities Commission of Malaysia. Many share-market regulators worldwide have introduced exclusive indices for these funds.

- The Dow Jones Company introduced the Dow Jones Islamic Market Index (DJIMI).
- Bursa Malaysia set up the Kuala Lumpur *Sharī'ah* Index (KLSI).
- The Financial Times Stock Exchange (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.

DJIMI:

- Lists only the stocks that investors from anywhere in the world can buy.

- Uses ratios from both income statements and balance sheets to determine debt or liquidity levels of stocks.

In contrast, KLSI:

- Does not impose restrictions on stocks based on the types of investors they allow.
- Considers ratios derived only from the income statement to determine debt or liquidity levels.

Screening

The DJIMI screening process involves identifying and rejecting stocks of companies that violate *Sharī'ah* norms by:

- Dealing in alcohol
- Dealing in pork products
- Providing conventional financial services
- Dealing in tobacco
- Manufacturing or selling weapons
- Running hotels, casinos, and similar businesses
- Dealing in music and film-making, including pornography

Filtering

The DJIMI filtering process rejects stocks based on the following financial ratios:

- Debt to Assets
- Liquid Assets to Total Assets
- Receivables to Assets

Challenges for Islamic Equity Funds

Challenges that hamper the growth of Islamic equity funds:

- Many *Sharī'ah*-compliant stocks are financially weak.
- Many companies don't list themselves on Islamic stock indices.
- The options available to fund managers are limited, so portfolios might not always help diversify risks.
- Many listed, *Sharī'ah*-compliant companies are monopolised by insiders and allow limited scope for outsiders to make profit.
- Brokers and malicious investors can control stock exchanges and stocks for their own benefit.
- The investor base is not at par with that of conventional capital markets.
- Fund managers have to reject many financially strong funds simply because they have high debt-to-equity ratios.
- The financial ratios for a company can fluctuate, and so stocks of these companies may violate *Sharī'ah* norms during certain periods. This can negatively affect diversity benefits, and finding a replacement stock during the lean period can be time-consuming and expensive.

- Fund managers themselves can indulge in practices prohibited by the *Sharī'ah*. There is a need for *Sharī'ah* scholars to define standard, *Sharī'ah*-compliant practices for fund managers.

Islamic Commodity Funds

Islamic commodity funds:

- Invest only in commodities.
- Distribute any profit among investors in proportion to their investments.

The *Sharī'ah* guidelines that apply to Islamic commodity funds are:

- Do not short sell.
- Do not undertake a forward sales contract unless it is a *Bai*' *Salam* or *Istisna*'*a* contract.
- Do not deal in commodities such as pork products and alcohol.

Real Estate Investment Trusts (REITS)

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

Investors in a REIT:

- Can diversify risks and profit from rest estate they don't fully own.
- Elect the REIT's board of directors.

A REIT's directors:

- Elect subordinate management professionals.
- Take major investment-related decisions.
- Are accountable to the investors.

Tax Liability

- A REIT can deduct its shareholders' dividends from its corporate taxable income.
- To qualify as a REIT, a company has to allocate at least 90% of its taxable income to its shareholders annually. However, the company cannot pass on its tax losses.

Types of Investments

The types of investments a REIT can make depend on:

- Property type
- Industry
- Geography

Some REITs focus on only one type of property, such as shopping malls or warehouses.

Some REITs invest only in one type of industry, such as healthcare. The types of healthcare facilities that a REIT can invest include:

- Acute care centres
- Rehabilitation and psychiatric hospitals
- Medical office buildings
- Nursing homes
- Assisted living centres

A REIT can also invest only within specific regions or countries or anywhere in the world.

Types of REITs

You can classify REITs according to two criteria. Let us find out more about these criteria and the corresponding REIT categories. Using ownership and lending as criteria, you can classify REITs into three types.

Equity REITs:

- Own and operate income-producing real estate.
- Engage in a variety of real estate activities, such as leasing and development of residential apartments and office buildings.
- Purchase and develop properties to build their own portfolios.

Mortgage REITs:

- Finance real estate owners and operators.
- Offer credit indirectly by acquiring loans or mortgage-backed securities.

Hybrid REITs act as both equity and mortgage REITs.

Note: Equity REITs are *Sharī'ah*-compliant but mortgage and hybrid REITs are not. That is because mortgage and hybrid REITs indulge in *Ribâ*-based activities. That is, they earn income through interest.

Most REITs are public. They are listed on stock markets and some may be included in *Sharī'ah*-compliant indices. Some REITs are private. They are neither listed on stock markets nor traded over-the-counter.

Private REITs are of three types:

- **Institutional REITs**, which target investors who can invest large sums of money.
- **Syndicated REITs**, whose shares financial consultants offer to investors as part of a package.
- **Incubator REITs**, which have the potential of going public in the future. Venture capitalists often fund these REITs.

REIT Structures

REIT structures are of three types. Let us discuss these types.

Traditional REIT

A REIT based on the traditional REIT structure owns its assets directly.

UpREIT

An UpREIT represents a collaborative venture between a REIT and the members of an external partnership. This venture is known as operating partnership. The REIT contributes only cash, and the partners contribute properties from their external partnership. The REIT itself does not own and operate any properties. The REIT and the partners receive units in the operating partnership proportion to their contributions. Usually, the REIT is the majority owner. After a year, the partners can exchange their units for cash or REIT shares.

DownREIT

A DownREIT is similar to an UpREIT except that in a DownREIT:

- The REIT also owns and operates assets.
- The REIT’s 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.
- Invest in almost any type of stock, sell short, use options and futures and buy stakes in illiquid securities.
- Are unsuitable for Islamic capital markets.

Most regulatory authorities discourage average investors from investing in hedge funds.

For example, the Securities and Exchange Commission (SEC) of the US disallows hedge funds to:

- Accept investments from individuals with a net worth of less than USD 1 million.
- Advertise.

Hedge funds:

- Are privately traded funds.
- Are suitable for investors who are very strong financially and have a high risk appetite.
- Try to surpass traditional mutual funds through short selling, derivative investing and arbitrage.

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

Key Terms

Ijarah Sukuk

Istisna'a

Mudarabah

Mudarabah Sukuk

Musharakah

Musharakah Sukuk

Murabahah

Salam or Bai' al-Salam

Sharī'ah

Sukuk

Chapter 4

Chapter Introduction

Challenges to the Growth of Islamic Capital Markets.

Islamic capital markets are still evolving. In contrast, conventional capital markets have:

- Reached an advanced stage of maturity.
- Established various reliable guidelines, processes and procedures that further enhance their growth and minimise risks.

The Islamic capital markets can use conventional capital markets as models and, thereby, accelerate their development.

The Islamic capital markets should also be prepared to handle the challenges that any conventional capital market faces. These challenges are mainly the result of factors such as 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 participants.
- Absence or restricted use of reliable supporting institutions, which can help define market standards and benchmarks for performance evaluation.
- Degree of integration with external markets.

The Islamic capital markets also face the additional challenge of establishing guidelines that conform to the *Sharī'ah*.

Learning Objectives

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.
- Explain how *Sharī'ah* scholars can help develop 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.
- Specifies guidelines to resolve disputes between investors and companies.
- Specifies guidelines to protect and prioritise the investors' rights.

Every capital market requires a sound regulatory and legislative framework. For Islamic capital markets, this framework also has to be *Sharī'ah* compliant. Most Islamic countries improvise and apply local regulations and laws to Islamic capital markets. This improvisation is based on the requirements of individual transactions. For example, the local regulations and laws might disallow government bodies to indulge in *Sharī'ah*-compliant transactions such as *Ijarah Sukuk*. So, every time a government body has to make an *Ijarah Sukuk* transaction, the legislative body has to amend or even ignore the local regulations and laws for that particular transaction. This:

- Is not a good practice.
- 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.

Understanding the Balance Sheet of an Islamic Bank

Balance sheets can be presented in two ways:

- According to Maturity profiles
- According to Functionality

Functionality-based view is more popular. Maturity-based view is important – it provides information about institutional exposure.
On the Liabilities side, Islamic banks follow the two-window approach:

- One – demand deposits window
- Two – special investment accounts

Depositors choose the window. Special investment accounts are not a liability in Islamic banks. Investors are partners. Investment accounts are liability in conventional banks. Special or restricted accounts are often shown as off-balance sheet transactions.

A 100 per cent reserve is specified for demand deposits (*Amanah*) because:

- Deposits must be returned at par value.
- There is no increment in value of the funds.

Special accounts are meant for investment. Depositors are aware of risk when they invest. Investors are sources of funds *(Rab al-māl).* The bank acts as agent *(Mudarib).* Profits from special investment are assets, not liabilities. Investors share profits and losses. Restricted profit-and-loss sharing *Musharakah* accounts are also offered for high net worth individuals. Greater choice of instruments is available on the Assets side.

- For short-term: trade financing and financial claims from a sales contract (*Mudarabah/salaam*)
- For medium-term: leasing (*Ijarah*) and manufacturing contracts (*Istisna'a*)

- For long-term: *Musharakah* partnerships

Islamic banks can form a syndicate with other institutions to provide medium and long-term capital. How it works:

- The bank appoints external entrepreneur as agent.
- The bank acts as principal.

Islamic banks also provide:

- Customized services.
- Guarantees.
- Underwriting services.

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.
- Is consistent with the other countries' frameworks regarding the types of financial products it endorses.

Ambiguities can result if local laws are:

- Used in their original formats to control Islamic capital markets.
- Improvised or overruled for individual transactions.

Standardisation can:

- Prevent ambiguities and inconsistencies across Islamic capital markets.
- Help minimise legal expenses.

Dispute Resolution

The guidelines and procedures for resolving disputes regarding Islamic financial products should be included in the existing dispute-resolution system after some modification. This can:

- Preclude any confusion.
- Help save the money and efforts required to maintain a separate dispute-resolution system for Islamic financial products.
- Enhance investors' confidence in the Islamic capital markets.

Strengthening

Very few Islamic capital markets strictly follow regulatory guidelines because of the absence of strong regulatory frameworks and agencies. Islamic countries should strengthen their financial regulatory frameworks by ensuring that Islamic capital markets strictly apply them.

To ensure strict application, Islamic countries should:

- Set up powerful, independent and trustworthy regulatory agencies and their affiliates.
- Empower these agencies to audit capital markets and enforce the regulatory frameworks.

Market Structure and Practices

A favourable market structure and *Sharī'ah*-compliant 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 *Sharī'ah* requirements through *Sharī'ah* boards.
- 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
- Margin account maintenance

These practices:

- Are disapproved by some *Sharī'ah* scholars.
- Can discourage Muslim investors.

Therefore, regulatory agencies should:

- Empower *Sharī'ah* boards to frequently audit market practices of companies for *Sharī'ah* compliance.
- Set up a procedure to define and standardise market practices according to *Sharī'ah* requirements.

To enhance and expedite its growth, an Islamic capital market needs to:

- Attract borrowers from multiple Islamic countries.
- 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. Most foreign investors lack confidence in Islamic capital markets because these markets:

- Lack transparency.
- Expose participants to wrong practices.
- Examples of wrong practices include:
- Price manipulation
- Front running
- Insider trading
- Blank selling

To kindle trust, regulatory agencies should:

- Enforce transparency in the issuance and trading of securities.

- Outlaw wrong market practices and conduct regular audits to identify the people who indulge in these practices.
- Penalise people who indulge in wrong market practices and set up rules that can discourage anyone from indulging in these practices in the future.

Use of Incentives to Promote Growth

Currently, operating costs are higher in Islamic capital markets than in conventional capital markets. This can discourage potential investors. Therefore, policy makers need to:

- Work towards reducing the operating costs.
- Ensure that the operating costs are equivalent to, if not less than, the operating costs in conventional capital market.
- One of the main reasons for higher operating costs in Islamic capital markets is the tax framework for these markets.

This framework is more demanding on investors than the tax framework for any conventional capital market. For example, investors in real estate and other underlying assets end up paying more in the form of:

- A higher percentage of capital gains tax and income tax.
- Double stamp duty.

Therefore, policy makers should restructure the tax framework so as to:

- Clearly define each rule and guideline.
- Remove ambiguities and disparities.
- Make tax structures more investor friendly.

The policy makers can:

- Waive additional stamp duties and other additional expenses the investors have to incur in Islamic capital markets.
- Offer incentives to attract retail investors from around the globe.
- Allow foreign retail investors to buy and sell through Internet banking.

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. Examples of tax breaks include tax deductions on:

- Dividend payments for *Sukuk* and other Islamic transactions.
- Research and development expenses.

A few countries have already formalised tax breaks and incentives for Islamic capital markets. For example:

- In 2003, the United Kingdom (UK) government waived the additional stamp duty that was applicable to Islamic mortgages.

- In 2004, 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

Supporting institutions such as industry associations, rating agencies and standards-setting agencies can play a key role in promoting the growth of Islamic capital markets.

- An industry association
- A rating agency
- A standards-setting agency

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 (IIFM):

- Is an industry association that was set up in Bahrain in November 2001.
- Became operational on April 1, 2002.
- Is a front for at least 265 Islamic banks and financial institutions from around the globe.
- Aims to enable the listing and acceptance of Islamic financial products on stock exchanges worldwide.

The IIFM board of directors established the Global *Sharī'ah* Supervisory Committee (GSSC) during the first decade of the 21st century. The GSSC:

- Helps review and certify new Islamic financial products.
- Helps formulate guidelines for new financial products.
- Advices on how new financial products can be made *Sharī'ah* compliant.

Through the GSSC, the IIFM has already certified global Islamic bonds issued by:

- Bahrain
- Qatar
- Malaysia
- The Islamic Development Bank (IDB)

The Liquidity Management Centre (LMC):

- Is a subsidiary of the IIFM.
- Was set up in Bahrain in February 2002.
- Helps Islamic financial institutions manage their surplus liquidity effectively.
- Consolidates the assets of various governments and business and financial institutions and issues them as *Sukuk*, which Islamic financial institutions can buy.

Sukuk issued by the LMC are part of a secondary market, so the financial institutions receive competitive returns even on short-term investments.

IIRA

The International Islamic Rating Agency (IIRA):

- Was established in Bahrain in October 2002 by the IDB.
- Assesses Islamic financial institutions and products for *Sharī'ah* compliance.
- Is responsible for releasing a set of rating standards.
- Makes all its findings, along with their chronologies, available to the public.

IFSB

The Islamic Financial Services Board (IFSB):

- Is a standards-setting agency that was established in Kuala Lumpur, Malaysia, in November 2002.
- Is an association of central banks, monetary authorities and regulatory and supervisory bodies for Islamic capital markets and financial institutions.
- Collaborates with other standards-setting agencies and conducts training and research about risk management.
- Provides technical assistance to institutions regarding risk management.
- Has released standards that specify how financial institutions should identify, classify, measure and report risks.
- 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. Considering this, the IDB set up the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in Bahrain in March 1991.

The AAOIFI:

- Is an autonomous, not-for-profit organisation.
- Defines accounting, auditing, governance and ethical standards for Islamic financial institutions worldwide.
- Takes into account both *Sharī'ah* principles and international standards and practices when defining standards.
- Prepares, issues and interprets *Sharī'ah* standards for Islamic financial institutions.

The governments of the following Islamic countries have recognised and adopted the standards defined by the AAOIFI:

- Bahrain
- Qatar
- Jordan
- Sudan

A few government agencies have used AAOIFI standards as their guides to define their own accounting and auditing standards. These agencies include:

- The Monetary Agency of Saudi Arabia
- The Malaysian Accounting Standards Board (MASB)

Financial Engineering

Like the conventional capital markets, Islamic capital markets can also use financial engineering to enjoy long-term growth. *Sukuk*, a financially engineered product, is already being used in Islamic capital markets.

However, there is a need to aggressively employ financial engineering to further develop areas such as:

- Money markets
- Intra-bank markets
- Securitisation

Money markets:

- Provide short-term liquidity.
- Enable capital markets to focus on long-term capital needs.

Securitisation:

- Is a means to pool and repackage financial assets and then sell them to investors.
- Can generate both long-term and short-term cash reserves.

Two types of products that financial engineers should concentrate on are:

- Mortgage Backed Securities (MBS)
- Asset Backed Securities (ABS)

Both MBS and ABS deal with the securitisation of a homogeneous pool of assets and have scope for immense growth.

Note: Examples of financial engineering in Islamic capital markets are discussed in detail in Chapter 5 of this course, **Innovations in Islamic Markets**.

Use of Training and Interaction to Promote Growth

Professionals who manage Islamic capital markets require detailed knowledge of:

- Principles, practices and laws related to finance, accounting and taxation.
- *Sharī'ah* principles.

There is still a dearth of such professionals, and this has led to a slow pace of growth in the Islamic capital markets.

To grow at a faster pace, 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, develop and conduct training programs that focus on Islamic capital markets.
- Encouraging greater interaction between *Sharī'ah* scholars and market professionals.
- Funding research on Islamic finance generously.

There is also a need to encourage greater interaction between primary and secondary markets. To do this, authorities should:

- Allow contracts to be sold and purchased internationally, across regions and markets.
- Foster ties between the different schools of thoughts about Islamic finance that currently exist.

Chapter Summary

You have completed the chapter, **Challenges to the Growth of Islamic Capital Markets**.

The key points of this chapter are as follows:

- Every capital market requires a sound regulatory and legislative framework.
- Islamic countries should consider three aspects when they customise regulatory and legislative frameworks for Islamic capital markets – standardisation, dispute resolution and strengthening.
- Noncompliance with *Sharī'ah* requirements, lack of foreign Islamic securities and mistrust by foreign investors are some of the factors that restrict the growth of Islamic capital markets.
- Policy makers should restructure the tax framework for Islamic capital markets so as to reduce operating costs.
- Supporting institutions such as industry associations, rating agencies and standards-setting agencies can play a key role in promoting the growth of Islamic capital markets.
- Islamic capital markets can use financial engineering to enjoy long-term growth.
- To grow at a faster pace, Islamic capital markets need a large pool of trained professionals who have advanced technical knowledge and in-depth knowledge of *Sharī'ah* principles.
- There is also a need to encourage greater interaction between primary and secondary markets.

Key Terms

Ijarah Sukuk

Istisna'a

Mudarabah

Mudarabah Sukuk

Musharakah

Musharakah Sukuk

Murabahah

Salam or Bai' al-Salam

Sharī'ah

Sukuk