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ISLAMIC CAPITAL MARKETS PRODUCTS, REGULATION & DEVELOPMENT



ISLAMIC CAPITAL MARKETS PRODUCTS, REGULATION & DEVELOPMENT

Proceedings of International Conference

Edited by

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Foreword

Islamic finance has witnessed fast growth over the past decade. The developments have been particularly significant in the area of tradable securities that form the basis of capital markets. While product innovations can add value and increase risk-return choices for the investors, it is known that not every product necessarily adds to the welfare of the society when asset markets are incomplete.

For a well functioning capital market which could contribute to socio-economic development it is necessary to have appropriate regulations, practices and support institutions. These are quite important requirements for the development of Islamic capital markets because of their nascent stage and operations in a challenging environment which is not neutral to Islamic paradigm. To analyse such issues in product innovation, regulation and practices in Islamic capital markets a conference was jointly organized by Islamic Research and Training Institute (IRTI) and Muamalat Institute in Jakarta from August 27 to 29, 2007.

Islamic Research and Training Institute is now pleased to present selected papers from the above conference in this book. I hope that the academics and professionals in economics and finance will find the present volume useful and stimulating.

Bashir Khallat
Acting Director General, IRTI

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Acknowledgments

IRTI would like to acknowledge with thanks Muamalat Institute and all the other institutions and individuals who joined with resources and efforts in organizing the conference that resulted in the papers which are published in this volume. Special thanks to all the authors and discussants who contributed with their intellectual capital and responded to our call for papers. We regret that only few papers could be accepted for presentation in the conference and even fewer are selected for publication in this volume. The institutional affiliation and contact information of the author(s) to each paper is given in the endnotes.

Thanks and acknowledgments are also due to the members of the Academic Committee of the conference who helped in developing the program and evaluating the submitted papers; and to the members of the Organization Committee, who ensured smooth execution of the event. High praises for the motivated and untiring efforts of Ms. Nurul Barijah Djaffar, Director Muamalat Institute and her team for the help in organizing the conference and taking care of all the local arrangements.

We have received great help and assistance from staff at Islamic Research and Training Institute and the Muamalat Institute during various stages of typing, revising, type-setting, and publishing of this book. In this regard particular mention is due for Mr. Shaikh Amanul Hoque, Mr. Sajjad Qurban and Mr. Mohammad Asiri.

Finally, all praise is for Allah the Lord, the Sustainer of all worlds (*Wa Alhamdu li Allah Rab al 'Alameen*).

Editor

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[1]

Introduction

Islamic Capital Markets: Current State and Developmental Challenges

*Salman Syed Ali**

Capital markets are an important component of the financial system for raising funds for long-term investment. They provide opportunities for diversification of risk through *cross-sectional* risk sharing. The long-term investments are facilitated through a series of short-term contracts in the form of tradable securities enabling the investors an opportunity to exit or enter through trade. Thus they provide an *element of liquidity* to the otherwise illiquid assets. The secondary market also provides pricing and valuation of assets on a continued basis thus eliminating arbitrage and inefficiencies.

Islamic capital markets are an integral part of Islamic financial system for efficient mobilization of resources and their optimal allocation. These markets complement the investment role of the Islamic banking sector. They are more relevant in an Islamic economy because prohibition of interest entails a greater reliance on equity and asset-based finance. For the investors to know the fair value of their investments, smooth out the risks through diversification and be able to liquidate their positions in real assets, such markets are indispensable. However, the institutional arrangements of the Islamic financial system may be different with respect to these markets as compared to their conventional counterpart. This realization is found to a lesser extent among some stakeholders than the realization of the same in case of Islamic and conventional banking sectors.¹

How the Islamic capital markets will develop and what direction they will take depends on a number of factors but most importantly on the realization of the similarities as well as the differences in the objectives and the means of Islamic system, and based on that, the introduction of new financial products, their characteristics, diversity and the use; the regulation and support provided to functioning of these markets; socio-economic conditions of the societies and most important, the political will for change towards an Islamic system without which no real change can occur.

While new products are steadily coming into the capital market and the Islamic investment funds are growing, Islamic capital markets still constitute a very small niche. For a discernible and beneficial impact of Islamic finance on the investment promotion, market stability and equitable socio-economic development there is a growing need to accelerate the process of product development. At the same time, it is also necessary to create appropriate regulatory environment and to transform the market practices. This task requires development of new human capital and knowledge base. The International Conference on Islamic Capital Markets: Products, Practices, and Regulation that took place in Jakarta during August 27-29, 2007 under the auspices of Islamic Research and Training Institute (IRTI) and Muamalat Institute was a move towards achieving these larger goals. The immediate focus of this conference was on three issues:

1. Design and use of Islamic financial products for capital markets.
2. Identification of needs for and implications of market regulation for development of Islamic capital market.
3. Identification of conventional market practices that are non-compliant to Shari'ah and ways for reformation.

In this chapter, we briefly survey the nature of Islamic finance, the current state of Islamic capital market, and its increasingly important role in the Islamic finance at the global level. We also highlight some of the challenges faced in the development of Islamic capital markets. We then briefly introduce the contribution of each set of conference papers (as most of them highlighted the unresolved issues and some provided a way to overcome those challenges). Lastly, we point out the areas that could not be covered by the conference and where next focus should be for research and development.

2. NATURE OF ISLAMIC FINANCE

Islamic financial system is a real economic activity based financial system. It is a part of the broader Islamic economic system that deals with the questions of allocation of resources, production and exchange of goods and services and the distribution of wealth in fair, equitable and socially beneficial ways. It is part of a consistent and integrated framework which considers finance as a supporting factor in the smooth functioning of real economic activity and in carrying out the social good as defined by the objectives of Shari'ah. In this system, finance does not exist for finance per se. Therefore, financing itself is not allowed to be an income generating activity unless it is combined with some real economic activity and involves taking the requisite risks associated with it. The nature of Islamic finance is aptly summarized by Shamshad Akhtar, Governor of the State Bank of Pakistan, at Georgetown University on October 18, 2007:²

Islamic economic system ... is accompanied by a rich and elaborate set of tenets, which among others, recognize the right to property

supported by elaborate obligations of stakeholders, principles and rules of conduct, a contract system and institutional framework and procedures for enforcement of rules which all together lay the foundation for Islamic business and financial architecture. It is this substantive Islamic ideological and legal framework, governed by Shari'ah injunctions and principles that have translated into defining the public and private economic and social affairs that eventually help frame the business and financial relations. The core of these relationships is backed by solid principles of contracts, rights and obligations of parties to the contractual arrangements.

... The main driver of enforcement of contracts and rules-compliance in Islamic system is ideology and faith which is in turn influenced by Islam's emphasis on establishing an equitable, ethical, just, and fair socio-economic system. It is this feature which shapes Islamic finance and also distinguishes it from the conventional finance.

This clear understanding of the objective and nature of Islamic financial system (i.e., justice and close link to real economic activity) is essential for taking any further steps towards the development of Islamic financial sub-sectors, be it Islamic capital market, Islamic banking sector or the insurance sector.

3. PRESENT STATE OF ISLAMIC CAPITAL MARKETS AT GLOBAL LEVEL

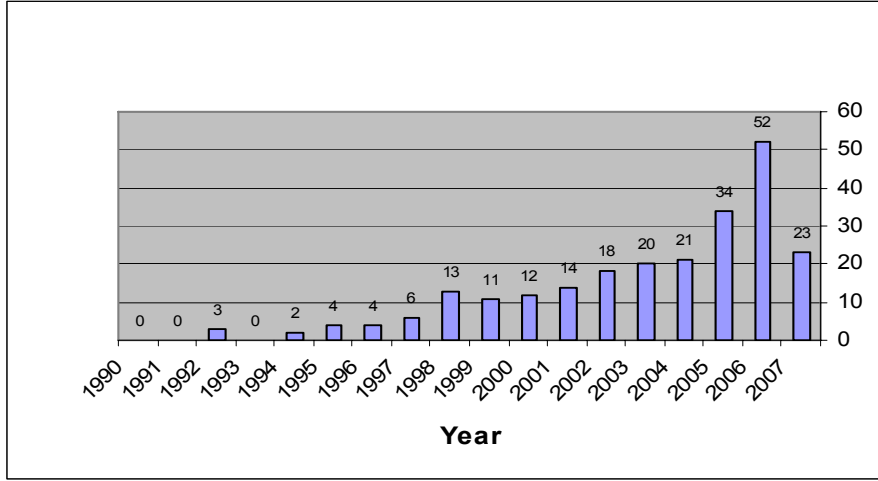
Over the past decade or so Islamic financial sector has grown, gained strength by creation of various support and infrastructure institutions, and expanded from being a banking-based industry to more wider areas incorporating financial market-based products and practices. As a result, Islamic financial markets have become probably the fastest growing sector in the Islamic finance industry. A number of innovative products, instruments and practices have been added that allow a larger range of risk-return combinations to suit a wider investor base. There is no unique measure to gauge this increased significance of capital markets in the Islamic finance, however a number of facts point to its fast growth. In what follows, we look at some of the facts such as:

- growth of Shari'ah-compliant funds,
- the size of Shari'ah-compliant equity market,
- introduction of innovative products such as *Shukūk*, and
- a number of significant institutional developments like emergence of the various regularly computed indexes for Islamic markets and rating methodologies for Islamic capital market products. Initiation of efforts towards streamlining and Shari'ah standardization of products and their regulatory mechanisms.

Growth of Sharī‘ah-Compliant Funds: The number and size of Sharī‘ah-compliant funds have increased from 13 in 1996³ to 150 in 2000 and to over 400 by 2006 with more than \$300 billion under management. The Islamic funds have grown at an approximate cumulative annual growth rate of 22 percent between 2000 and 2005.⁴ Year-to-year growth has also been explosive as can be observed by the number of new equity funds incepted each year (*see Figure 1.1*). However, this also implies an average fund size of only about \$0.75 billion. Moreover, the dispersion of funds by size is skewed towards the smaller fund sizes⁵ reflecting the various operational constraints and regional focus in marketing and deployment of these funds. In terms of distribution, by type, the Islamic funds are highly concentrated in equities and thinly spread over other asset classes (*see Figure 1.2*).

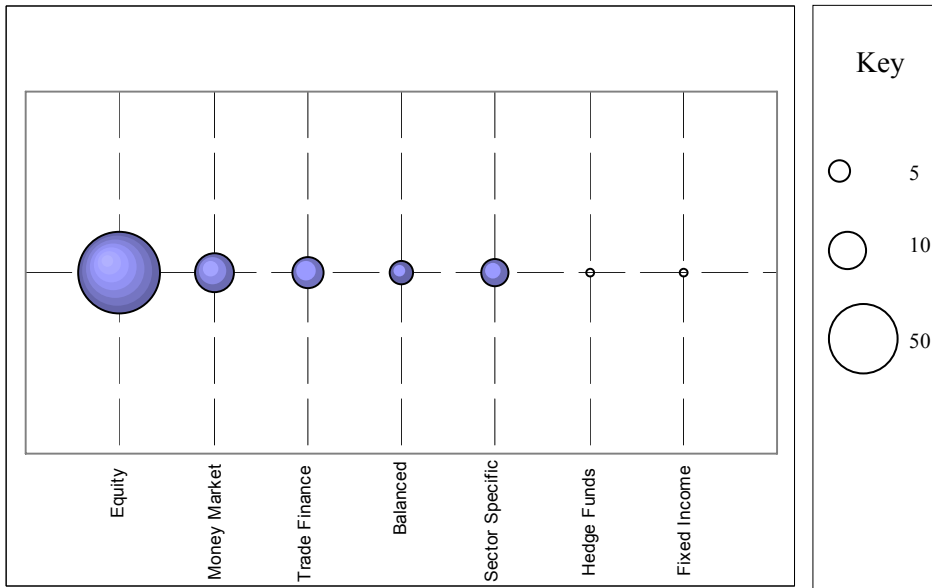
Growth in Sharī‘ah-Compliant Equity Market: Another measure of growth is to look at the size of Sharī‘ah-compliant stocks⁶ in total equity market. Uniformly applying the screening criteria of Dow Jones Islamic Market Index (DJIMI) to local stock markets of Bahrain, Malaysia and Pakistan (three IsDB member countries) a recent IRTI study (Ali, 2005) found that market capitalization of Sharī‘ah-compliant stocks was about US\$104 billion in 2004. Assuming that these three countries constitute 30 percent of the stock capitalization in the IsDB-member countries, the Ten Year Framework and Strategies (TYF&S, 2006) document of IRTI estimates the capitalization of Sharī‘ah-compliant stocks in the member countries to exceed US\$300 billion.

Growth in *Ṣukūk*: *Ṣukūk* are the new products on the scene. These are defined as “financial securities of equal denominations representing undivided ownership interests in a portfolio of eligible existing and/or future assets, usufruct, services and business activities”.⁷ There are now various types of *ṣukūk* in the market such as those based on leasing (*ijārah*), partnership (*mushārah*), build-to-order projects (*istiṣnā‘*), etc. Various new varieties such as convertible *ṣukūk*, and asset substitution *ṣukūk* have also come into the market. The underlying concept in much of these *ṣukūk* is securitization of existing or to be constructed/developed assets or usufruct. However, *ṣukūk* differ from conventional securitization in an important way that *ṣukūk* are not sale of receivables alone but carry ownership, albeit beneficial ownership, in the underlying asset or usufruct. Moreover, their secondary market tradability is subject to Sharī‘ah principles governing the trade in the underlying asset.



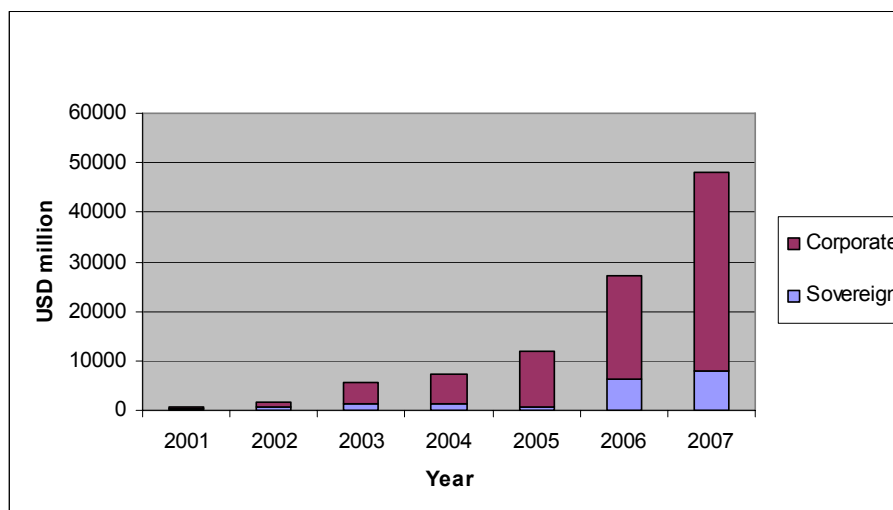
Source: Author’s calculation based on data from Failaka Islamic Funds Report 2006

Figure 1.1 Number of New Funds Incepted



Source: Based on Ernst & Young, Islamic Funds and Investment Report 2007.

Figure 1.2 Supply of Islamic Funds by Type and Size



Source: Author's calculations based on IFIS data. These include all global and domestic issues irrespective of whether they follow AAOIFI or Malaysian local standard.

Figure 1.3 Şukūk Issuance by Year (2001—2007)

Şukūk market started with the issuance mostly by the sovereign states during 2001 and 2002. However, it quickly stimulated corporate issuance that now constitutes the majority of new şukūk (see Figure 1.3). By the end of 2007 the cumulative issuance over previous six years had reached USD18.56 billion and USD83.72 billion, respectively, for sovereign and corporate şukūk. The average annual growth rate of new issuance over the last six years had been 517 percent for sovereign and 1242 percent for corporate şukūk. Most of the sovereign issues were based on *ijārah* structure, whereas *Mushārahah*, and *Murābahah* types were dominant over *ijārah* in the corporate şukūk issues (see Figures 1.4 and 1.5). If we classify these şukūk from non-tradable to tradable categories we find that sovereign şukūk are distributed somewhat similar to a normally distributed curve but skewed more towards tradable category. If we arrange them from fixed-returns to potentially variable-returns type (though in practice almost all have been structurally massaged to give fixed returns) sovereign şukūk again have near bell shaped distribution. In contrast, the corporate şukūk show a different kind of distribution which is fat at tails and thin in the middle. The implication could be read as that the private sector is doing more experimentation with şukūk structures as compared to the sovereign bodies. It is trying to cater to the needs of fund-seekers as well as investors/şukūk holders, albeit there are Shari‘ah and legal issues in many of these innovative structures.

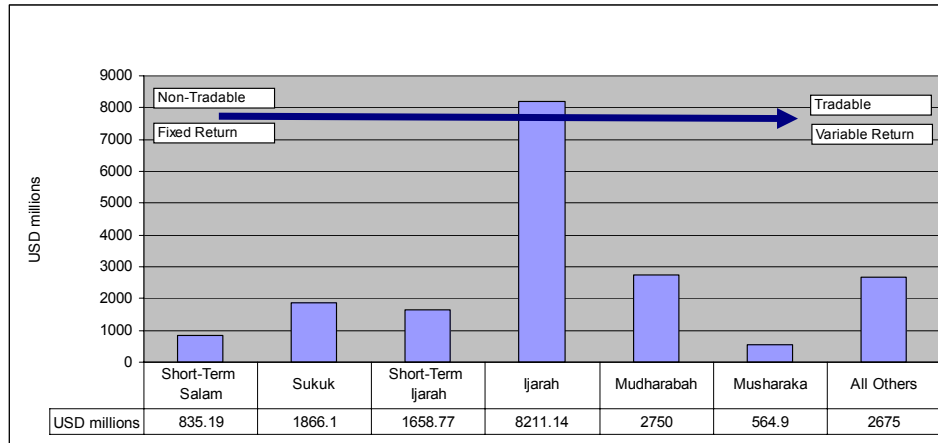
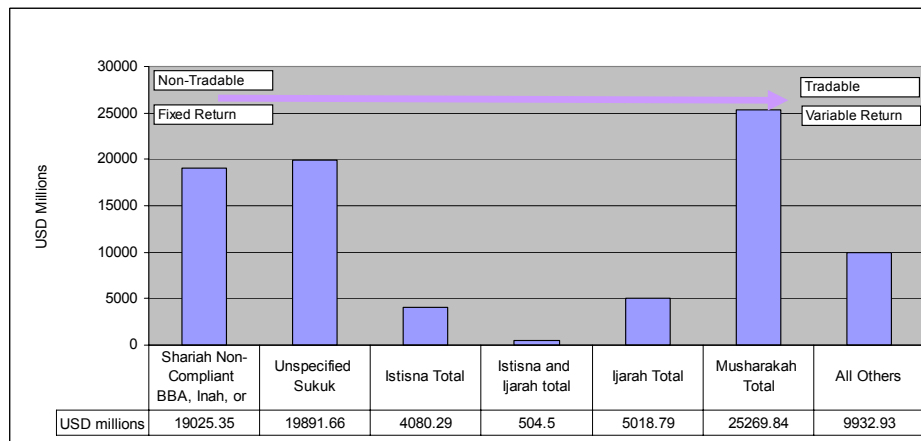


Figure 1.4 Sovereign *Ṣukūk* by Type and Cumulative Issuance 2001-2007



Source: Author's calculations based on IFIS data. These include all global and domestic issues irrespective of whether they follow AAOIFI or Malaysian local standard.

Figure 1.5 Corporate *Ṣukūk* by Type and Cumulative Issuance 2001—2007

Notes: Rationale for the above left to right arrangement of *Ṣukūk* types is as follows:

- Shari‘ah non-compliant BBA and ‘*Inah* structures are non-tradable and fixed return instruments.
- Unspecified *Ṣukūk* are generally *murābahah* based *ṣukūk* therefore, non-tradable and give fixed returns.
- *Istiṣnā‘* *Ṣukūk* are non-tradable and give fixed returns.

- *Salam Şukūk* are non-tradable and give fixed returns.
- *Istişnāʿ-cum-Ijārah şukūk* can be non-tradable or tradable depending on many factors such as proportion of *istişnāʿ* vs *ijārah* assets in the pool; transition from *istişnāʿ* stage to *ijārah* stage in case of project finance etc. These are generally fixed return instruments.
- Short-term *ijārah* are tradable but fixed return *şukūk*.
- *Ijārah şukūk* are tradable, can be fixed or floating rate instruments.
- *Mudārabah şukūk* are tradable, potentially variable return (but most are structured to give fixed return).
- *Mushārahah şukūk* are tradable, potentially variable return instruments (but most are being structured to ensure fixed type returns).

Development of Institutional Infrastructure: Over the past decade, a number of positive developments have taken place in the creation and functioning of a number of institutions and practices that are contributing to the accelerated growth of Islamic capital markets. These include, various regularly computed indexes for Islamic markets e.g., Dow Jones Islamic Market Index (DJIMI) at global level as well as at regional or country levels. Index for global *şukūk* has also been started recently. Most of the *şukūk* issuances now are rated as prominent rating agencies have entered the market with creation of their respective rating methodologies for Islamic capital market products. These factors have contributed to easing the issuance and trading costs for large institutions to operate in Islamic capital market. The accounting standards for various Islamic financial contracts established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have also contributed directly and indirectly to this process as more countries are adopting these standards. The work of Islamic Financial Services Board (IFSB), an assembly of central bankers, though targeted for better risk management and corporate governance of Islamic banks, is indirectly contributing to the working of the capital markets as almost all Islamic banks also participate in the capital market in one way or the other. The efforts of AAOIFI, to streamline Sharīʿah standardization of banking as well as capital market products, has also greatly contributed to increasing the confidence of public in Islamic financial products. However, there are issues in following through and implementation of these Sharīʿah standards, an area where more attention is needed.

Increased Competition between Financial Centres: Increased competition between various regions to attract Islamic capital has also contributed to the development of global Islamic finance and Islamic capital markets at international level. Malaysia, Bahrain and the UAE, among the OIC member countries, and London and other offshore jurisdictions in non-OIC member countries are aspiring to develop themselves as centres of Islamic finance. The high amount of liquidity in the GCC countries owing to rising oil prices, migration of capital from the US

back to the OIC countries due to strangling foreign and financial policies of the US after September 11, 2001, and better export revenues of most of the OIC countries during the last decade, have all contributed to accumulation of capital searching for safer investment opportunities. This is providing a source for this competition and indirectly helping in the growth of Islamic capital markets.

4. ISSUES AND PROBLEMS FACED BY ISLAMIC CAPITAL MARKETS

The above facts about high growth of Islamic Capital Markets at the global level should not obscure the shortcomings and problem issues in this sector. An obvious fact is that the capital markets at individual country level are underdeveloped in many OIC countries and segmented. Of the 57 OIC-member countries only 21 have stock markets of any significance that are covered in the World Development Indicators (World Bank, 2006). Most of these markets are neither deep nor broad-based. Due to a number of reasons, most companies in these countries do not raise funds from capital markets. Rather, they rely on internal funds or bank borrowing. As a result, the capital structure of corporate sector is skewed towards debt and very little domestic capital is floated. However, the situation is gradually changing towards betterment as countries are moving towards financial liberalization. Portfolio capital flows as well as efforts by foreign investors to tap emerging markets to raise funds is invigorating these markets. Islamic capital markets, currently a part of the larger conventional markets, are affected in the same way. However, many institutional bottlenecks such as weak legal system, misplaced incentives schemes, lack of transparency and accountability etc., are posing major hurdles. A discussion of all these broader issues is beyond the scope of this overview chapter.

Focusing on countries where the capital markets are vibrant and Islamic capital markets are also functioning or to the least, the countries where Islamic capital market products are offered we find there are three kinds of issues or problems. These problems are discussed below under the headings: issues related to products, regulations, and practices.

Issues in Products: Although new products are constantly coming to the market their ability to widen the available risk-return choices are very limited. Venture capital financing products are starkly missing. Moreover, the existing products are not necessarily contributing to the healthy growth of capital markets, particularly in the direction of fairness and equity where Shari‘ah would ideally like to see it.

For example, many of the *sukūk* structures do not conform to the Shari‘ah standards outlined by AAOIFI.⁸ Moreover, these products are mostly directed towards attracting investment from banks which are less open to risk taking or innovation and more comfortable in adhering to their practices, procedures and product structures. Common individual investors and other non-bank institutions who look forward to genuine Islamic products and have wider range of risk appetite are not the target of product design because they constitute retail market

which is either not a very valuable proposition or have not been explored seriously. The products generally try to replicate the features of conventional financial products while trying to remain within Sharī‘ah bounds. This has resulted in complicated products which are hard to understand, costly to construct and implement, and combine many different contractual structures which are individually Sharī‘ah-compliant but may contradict the objectives of Sharī‘ah on a composite level. Apart from their structure and strange allocation of risk between different parties there is also the issue of pricing and rate of return on these products. Often the return is tied to LIBOR by one-way or the other than to the natural pricing factors of the underlying business that the *ṣukūk* represent. Such artificial pricing ties the fate of investment (and the financial products) with what happens in the money market. This also brings about the same problems of conventional finance into Islamic finance. While the returns and pricing mechanism should have been tied to the real factors affecting the new products.

One can clearly see that the credit rating (of the rated *ṣukūk*) obtained from the rating agencies reflect only the rating of the guarantor entity who provided the buy-back promise or the coverage for default by issuer. This is also explicitly stated in the rating methodologies for *ṣukūk* by the reputed raters like S&P, Moody, Fitch etc. Thus the income generation potential of the asset underlying a *ṣukūk* issue is of very little significance, if any, in the rating of *ṣukūk*. This makes *ṣukūk* akin to conventional bonds and the rating methodology chosen by the raters simply proves this equivalence.

Another example can be given from *mushārahah* based *ṣukūk*. Investor preference for Sharī‘ah compliant fixed income tradable products were the original impetus behind the launch of *ṣukūk* products. *Ijārah* contract is much suitable for that purpose hence most of the initial *ṣukūk* were *ijārah* based. However, of recent, there has been issuance of *mushārahah* based *ṣukūk* as well. But instead of providing variable returns which are the natural consequence of *mushārahah* contract the investors are being given fixed returns. This is done by specifying a hurdle rate (or an amount) such that any earnings above it is given to the manager/obligor’s agent as incentive payment. The down-side for the investor, in case of low earnings, is being protected by various kinds of arrangements such as income smoothing reserve, borrowing facility from the obligor, advances to be adjusted against future payments etc. All these, either result in giving a wrong name (*mushārahah* or *muḍārahah*) to an otherwise fixed income product or Sharī‘ah violation in the name of Sharī‘ah-compliant products.

Some hedging products and funds have also been recently launched in the market. These are targeted to provide either a ‘Sharī‘ah-compliant’ total return swap or to provide capital protected funds at cheaper costs than what was previously possible with combination of *murābahah* and *‘arbūn* sale contracts in the fund’s portfolio. These new products are based on so called *wa’d* (promise) structures, where one party promises today to buy the assets of the other in future,

at a price referenced to some observable index if a specified state occurs. While the other party promises to sell the same asset at a different price reference to an index if another state occurs. This structure thus allows for capital protection, guaranteeing returns to the seller within certain bounds, paying returns of any reference asset or index without the need to own it, etc.⁹ There are many Sharī‘ah and economic issues/problems related to such products as they distort the incentives of the parties involved, opens the door for interest and gambling, and abolish the need for Islamic system if any observable event or index can be used as reference price. Still these products have been developed and marketed. This brings us to highlight the need for proactive role of Sharī‘ah boards and Sharī‘ah scholars along with economists and Islamic finance experts that is missing from the current process of product development and its continual monitoring. This also exposes the subtle problems in allowing LIBOR as innocuous pricing benchmark for Islamic financial products in the past and validating of one-sided promise as a building block for products built around a nexus of promises.

However, there remains a huge potential for *sukūk* products for various projects similar to BOT and municipal and public utility projects which needs to be exploited.

Issues in Regulation: While need for separate regulations is recognized for Islamic banks by many countries and much research and development efforts are under-way in this direction such recognition is not widespread in the case of capital market regulation. As a consequence, in many countries the Islamic capital market products are regulated using same set of regulations that exist for conventional capital markets. While it is true that many of the objectives of these regulations are common to both markets, Islamic capital market regulation not only needs different procedures and infrastructure institutions but it also requires an extended objective. The IOSCO objectives of securities market regulation stipulate (i) investor protection, (ii) transparency and disclosure, and (iii) avoidance of systemic risk. Note that these objectives are equally applicable to equity, bond, and derivative securities. Much of the second two categories involve Sharī‘ah non-compliant securities and trade. It often represents trade in pure financial assets with no or little association with real economic activity. This shows that these objectives of regulation are incomplete for Islamic capital market. A fourth important and explicit objective has to be added. This is, (iv) keeping a constant link of financial asset with real economic activity. Ensuring of in tandem growth of the real and the financial sectors is an independent objective not covered by the IOSCO stated three objectives of securities regulation. It goes beyond saying that Sharī‘ah rules in the form of key prohibitions of *ribā* and *gharar* are always the added dimension to these objectives.

Issues in Practice: On the side of actual trading practices that are in vogue among the stock traders and the methods followed in issuance of IPOs a number of problems remain as challenge. Some of these issues are common to both

conventional and Islamic capital markets but some are unique to the Islamic capital market.

Situations arising from conflict of interest, such as brokers' and investment agents' dealings in their own accounts as well as the accounts of their clients, transactions with related parties, situations pertaining to inadequate disclosure or misleading information, fraud, collusion and market manipulation, are some of the issues in practice that are not unique to Islamic capital markets. They exist in various markets in varying degrees, and can be reduced through moral uplift, improved corporate governance, and better regulation and its enforcement.

There are however some issues in practice that pose problems unique to Islamic capital markets. One such issue, for example, is traders' temporary borrowing of money for use in stock market trade. Such borrowing, at present, is available only on interest. In many less developed countries borrowing from the formal sector is not available for this purpose or it is costly. In these places, traders rely on informal form of mutual borrowing to defer the settlement of payment in stock purchases (often referred to as *badla* in Indo-Pak subcontinent and by other names elsewhere). This kind of borrowing is not only on interest but also unrestricted and unregulated and hence poses a systemic risk. Conventional capital market response to this issue may be one of discouraging the informal borrowing and bringing it into the regulated sector. However, for Islamic capital markets this is not a solution if interest remains the key instrument for meeting the liquidity and settlement needs arising from trade in securities. Some alternate institutions are needed to ensure minimization of situations of 'unforeseen' liquidity needs and also some mechanisms to address the problem if such a need arises.

A related matter is that of margin-trading. Conventional financial markets allow, albeit regulated, trading of stocks by making only a margin payment and settling the trade later on a netting basis. This increases market liquidity by increasing the trading capacity of the traders but also increases price volatility and herd behaviour among the traders. This also is akin to trading without proper possession which is not allowed in Shari'ah. Similar is the practice of short-selling of stocks which is clearly sale without possession, not allowed in Shari'ah. Reforms and abolition of such practices is a challenge.

Another issue of practice unique to Islamic capital market pertains to secondary trade in companies whose assets are still in cash or 'near money' form. This is not an issue per se in the conventional markets where money and debt can be bought and sold. Shari'ah rules do not allow trading in money except when traded at par and on spot. In order to avoid secondary market trading of companies such as those which are in process of IPO or provisionally listed on stock exchanges, etc., some information disclosure and enforcement mechanism is needed. The appropriate listing rules and the stock screening norms can help in this regard.

Yet another issue relevant for practice as well as to products is that of benchmarking with LIBOR in pricing of tradable securities. Many products such as *ṣukūk* and others are increasingly promising to pay a return benchmarked to LIBOR while the underlying asset behind these securities belong to asset classes quite different from money, that not only have different risk profile but also different economic behaviour. Such tying of the fate of one asset with that of the other not only creates economic inefficiency by disequilibrium prices but also opens up door to participation in Sharī‘ah noncompliant activities, albeit indirectly. Further, it keeps alive and re-enforces the interest based system mentality among the investors and entrepreneurs. For a systemic change towards Islamic finance and development of Islamic capital markets, it is necessary to evolve a system more tied with the dynamics of real sector than the one which only tries to imitate the conventional financial sector.

5. INTRODUCTION TO CONFERENCE PAPERS

The conference on Islamic capital markets included presentation of thirty contributed papers along with a discussion on each, two keynote speeches, a very interactive panel discussion on ‘Promise-based Tradable Products’, various sessions about industry awareness, an inaugural session and a special regulators session for enhancing cooperation among the regulatory authorities of different OIC member countries.

The present volume contains twenty selected papers from the conference. We can broadly classify these papers under three headings: Market Products (which include *Ṣukūk*, Derivatives, Stocks, Islamic REITs); Market Development; and Comparison of Islamic Products and Markets with conventional ones.

Capital Market Products: The first paper in this part summarizes and spells out what should be the objective of product development in Islamic finance. *Sudin Haron and Wan Nursofiza*, in "Creating a Dynamic Capital Market: The Essential Role of Innovation" advocate the importance of innovation in product development and emphasize the need for Islamic products to be qualitatively different from conventional products to suit the requirements of the Islamic system. The products therefore should be Sharī‘ah compliant both in their 'form' and 'substance'. *Muhammad Al-Amine* in “*Ṣukūk* Market: Innovations and Challenges” provides a good survey of *ijārah* and *mushārahah ṣukūk* structures and their varieties in vogue. He also provides a survey of critical economic and Sharī‘ah issues pertaining to these *ṣukūk* types issued so far. The paper stresses the need for more cooperation between financial experts and Sharī‘ah scholars as well as more interaction between Sharī‘ah boards of various bodies to keep such products uniformly Sharī‘ah-compliant while contributing to the development of capital markets. The paper by *Shamsiah Mohamad and Mohammad Fadhly* entitled “Key Sharī‘ah Rulings on *Ṣukūk* Issuance in the Malaysian Islamic Capital Market” discusses the basis and implications of four key rulings of the Sharī‘ah Advisory

Council of the Securities Commission of Malaysia. The rulings on (i) the nature of underlying asset, (ii) its pricing, (iii) that *iqṭāʿ* can be tangible as well as non-tangible asset, and (iv) the conditions on selling of debt, are the core which form the basis for many kinds of domestic *ṣukūk* issuance in Malaysia, including private and public *murābahah* debt based *ṣukūk*. These two papers provide a good amount of food for thought along Shariʿah dimension for understanding the issues and debate. The information can help in designing of new *ṣukūk* products streamlined for Shariʿah compliance. The next two papers focus more on the economic aspects of *ṣukūk* products. *Zohra Jabeen and Memoona Khan* in “An Inquiry into the Usage of Real Assets in Islamic Transaction and their Benchmarking: The Implications for Islamic Capital Markets” build on the premise that Islamic financing philosophy is based on real economic activity not pure financing. Using economic reasoning and the concept of return on capital they argue why Islamic capital market products such as *ṣukūk* should not be linked or benchmarked to conventional debt market returns such as LIBOR. Rather, their return should be linked to the returns of the underlying asset for economic efficiency reasons. Capital allocation will then become tied to the performance of the domestic real sector instead of significantly depending on the events in the international money markets. *Irfan Beik and Didin Hafidhuddin* in their paper “Enhancing the Role of *Ṣukūk* on Agriculture Sector Financing in Indonesia: Proposed Models” identify that Indonesia is an agrarian economy but access to credit is a big problem. They put forth the idea of using *ṣukūk* for financing small as well as large scale agricultural projects through *salam* based *ṣukūk* as well as combination of *muḍārabah* and *istiṣnāʿ* based *ṣukūk*. These four paper put together bring together new contribution to the area of *ṣukūk*.

The next set of five papers constitute a cluster on derivative products. *Andreas Jobst* in “Derivatives in Islamic Finance” explains his understanding of Islamic finance and how combining a unilateral promise, which is generally accepted by *fuqahāʾ*, with financial contracts such as *murābahah*, *ijārah* etc., makes them closer to a derivative product based on put-call parity. The understanding is not necessarily correct but it gives a new direction to think. The paper also develops a pricing formula for such products. *Nurdin Ngadimon* in his paper “Intangible Asset: A New Asset Class to Structure Islamic Financial Products” takes up the issue that most of the existing Islamic financial products for the capital markets are based on tangible assets. However, intangible assets constitute a large portion of assets in the present-day economies. If Shariʿah permits recognition of intangible asset as a valued asset then products based on this asset class can also be designed thus expanding the scope of Islamic capital markets. He provides a survey of opinions of the four major schools of Islamic jurisprudence on *mal* (assets) and *ḥuqūq* (rights) to conclude that recognition of commercial value of tangible as well as intangible assets is consistent with Islamic jurisprudence and financial products based on both kinds of assets can expand the possibilities of capital market development. We can well imagine that as intangible assets can either have value

of their own or their value can come (derived) from some underlying tangible asset the products based on intangible assets can very well expand the possibilities of financing. The paper by *Mohammed Ayyash* entitled "Sharī'ah Alternatives to Non-Sharī'ah Elements in Modern Commodity Futures Trading" finds that, while the underlying objectives of conventional commodity futures trading activities are not inconsistent with the principles and teachings of Islam, the conceptual structure and actual contracting practices are contrary to these principles. The paper identifies non-Sharī'ah elements of conventional futures and promotes *Salam* sale contract as a viable alternative. It also provides a good summary of the juristic views on legal and economic conditions for validity of *Salam* contract. *Mohammed Arbouna and Hurriyah El-Islamy* in "Islamic Finance Rate of Return Risk Management: Challenges and Propositions" contend that risk is indispensable feature of business and commercial transactions. Trade based modes of Islamic finance create debt obligations. These trade related debts, like their conventional counterpart pure debts, are exposed to rate of return or market risk. Such risks are managed in the conventional system through trading in debt and other financial derivative instruments which are based on *ribā*. The authors highlight possible Sharī'ah-compliant tools and strategies to manage rate of return risk. In this regard, they discuss swapping of usufructs, variations of future profit ratios, receivables trading against assets, combination of securitization with *hawālah*, lease back and re-leasing, converting debt into shares, return protection *waqf* fund, waiver of right to profit, and conditional rate of return investment. Their paper points to the need of further research and cross discipline collaboration among scholars to understand and resolve the issues. *M. A Khan, Gulam Muntaqua, and Mohammad Abdul Samad* in "Sharī'ah Drive Against Derivatives" point out that conventional financial sector is increasingly relying on a wide range of derivative products to shift risk and improve levels of earnings. However, they create new risks at the aggregate level. While there are proponents as well as critics of such products, the derivatives trading mechanism and their overall long-term effects need to be analyzed to make a comprehensive conclusion for Islamic capital markets.

Next two papers deal with investment in equity. While investment in stocks and shares as such is not an impermissible activity in Sharī'ah, it is sometimes the non-permissible nature of the business of the issuing company, mixing of non-permissible incomes or activities and the capital structure of the issuer that can render investment in, and trading of, its shares non-permissible. Various entities including fund managing companies and financial market index providers, including Dow Jones Company, have come up with operational definitions to screen out non-permissible stocks. *M. H. Khatkhatay and Shariq Nisar* in their paper "Investment in Stocks: A Critical Review of Dow Jones Sharī'ah Screening Norms" provide detailed methodology of Dow Jones Islamic Market Index (DJIMI) and evaluate it for its shortcomings in handling of the objectives of screening. They advocate some alternative financial ratios and two tier screening method. *Rasem Kayed and Kassim Mohammed* in "Managing Risk of Islamic

Equity Investments: Initiatives and Strategies” highlight that a key tenet of Islamic value system is fairness and justice. Building on this they discuss a framework for the concept of ‘just risks and fair returns’. They also provide an overview of various ways to risk management and advocate equity investment as a way to balance investor incentives between too low and too high risk taking.

Continuing further with more products our next two papers are on Islamic Real Estate Investment Trusts (IREITs). Securities Commission, Malaysia has recently revised its IREITs Shari‘ah guidelines. As a result, there have been a few successful floatation of IREITs in Malaysia. Some of these are quite innovative in applying this concept to agricultural production sector; an example among them is IREIT on palm tree plantation lands and palm oil extraction units. *Asyraf Dusuki* in “Practice and Prospect of Islamic Real Estate Investment Trusts (IREITs) in Malaysian Islamic Capital Market” discusses these new guidelines along with structures and experiences of some of the IREITs issued in Malaysia. *Abdulazeem Abozaid* approaches the subject from juristic angle in “Examining the Malaysian Shari‘ah Guidelines for Islamic REITs”. He highlights that the current guidelines of the Securities Commission are of an ad hoc nature in the given market environment which is dominated by conventional finance. He makes some suggestions for moving forward from the current situation and points that the ultimate objective of the guidelines should be eventual Islamization of all activities under IREITs.

Market Development: Islamic capital market development will require going beyond the conventional products and regulation philosophy. It will also demand development and reformation in existing trading practices. The next three papers address these concerns to some extent. *Farhan Hameed* in “Venture Capital Funds: A Venue for Growth of Islamic Capital Markets” argues that with Shari‘ah constraints on *Ribā* and asymmetric allocation of risk, it is the promotion of venture capital that offers most prominent venue of growth for Islamic capital markets. Discussing the historical and present-day evolution of venture capital he builds a case for venture capital fund to take up the critical functions of investment selection and management mentoring. It also suggests for the role of government in development of venture capital industry. *Amy Mardahatillah et al.* in “Analysis of Risk Attitudes, Spirituality, and Shari‘ah Consciousness of Current and Prospective Investors: An Empirical Survey in Malaysia” provide a survey of correlation between degree of risk taking, spirituality (defined as an emotional spirituality quotient which is God-given trait), and Shari‘ah consciousness (defined as sensitivity level towards observance of Shari‘ah rules) of current and prospective investors in their investment decisions. The study finds no strong correlation between the degree of risk taking and investment decisions, some evidence of correlation between Shari‘ah consciousness and investment in Islamic capital market, and a strong correlation between spirituality and Shari‘ah consciousness. The study points to the possibility of attracting larger number of Shari‘ah conscious investors to the Islamic capital markets by devising appropriate marketing strategy.

However, it is based on a small and non-representative sample. Nevertheless, it opens up another dimension of research area for the development of Islamic capital markets. *Ali Ibrahim* in “Developing Capital Markets in Muslim Countries: Strategies and Policies for Securities Regulation and Corporate Governance” addresses the issues of support and infrastructure framework for the development of Islamic capital markets. He emphasizes the role of home-grown regulatory measures and the need for integrated capital markets for coordinated development of these markets across Muslim countries.

Systemic Comparison: An understanding of comparative level of development and evolution of Islamic segment of capital markets in different countries is useful in devising appropriate market development policies at the level of individual countries and regions. This section presents three papers that together provide such a comparison across three countries (Indonesia, Malaysia, and Pakistan) and a survey of institutional developments for Islamic capital markets at the global level.

Huma Ayub and Behzad Kawish in “Design and Use of Innovative Islamic Capital Market Products: Experience of Pakistan and Malaysia” compare the development of the Islamic component of the capital markets in the two countries and conclude that, while the demand and potential for growth is high in both countries, Malaysia has made more sustained institutional efforts in creation of Islamic capital markets than Pakistan. It is the efforts in product innovation, institutional facilitation, and internalization of learning by doing process that Malaysian market has grown at a faster pace. *Ascarya and Diana Yumanita* in “Comparing the Development of Financial/Bond Markets in Malaysia and Indonesia” inform that Malaysia and Indonesia are developing their Islamic bond markets in different ways. While Malaysia started early and adopted a top-down approach with strong commitment from the government, Indonesia started late in 1992 and adopted a bottom-up approach with less government commitment. At present, the Islamic capital markets in Malaysia are much more developed than in Indonesia, however, there is a larger potential for development of such markets in Indonesia if facilitated through conducive legal framework and active role of the government. *Iqbal Anjum* in “Role of Islamic Financial Institutions in Enriching the Structure and Menu of Financial Instruments for Capital Markets” surveys the role of Islamic financial institutions, banks, and other institutions in development of Islamic capital markets. The paper also provides an overview of the evolution of these markets in Indonesia, Malaysia, and Pakistan.

6. CONCLUSIONS

The area of Islamic capital markets is vast and interesting with many open issues inviting the attention of researchers, policymakers, and the main players of the market: investors and fund seekers. The papers presented in this collection fill only a small gap and much remains to be done for the development of these markets. The gaps in the current literature are present particularly in the areas of

objectives and principles of Islamic securities market regulation, reforms of trading practices, and development of appropriate infrastructure and core institutions. These developments are important as they also help in useful product innovations and contribute to the overall progress of the society.

We hope that this volume will stimulate a comprehensive effort at theoretical and practical levels from all stakeholders and larger society interested in Islamic finance and towards Islamic capital markets development.

Notes

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¹ See for example, IOSCO (2006), a survey done among the capital market regulators found that majority of them think that current rules and regulations governing the capital markets are sufficient for introduction of Islamic products and smooth functioning of their markets.

² "Islamic finance – its sustainability and challenges" Closing keynote address by Shamshad Akhtar, Governor, State Bank of Pakistan, at Georgetown University, Washington DC, 18 October 2007. Available at <http://www.bis.org/review/r071109d.pdf>

³ Failaka, Islamic Funds Report 2006.

⁴ Ernst & Young, The Islamic Funds and Investment Report 2007, page 41.

⁵ Ernst & Young, The Islamic Funds and Investment Report 2007, page 42.

⁶ Since stocks represent a share in the ownership of the underlying business of a company, trade in them are generally Shari'ah permissible unless the core business activity of the company is in violation of Shari'ah restrictions. In case of mixture of a non-permissible source of income with a permissible business activity the non-permissible income has to be negligible. Different jurisdictions apply different levels of tolerance in defining the negligible. Further, for the tradability of shares in the secondary market the asset composition of the company also matters in most jurisdictions. The asset composition of the company should be such that majority of its assets should not be in money or money equivalent form (such as debt, income receivable, cash etc). For then, it would become trading in money or trading in debt, which is not permissible. DJIMI criteria apply screens for core business, screens for non-permissible income, and liquidity and debt ratio screens. For details on differences across jurisdictions see Ali, 2005.

⁷ AAOIFI definition.

⁸ It is easy to conform this in case of *Shukūk* by comparing the conditions spelled out in Shari'ah Standard Number 17 of AAOIFI with terms and conditions in the offering documents of various *Shukūk*. However, the degree of severity of violation varies.

⁹ For details of a total return swap based on promise (*wa'd*) structure see Deutsche Bank (2007). For application to capital protected funds based on *wa'd* see NCB Capital (2007) AlAhli BRIC Secured Equity Fund 'A'.

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PART-I: PRODUCTS AND STRATEGIES

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Creating a Dynamic Islamic Capital Market: The Essential Role of Innovation

*Sudin Haron** and *Wan Nursofiza***

ABSTRACT

Islamic finance has witnessed and experienced unprecedented expansion over the last decade. In the last decade, Islamic finance has swelled in size and expanded in complexity as market players compete furiously to produce new, Shari'ah-compliant financial products. Nonetheless, greater innovation is needed to continue the excitement generated by Islamic finance into the future. However, it is not enough for Islamic financial products to simply mirror conventional products. Islamic finance needs to be qualitatively different from conventional finance, not only in terms of form but most importantly in substance.

1. INTRODUCTION

The Islamic financial services industry has witnessed unprecedented expansion over the last decade. From humble beginnings in the 1970s, the industry has grown in both size and significance in more than 75 countries. Today, the industry has gained considerable interest as a viable and efficient alternative model of financial intermediation as a result of the growing awareness of and demand for investing in accordance with Shari'ah principles. The market for Islamic financial products has registered an annual growth rate of 15% over the last five years, a rate that seems sustainable given Gulf investors' accumulating reserves of petrodollars and Western banks' search for high-growth markets. With more than US\$250 billion worth of deposits held by 300 Islamic financial institutions and an estimated US\$200 billion worth of assets held in Islamic windows of conventional banks, this industry represents an attractive investment opportunities. The growth of Islamic banks and *takāful* institutions has given rise to the need of products for the management of balance sheet liquidity. The development of the Islamic capital market is therefore the outcome of a natural progression in the growth of the Islamic financial services industry. However, the further growth of Islamic finance depends largely on innovations in Shari'ah-compliant products for investment, liquidity management and risk management purposes.

This paper critically reviews the creation of a dynamic Islamic capital market through the essential role of innovation and is divided into 6 sections. Section 3 provides an overview on the functions of the Islamic capital market. Section 3 elaborates the development of Islamic financial products. Section 4 highlights the role of innovation in creating a dynamic capital market. Section 5 addresses the challenges and obstacles for future growth of Islamic finance. The final section provides the conclusion.

2. FUNCTIONS OF THE ISLAMIC CAPITAL MARKET

Islamic capital market is supposed to perform all the functions of conventional capital markets but with justice and equitable distribution of benefits. The Qur'ān and *Ḥadīth* has given clear guidance on moral rules and obligations, prohibition of interest, and the prohibition of obtaining others property by wrongful means. Based on these guidelines, an Islamic capital market should function without interest as well as without malpractices tantamount to grabbing others' property by wrongful means. Another aspect of Islam is that it prescribes to the compulsory financial obligation of *zakāt*. The Qur'ān prescribed that the purpose of *zakāt* is "so that the wealth does not circulate only among your rich folk" (Al-Hashar 59:7). In this sense, if the capital market is not growing to allow for the increase in wealth and economic growth or if the growth results in the concentration of wealth to few groups of individuals, this indicates that there exists some weaknesses in the system and corrective measures need to be implemented by the regulatory authority.

In the conventional financial system, an ideal effective and efficient regulatory structure is said to promote financial markets that are: (1) liquid and efficient where there exist free flow of capital and it is allocated properly given the underlying risks and expected returns; (2) transparent and fair where information must be reliable and relevant and must flow in a timely and fair-handed manner to all market participants; and (3) ethical and sound where market participants must act with integrity and in accordance with principles of unassailable conduct as they make capital transactions and other related activities. The success of regulators in this case is seen in terms of the extent to which they can build investor confidence in the integrity and fairness of transactions in capital market and the extent to which they are able to develop the markets in the direction of better transparency, greater competition and hence greater efficiency.

In contrast, the Islamic framework of finance consists of three institutions, namely *ukhuwah* (brotherhood), *ʿadl* (justice) and *iḥsān* (benevolence). Under the institutions of *ukhuwah* or brotherhood, Islam unites all individuals in the bond of universal brotherhood whereby all individuals are regarded as members of a single family but each of them is entitled to equal social status. This implies that cooperation and mutual help is the backbone of this brotherhood institution. When looking from this perspective and applying this concept to modern finance, we can

infer that Islam views financier and clients as members of one brotherhood and rules out any relationship in which the financier acts from a position of power and strength and the client acts from the position of socially weak. This motivation affects the forces of demand and supply in the financial market in a complimentary manner whereby both parties understand each other's interest and through fair dealing focus on favourable synergies which facilitate greater use of risk-sharing modes of financing.

The institution of *'adl* (justice) plays a key role in realising the goals of social balance because it provides legally enforceable measures specified in the contract. The fulfilment of contract removes any injustice and exploitation. Islamic *fiqh* has developed a comprehensive code for making contracts which regulate the role of both parties and emphasises that all contracts should be honoured in accordance to the terms stipulated. Hence, adherence to the principles relating to financial contracts minimises the possibility of fraud and deception. The institution of *ihsān* essentially means foregoing one's rights for the sake of others. This is an act which is considered to be a virtue of higher order and consistent with the Islamic concept of rationality. The individual displaying benevolence understands that Allah will compensate him for his sacrifices. Islamic teachings call upon both the financier and the client to be kind, honest, accommodating and generous. In fact, *ihsān* contains set of values that give rise to professionalism, high ethical conduct and the concept of trust the by-product which is good governance. In Islam, elements of good governance that is trust, accountability and ethical conduct are the way of life.

The Islamic capital market provides a stable and viable source of long-term funds for financing large investments and development projects as well as for capital and business expansion. The Islamic capital market also ensures greater diversification of risks emanating from asset and liability mismatches facing Islamic financial institutions. The market has a pivotal role in ensuring the overall stability of the Islamic financial system through its contribution to the enhancement of a resilient and robustness Islamic financial system in withstanding financial shocks. Thus, developments and innovation in Islamic capital market products transpired in response to the growing needs of the Islamic financial industry. At present, a wide selection of Islamic capital market products and services are available in the market to meet the needs of those who seek to invest in accordance with Sharī'ah principles which includes Sharī'ah-compliant stocks, Islamic bonds, Islamic funds and Islamic risk management products. Nonetheless, the strong growth for Islamic finance products is not only driven by increasing demand from those who want to invest in instruments that are Sharī'ah-compliant so that they are able to meet their religious obligations but also by non-Muslims who find some of the risk-return features attractive, or by those investors who subscribe to ethical investment philosophies.

3. DEVELOPMENT OF THE ISLAMIC FINANCIAL PRODUCTS

As outlined earlier, the development of an Islamic capital market was the result of the pressing need to address liquidity management of Islamic financial institutions. During the 1980s and 1990s, Islamic financial institutions were able to mobilise their deposits by investing in a handful of financial instruments which were dominated by trade financing. Activities on the asset side of these institutions included cost-plus-sale, Islamic leasing, trust financing and equity participation. However, the asset composition of Islamic financial institutions remained fairly static and was heavily focused on short-term instruments, mainly commodity financing due mostly to the lack of liquid assets. Hence, the management of balance sheet liquidity became a major challenge facing the Islamic financial institutions owing to the scarcity of Islamic capital market instruments. This gave rise to the demand for the introduction of new Islamic financial instruments and the promotion of financial engineering.

The development of the Islamic capital market can be seen through the development of a wide range of Islamic capital products that are becoming widely available such as the Sharī'ah-compliant stocks, Islamic funds, Islamic bonds and Islamic stock broking services. To date, investors are able to place their savings in a wide range of Sharī'ah-compliant funds with real estate and private equity investment continues to be the primary choice. The Islamic capital market is also seeing an increasing wide offering of more innovative Sharī'ah products, including exchangeable or convertible *ṣukūks*, commodity linked certificates, equity linked notes and structured foreign-exchange linked-products. In the capital markets, the introduction of the global sovereign *ṣukūk* more than a decade ago was an important innovation that has since gained significant ground. Today, the global market for *ṣukūk* has exceeded US\$50 billion. Commodity *murābahah* investments have also grown to be increasingly common, with such investments forming about 70% of Islamic short and medium-term money market transactions in the Islamic finance industry.

In terms of Islamic product innovation, Malaysia remains at the forefront particularly in *ṣukūk* issuance. The launch of *ṣukūks* by Malaysian companies has demonstrated the ability of local intermediaries in structuring products and offering services that are acceptable to the global financial investors. *Ṣukūks* originating from Malaysia now account for nearly 70% of all *ṣukūks* issued globally. The Malaysian Islamic financial markets has also successfully introduced a variety of Islamic financial hedging instruments such as the Islamic profit rate swap, Islamic cross-currency swap and Islamic forward rate agreement. With the introduction of the Commodity *Murābahah* Programme (CMP) by the Central Bank of Malaysia earlier this year, the Malaysian government hopes to further spur the infrastructure development of the Islamic financial system in the country and to diversify the policy instruments to manage short-term liquidity in the Malaysian Islamic capital market. The CMP is the first commodity-transaction that utilises crude palm oil-

based contracts as the underlying assets. With a more widely usage of commodity *murābaḥah* transactions globally, this will add breadth and depth to the Islamic money market as it facilitates a more efficient distribution of money-market liquidity and expands the range of instruments that market participants can actively transact in.

4. THE ESSENTIAL ROLE OF INNOVATION

Product innovation must be a continuous and deliberate part of the process of market development. Given that innovation is the key to sustaining growth and securing competitive advantage, greater innovation is needed to continue the excitement generated by Islamic finance into the future. Innovation in this context refers to the development of new Islamic financial products and services and increasing the range of products and services to meet the more sophisticated and complex requirements of today's consumers and businesses. Hence, innovation in Islamic finance must not only be Sharī'ah-compliant but credible as well as competitive.

The role of innovation in creating a dynamic Islamic capital market is manifold. First, innovation enhances the overall efficiency by which the Islamic products and services are being provided. This may be achieved via several channels such as the application of technology that improves convenience for customers and reduce the cost of financial transactions by driving down operational costs. Innovation also entails the introduction of new structures that may contribute towards enhancing convenience for consumers and businesses. Thirdly, innovation plays a role towards creating new markets and expanding the markets for Islamic products and services. Innovation should also offer flexibility to structure different types of financial products, which among others would allow a shift from debt-based financial system more to an equity and partnership-based system.

The pace of innovation that has taken place in the Islamic financial services industry has contributed to the development of a broad and diversified range of Islamic financial products and services that has been able to effectively mobilize financial resources to meet the investment requirements of the economy. No doubt that the development of a dynamic capital markets must be accompanied by product innovation. Many of the innovations in the past decade have been aimed at addressing this lack of suitable investment opportunities. Islamic banks and the Islamic banking divisions of conventional banks have become increasingly more creative in the design of new financial products. Innovations in *takāful*, Islamic bonds (*ṣukūks*), derivatives, and equity funds have fulfilled the needs of investors by providing a range of investment opportunities, more liquidity in Islamic capital markets, and risk management tools.

Notwithstanding this significant progress, the process of innovation in Islamic finance has generally been structured mainly along the adaptation approach. Although there are Islamic financial instruments that are distinct from the

conventional financial instruments, the numbers are still few and far behind. In most instances, the Islamic financial products are repackaged along the features of the conventional financial products, while eliminating the elements that are not in compliance with the Shari'ah. Hence, what we have seen so far is what can be termed as "Shari'ah Synthetics" which refers to creating compliant copycat products. Hence, is it enough for Islamic products to mimic conventional products, or should Islamic finance also aim to be qualitatively different from conventional finance? Should Islamic finance reproduce the entire range of products provided by conventional banks? Many proponents of Islamic finance argue that the industry should focus more on developing existing products more deeply and create more mature, robust infrastructure before it embraces too many ideas. The industry is much in need of consolidation and refinement as it is of innovation and new products. Innovation is important to create breadth and depth in the Islamic capital market, but present products must be further improved and refined so as Islamic financial products do not simply mirror conventional ones. By confining product development to mere evaluation and adaptation of products in the conventional markets, the Islamic capital market will have to play a perpetual catch-up game with the conventional financial system. There will also be a continuous reliance on the expertise within the conventional market to take the Islamic capital market forward.

An example of the most visible sign of this innovation is seen in the world of *sukūk*. The issuances of *sukūk* over the last five years have risen sharply and are now producing numerous permutations. New issues of *sukūk* may be convertible to equity after a certain period of time, or they may include securitised elements. Nonetheless, such innovation although remarkable, raises several important questions. Firstly, is there any point in producing an Islamic imitation of conventional products? Instead of trying to emulate conventional products, we should be creating Islamic financial that meet the investment needs that cannot be fulfilled by conventionally. This is because Shari'ah-compliant financial instruments that are unique have a place in the global financial market whereas imitation Islamic financial products would not create a long lasting competitive advantage. Islamic finance should be more focus on looking for niche opportunities that conventional finance cannot fill. Furthermore, because of the transformation costs, complex Islamic financial products appear to be inherently less transparent and less efficient than conventional ones. This may have the undesirable effect of making Islamic finance a less attractive practice in the longer run. Rather than compete with the conventional finance, Islamic finance should offer complementary set of instruments targeted at a different kind of investor. It also calls for a fundamental paradigm shift in the development of Islamic finance to reduce complexity and increase competitiveness. In essence, forward thinking, not imitation is required.

Secondly, are Islamic financial products moving away from their roots? There is already a growing debate over whether securitisation is in fact Shari'ah-

compliant since it could be viewed as a way of guaranteeing future incomes. Many have argued that these innovations increasingly contravene the spirit of Islamic finance since concepts such as derivatives and hedge funds are considered particularly controversial given the Qur'ān's ban on *gharar* (speculation). Most of the financial instruments introduced lately, such as *tawarruq* and *ṣukūk*, are the results of financial engineering based on convenient fusion of various Islamic modes of transactions with no allowance for the fundamentals of those transaction modes. For example, *ṣukūks* are structured based on the notion of leasing of assets but this is not an instrument for mobilisation of funds. Furthermore, the sale to Special Purpose Vehicle (SPV) also contradicts the basic *fiqh* in several aspects. First, the government sells an asset to an SPV which was created by the government itself. This conflicts with the principle of independence of the buyer and seller known as *hurriyyah al-'aaqidayn*. Second, the sale to the SPV is also considered as not a valid sale as it involves a transfer of ownership to the SPV whereby it is required to reimburse all the proceeds from the sale of the *ṣukūks* to the government. The stated rental of the leasing back of the *ṣukūks* is often stated in terms of LIBOR plus some basis points which is variable in nature, not fixed as required by Sharī'ah for lease contracts. Finally, even if it is possible to produce hedge fund and find someone to certify it as Sharī'ah-compliant, should it be done anyway? At this juncture, it is critical that we look back at the purpose of Islamic finance.

Islamic finance should be more focused in innovating profit sharing instruments, which is the cornerstone of Islamic financial intermediation process. This is the real distinguishing characteristics and features of Islamic finance as opposed to conventional banks. However, Islamic financial institutions have been less open to adoption of profit-loss sharing instruments such as *mushārah* and *mudārah* because of their low appetite for risk, the associated costs of monitoring such transaction, lack of transparency in markets within which Islamic financial institutions are operating as well as the reluctance of depositors to take risks. However, high dependence on *murābahah* and on other short-term transactions has limited the asset diversification potential of Islamic financial institutions. Hence, these institutions end up with portfolio that resembles conventional fixed income securities in terms of risk-return profile. The lack of appreciation of profit sharing principle and the reluctance of financial institutions to experiment and expose themselves to this type of transactions have delayed the proper application of Islamic finance and banking. As such, this prevented the desired level of portfolio diversification that Islamic finance theoretically have potential for.

5. CHALLENGES AND OBSTACLES FOR FUTURE GROWTH

The introduction of new Islamic capital market instruments will continue to be an uphill task if reviews are not made to the existing framework and structures governing the issuance of global Sharī'ah-complaint products. Fervent structural

changes as well as judicial consciousness are imperative for the Islamic industry to survive the currents of globalisation and change as the current Islamic capital market products are segmented across countries. High transaction cost is still regarded as an issue and this stems from the differences in the regulatory and listing requirements, different trading platforms and trading rules, lack of support institutions for cross-border transactions and a range of Shari'ah compatible criteria. Even if a robust regulatory structure is in place, the challenge that lays ahead remains on how to bring convergence on regulatory structures across national borders. As discussed earlier, the Islamic capital market needs to be opened and accessible to all investors be it Muslims or non-Muslims. But in order to attract big players into the market, we need to understand what global institutions look for when exploring the world's capital markets. Above all, they seek familiarity with the financial systems and regulations as well as certainty that justice will be upheld by the rule of law. Hence, this creates the challenge of developing homogeneity in the Islamic capital market.

Another issue facing the development of the Islamic capital market is the lack of convergence of Shari'ah interpretations. Different Muslim countries have adopted different practices in relation to various Islamic capital market product and services which is a result of the varying interpretation on various Shari'ah issues across jurisdictions due to the different school of thought among Shari'ah scholars. This may have implications for cross border flows in relation to investment and trading of international Islamic instruments. Convergence of Shari'ah interpretations will facilitate higher level of issuance of globally accepted Islamic capital market products and services in the international market. Arguably, the harmonisation of Shari'ah interpretations could lead to the creation of more homogeneous Islamic capital products and services that in turn will increase investor's demand and enhance the overall growth of the Islamic capital market. Furthermore, standardised practices among market players in the market should result in a reduction in transaction cost as well as risks. Differing Shari'ah transactions may also impact the enforceability of a transaction, as differences in interpretation would affect the recognition of legal rights and liabilities of parties to a transaction, particularly in a cross-border transactions and listings. In order to expand the market for Islamic products and make them available at global level, efforts have been underway to cross-list Shari'ah compatible products across markets.

Product innovation is crucial in the process of deepening and broadening the Islamic financial industry and thus a critical factor in the development of the Islamic capital market and finance. For Islamic capital markets to remain competitive, attractive and innovative; indigenous Islamic financial products must be introduced to meet the risk-reward profiles of investors and issuers, fulfilling all the tenets of the Shari'ah while remaining sufficiently cost-effective and competitive vis-à-vis conventional products. Finally, Islamic financial products must be competitive investments in themselves. Islamic banks can no longer rely

solely on the religious fervour of their clients as a stimulant for demand. As more non-Muslim investors (especially from Europe and the US) show more interest in Islamic products, banks must structure instruments so that they offer equivalent or better investment returns than their conventional rivals.

6. CONCLUSION

The Islamic finance industry has enormous potential and has come on leaps and bounds over recent years, which can be seen in the decision by big western banking groups to launch their very own Sharī'ah compliant banking facilities. Today, the Islamic financial services industry is at the threshold of a new level of development. There is now a higher degree of Sharī'ah dynamism that is evident in the evolution of sophisticated Islamic financial products that are being structured based on multiple Sharī'ah concepts. As we advanced forward, it is timely to move away from "plain vanilla" innovation or adaptation approach and to embrace a new wave of innovation that will evolve Islamic financial instruments into distinct products that will maximize the potential and wisdom of the Sharī'ah and that meets the greater sophistication of consumers and the more complex requirements of today's businesses. This paradigm of innovation in Islamic finance, which by itself shall accord Islamic financial institutions with the competitive advantage to forge ahead, entails substantial and continuous investments in research and development. Islamic finance is at a crossroads, and its champions need to decide where it should head: to tackle conventional finance head-on, or to look for a less crowded area, perhaps with a smaller pool of investors, where it can flourish.

Notes

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Şukūk Market: Innovations and Challenges

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ABSTRACT

Şukūk products offer a vast scope of innovation and a large potential for the growth of Islamic finance. Various structures of Şukūk based on Ijārah, Mushārahah, Muḍārbah and many hybrids such as Şukūk based on the combination of Ijārah with Istiṣnā' or the combination Ijārah with Istiṣnā' and Murābahah etc., has evolved. Structures with convertibility features and those allowing the possibility of substitution of the underlying assets have also come in the market. However, these innovations have generated various Sharī'ah, legal and economic issues and controversies. This paper discusses some of these important issues and challenges. Specifically, it deals with the issues of capital guarantee, contractual structures, pricing, and asset substitution in case of Ijārah Şukūk, Mushārahah Şukūk, and their various forms. It also covers the issues pertaining to rating of Şukūk, harmonization of Sharī'ah rules, and problems involved in defining the governing law for Şukūk issuance.

1. INTRODUCTION

The size of global Sharī'ah-Compliant assets is estimated at about \$400 billion to \$500 billion. Institutions like Standard & Poor's Ratings Services believe that the potential market for Islamic financial services is closer to \$4 trillion, meaning that Islamic finance currently has only achieved about 10% of its potential and therefore still has a long way to go. The market share of Islamic financial institutions is estimated to stand at 12 per cent in Malaysia and 17 per cent in the six GCC countries where it is growing faster than anywhere else.

One area of Islamic finance that attracted and continues to attract lot of interest from the business community worldwide is the global *Şukūk* market. The market is currently estimated at \$70 billion in value, and is expected to top the symbolic \$100 billion mark by 2010, according to recent estimates.¹

Companies and governments seeking capital for the huge infrastructure projects from the Gulf region and across the Muslim world are expected to sell about \$30 billion of Islamic bonds during the next three years. It is also projected that in the

next decade, there will be over \$1 trillion worth of investment opportunities in substantial projects in the Gulf region alone² and the *Ṣukūk* market is presumed to play an important role in securing these funds. Even outside the Muslim world the issuance of *Ṣukūk* is gaining momentum. After the 100 million Euro *Ṣukūk* issued by Saxony Anhalt in Germany, the British Government is looking into issuing its first Shari‘ah-compliant bond in a bid to boost London's position as a centre for Islamic finance³. Japan is also considering issuing *Ṣukūk*.⁴

However, the challenge that lies ahead is on the area of financial instruments and products innovation in the Islamic capital market in general and the *Ṣukūk* market in particular. It is true that the *Ṣukūk* structures are now to some extent diversified. We have for instance, *Ṣukūk* based on *Ijārah*, *Mushārahah*, *Mudārbah* and hybrid *Ṣukūk* based on the combination of *Ijārah* with *Istiṣnā‘* or the combination *Ijārah* with *Istiṣnā‘* and *Murābahah*. However, more instruments are needed and existing products need to be refined as some *Ṣukūk* structures are still debated and contested.

The present paper will look at the existing structures of *Ijārah Ṣukūk* whether they are based on the concept of sale and lease-back mechanism or the head lease and sub-lease structure and the criticisms addressed against these structures. The paper will touch on some of the criticisms addressed against the *Ijārah Ṣukūk* structure such as (i) the issue of guarantee and whether it transforms the transaction into a form of *ribā al-duyun* or not, (ii) the mechanism of sale and lease back and whether it resembles *bay‘ al-Wafā* or *bay‘ al-Inah* rejected by the majority of Muslim scholars, (iii) the purchase undertaking at a pre-determined price representing the original or principal amount of the *Ṣukūk* and finally, (iv) the pricing mechanism of *Ṣukūk* issuance which is generally tied to the London Inter Bank Offer Rate (LIBOR) and not to the actual rental of the asset underlying the *Ṣukūk* issue.

A basic requirement for Shari‘ah compliance of any *Ṣukūk* structure is that it shall be backed by tangible assets. However, a concern has been voiced regarding the limited number of assets eligible for *Ṣukūk* under the ownership of Islamic financial institutions or corporations looking for fund raising. This shortfall of eligible assets could impede or slow down the regular issuance of *Ṣukūk*. However, a recent innovation has permitted the substitution of the *Ṣukūk* asset during the life of the *Ṣukūk* to address these apprehensions. The paper will outline the main feature of this experience.

As a sign of innovation, a number of important Global *Ṣukūk* transactions have been issued in the past two years under the *Mushārahah* structure. However, this mechanism has become a point of serious controversy among Shari‘ah boards of Islamic financial institutions. While some Shari‘ah Boards approved the structure or allowed their respective institutions to invest in such business deals, others have prevented institutions under their respective supervision to invest in such *Ṣukūk* viewing them Shari‘ah non-compliant. The main issue of disagreement has been

the permissibility for one of the *Mushārahah* partners to give an undertaking to purchase the shares or units of the second partner of the *Mushārahah*, at the maturity of the *Ṣukūk*, at face value and predetermined price. A number of Sharī‘ah scholars uphold the permissibility of such an undertaking and as a result validate all *Mushārahah Ṣukūk* issuance in the market. It should be noted that such a purchase undertaking is allowed, according to the proponents of this opinion, under *Sharikat al-Milk* and not under *Sharikat al-‘Aqd*. However, is there any genuine difference between the two contracts that justify permissibility under *Sharikat al-Milk* and not under *Sharikat al-‘Aqd*? The paper will look at the implications of the purchase undertaking by one of the partners at pre-agreed price.

Economic value added and Sharī‘ah compliance are at the heart of product development in *Ṣukūk* market. It thus requires a process of Sharī‘ah approval. Unfortunately, it seems that the existing mechanism of Sharī‘ah scholars’ involvement in product development, harmonization and approval may not be adequate enough for a rapidly growing market that needs to expand according to international standards of best practices and at the speed of market demand. Organizations such as the OIC Fiqh Academy or the AAOIFI Sharī‘ah Board have done commendable job but they are still suffering from a number of shortcomings. For instance, the practical aspects of *Ijārah Ṣukūk* or even the theoretical characteristics of the *Mushārahah Ṣukūk*, and despite their existence in the market for a number of years, have not yet been discussed by the Fiqh Academy which is in reality the highest and most influential Sharī‘ah institution addressing financial issues. Thus, there is no Sharī‘ah resolution from these institutions determining what is Sharī‘ah compliant and what is not. Such a vacuum might have grave consequences to the industry as a whole and the *Ṣukūk* market in particular. Thus, any future resolution by the Academy against the existing structures might create a controversy that might erode market confidence on the *Ṣukūk* market. At the same time any approval of the existing structures, despite their shortcomings, might constitute a compromise of Sharī‘ah principles. The present paper addresses the shortcomings in the Sharī‘ah scholars’ institutional decision making and their present involvement in capital market product development and suggests solutions to the problem.

A key development within the Islamic capital markets products and their acceptance into the global financial system is the increased use of credit ratings in *Ṣukūk*. However, almost all conventional rating agencies are using conventional methodologies to rate Islamic financial instruments including *Ṣukūk* despite the acknowledgement of these rating agencies that Islamic financial institutions and instruments have their own characteristics. The international Islamic rating agency is supposed to play a pivotal role in addressing the issue but no major headway has been achieved yet. The paper will assess the status of *Ṣukūk* rating and its impact on the development of Islamic capital markets.

A properly functioning financial market depends on the enforceability of the contracts concerned. However, looking at the governing laws of *Şukūk* in the market it is clear that many contracts forming these transactions are governed by conventional laws such as the English law. This is despite the fact that all contracts are supposed to be based on Sharī‘ah principles and should not contradict its general principles. The paper will look at the impact of this legal dilemma and its impact on the development of a stable and long-standing Islamic capital market.

2. CRITICISM AGAINST THE *IJĀRAH ŞUKŪK* STRUCTURE

The *Ijārah Şukūk* structure was the first *Şukūk* structure marketed at global level. The structure has been used by sovereign as well corporate bodies. However, it has also been criticized by some Sharī‘ah scholars.

One of the most mentioned objections against *Şukūk-Ijārah* is the issue of guarantee. Generally, in *Şukūk* issuance, a third party who is normally the originator of the *Şukūk* will provide a guarantee for the principal capital of the *Şukūk*.

2.1. Guarantee in *Şukūk* Issues

The issue of guarantee generally arises when the originator (sovereign or corporate) benefiting from the *Şukūk* proceed establishes a Special Purpose Vehicle (SPV) that issues the *Şukūk* while the originator stands by to provide a guarantee against any shortfall.

The first collective resolution regarding Guarantee in *Şukūk* was issued by the Islamic Fiqh Academy in its resolution 30(5/4) pertaining to *Muqāraḍah Şukūk*. The resolution states the following:

"There is no Sharī‘ah objection to mention in the prospectus of the issue or in the document of *Muqāraḍah Şukūk* the promise of a third party, who is independent personally and in term of financial liability from the two parties to the contract, to volunteer an amount of money for no consideration to be allocated to make good a loss on a particular project. However, this is circumscribed with a condition that such a promise should be an obligation independent from the *Muḍārabah* contract. In other words, the third party performance of his obligation should not be a condition for the enforcement of the contract and the conditions and liabilities of the parties to the contract. As such, neither the bond holders nor the manager of the *Muqāraḍah* would be entitled to claim that they may fail to honour their obligations relating to their contracts because the volunteer failed to fulfil his promise and the performance of their obligations takes into consideration the promise from the volunteer."⁵

The AAOIFI Sharī‘ah Standards no.17. on Investment *Şukūk* states the following:

"The prospectus must not include any statement to the effect that the issuer of the certificates accepts the liability to compensate the owner of the certificates up to the nominal value of the certificates in situations other than torts and negligence nor that he guarantees a fixed percentage of profit. It is, however, permitted to an independent third party to provide a guarantee free of charge, while taking into account item 6/7 of Shari'ah Standard No. (5) in respect of guarantees. ..." ⁶

This position of the AAOIFI shall also be read in close link with what has been stated in Standard no. 5 concerning the issue of guarantee in particular. The standard states the following:

"It is permissible for a third party, other than the *muḍārib* or investment agent or one of the partners, to undertake voluntary that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the *muḍārabah* financing contract or investment agency contract." ⁷

Based on the above, the concept of third party guarantee has become one of the widely used mechanisms to protect investors in *Ṣukūk*. Theoretically, the third party guarantee shall be benevolent and without any fee or consideration. Thus, if the third party guarantee is benevolent and given by a public entity such as the government for the sake of encouraging investment in the country, contemporary Muslim scholars have two opposing opinions on the issue.

The first group argues that guaranteeing the principal in *Ṣukūk al-Muḍārabah* or *Ṣukūk Mushārah* or even *Ṣukūk al-Ijārah* will definitely open the door of *ribā*. Moreover, it contradicts the nature of *Muḍārabah* contract whereby guaranteeing the capital is prohibited by all schools of Islamic law. In addition, even if the third party guarantee is given by the government as it is suggested by the proponents of this opinion, it shall be declared non-permissible as the government treasury is the property of the whole community and should not be exposed to financial risk and venture of some individuals or entities. Finally, if the third party is not a government it would not be imaginable from a practical point of view for an entity to provide a benevolent guarantee to another entity without a specific consideration be it a monetary consideration or services. ⁸

The second group argues that as long as the third party providing the guarantee has its own legal and financially independent personality from that of the contracting parties, he can guarantee the whole capital or a specific percentage of it. This is based on the general principles that every thing is permissible unless there is a clear text about its prohibition and there is no text prohibiting a guarantee from a third party. Indeed such a guarantee will not be permissible if it is coming from the partner of the *Muḍārabah*.

From practical point of view let us take the example of guarantees in two early global *Ṣukūk* structures. First, we have the Trust certificates issued by Solidarity

Trust Services Limited (SPV), whereby the originator was the Islamic Development Bank (IDB). The second is the case of the *Şukūk al-Ijārah* issued by Malaysia Global (SPV) where the originator was the Government of Malaysia. Thus, it is argued whether Solidarity Trust Services Limited a wholly owned subsidiary of the Islamic Development Bank, or Malaysia Global *Şukūk*, an SPV 100% owned by the Ministry of Finance, Malaysia, are independent legal entities and autonomous in terms of financial liability from the guarantors, the Islamic Development Bank and the Government of Malaysia respectively? For the proponent of the permissibility of the two example the above principle of third party guarantee would have been observed in the two transactions because legally the issuers in the two cases have their independent legal entity which is totally separated from that of the originators and therefore the two transactions are permissible

The second group of scholars on the other hand, maintains that the transaction will be a kind of *ribā al-Duyun* because of the following:

1. Through this guarantee the amount invested in the Trust Certificates will be redeemed in full on the date of maturity (100%) or even earlier as the principal amount invested in the certificate is guaranteed by the Islamic Development Bank or the Government of Malaysia.
2. In addition, Certificates holders are entitled to receive periodic distribution amount calculated on the basis of fixed return per annum in respect of the Trust Certificates.

Based on the above, the opponents of third party guarantee in *Şukūk* argue that in such cases where the capital invested is guaranteed by the issuer or any interested party in the transaction and when the capital owner is entitled to receive periodic payment as proceed of the capital, and in the form of a fixed percentage rate, the transaction would be akin to an interest based transaction. Moreover, the Islamic Development Bank or the Government of Malaysia in these particular cases are not mere third parties whose gratuitous guarantee might be permissible or not. In fact, both originators have vested interests in the issuance of these *Şukūk*. The guaranteed fund is used to purchase the *Şukūk* of IDB for instance, and in the absence of the guarantee the fund will not have been collected and the *Şukūk* will not have been marketed.

2.2. The Sale and Lease Back Structure

The second criticism against the *Şukūk al-Ijārah* structure is not confined to the *Şukūk* market but goes beyond that. It touches on the Shari‘ah compliance of one of the widely used instrument by the Islamic finance industry. It is about renting an asset to the party who sold it. The issue is also at the core of the *Ijārah Şukūk* structures.

It is argued by the opponent of the structure that it is just another form of *bay‘*

al-Wafā or a variation of *bay' al- Istighlal* or a kind of *bay' al-Inah* which are all types of contracts contested by the majority of Muslim scholars .

Bay' al Wafā is allowed by a minority of Muslim scholars, but rejected by the majority and the Islamic Fiqh Academy in Jeddah passed a resolution in 1412AH (1992) disallowing it. *Bay' al-Wafā* is a contract whereby the owner of an estate (house or land) sells it, with a condition that he will have it back once he returns its price to the buyer. In other words, he who needs cash sells his estate in cash, with the condition that whenever he returns the cash to the buyer, the latter returns to him his estate. Thus, it is a sale contract with an attached condition of abrogation, the seller returns the cash and the buyer returns the estate.

Thus, it is argued, even if the estate was rented out to the seller, this means renting the estate (or selling it on instalments) to who sold it in cash would give the same result as such renting could be a *Ijārah muntahiya bi al- tamleek* (a renting contract that ends with ownership) and therefore, the transaction of sale and leaseback is similar to *bay' al-Wafā* contract.

The concept of sale and lease back is also similar to *bay'al- istighlal* according to those who reject the structure. *Bay'al-Istighlal* or the exploitation sale is to sell an estate with a promise condition, whereby the seller leases out this estate and whenever he pays back the price, he gets back his estate and this is the end result of the concept of sale and lease back.⁹

The concept of sale and lease back is also considered as a form of *Bay'al-Inah*, which is prohibited by the clear *ḥadīth* of the Prophet especially when the sale and lease back is combined with a purchase undertaking at pre-agreed price from the original seller. This is because the main feature of *Bay'al-Inah* is that the merchandise returns back to the seller and the same happens in the sale and lease back mechanism. In *al-Inah* contract, there are two sales in one transaction one with a spot specific price and the other with a deferred higher price. For example, someone sells an item for SR1000 and buys it back cash for SR900, which means he borrowed SR900 to be repaid SR1000. Thus, the *ribā* in *Bay'al-Inah* is the difference between the two prices.

Based on the similarities and end result between the above three type of contracts the sale and lease back structure is considered as stratagem to *ribā*. It shall be noted that the concept of sale and lease back has been approved by the Sharī'ah Board of the Accounting and Auditing Organization of Islamic financial Institutions.

2.3. Pricing of Ṣukūk¹⁰

The pricing of Ṣukūk is another point of criticism against Islamic bonds. Muslim economists and Sharī'ah scholars have not come up with an alternative to the interest rate as a readily available indicator of profitability. Hence the use of LIBOR as a benchmark became part of the practice in Islamic financial institutions.

However, what shall be noted is that while it is permissible to use LIBOR as a benchmark it is not correct to rely on it for determination of returns. In *Şukūk al-Ijārah* the *şukūk*holders are supposed to receive their returns from the rent of the underlying asset of the *Şukūk*. However, in practice this return is not at all reflecting the rental of the underlying asset but the prevalent interest rate. For example, if there are two real assets which are totally different from each other, then based on market realities we expect to have different rental income on them. However, it is observed that same rate of return, as reflecting the prevailing interest rate, is paid on them if they are used as underlying assets for two different *Şukūk* issues. Such a practice is definitely unacceptable from Sharī‘ah perspective. Even from practical point of view it has commercial implications. Specific *Ijārah Şukūk* using certain real estate properties as underling assets and despite the fact that rent of properties is going up in this particular jurisdiction where the assets are located, *şukūk*holders will end up getting their returns coming down because the interest rate is coming down in the international market. Thus, return on *Şukūk* is not reflecting the performance of the underlying asset but the prevalent interest rate.

The above fact is clearly reflected in the recent widening of interest rate spreads whereby the *Şukūk* issuers are forced to be reworking their pricing scale exactly as it is in the conventional bonds.¹¹

3. ADDRESSING THE SHORT SUPPLY OF ELIGIBLE UNDERLYING ASSETS FOR *ŞUKŪK*

One of the fundamental difference between a Sharī‘ah compliant *Şukūk* issuance and conventional bond structures is the requirement of a tangible asset to underlay any *Şukūk* issuance. However, one of the challenges in accessing the *Şukūk* market and assuring continuity in *Şukūk* issuance is determination and segregation of the pool of assets that will produce a Sharī‘ah-compliant income stream. Interest based income securities can be backed by pure receivables (e.g. credit cards or mortgages used in conventional asset-backed financing) however, these will not qualify as acceptable assets under Sharī‘ah. To date, a popular asset class for *Şukūk* issuance has been real estate or other tangible assets. The rental income generated by these assets can provide cash flow returns to the *şukūk*holders, and the originaotr’s obligation to repurchase these assets ensures principal repayments on scheduled maturity dates. Other eligible asset classes for *Şukūk* include goods or commodities, and movable assets like aircrafts and motor vehicles. However, the problem is that the eligible assets are limited and a company that had issued *Şukūk* using certain assets as underlying asset in a specific issue has to wait until maturity before being able to make use of the same underlying assets again. This issue is considered as one of the impediment that may limit the growth of the *Şukūk* industry.¹²

This problem has been addressed through an innovative structure used in DAAR *Şukūk* I & II. In this structure the underlying assets of the *Şukūk* were

certain properties that included specific land and buildings. The originator or beneficiary of the *Ṣukūk* was Dar al-Arkan a Saudi real estate development company. The issue was managed by a consortium of leading banks while the Sharī‘ah and structuring adviser was Unicorn Investment Bank.

The originator of the *Ṣukūk*, as property developer, may need to repossess the underlying assets of the *Ṣukūk* once again before the maturity of the *Ṣukūk*, say, in order to be able to sell it in the market and use their income for its next phase of property development. The originator therefore, would like to replace the assets underlying the *Ṣukūk* with some other assets. However, based on the *Ṣukūk* issuance structure these properties underlying the *Ṣukūk* are under the ownership of the *ṣukūk*holders until the maturity of the *Ṣukūk* while the originator is just a lessee. Although the originator who is the lessee has the right to purchase these assets at the maturity of the *Ṣukūk* through the purchase undertaking he signed with the issuer or the *ṣukūk*holders, he has to wait. No solution was in place for such situations.

The innovative structure in DAAR *Ṣukūk* addresses this concern. In such situations the parties may agree that the property underlying the *Ṣukūk* assets may in certain circumstances be substituted in whole or in part at the option of the originator on any periodic distribution date, pursuant to the terms of a property substitution undertaking.

For a better understanding of the structure, it would be useful to outline at the outset the general characteristics of an *Ijārah Ṣukūk* structure and how a substitution undertaking fits in.

3.1. General Characteristics of Modern *Ijārah Ṣukūk*

If an Islamic financial institution wants to tap the debt market in a Sharī‘ah compliant manner using the *Ijārah Ṣukūk* structure the following steps are generally followed:

- A special purpose company needs to be established, it can be called for this general description Islamic Global *Ṣukūk* (IGS).
- The IGS will issue trust certificates or *Ṣukūk* to potential investors and will use the money raised to purchase a rent generating asset from the originator.
- IGS will then lease the asset back to the financial institution or originator for a period corresponding to the duration of the trust certificates or *Ṣukūk*, and will keep the asset in trust for the holders of the *Ṣukūk*.
- The Issuer will be responsible for major maintenance and structural repair required by the asset while Islamic financial institution would perform all ordinary maintenance and repair required for the *Ṣukūk* assets.

- The lease rental payments from the originator to the IGS will exactly match the periodic payments due to the holders of the *Şukūk*. These rental payments are not fixed and may be calculated for instance, on six months US dollar Libor plus a margin.
- All claims due to IGS, the special purpose company issuing the *Şukūk*, including the rent that will fund the periodic payments on the trust certificates are direct, unconditional and irrevocable obligations of the originator under the agreement.
- The originator is also giving a binding promise to purchase from the IGS, upon the maturity of the lease, the asset leased at an agreed exercise price which will be used for the repayment of the principal to the holders of the *Şukūk*.

Besides the above general characteristics of an *Ijārah Şukūk* structure the issuer, in the new structure is giving an undertaking to the originator pursuant to which the issuer agrees to purchase from the originator certain land and buildings (Asset B) of similar features and with an equivalent value to the property to be substituted and which represent currently the underlying asset of the *Şukūk*. The value and benefits of the new asset will be determined pursuant to a valuation report by an independent third party. It shall be noted that this process of substitution will take place in the event that the originator wishes to substitute the land and buildings with an asset of an equivalent value. In this case, a corresponding purchase agreement will be executed. The consideration due to the originator in exchange of the asset B is deferred.

Thus, the substitution steps will be as follow:

1. The originator issues an exercise notice to the issuer expressing his intention to exercise the substitution undertaking in his favour and expressing its willingness to substitute the *Şukūk* asset.
2. The issuer buys asset (B) from the originator in consideration for (asset A) from the originator on a deferred basis in order to make sure that the *Şukūk* are not left without the backing of asset at any given time even for a short period.
3. The originator agrees in the subsequent lease renewal notice, to take on lease the substituted assets.

Thus, through the above mechanism the originator will be able to substitute *Şukūk* assets for assets of an equivalent value during the tenor of the *Şukūk*.

4. CONTROVERSY OVER *MUSHĀRAKAH ŞUKŪK*

As a sign of diversification in *Şukūk* instruments and a departure from the commonly used *Şukūk al-Ijārah* structure, the *Mushārahah Şukūk* structure was introduced at international level in 2005.

Some the pioneering issuances involving the *Mushārahah* structure include the \$200 million 5-year *Şukūk Al Mushārahah* issued by Dubai Metals & Commodities Company (DMCC) Authority, which was the first international *Şukūk* to be structured as a *Mushārahah* and the first rated Dubai *Şukūk* issue (a senior unsecured A rating by Standard & Poor's). The proceeds of the *Şukūk* is being used to build the Almas Tower, the AU Tower and the AG Tower at the DMCC Free Zone.

The second major issue is the 7-year non-amortizing \$550 million *Şukūk Al-Mushārahah* issued by Wings FZCO on behalf of Emirates Airlines in June 2005, which was the first *Şukūk* issued by an airline and the largest corporate *Şukūk* issued to date. The issue's mandated lead manager was Dubai Islamic Bank, which also is the joint book runner with HSBC and Standard Chartered Bank. The proceeds of the issue, which is listed on the Luxembourg Stock Exchange, will be used to finance the new Emirates Engineering Center and headquarters building in Dubai. The issue, which is priced as 0.75 percent over LIBOR with 12-months periodic coupon payments, was well received by the market and oversubscribed to the tune of \$824 million.

The landmark *Şukūk* based on *Mushārahah* was Dubai Ports, Customs and Free Zone Corporation (PCFC) issue. It was a landmark deal as one the world's largest single *Şukūk* issue to date. It is also the first *Şukūk* issue to be convertible into equity upon an IPO, and as the first *Şukūk* to be listed on Dubai International Financial Exchange.

The landmark issue was originally planed for US\$2.8 billion. However, it was increased to US\$3.5 billion due to the overwhelming response from investors. The issue was oversubscribed raising more than US\$11.4 billion. The issue was lead-managed by Dubai Islamic Bank (DIB) and Barclays Capital. The *Şukūk* offers a return of 7.125 per cent per annum if a Public Equity Offering happens in two years and a higher return of 10.125 per cent per annum on any amount of the *Şukūk* outstanding at maturity which have not been redeemed from equity offerings.¹³ Nearly 60 per cent of the orders came from the Middle East, 30 per cent from Europe and the rest from Asia. On the other hand, 70% of the *Şukūk* were allocated to bank, 7 per cent to high net worth investors and the remaining to asset and fund managers.¹⁴

Besides the above early *Şukūk* structures based on *Mushārahah* we have many other *Şukūk* issuance such as the \$270 million QREIC *Şukūk* in 2006; 200\$ Lagoon City *Şukūk*; \$225 Sharjah Islamic Bank *Şukūk*; \$150 Investment Dar Second *Şukūk* and many others

These different issues of *Şukūk al-Mushārah* show the great influence of *Şukūk al-Mushārah* in the *Şukūk* market and by consequence the great need to have a the structure of such products based on clear fundamentals and acceptable to most Shari‘ah scholars. This is in order to keep the confidence of the market in *Şukūk al-Mushārah* and to avoid possibilities of controversy and difference of opinions later.

Literally, *Mushārah* means sharing. *Mushārah* is generally a form of partnership between two parties in a lucrative project sharing the profits and loses of the joint venture. If it is a diminishing *Mushārah* one of the partners undertakes to purchase the share of his partner gradually either using his profit in the partnership or from other sources. One of the classifications of *Mushārah* with particular implications to our discussion on *Şukūk al-Mushārah* is to divide it into *Sharikat al-Milk* (co-ownership) and *Sharikat al-‘Aqd* (contractual partnership).

Several points have been mentioned as factors of differences between *Sharikat al-‘Aqd* and *Sharikat-al-Milk*.

1. Ownership in *Sharikat al-Milk* results from a joint ownership of assets while in the other form of joint venture which is *Sharikat al-‘Aqd* the partnership is based on a contractual offer and acceptance relationship.
2. Division of profit under the two concepts generally differ. Splitting of the profit in *Sharikat al-Milk* follows the ratio of shares while in *Sharikat al-‘Aqd* the ratio of profit may differ from that of the capital contributed.
3. *Sharikat al-‘Aqd* is formed with the intention of profit generation which is not the case with *Sharikat al-Milk* which can be formed on principles of non-profit or just consequential as in case of inherited property.¹⁵

The *Şukūk* structures based on *Mushārah* as stated earlier are generally based on diminishing *Mushārah* (*Mushārah Mutanaqisah*). Diminishing *Mushārah* is a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. This transaction starts with the formation of a partnership, after which buying and selling of the equity takes place between the two partners.

It is therefore, necessary that this buying and selling contract is not stipulated in the initial partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted to make a contract as a condition for concluding the other. The capital of the partnership in *Mushārah* could be in cash or in kind accurately valued.

Each partner should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into a monetary value, for example, a land or building or car or any other form of asset required for the operation of the partnership. The loss, if any, shall be borne by the parties in accordance with the participation ratio of each partner as equity stake of one partner decreases and the stake of the other partner increases.

One of the partners may arrange for the acquisition of the equity share of the other in a manner that serves the interests of both parties. This includes, for example, a promise by the first party to set aside a portion of the profit or the return that it may earn from the partnership for the acquisition of a percentage of the equity of the other party. The subject matter of the partnership may be divided into shares, in which case the second partner can purchase a particular number of these shares at certain intervals until the partner becomes the owner of the entire shares and consequently becomes the sole owner of the subject matter of the partnership.

It is permissible for either of the partners to rent or to lease the share of the other partner in a diminishing *Mushārahah* for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

In *Şukūk al-Mushārahah* the originator or the company looking to expand its operation owns some assets (land, cars etc..) and is looking forward to develop it through the issuance of *Şukūk* and approach the market in order to secure the needed capital by entering into *Mushārahah* (partnership or joint ownership) with the issuer of the *Şukūk* and a trustee of the *şukūk*holders.

The general structure of the *Şukūk al-Mushārahah* is as follow:

1. A Special Purpose Vehicle Company (SPV) representing the *şukūk*holders through the issuance of *Mushārahah Şukūk* will enter into a *Mushārahah* agreement with the originator.
2. The SPV Company that issues the *Mushārahah Şukūk* will contribute X% of the capital in cash while the originator will contribute Y% of the capital in-kind in the form of vehicles, real estates or other kind of asset which will be valued at their actual value.
3. The proceeds of the issue (i.e. *Mushārahah Şukūks*) will be used by the SPV to make its contribution to the *Mushārahah*.
4. Profits will be distributed, among the partners in proportion to their respective capital contributions.
5. The originator will undertake management of the *Mushārahah* under a separate management agreement.

6. In case the profits exceed certain percentage agreed upon in the management agreement, the Manager is entitled to such excess amount as a bonus or incentive fees in consideration for its good management.
7. The originator will give an irrevocable undertaking to purchase the units of the SPV in the *Mushārah* pool under the declining *Mushārah* concept (or at maturity) to issuer in a way that the entire *Mushārah* units are eventually owned by the originator at a price equivalent to the original contribution of the SPV to the *Mushārah* pool.

It is the last point regarding the undertaking by the originator to buy the unit of the SPV in the *Mushārah* at face value at pre-agreed price and not at market price that has raised differences of opinion among contemporary Shari'ah scholars.

It is upheld by the opponent of the current *Mushārah Sukūk* structure that a *Mushārah* is essentially a partnership under Islamic law and one of the fundamental concepts is that partner A cannot guarantee the capital of partner B. Yet, through the purchase undertaking at face value, *Mushārah Sukūk* structures effectively do just that where partner B's capital is guaranteed by partner A. This will transform the transaction into an operation akin to a *ribā* based business deal.¹⁶

5. RATING *ŞUKŪK*

A key development within the Islamic capital markets is the increased use of credit ratings. Infrastructure companies and sovereign entities are looking to capitalize and harness investors growing appetite for their assets. As noted earlier, almost all conventional rating agencies are using conventional methodologies to rate Islamic financial instruments including *Şukūk* despite their acknowledgement that Islamic financial institutions and instruments have their own characteristics. However, the exclusive characteristics of Islamic instruments are not reflected in the rating and it is very probable that if these characteristics were taken into consideration the rating of Islamic instrument might have been much better. The focus, of conventional rating agencies in their rating of *Şukūk* is on the credit of the entity providing the guarantee or the entity providing the purchase undertaking to purchase the asset at maturity at a predetermined price. The pre-determined price would be an amount equal to the principal amount to be redeemed under the *Şukūk* notes plus the coupon amount outstanding at the time the purchase undertaking was exercised. Interestingly, this changes the risk profile of the transaction from the asset risk of the underlying asset to the credit risk of the entity to which the assets can be put in a default. Following rating conventions, a *Şukūk* with a purchase undertaking would not have a rating higher than the rating given to the entity to which the *Şukūk* assets can be put, as the primary risk to the investor is not the asset risk but a credit risk of the originator. It shall be noted that the issue of guarantee and that of purchase undertaking are controversial matters from Shari'ah perspective and therefore, fresh thinking is needed to address them. The International Islamic rating Agency is supposed to play a much greater role in this

particular issue with a direct involvement of the respected Sharī‘ah scholars that it has been able to regroup as its Sharī‘ah board. The role of Sharī‘ah scholars is definitely important in the rating process but it is obvious that this is important in the development of the Islamic finance industry as whole and the *Şukūk* market in particular. However it seems, as noted earlier, that the existing mechanism of Sharī‘ah scholars’ involvement in product development and harmonization and approval may not be adequate enough for a rapidly growing market that needs to expand according to international standards of best practices and at the speed of market demand. The issue will be discussed next.

6. SHARĪ‘AH HARMONIZATION AND GOVERNANCE IN ISLAMIC FINANCE

The emergence of modern Islamic economics as well as the expansion of Islamic finance has always been associated with the involvement of Sharī‘ah scholars. They have been the main drivers behind the acceptance of the new system giving it the needed legitimacy within the Muslim masses. They played an important role in product development. This involvement is much needed nowadays ever than before as the industry has become one of the most dynamic areas in international finance. This requires closer cooperation among Sharī‘ah scholars and industry players at the international level. Divergence in Sharī‘ah interpretation might affect the credibility of the industry. This concern has been raised in several forums and researches. The causes for the differences of opinion, the measures already undertaken to address these concerns and the actions that need to be taken are explored below.

6.1. Causes for Differences of Opinion

The primary sources of Islamic law are the Qur’ān and the *Sunnah*. However, the development of Islamic law relies on *ijtihad* or personal reasoning which depends on the intellectual capabilities of each scholar. Moreover, the primary sources address certain issues in general terms and sometimes worded in a way that is subject to different interpretations. A *mujtahid* is also under obligation to take into consideration the effects of necessity, public interest and dire needs. All these are factors of difference of opinion.¹⁷

Moreover, Islamic Law has been sidelined during the colonial era and the laws of the colonial powers were implemented even after independence. Efforts to reintroduce Islamic law, after the advent of Islamic banking in particular, have been based on scattered initiatives that did not help much to solve the problem of differences of opinion.

The influence of major Islamic school of *Fiqh* has still an impact in Muslim scholars' thinking. This may be explained by the approach taken by the Malaysian scholars in their adoption of certain Islamic financial products based on *bay‘ al-inah* arguing that it is approved by some early Shaf‘ī scholars. This could also be

explained by the emergence of modern concept of *tawarruq* firstly in Saudi Arabia where the prevailing school is the Hanbali School which is also the only classical school that has explicitly approved *tawarruq*.

Although most of the resolutions of Shari'ah Boards of Islamic financial institutions are similar and harmonious to a large extent, there are occasions of differences due to limited coordination that sometimes create confusion among the practitioners and weakens the case of Islamic financial institutions in court litigations.

6.2. Harmonization Efforts

Towards better harmonisation and standardization of Islamic financial issues, including Shari'ah matters, several Islamic finance infrastructure organizations have been established. Each institution has its core mandate while Shari'ah issues represent a common concern to all these institutions. Thus, there is always a Shari'ah aspect in the accounting and auditing standards, in the prudential and supervisory issues and in the rating or arbitration aspects. Unfortunately, there is no effort to coordinate the Shari'ah issues separately raised in all these institutions.

The work of the Organization of Islamic Conference (OIC) Academy and the Rabitah Fiqh Academy are good examples of an attempt of Shari'ah harmonization. Researches in these institutions are done by renowned scholars representing different regions and the resolutions of these forums are not based on a specific school but on the whole heritage of Islamic law. Many of the modern Islamic finance products are directly developed or approved by the two academies.

However, the efforts by the two Academies have also their shortcomings. For example, each of the two Academies is meeting only once a year; they are not focusing on Islamic finance issues only and the involvement of Muslim economists seems to be limited.¹⁸ Moreover, the papers and the discussions are not accessible to English speaking practitioners as they are documented in Arabic and the two institutions are lacking adequate resources for employing full-time professional staff well versed in both the Shari'ah and finance.

Mandated with the setting of Shari'ah standards the AAOIFI's Shari'ah Board addressed some of the shortcomings of the two Academies by having meetings and consultations throughout the year; focusing on Islamic financial issues; translating its standards into English and having public hearing sessions to get feedback from the industry players on every standard before its final approval.

However, there are still a number of issues that need to be addressed such as the quality and number of academic research forming the basis for the issuance of standards. Only one or two pages are attached as Shari'ah basis of a standard instead of publishing the relevant researches. In addressing issues already covered by the OIC Islamic Fiqh Academy, the AAOIFI's Shari'ah Board needs to be more critical as there is always room for improvement. Public hearings to get feedback

from the players on a draft version of a standard shall not be limited to refining the existing ideas and styles but shall also involve fresh criticism on Sharī‘ah grounds.

However, the adequate solution to these issues seems to be the establishment of an independent international Sharī‘ah Board.

6.3. International Sharī‘ah Board

The new body shall have the objective of coordinating the work of Sharī‘ah boards of Islamic financial institutions; setting up Sharī‘ah standards; revising existing standards and providing adequate Sharī‘ah supervision and governance in coordination with the Central Banks and Monetary Agencies.

The new institution shall not take over the role of the existing Sharī‘ah Boards in individual financial institutions, as their existence is not only a vital mechanism for Sharī‘ah compliance and corporate governance but also an important means for innovation and product development.

The new institution shall focus on economic and financial issues, have representation from major players and countries, accommodate influential scholars in the industry irrespective of their country of origin, and be subdivided into several subcommittees with each subcommittee focusing on the functions of a specific infrastructure institution. Members of the different subcommittees shall be involved in the discussion of fundamental Sharī‘ah issues so that final approval of a standard or the endorsement of a product will not carry only the stamp of the specific committee but also the tacit approval of the international Board.

Financial constraint that might face the new institution can be handled through membership subscription fee to the new institution by the Islamic finance industry players. It is advisable that the new institution have its own secretariat to ensure its integrity and independence.

6.4. Government Support

Governments can contribute to Sharī‘ah harmonisation and governance by establishing national Sharī‘ah Boards to coordinate Sharī‘ah issues at national level and to expedite harmonisation at the international level. They can also undertake legal reforms in areas related to commerce and finance, support researches that promote Sharī‘ah convergence and cooperate with the international Sharī‘ah Board with regards to Sharī‘ah issues affecting the industry at the international level and support the role of the international Islamic Arbitration Centre to minimize litigation before non-Islamic courts.

7. GOVERNING LAW AND SHARĪ‘AH COMPLIANCE

7.1. Problem and Background

A properly functioning financial market depends on the enforceability of the contracts concerned. Markets may thrive on economic uncertainty, but not under

legal ambiguity.¹⁹ One of the issues of concern in Islamic finance is the issue of dispute resolution and the submission of litigations before local or foreign jurisdictions without contravening Sharī‘ah principles.

While Islamic financial institutions shall comply with Sharī‘ah in all aspects of their operation including litigation and dispute resolution, local and foreign court jurisdictions are conventional in nature. Even in those countries where Sharī‘ah is considered to be the fundamental source of legislation, the laws can be at variance with the Sharī‘ah. In some countries, while Islamic financial practices are encouraged the prohibition of *ribā* has not been incorporated into the national commercial laws. The issue is complicated by the unpredictability of court decisions and the non-acceptance of its own decisions as a binding precedent for the later cases, the non-codification of Islamic law and the differing interpretations of Sharī‘ah by Sharī‘ah Boards.

The question is how to document an Islamic finance transaction in a manner that conforms to Sharī‘ah principles and the governing law of a contract.

7.2. Current Solutions

Sample of contracts executed by Islamic financial institutions show that the clauses on the governing law are sometimes qualified to include expressions that restrict contacts' applicability so that they do not contradict Sharī‘ah. It is common to find qualifying statements like “as long as it does not contradict Sharī‘ah principles”; or “subject to the glorious Sharī‘ah rules”; or “without prejudice to the Islamic Sharī‘ah principles”. Sometimes a separate clause on Sharī‘ah compliance is included and a subsequent clause on the governing law is added but qualified by providing that this Agreement is governed by the Law of X country without prejudice to the terms and conditions herein contained, including Sharī‘ah Compliance. This qualification is sometimes limited to the avoidance of *ribā* and therefore, clause to the effect that each Party hereby irrevocably and unconditionally waives and rejects any entitlement to recover interest from the other Party.

The resort to English law, in particular, as governing law in Islamic finance is becoming increasingly common. Islamic financial institutions resort to English law in the documentation of financial transactions perhaps due to the non-existence of well recognised local Sharī‘ah court handling Islamic financial matters, the presumed weakness of local legislations with regard to issue pertaining to cross-boarder legal aspects, and the hope for better rating from conventional rating agencies which prefer English law as governing law.

However, the question that will arise is whether this mechanism really harmonises between conventional legislation, court and Sharī‘ah principles. Some legal practitioners consider the choice of English law as the right choice that will ensure Sharī‘ah compliance and at the same time provide conformity with best legal practices. The issue is best highlighted in *Shamil Bank of Bahrain vs. Beximo*

Pharmaceuticals Ltd & Others case on the basis of default payment in a *Murābahah* agreement. The parties' choice of law was expressed in these wordings "Subject to the principles of Glorious Shari'ah, this agreement shall be governed by and construed in accordance with the laws of England."

The High Court and Court of Appeal granted judgment to the Shamil Bank on its claims concluding that the principles of Shari'ah did not apply to the *Murābahah* agreements, principally because that had not been the parties' intention. The Court's reasoning was that:

- The reference to the "Glorious Shari'ah" in the governing law clause was merely intended to reflect the Islamic religious principles according to which the Bank held itself out as doing business.
- The reference to a choice of law shall be the law of a country, not to a non-national system of law such as Shari'ah without identifying those aspects of Shari'ah which were intended to be incorporated into the contract.
- It was improbable that the parties were truly asking the Courts to get into matters of Islamic law and its application.
- The Court is of the opinion that if the relevant Shari'ah principles been validly incorporated in this case, the borrowers might have succeeded in their application.²⁰

From the above judgment it is clear that resort to conventional courts by Islamic financial institutions is not without shortcomings. While the fundamental clauses of a contract in Islamic finance are based on Shari'ah principles the conventional court is unfamiliar with such principles and this will definitely affect its decision. Thus, in a litigation based on a *Murābahah* contract the court is not considering the contract in the transaction as a relation between buyer and seller but a relation between a borrower and a creditor and this represents a clear departure from the spirit of the transaction.

7.3. Way Forward

A permanent solution to this problem would be a long process. It resides in the systematic harmonization of documentation of Islamic financial contracts, the minimization of the differences between Shari'ah boards and the codification the fundamental principles of Islamic commercial law into clear set of legislation based on core Shari'ah principles and international best legal practices. Such a process will not be effective unless some countries adopt these principles as basis for national legislation.

A transitional solution would be a process of standardisation of Islamic financial contracts by identifying the fundamental Shari'ah principles which must be incorporated into a particular contract. The standardised contracts need to be endorsed by the Shari'ah Board of Islamic infrastructure institutions such as

AAOIFI, IIFM, IIRA and IFSB in order to give it an international dimension and acceptability in court litigation.

However, the immediate solution resides on the adoption of arbitration as an alternative method of dispute resolution in Islamic finance. Parties looking to enter into agreements incorporating Shari'ah principles shall include provisions to the effect that disputes about Shari'ah and its applicability shall be submitted to selected arbitrators who enjoy the confidence of the parties and possess the experience and capability in settling complicated commercial disputes. This might help to streamline the resolution of disputes and reduce the need for court proceedings which could be costly. Arbitration is also preferable due to the long process of court litigation, insufficient knowledge about the legal systems of other countries and the desire of investors to keep their investment disputes confidential.

8. CONCLUSION

Despite the encouraging growth and development of the *Ṣukūk* market it seems that there are many controversial issues that need prompt solutions in order to sustain the development of the *Ṣukūk* market. This requires a close cooperation among financial experts and Shari'ah scholars on one hand, and more interaction among Shari'ah boards on the other. The focus of the Islamic capital market shall not be only on how to raise the funds and be acceptable to international financial institutions, although these are valid and well needed objectives, but to be Shari'ah compliant first and foremost. This will also help in the growth of real economy and socio-economic development of the society.

Notes

* Unicorn Investment Bank.

¹ Standard and Poor's (2007, April).

² Standard and Poor's (2006, October).

³ Parker, Mushtaq (2007, April).

⁴ *Financial Times* (18 August 2006).

⁵ Islamic Fiqh Academy, Resolution no 30(5/4)

⁶ AAOIFI Shari'ah Standards no. 17. on Investment *Ṣukūk*, clause 5/1/8/7.

⁷ AAOIFI Shari'ah Standards no. 5 on Guarantees, clause 7/6.

⁸ See Al-Shibali, Yousouf Abdullah (no date), *Al-Khadamat al-Istithmariyyah Fi al-Masarif Wa Ahkamuha fi al-Fiqh al-Islami*, vol.2 pp-140-147.

⁹ See, al Masri, Rafic Yusus (2006/ 1427 A.H.).

¹⁰ See, Shari'ah Standards no 9.

¹¹ See, Augustine, Babu Das (2007, July 25).

¹² Clifford Chance (2006, September).

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- ¹³ Zubairi, Sohail (2006, February 15).
¹⁴ Stubing, Darren (2006, April).
¹⁵ Tyabji, Masood (2006/7).
¹⁶ See, Hammad, Nazih Nazih (2007); Abdul Sattar Abu Ghuddah (2007).
¹⁷ See, Kamali, Mohammaed (2000).
¹⁸ Going through the different financial issues discussed by the OIC Academy it is clear that in some sessions there is no economics expert involved. Perhaps it is believed that the issues are not complicated to warrant the presence of an economist.
¹⁹ See, Blair, William (2005).
²⁰ Lovells, “Shari‘ah Law in the English Court” www.lovells.com September 2004

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Key Sharī'ah Rulings on *Ṣukūk* Issuance in the Malaysian Islamic Capital Market

*Shamsiah Mohamad** and *Mohd Fadhly Md Yusoff***

ABSTRACT

The availability of Sharī'ah rulings on the issuance of ṣukūk is key to ensuring that Islamic products are Sharī'ah compliant and "true to form". As the regulator of the Malaysian Islamic capital market, the Securities Commission (SC) with guidance from the Sharī'ah Advisory Council (SAC), has outlined the Sharī'ah rulings for the issuance of ṣukūk. This paper elaborates on the key Sharī'ah rulings and its justifications.

1. INTRODUCTION

The Malaysian capital market has registered strong growth over the years and today, it is 2.4 times the size of nominal GDP. Adding the equity and bond markets together, the size of the Malaysian capital market as at end-2006 was RM1.3 trillion. It had expanded by 17% or by RM190.1 billion, year-on-year. The one-year increase in 2005-2006 was almost equal to the total size of the capital market in 1990 of about RM200 billion. This reflects the increasingly important role of the capital market in the national economy.

Similarly, the growth and development of *ṣukūk* has been impressive. As at 30 April 2007, the total outstanding corporate *ṣukūk* stood at RM112.2 billion or 49% of total outstanding corporate bonds. In 2006, over 55% of all approved bonds in Malaysia were *ṣukūk*, valued at RM42 billion. In fact, it has been independently recognised that Malaysia originates over 60% of the world's *ṣukūk* issues.

The year 2006 also saw the issuance in Malaysia of more globally accepted *ṣukūk*, employing the concepts of *muḍārabah*, *mushārah* and *ijārah*. Twenty-seven out of 64 *ṣukūk* issued were based on these principles. In terms of value, *ṣukūk* structured using *mushārah*, contributed RM29.4 billion or 70% of the total value of *ṣukūk* approved by the SC (Securities Commission Annual Report 2006: 6-45).

Thus, based on the promising growth and development of the Islamic capital market (ICM) within Malaysia, the SAC¹ of the SC plays a vital role in ensuring that ICM products and services are Sharī'ah compliant. Before being introduced into the market, ICM products and services undergo thorough research and deliberations to ensure their permissibility from the Sharī'ah perspective. For this purpose, the SAC adopts two significant approaches:

- (a) Study the validity of conventional instruments from the Sharī'ah point of view, focusing on the structure, mechanism and use of the instruments to ensure their compliance with Sharī'ah principles; and
- (b) Formulate and develop new financial instruments based on Sharī'ah principles.

When conducting research, the SAC uses both primary and secondary sources. The primary sources are the Quran and the *Sunnah*. Apart from the two primary sources, the SAC also uses secondary and other sources which have already been applied in Islamic jurisprudence such as *ijmā'*, *qiyās* etc.

In this paper, we present the following rulings resolved by the SAC on *ṣukūk* with justification made for each ruling:

- (a) Ruling on underlying asset and utilisation of proceeds;
- (b) Ruling on asset pricing;
- (c) Ruling on *al-iqta*; and
- (d) Ruling on *Bay' al-Dayn*

2. SHARĪ'AH RULINGS ON ṢUKŪK ISSUANCE AND ITS JUSTIFICATION

2.1. Ruling on Underlying Asset and Utilisation of Proceeds, and Its Justification

2.1.1. Sharī'ah ruling

The SAC resolved that any assets used as an underlying asset for the issuance of *ṣukūk* must be Sharī'ah compliant. Therefore, any asset used for Sharī'ah non-permissible activities cannot be an underlying asset, such as a building where major tenants operate conventional banking.

The SAC also resolved that any proceed obtained from *ṣukūk* must be utilised for Sharī'ah-compliant purposes.

2.1.2. Basis of the Ruling

The resolution is made after conducting a research on sale and purchase of grapes or its juice to liquor producers (بيع العنب لمن يتخذه خمرا). Reference is made to

this case as the underlying asset is *ḥalāl* but the purpose of the transaction is for a Sharī'ah non-permissible activity.

Past Islamic jurists differed in determining the ruling of selling grapes to liquor producers. There are three views on the matter, as follows:

(a) First View

The sale transaction is valid as the subject matter is *ḥalāl* and the buyer's intention does not affect the validity of the transaction.

Al-Sarakhsi(not dated:26) wrote in al-Mabsut:

وَلَا بَأْسَ بِبَيْعِ الْعَصِيرِ مِمَّنْ يَجْعَلُهُ خَمْرًا ؛ لِأَنَّ الْعَصِيرَ مَشْرُوبٌ طَاهِرٌ حَلَالٌ ، فَيَجُوزُ بَيْعُهُ ، وَأَكْلُ ثَمَنِهِ ، وَلَا فُسَادٌ فِي قَصْدِ الْبَائِعِ إِنَّمَا الْفُسَادُ فِي قَصْدِ الْمُشْتَرِي ، وَلَا تَزْرُ وَأَزْرَةٌ وَزَرَ أُخْرَى .

Meaning: There is no harm in selling juice to liquor producers because it is clean and *ḥalāl*. Therefore it can be sold and the seller can use the money generated from the transaction. There is no negative intention from the seller. The negative intention is only comes from the buyer. No one is obliged against other people's sins.

This view is given by Abu Hanifah (al-Sarakhsi[not dated]:26), and others Hanafits (al-Ayni[not dated]:249; Ibn Nujaym1993:230; Ibn Abidin[not dated]:391; Shaykh Nizam1991:116).

(b) Second View

The transaction is prohibited because it involves in prohibited activity in Islam. Allah s.w.t. (5:2) states:

وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

Meaning: But do not help one another in sin and transgression.

This verse clearly states that helping others to commit sins is prohibited. Therefore, if the execution of the transaction is driven by a purpose which is contradictory to Islam, then the transaction is prohibited especially when the purpose is clearly stated in the contract or can be easily identified.

This second view is also supported by the Prophet's *ḥadīth* which stated that any activity related to something prohibited in Islam is also considered *ḥarām*. The Prophet s.a.w declared (Ibn Majah, Kitab al-Ashribah, Bab Lu`inat al-Khamr `ala `Asharah Awjuh, *ḥadīth* no: 3380):

لُعِنْتُ الْخَمْرَ عَلَى عَشْرَةِ أَوْجِهٍ: بَعِيْنَهَا وَعَاصِرَهَا وَمُعْتَصِرَهَا وَبَائِعَهَا وَمُبْتَاعَهَا وَحَامِلَهَا وَالْمَحْمُولَةَ إِلَيْهِ وَأَكْلَ ثَمَنِهَا وَشَارِبَهَا وَسَاقِيَهَا

Meaning: The cursing of liquor comes in 10 forms, the liquor, the producer, the processor, the seller, the buyer, the person who delivers it, the recipient, the person who drinks it and the person who serves it.

This view is declared by the Maliki school (Ibn Juzay[not dated]:117; Wizarah al-Awqaf wa al-Shu'un al-Islamiyyah 1987:208), Hanbali school (Ibn Muflih1985:42; al-Buhuti1997:181; Ibn Qudamah 1994:306), and Abu Yusuf and Muhammad (al-Sarakhsi[not dated:26).

The Shafi'i school also shared the same opinion, provided that the seller knows that the buyer will use the grapes/juice to produce liquor (al-Nawawi[not dated]:353; al-Ramli 1984:471).

Al-Suyuti (1994:552-553) wrote in al-Ashbah wa al-Naza'ir:

الْبَيْعُ أَقْسَامٌ صَحِيحٌ قَوْلًا وَاحِدًا وَفَاسِدٌ قَوْلًا وَاحِدًا وَصَحِيحٌ عَلَى الْأَصَحِّ وَفَاسِدٌ عَلَى الْأَصَحِّ وَحَرَامٌ يَصِحُّ وَمَكْرُوهٌ ... وَالْحَامِسُ ... وَبَيْعُ الْعِنْبِ لِمَنْ عَلِمَ أَنَّهُ يَعْصِرُهُ خَمْرًا ، وَالْبَيْعُ وَقْتَ النَّدَاءِ لِيَوْمِ الْجُمُعَةِ وَالسَّادِسُ : بَيْعُ الْعِنْبِ لِمَنْ يَظُنُّهُ يَعْصِرُهُ خَمْرًا ...

Meaning: A sale transaction falls into several categories; (first) valid, (second) *fāsid*, (third) valid based on a more authoritative view, (fourth) *fāsid* based on a more authoritative view, (fifth) prohibited but valid and (sixth) *makruh*²... and the fifth transaction, such as the sale of grapes where the seller knew that the buyer will produce liquor from the grapes and the sale during the Friday *azan*, and the sixth transaction, such as the sale of grapes whereby the seller has *zan*³ that the buyer will produce liquor from the grapes...

Otherwise in Nihayah al-Muhtaj (al-Ramli 1984:471), it is written that if the seller has *zan* that the buyer will use the subject matter to commit sins, then the transaction is considered *ḥarām*. In the contrary, if the seller is not sure (شك) whether the buyer will use it to commit sins or not, then the transaction becomes *makruh*.

(c) Third View

The transaction is *makruh*. This is Imam al-Shafii's view (not dated:237) and other Shafiits like al-Syirazi (not dated:48).

In conclusion, a majority of Islamic jurists declared that the sale of grapes/juice to liquor producers is prohibited and this is more preferable than other opinions. After reviewing all views and their justification, the SAC resolved that assets used for Sharī'ah non-compliant activities cannot be used as underlying assets for the issuance of *ṣukūk* and proceeds obtained from the *ṣukūk* must only be utilised for Sharī'ah-compliant purposes. The resolution was made to protect the image of the ICM.

2.2. Ruling on Asset Pricing and its Justification

2.2.1. Sharī'ah ruling

The SAC has issued the guidelines on asset pricing for *ṣukūk* to facilitate the process of determining the selling price of an underlying asset for *ṣukūk* structured under *uqud muawadat*.

The SAC resolved that the purchase price⁴ of the asset, if it is sold at a premium, shall not exceed 1.33 times (one and one-third) of the market value. On the other hand, if the asset is sold at a discount, the purchase price shall not be less than 0.67 (two-thirds) times of the market value (http://www.sc.com.my/eng/html/icm/fr_icm.html, 24/7/2007).

2.2.2. Basis of the ruling

In Islam, the price of an asset is based on the value of the asset. According to Qal`ahji (1991:110) the value of the asset is based on the following factors:

- (a) The benefit of the asset;
- (b) The extent of effort put in to own the asset;
- (c) Production cost;
- (d) Demand and supply; and
- (e) The risk level.

It is difficult to determine whether an asset price is fair or not. It is also hard to decide whether premium or discount to the price is fair to both parties involved. This is because the sale and purchase contract is based on the *al-taradi* concept. A maxim of Islamic jurisprudence stated (al-Zarqa 1968:1083):

الأصلُ في العَقْدِ رِضَا الْمُتَعَاقِدَيْنِ

Meaning: Originally, a contract is based on an agreement between two parties.

Even though a contract originally is based on *al-taradi* between two parties, the Islamic jurists also concerned about selling an asset above the value of the asset. This concern is evident when they discussed about *al-ghabn⁵ al-fahish*. Islamic jurists differed in their opinions whether a contract can be terminated if there is *al-ghabn al-fahish*. There are three views on this matter, as follows:

(a) First View

According to some Hanafits, Malikits and Hambalits, the contract can be terminated whether *al-ghabn al-fahish* is caused by *al-taghrir* (cheating) or not (Ibn Nujaym 1993:125; al-Haskafi 1995:142; al-Shawkani 1994:266-267; Wizarah al-Awqaf wa al-Shu'un al-Islamiyyah 1987:141).

(b) Second View

According to some Hanafits, Maliki school and Syafii school, the contract is not affected at all by *al-ghabn al-fahish* whether it is caused by *al-taghrir* or not (al-Haskafi 1995); al-Dasuqi: 207; al-Sharbini 1995:51, Wizarah al-Awqaf wa al-Shu'un al-Islamiyyah 1987:140).

(c) Third View

The contract can be terminated if it is caused by *al-taḥrīr* only. This is a more acceptable view among some Hanafits, Malikits and Hanbalits.

The Islamic jurists also have different opinions in determining the benchmark of *al-ghabn al-fahish*. According to Ibn Abidin, *al-ghabn al-fahish* occurs if the price is not within the asset evaluation range given by an independent valuers. For example, an asset was sold at RM10. But after referring to valuers, the indicative price ranged from RM5-RM7. Hence the additional RM3 is considered *al-ghabn al-fahish*.

According to the latest Hanafits, the benchmark of *al-ghabn al-fahish* is as follows (Ibn Nujaym 1993:282, Haydar 1991:131):

- (a) 5% for ordinary goods;
- (b) 10% for animals, including those used for riding; and
- (c) 20% for fixed asset.

The Shafii school and some of Malikits said *al-ghabn al-fahish* occurs when the profit is above one-third of the asset value. (al-Hattab [not dated]:398; al-Ghazali 1994:76). On the contrary, the Hanbali school refers to *ʿurf* in order to determine the benchmark of *al-ghabn* (al-Mardawi 1997:494; al-Bahuti 1970:233).

In determining the benchmark of *al-ghabn al-fahish*, the views of the Shafii school and some of Malikits are more practical. Moreover, the Prophet s.a.w. said that giving away one-third of the will is already considered a lot.

In conclusion, Islam takes into account the factors of demand and supply in price determination, however public interest must not be jeopardised. This is in accordance with the *ḥadīth* of the Prophet s.a.w (Narrated by Ibn Majah, Kitab al-Ahkam, Bab Man Bana fi Haqqih ma Yadurr Bijarih, *ḥadīth* no: 2340):

لا ضرر ولا ضرار

Meaning: There shall be no harm nor causing of harm (in Islam).

This is in agreement with the maxim of Islamic jurisprudence (al-Suyuti 1994:112)

الضرر يزال

Meaning: Whatever harm should be eliminated.

Thus, based on the *ḥadīth* and the maxim which state that demand override any form of harm, the Islamic jurists therefore decided that *tas`ir* (limitation of price) is allowed.

Based on the above justifications, the SAC of the SC resolved that the purchase price of the asset must be in the range of 0.67 to 1.33 times of the market value of the assets.

To further facilitate the asset pricing process, the SAC resolved that if the market value cannot be identified, hence fair value or any other suitable value can be used as long as it is on willing buyer-willing seller basis.

2.3. Ruling on *al-Iqta* and its Justification

2.3.1. Sharī'ah ruling

All contracts awarded by the government, i.e. concession, construction, supply and service contracts are accepted as approved underlying assets for structuring *ṣukūk*. The same principle can also be applied to contracts awarded by state governments, government agencies and government-related companies. The decision was made based on the principle of government award (*iqta*).

2.3.2. Basis of the ruling

Past Islamic jurists have discussed on *iqta* in relation to *ihya al-mawat* (developing neglected property).

There are two ways of *ihya*:

- (a) *Iqta imam* (gift of the ruler); and
- (b) *Ihya mawat thumma ijazah amir* (developing the neglected property and then obtaining the permission from the ruler).

There were two approaches used by Islamic jurists to define *iqta*:

- (a) Definition of *iqta* relating to *ard* (real estate); and
- (b) Definition of *iqta* in general that is on *māl* (assets or properties).

According to Qadi Iyad, *iqta* is the ruler's gift of Allah's property to whoever eligible to manage it. Normally *iqta* occurs in respect of real estates (Ibn Hajar al-Asqalani 1993:323).

In al-Mawsuah al-Fiqhiyyah, *iqta* is defined as ruler's gift in the form of real estate. The said gift is either in the form of ownership or rights to derive benefits from the real estate (Wizarah al-Awqaf wa al-Shu'un al-Islamiyyah 1987:81)

There are several conditions on *iqta*, as follows (Hawwas 1994:25-34)

- (a) *Iqta* is only given by the ruler with the objective of *maṣlahah*;
- (b) *Muqta* (one who is conferred with *iqta* property) is capable of developing *iqta* properties;
- (c) *Iqta* property is not owned by anybody; and
- (d) *Iqta* does not contradict *maṣlahah ammah*.

Based on the above, it can be concluded that the government plays an important role in *iqta*. It also shows that there is no special condition that says *iqta* is limited to real estate only.

Imam al-Syawkani when discussing *ihya mawat* has a special section on the status of neglected animals. This is based on the sayings of the Prophet s.a.w. which showed that such animals can also be bred. The Prophet said (Narrated by Abu Dawud, Kitab al-*Ijārah*, Bab fi Man Ahya Hasiran, *ḥadīth* no:3524)

من وجد دابة قد عجز عنها أهلها أن يعلفوها فأخذها فأحياها فهي له

Meaning: “Whoever finds an animal neglected by the owner without any food, and is taken and bred, then the said animal becomes his.”

The Prophet s.a.w. also said (Narrated by Abu Dawud: *ḥadīth* no:3525)

من ترك دابة بمهلكة فأحياها رجل فهي لمن أحياها

Meaning: “Whoever leaves the animal at a place that can destroy the said animal, and then bred by another person, then the said animal which is being bred becomes his.”

According to Abu Yusuf, *iqta imam* in the form of *tamlīk raqabah* (individual ownership) is not limited to immovable property but also can be extended to movable property (al-Khafif:263). Therefore, there is room to widen the scope of *iqta* by the ruler.

Shaykh Najib al-Muti'i said that *iqta* is similar to *tarkhis* (concession/permit/license) whereby, if a businessman or contractor wants to build a road, he should get permission from the government. Only then, he is allowed to carry out the construction, maintenance and other related works and may impose a *mukus* (toll) to finance the cost and expenditure incurred by him ([16]:149).

Some of the Islamic jurists who attended the Dallah Baraka Symposium (Syarikat al-Barakah li al-Istithmar wa al-Tanmiyyah 1997:220-221) considered *‘aqd imtiyaz* (concession contract) as a form of *iqta* awarded to the concession holder for a certain period of time and thereafter, be returned back to the government.

Based on the above views, it can be concluded that the scope of *iqta* can be extended to various forms of assets, regardless of whether they are real estate or rights of broadcasting, supply, maintenance or others of similar nature.

2.4. Ruling on *Bay ‘al-Dayn* and its Justification

2.4.1. Sharī‘ah ruling

The SAC resolved that the principle of *Bay ‘al-Dayn* i.e. debt trading as one of the concepts to develop Islamic capital market instruments.

2.4.2. Basis of the ruling

The resolution was made by the SAC after conducting thorough research on the issue. In this regard, a majority of Islamic jurists are unanimous in allowing the activity of selling debts to the debtor. This is because there is no issue of *gharar* (uncertainty) as the debt can be delivered to the debtor. On the contrary, they differ in opinion with regard to selling the debts to a third party who has no obligation to settle the debt.

The Hanafi school was unanimous in not permitting *Bay' al-Dayn* because the risk cannot be resolved in the context of debt selling. This is because the debt is in the form of *mal hukmi* (intangible assets) and the debt buyer takes on greater risk because he cannot own the item bought and the seller cannot deliver the item sold (al-Kasani [not dated]:148).

However, the Maliki school allowed debt selling to a third party subject to the following conditions (al-Dasuki [not dated]:63):

- (a) Expediting the payment of the purchase;
- (b) The debtor is present at the point of sale;
- (c) The debtor confirms the debt;
- (d) The debtor belongs to the group that is bound by law so that he is able to redeem his debt;
- (e) Payment is not of the same type as *dayn*, and if it is so, the rate should be the same to avoid *ribā*;
- (f) The debt cannot be created from the sale of currency (gold and silver) to be delivered in the future;
- (g) The *dayn* should be goods that are saleable, even before they are received. This is to ensure that the *dayn* is not of the food type which cannot be traded before the occurrence of *qabd*; and
- (h) There should be no enmity between the buyer and the seller, so as to prevent difficulties to the *madin* (debtor).

The conditions can be categorised as follows:

- (a) To protect the right of the debt buyer;
- (b) To avoid debt selling before *qabd*; and
- (c) To avoid *ribā*.

The Shafii school also allowed selling of debt to a third party provided that the debt was *mustaqir*⁶ (al-Syirazi [not dated]:262) and was sold in exchange for *ayn* (goods) that must be delivered immediately. When the debt is sold, it should be paid in cash or tangible asset as agreed.

According to Ibn Qayyim, *Bay' al-Dayn* is permissible because there was no general *nas* or *ijmā'* that prohibited it. Even though there was a *ḥadīth* that stated the prohibition of *Bay' al-Dayn* but it was referring to *Bay' al-Dayn bi al-dayn* or *bay' al-kālī' bi al-kālī'*⁷ (Ibn Qayyim 1995:388).

After reviewing Islamic jurists' opinions and their justification on this matter, it can be concluded that the main reason for the varying opinions among past Islamic jurists is on the ability of the seller to deliver the items sold. This was stated by Ibn Taymiyyah himself and was also based on statements made in the great books of the four schools of thought.

However, the ability of the seller to deliver the items sold can be overcome via supervision and control. In this context, the interest (*maṣlahah*) of buyers should be safeguarded because he is the party that has to bear the risks of acquiring the debt sale while making the sale contract. In the Malaysian context, the debt securities instruments based on the principles of *Bay' al-Dayn* are regulated by the SC⁸ and the Central Bank of Malaysia in order to safeguard the rights of the parties involved in the contract. Therefore, the conditions set by the Maliki school and the fear of risks by the Hanafī school can be overcome through regulation and surveillance.

Thus, it can be concluded that *Bay' al-Dayn* is permissible if the risks can be mitigated and the buyer's *maṣlahah* (interest) can be protected. All of these can be achieved through a transparent regulatory system.

3. CONCLUSION

Indeed, the four rulings discussed in this paper are the key rulings that form the basis for the issuance of *ṣukūk* in Malaysia and also provide appropriate guidance to facilitate the structuring, issuing and trading of *ṣukūk*. These rulings can address the needs of the industry which are becoming more intricate and demanding, as they cover all aspects of *ṣukūk* issuance ranging from the issue of underlying assets to the utilisation of *ṣukūk* proceeds. As such, Sharī'ah rulings resolved by the SAC are not only vital in ensuring the Sharī'ah status of ICM products and services, but also enhancing the growth and development of the Malaysian ICM.

In addition, every ruling made by the SAC is based on comprehensive and thorough research in order to build confidence to the industry and stakeholders, on the Sharī'ah status of ICM products and services introduced.

In fact, it is the practice of the SC that all rulings must be based on the process of *ijtihād jama'ī* (collective *ijtihād*) rather than *ijtihād fardhi* (individual *ijtihād*) because of its reliability and validity as compared to *ijtihād fardhi*. It is also to enable harmonisation of opinions.

It is hoped that the explanations in this paper will provide clarity on the rulings and views of the SAC, as well as the methodologies and arguments used as the bases of such rulings.

Notes

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¹ Please see Appendix I.

² *Makruh* means you are rewarded if you do not commit a certain act but even if you commit that act, you are not punished.

³ *Zan* is between *yaqin* (certainty) and *shak* (doubt).

⁴ The purchase price refers to the price of the first leg transaction of *'uqud mu'awadat*.

⁵ *Al-Ghabn* refers to an unfair excess between the asset price and the value of the asset. It is divided into *al-ghabn al-fahish* (excessive) and *al-ghabn al-yasir* (minimal).

⁶ *Dayn mustaqir* is redemption-guaranteed debt, e.g. compensation value of damages and properties of the debtor.

⁷ *Bay' al-kālī' bi al-kālī'* means a debt sale that is paid by debt.

⁸ The SC issued the *Guidelines on the Offering of Islamic Securities* ("IS Guidelines") in 2004 which provide specific guidelines and directives on the issuance of Islamic securities (*shukūk*). *Shukūk*, like other securities, must comply with all SC guidelines or directives, where applicable. The IS Guidelines list the types of Islamic contracts approved for structuring, documenting and trading of *shukūk*. It also stipulates the requirements and qualifications expected of Shari'ah advisers.

APPENDIX I**MEMBERS OF THE SC's SHARĪ'AH ADVISORY COUNCIL
1 JULY 2006 - 30 JUNE 2008**

1. Y.A.A Datuk Sheikh Ghazali Hj Abdul Rahman (Chairman)
Director General / Sharī'ah Chief Justice, Department of Sharī'ah
Judiciary Malaysia
2. Y Bhg Datuk Hj. Md Hashim Hj Yahaya
Very Distinguished Academic Fellow
Ahmad Ibrahim Kulliyah of Laws
International Islamic University Malaysia
3. Y Bhg S.S. Dato' Hassan Hj Ahmad
Mufti of Penang, Malaysia
4. Y Bhg Dato' Dr Abdul Halim Ismail
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BIMB Securities Sdn Bhd
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An Inquiry into The Usage of Real Assets in Islamic Transactions and Their Benchmarking: The Implications for Islamic Capital Markets

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ABSTRACT

Operations of Islamic financial institutions are expected to be directly associated with real sector activities. Hence they cannot function as a pure financial intermediary devoid of asset exchange and/or transformation. Economies which wish to establish a strong niche in Islamic Banking must develop capital markets to enable financial institutions to invest their surplus liquidity in income generating, Shari'ah-compliant capital market products, such as long term and short-term sukūk and other instruments. However, for the capital market to fulfil the Maqāṣid-al-Shari'ah (principles of Shari'ah) the products have to be asset-backed and their returns should not be linked and benchmarked to the conventional money market instruments or LIBOR. The paper explores these points in linking-up the returns to underlying real assets and value addition. It uses the experiences of Pakistan International Sukūk and various other sukūk to assert the above point while the main discussion pertains to return on "capital" as a factor of production.

1. INTRODUCTION

What is striking about Shari'ah guidelines regarding Islamic business activities and financial services is that they are logically consistent with one another and linked together in a holistic fashion. Undoubtedly, the *Maqāṣid-al-Shari'ah* (or guiding principles of Shari'ah) comprise normative, value laden ethical guidelines and are prescriptive in nature. Islamic principles specify how to ethically conduct business and monetary activities with the explicit goal of attaining a more just society and a prosperous economy. Moreover, within Islamic Economics there is no micro or macro level of analysis but holistic financial guidelines are given for undertaking business activities and financial intermediation. There is no de-linking of the micro and macro explanatory analysis regarding economic activities and money market services or capital market services as well as other financial services.

In the Islamic system, financial intermediation plays the important role of pooling together the economy's savings and utilizing them in production and

exchange (trade) based business and investment activities through Sharī'ah permissible modes of financing. Financial intermediaries play a proactive role in collectively investing the investors' (depositors') capital and their own capital in trade and investment opportunities. Financial intermediaries have a responsibility to return the rewards to all of the stakeholders and sharing the risks. They have to do responsible financial intermediation, in employing their specialized acumen of portfolio diversification and a keen eye for investment opportunities and business analysis. The returns they offer to their depositors and investors (in investment banking and *ṣukūk's* case) are primarily driven by profit in selling and the value addition made in trade –related transactions and participation in equity returns and rentals, mainly through *Muḍārabah*, *Mushārah* and *Ijarah* contracts.

2. ISLAMIC ECONOMIC PRINCIPLES

The principles of Islamic Economics reiterate that all dealings in business and financial exchanges must be fair to all parties and stakeholders. Most importantly, such exchanges must be commensurate with the goals of socio-economic justice and the (universal) brotherhood of Islam. Needless to say, the practical implementation of the Islamic socio-economic system also needs to evolve, in accordance with these guiding principles. The practical shape which Islamic financial transactions have taken at various places and times, have been predicated upon Muslims' spatial and temporal understanding of relevant Islamic principles, and socio-economic principles in particular.¹ The new Islamic financial products comprise the collective result of efforts of the Islamic *Ummah*, consisting of economists, researchers, financial managers and bankers, Sharī'ah scholars etc. Transactions, for which we know the Holy Prophet (SAW) set an authentic precedence have been adopted. Additional types or variations in business transactions, which suit the current needs of society, have also evolved. Their chief claim to legitimacy is to conform with the purpose of the Sharī'ah. Any transaction found repugnant to the Sharī'ah is declared null and void.

2.1. Asset –Backed Transactions and *Ribā*

Practically speaking, asset-backed transactions in Islamic finance and banking denote that instead of lending money to a customer (borrower) at a rate of return or interest, the bank adopts a number of mechanisms and contracts called *Murābahah*, *Muḍārabah*, and others in which the bank performs some activity or sells assets to customers after purchasing it from the market (or a third party) and earns a profit through various mechanisms. These mechanisms consist of price mark-up in trade, known as *Murābahah* profit, management fee earning called *Muḍārabah* profit, as well as return on equity, known as *Mushārah* profit and “rent” revenue from *Ijarah* contracts. While these mechanisms share similarities with common world wide business mechanisms, they are distinct from them in that they are not based on interest and involve underlying tangible assets and services.

The strict Islamic injunction to only engage in asset backed financial transactions is the result of the Holy Qur'ān's verdict on banning *Ribā* or usury (interest) and the *Aḥādīth* on banning usury of all kinds (*Ribā al-Nasiyyah* and *Ribā al-Faḍl*). Since Allah (SWT) has permitted trade and banned usury, the spirit of Islamic doctrines have led to the adoption of the goods-based or services-based transactions (i.e. real assets and services) involving profit earned through trade, as well as human services and contributions in equity. Islamic Financial intermediation or Banking is a fairly comprehensive system and encompasses all of the business exchanges prevalent in Islamic times. *Ribā al-Nasiyyah* is in lending, while *Ribā al-Faḍl* pertains to *Ribā* in trade and represents all forms of exploitations in business exchanges that are unjust and dishonest. It also includes extra money earned through cheating and deception.² Even those asset-backed transactions that lead to *Ribā* have been prohibited by the Holy Prophet (SAW), in *Ribā al-Faḍl*. The necessary condition of avoiding *Ribā al-Faḍl* is to eliminate cheating in prices as well as quality.

Fair dealing and fair exchange is also a cardinal principle of the Sharī'ah. For example, the Holy Prophet recommended the sale of one commodity in the market for a price and the subsequent purchase of another commodity through money instead of barter of commodities that varied in quality, lest the parties to the exchange feel that they received an unfair price.³ The Prophet's (SAW) ruling and explanation⁴ determines that business transactions should consist of on-the-spot transactions, involving the same genre of commodities with the same weight.⁵ What is striking about this ruling is the weight importance given to standardization of commodities, an important concept of quality management. Injunctions against barter etc. were likely to have been contrary to normal practice and may well have been very novel ideas, at the time of the Prophet.

2.1.1. Transaction mechanism and pricing

In order to understand the underlying principles and injunctions of the Sharī'ah, regarding permissible and impermissible economic exchange of goods and services for money, it is critically important to understand the mechanism and pricing which are fundamental to the asset-backed transactions within the Islamic financial system. A case in point presented in this study discusses the pricing of those asset-based transactions which comprise capital market activity although the same principles would apply to the banking sector too.

2.2. Concept of Capital in Islamic Economics vs Neo-Classical Economics

According to Islamic Theory, the primary right to wealth is enjoyed by the factors of production. In Islamic theory, there are three factors of production, namely capital, land and labour, which also includes organization and planning activity. This is slightly different from neo-classical economics in which entrepreneurship is the fourth factor of production, distinct from the other factors because the entrepreneur is a risk taker. It is not surprising that entrepreneurship is

not a factor of production in Islamic Economics as it considers the sharing of the entrepreneurial-cum business risk between contributors of capital (financial and real assets) and human efforts in the shape of entrepreneurship acumen. Risk taking and investing are considered to be a joint activity.

In Islamic Economics, capital is defined as that means of production which cannot be utilized unless it is wholly consumed or changed in form. Thus it cannot be rented or leased unless its form is changed.⁶ Thus money becomes capital if it is consumed in the process or transformed into goods or rewards of services performed. This definition is similar in principle to the definition of capital in Neo-Classical economics, in which capital consists of those goods which are used to produce other goods, and investment is the creation of new capital goods. Capital is not defined to be money capital in investment theory, but only in terms of “real” or physical capital (goods). However, in Finance and Financial economics and investment practice, the distinction becomes blurred and terms such as money capital are used to represent money which will be used to buy capital goods in the future. According to Muslim scholars, money is not capital or representative capital at any time. It is “potential capital” which, through the services and efforts of the entrepreneur, is put into productive use and converted into actual capital.⁷ The provider of money has no role in this process unless he or she is also sharing the risk of the “conversion process” and that also in the role of an equity provider and not as a lender. The entrepreneur takes on business risk and through his efforts and ability utilizes money and other inputs in producing final goods and services, generating revenues and profits. Current residual profits are then shared among the equity stakeholders as well as the entrepreneur even if the latter’s contribution in equity capital is nil. It is this activity and acumen of the entrepreneur that entitles him or her to the profit. If the contributor of money capital (saver-investor) was a lender only as in conventional economics, he or she would lose on two counts. First, the right to further long run profits due to the current successful business and the retained earnings in business which would ensure growth. Secondly, the right to the additional profits, if the earned profits percentage is more than the interest percentage agreed with the lender. Hence it is argued that interest (given to the lender) cannot be the price of this money since money *per se* is not capital,⁸ without being employed in an investment activity, in which the risk is to be shared too.

2.2.1. The fair share concept

Continuing from the previous premise, take the example of a bank depositor. If a depositor’s money is used in the production process in order to produce additional wealth, the depositor is entitled to a fair share in the profits rather than a predetermined fixed percentage, which is likely to be much less than the profit share owed to him or her. Hence the provider or depositor of money is also dealt with unfairly with regard to the remuneration he or she receives, for his or her money contribution to the production of a good or service. To sum up, the profit

earned due to entrepreneurial activity and on financial capital (money invested in the capital productivity process)⁹ through participation in risk as well as reward, is the legitimate profit of an entrepreneur and investor, in Islamic Economics.¹⁰

2.2.2. World economic problems

At the macro level, modern industrial economies are found to be inherently unstable subject to the phenomena of business cycles, when increases in output, are accompanied by demand pull or cost push inflation. Major structural changes in an economy are accompanied by large swings in output, unemployment, changes in prices, etc. In the international economy, the flow of international capital across borders is also inherently destabilizing. The East Asia crisis of 1996 serves to illustrate how international debt incurred by the East Asian countries led to a severe recession across nearly all of the countries of the region. Neo-classical economics subsumes that modern economic systems are inherently unstable and offers few answers to dampen the destabilizing forces inherent within it. While structural shifts in the economy due to energy crises, changes in technology etc occur and cause economies to undergo often painful changes, economies of different countries need to have develop sound and inherently stable mechanisms to deal with fundamental problems of resource allocation, production and exchange of goods and services etc. If these resource allocation and pricing mechanisms work with efficacy, they will act to dampen extraneous structural forces.

2.2.3. Factor-pricing in conventional economics - moving from micro level to macro level

The search for possible answers may be fruitful, if analytical tools derived from the micro-economic foundations of factor markets are applied consistently at the market and macro level. The microeconomic pricing of a factor is determined by its supply and demand and its derived demand in various industries such as consumer goods or durables (houses, automobiles, etc) in a given period of time. Consumer durables conform to physical assets in finance. When such micro-level industry analysis is carried over to the macro level, simplified assumptions need to be made for the aggregation of demand and supply of land and labour respectively, in order to determine their resource prices, namely, rent and wages.

2.2.4. Determining interest rate, vis-a-vis the reward for capital

At the macro-level, in conventional economics, the interest rate is considered as the real or “true” reward or “price” of capital. It is determined by the intersection of the demand of loanable funds for investment and the supply of capital funds or savings in the economy. In neo-classical economic theory this is clearly shown to be the method of interest rate determination. However, in reality, Governments determine interest rates. One of the major goals of monetary policy is in fact to determine the interest rate in order to direct the economy according to their priorities. In the United States of America, the Federal Reserve Chairman determines the interest rate. In Pakistan too, the State Bank of Pakistan in tandem

with the Ministry of Finance determines the interest rate. The problem is that this interest rate is often arbitrarily set, according to the economic and financial priorities of the Government. If the interest rate does not reflect the “true opportunity cost” of capital, then there is misallocation of resources and in particular, capital.

The Government sets the short term interest rates for the securities markets as well as longer term interest rates for longer term financial instruments. Even more importantly, the interest rate serves as a signal for loaning and borrowing of funds for all investment and exchange purposes. Unfortunately, for reasons of expediency, the Government often simply equate the rate of return on capital to the rate of interest which it has fixed on short term securities and bonds.

Hence securities and their interest are money market instruments and capital should not be measured by these tools but by its own market tools.¹¹ This argument is particularly valid in the context of Islamic prohibition of *Ribā* (interest) on loans, which prohibits lending for buying a good through the mechanism of a positive interest rate derived through the money market. This interest rate is not linked to the real value of the resources used in the production of that good. Incorrect and biased assessment of the “true” opportunity cost of capital may also bias the economy in favour of debt rather than equity in terms of business transaction. The prohibition on *Ribā* nullifies as impermissible, the proposition in capital market theory by Modigliani and Miller,¹² in favour of minimizing cost of funds through optimal use of debt¹³ as it rules out the use of debt capital as unjust.

3. AN ALTERNATIVE PROPOSAL

Application of Pricing of Capital/Investment on the Basis of Returns and Risks of Underlying Assets in *Şukūk*

For providing alternate avenues of investment of surplus “money”, whether of households (individuals) or of institutions, the Islamic Financial System should develop and provide risk-bearing instruments of investments. These instruments should also have liquidity attributes, in addition to providing profitability and security.¹⁴ An acceptable Islamic investment instrument, in addition to being representative of a share (portion) in a real asset, should have the attributes of risk-bearing, and have a rate of return, which should be tied to the performance of the real asset(s).¹⁵

The *Şukūk* are investment certificates of equal value representing the right or claim of the bearer to a portion of the underlying asset and the returns from it, as defined in the *şukūk* agreement with the investors. These are equity claims and not debt claims.¹⁶ They represent an undivided beneficial interest in the underlying tangible assets, and their usufruct. Physical assets consist of land parcels or buildings or project assets. Sovereign *şukūk*, in particular, comprise a variety of such assets. *Şukūk* are investment instruments as well as sources of generation of

funds for firms, commercial banks, autonomous bodies and (sovereign) Governments.

The *ṣukūk* are designed according to the available options of the Sharī‘ah-based contracts specified, according to the Sharī‘ah rules of issuance and trading. There are a variety of *ṣukūk*,¹⁷ based on the underlying contracts. They can be traded according to the terms governing trading of the assets and rights they represent. Profit (return) and loss (if any) are shared according to the contract terms, which are given in the subscription prospectus. Usually the global *ṣukūk* specify the return as an x basis points with respect to LIBOR (London Interbank Offer Rate) e.g. LIBOR plus 2.2 for the Pakistan’s (PISC) sovereign *ṣukūk* in 2006. The 2.2 margin represents the sovereign risk inbuilt in the price.

3.1. WAPDA *Ṣukūk*- An *Ijārah Ṣukūk* Example

We take the example of the WAPDA¹⁸ *ṣukūk* here. It is an *Ijārah ṣukūk* structure. In an *Ijārah* contract, the usage of an underlying asset is sub-let on the basis of receiving periodic *Ijārah* rent. An *Ijārah ṣukūk* holder receives a portion of the rent stream received from the underlying *Ijārah* contract. Since the rent amount has to be agreed between the contracting parties to the *Ijārah*, the rent return is a fixed amount, and hence the mechanism adopted by the *ṣukūk*, also gives a fixed stream of return to the *ṣukūk* holders. This fixed stream is particularly attractive to those investors requiring fixed income returns. Usually, the contract follows a somewhat circular path. The underlying assets are sold to a contracting party, a Special Purpose Vehicle (SPV) and then sub let by the same originator from the SPV.

WAPDA floated a local currency *Ijārah Ṣukūk* on January 06, 2006 for Pakistani Rupee (PKR) 8.0 billion, for seven years, through a specifically set-up Special Purpose Vehicle namely WAPDA First *Ṣukūk* Company. The primary objective of fund generation through the *ṣukūk*, was to improve WAPDA’s existing capacity at one of the sites at Mangla Dam. The underlying assets of the *ṣukūk* thus consisted of 10 hydel power generating Turbines of Mangla Hydel Power Station under Sale and Lease back arrangements. They are sold to the SPV namely the WAPDA First *Ṣukūk* Company and then leased back by WAPDA, the originator for a period of seven years, corresponding to the life of the *Ijārah Ṣukūk*. Their estimated value is written as the value of the underlying assets.¹⁹ The rate of return offered on WAPDA *ṣukūk* is 6-month KIBOR (Karachi Interbank Offer rate) plus 35 basis points.²⁰

3.1.1. Analysis of the return on investment in the *ṣukūk*

The return on investment to the *ṣukūk* holders, as given above is 6 month KIBOR plus 35 basis points. This rate is derived by virtue of the cost of funds in the money market and a certain proportion (0.35 basis points) above it, representing the relative risk on the instrument (*ṣukūk*) as compared to the market risk. The investors’ exposure is on the originators, their fund generating capacity

and the legal structure of the contract which ensures secure payments to the *ṣukūk* investors, while remaining Sharī‘ah permissible. This pricing has no relationship with the actual underlying activity and the resource –generating ability, risk and return (in the past and expected in the future stipulated period) of the firm and its project, i.e. WAPDA and the hydel power plant’s output and risks. Take for example if this rate offered to the *ṣukūk* investors is more than the actual (expected) resource and return generating ability of the WAPDA, who is going to bear the cost ultimately? This payment is guaranteed by the Government of Pakistan. It means that if WAPDA cannot pay the return offered, the government is liable to pay. Any payment by WAPDA or by the government which is over and above the return from the underlying project, or above the internal rate of return on capital employed by WAPDA, means negative Net present Value and negative growth for WAPDA. In a broader picture, it means shrinkage of the GDP of a country. Who bears the cost of “negative value addition”? It is to be compensated through taxing the consumers of WAPDA and /or tax-payers’ money utilized for making good the loss. This is misallocation of resources or “spilling” of resources which could have been utilized in other avenues. Although the *ṣukūk* holders get a known floating rate of return from their investment, which is Sharī‘ah permissible, yet they do more harm to the economy in inefficient allocation of resources and in paying more cost than the return generated on capital employed. This phenomenon is creating an anomaly in the system. That is the investors are investing in the scrips (*ṣukūk*) and are getting a return with which they are satisfied, and hence willing to contribute their money capital to be utilized. However, the firms which need the funds have to offer the rates that induce investors to invest, even if the firms do not generate equivalent amount and rate of return from the underlying project. In a nutshell the returns to the investors have no relationship to the underlying assets. The asset is as-if a “dummy”, introduced to make the transaction, Sharī‘ah permissible.

Now let’s assume that WAPDA, by virtue of the additional investment funds from the *ṣukūk*, is able to generate an internal rate of return on capital employed that is more than the 6 month KIBOR plus 35 basis points. In this case, aren’t the *ṣukūk* holders entitled to proportionate share in the return, if they are bearing the business risk with them? Of course, they would be entitled to a higher return in that case. But in the case of Ijarah returns, the *ṣukūk* holders would take the previously agreed return and WAPDA’s permanent shareholders would reap the reward, while the company’s growth will be profitable for the economy as a whole and would add to the GDP and GNP. Hence profitable ventures would perhaps do less harm to the whole economy but denying the equitable share to the *ṣukūk* holders. In the long run, though profitable firms would be able to attract more funds by offering better rates which are commensurate with their rates of return. Hence, it is felt that securities such as these *ṣukūk*, whether issued by the autonomous bodies or by corporate companies would do more good to the economy, if apart from the benefit drawn by the companies and the investors, the price tag attached to the *ṣukūk* is

based on the actual (real) returns of the firms.²¹ Currently they are based on the asking rate of the fixed income investors in the market. The reason why this particular example of *Ijārah sukūk*, with government guarantee was taken was also to show that, although it is good to put idle resources like land parcels to productive use, or securitize existing assets like the hydel power plants, it is very crucial to generate at least the requisite returns, given a certain level of risk. Autonomous bodies of the government, usually have the facility of the government exchequer, for immediate relief, in bailing them out, but this leads to inefficiencies in the economy and loss of national economic resources.

3.2. *Mushārahah Sukūk* and Two Tiered *Sukūk* Leading to IPO — What Promise Do They Hold?

Other structuring examples of *sukūk* (securities) would include asset-backed *sukūk* in which the return on securities represent the returns from the project and return on equity. This can be explained with the help of an example of a *Mushārahah sukūk* or a two tiered *sukūk*. If the *sukūk* represents certificates of partnership, the *sukūk* holders shall be partners in the profit and loss of the underlying *Mushārahah* project, based on predetermined profit and loss sharing ratio between the *sukūk* holders on the one hand and the issuer of *sukūk*. By forming a separate project, and project assets and activities, based on the *sukūk* can be issued against the project based on the principle of *Mushārahah* contract or *Mudārahah* contract principle instead of floating common equity. The *sukūk* holders shall contribute in equity of the project in capital participation with the issuer (issuer as *Mushārik* or as *Mudārib*).

Another example where, *sukūk* are a preliminary step to stock floatation is a two-tiered *sukūk* structure. In this the *sukūk* are floated initially with the option of conversion into shares at redemption which is also the time of public offering of shares. This type of *sukūk* arrangement was seen in the PCFC Development FZCO *sukūk* of Dubai (Jebel Ali Free Zone) jurisdiction. *Mushārahah sukūk* worth U.S \$3.5 Billion were issued on 23rd January 2006, due 2008. The proceeds were used to finance the takeover of the P & O Ports worldwide interests by the Dubai Ports Authority. The issue was priced as follows. a) If redemption of *sukūk* takes place at the QPO redemption date, the *sukūk* holders are paid a fixed return of 7.125 per cent per annum accumulated return and b) If the *sukūk* are held till final or mandatory redemption date, a fixed return of 10.125 per cent per annum accumulated return shall be paid.

3.2.1. Analysis of *mushārahah sukūk* and two tiered *sukūk* leading to IPO

The 7.125-10.125% rates offered are predetermined fixed rates offered on equity and hence subject to debate. i.e. Why is the rate not proportionate to equity contribution instead of specifying a fixed rate even if that means giving an expected rate. Hence in some cases, to manage the issue of Sharī'ah permissibility,

while the base contract between the Originator and the SPV (Issuer of *ṣukūk*) is a *mushārah* contract, the relationship between the SPV and the *ṣukūk* holders is that of *Ijārah*. It means that the *ṣukūk* holders are given the *Ijārah* rights on the basis of the rent agreed as say, 7 %, if the *Ijārah* contract is for a certain number of years, and 10% if the contract is for a longer/different period. This makes the *ṣukūk* structure, as a combination of *Mushārah* and *Ijārah*.

In the next step of the PCFC *Mushārah ṣukūk*, the *ṣukūk* are converted into shares of the company, as the option is given to the *ṣukūk*-holders to convert at a specified rate, into the initial equity. This move changes the status of the *ṣukūk* holders into equity contributors and sharing in the return as well as the risk.

When the nature of relationship of the *ṣukūk* holders and the issuer becomes *Mushārah*-based or *Muḍārah*-based, it means that the return from the project would be distributed among the stakeholders on the basis of agreed profit-sharing ratios and risk shared according to contribution of equity capital of each partner (and loss of management fee in the case of *Muḍārah*-based *ṣukūk*). The resultant return (referred to in terms of pricing) will be a direct product of the output of the business/project instead of a referenced benchmark which has no direct link with the cost and output of the underlying activity.

As far as possible, pricing on the basis of principles that give a share of profit, along with (the responsibility of) bearing risk to the contributors of all kinds of capital (human, financial, asset/machinery/technology) in the success or failure of a business enterprise or venture, in effect makes risk more diversified and return shared more widely and justly. Due to these aspects, profit and loss sharing mechanism related to the underlying output and value addition would add to the widespread (real) growth and development in the economy²² and not just benefiting the investors or corporates.²³

3.3. Rate of Return on Financial Capital in Comparison with Production and Services Industries/Sectors

The production of a good or service requires the input of financial capital as well as land, labour and entrepreneurial ability.²⁴ The internal rate of return on capital employed differs from firm to firm and from sector to sector. It also differs over time in the long run (if we assume the short run to be constant, for simplicity). Hence the rate which profitable businesses with brighter prospects would be willing and able to offer, must be better (higher) than other firms in the same or other industries of similar risk level. Thus at this time, the oil and gas companies as well as the telecommunications and mobile sectors enjoy a higher rate of return than the textile industry which in turn is more profitable than certain other industries in Pakistan according to the level of usage of capital and its demand. In fact the pricing of capital, based on the rate which the firms can offer, will reflect the true level of scarcity of this factor, and as such yield its true opportunity cost or economic price. Thus the rate of return, in the form of reward for equity investment

of financial capital would also vary. Deriving the “true opportunity cost of capital” is an empirically difficult task, though certainly not impossible. A “weighted average cost of capital” can be derived for the various firms and industries.

This analysis is particularly relevant as Islamic finance emphasizes dealing with real assets in financial transactions of exchange. Thus these asset-based contracts must be priced in a manner that represents the real prices of the factors and commodities markets instead of money market driven rates. Otherwise, asset-based products would remain in form but ineffective in spirit. The reason being that the price (return) determined for the capital contribution (say for example, return on the *ṣukūk* investors’ funds) is not based on the expected internal rate of return on that capital employed by the firm in a sector. The stakeholder or contributor of equity draws benefits which are not according to the spirit of the underlying transaction. This means that the purpose of the asset-based transaction is defeated. Although there is no clear verdict of the Shari‘ah scholars on this issue (to the authors’ knowledge), the deliberations (and *Aḥādīth*) on description of *Ribā al-Faḍl*, throws light on the undercurrents in exchange as well as sale of commodities for a price.

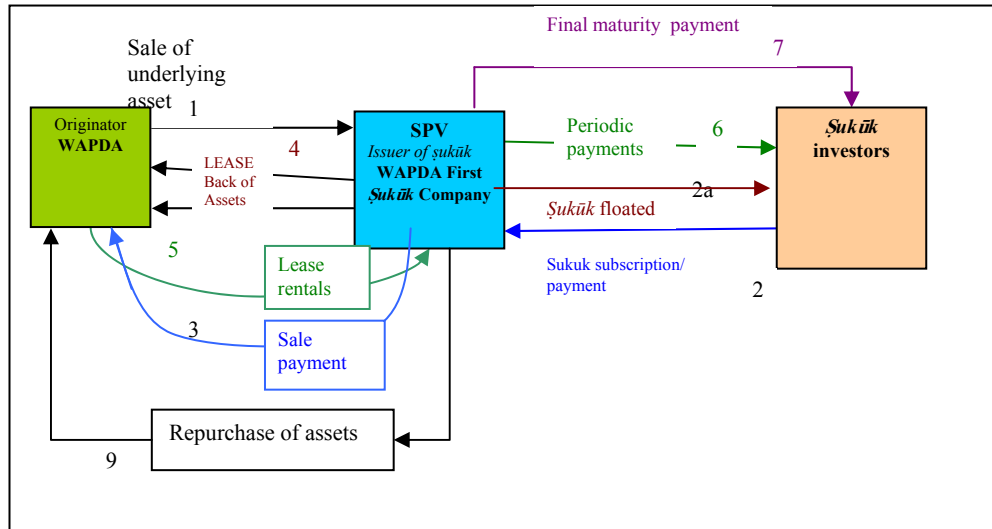


Figure 5.1 WAPDA's Ijarah Sukuk Structure

Source :Authors' own

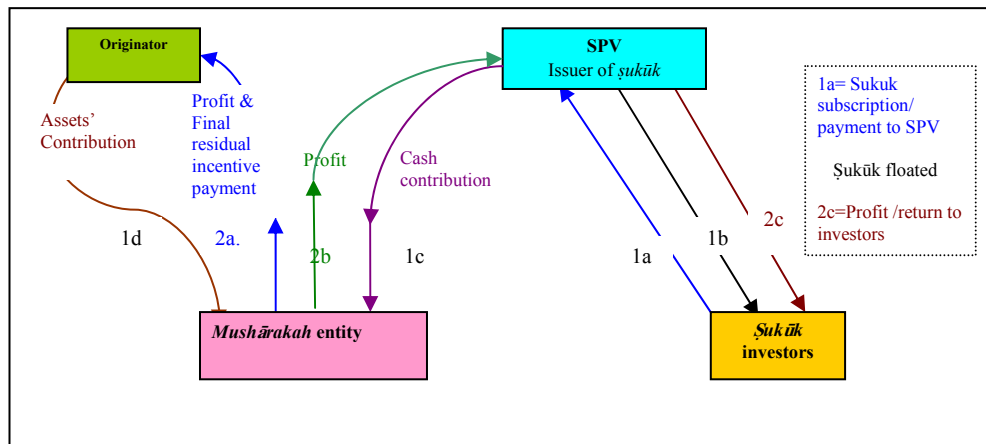


Figure 5.2 Musharakah Sukuk- Basic Structure

Source : Authors' own

4. CONCLUSION

In the light of the above analysis, it is proposed that the investment products being based upon the real factors of production, should be priced in terms of their underlying risk and return structure, which would set the pricing of investments (capital) in the factors market instead of using the money market barometers of effective interest rates of securities and for banks. The advantage of such a move would be that the return to the investors in an economy will be related to the actual output of the economy. In addition, such projects and the cost of investments for the issuers would not be affected adversely by any adverse changes in international lending rates (like LIBOR). More specifically, the firms which are more efficient and whose products are in demand would be in a position to offer better rates attract investors. In addition, if certain sector's firms offer even a lower return than others, they may be picked for investment, based on their stability of returns. Linking pricing of the securities to the returns from the underlying assets or the returns from the parent company's diversified portfolio, would enable uniform or comparable returns to securities holders which would not be to the detriment of the equity holders of the firms.

When the investment decisions of the investors are based upon the actual performance of the project or company or even a Financial Institution's investment portfolio mix, in which the investor becomes an equity holder/participant through his/her monetary contribution, the flow of capital (investment) would be more efficient and would be responsive to the risk and return from the underlying investment projects or investment portfolios' mix. This, in our view is the essence of responsible investment according to the goals of Shari'ah, instead of seeking only the best return, which may be at the cost of loss or handicap of others and with negative impact on the economy, due to the injustice.

Notes

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¹ Chapra. U., (1995) Chapter 2.

² Chapra. U., (1995:58).

³ Usmani. I., (2002:45) Darul Ishaat, Karachi.

⁴ "From Abu Sa'id al-Khudri (RA): The Prophet, (SAW) , said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in riba. The taker and the

giver are alike [in guilt]." (Usmani, I. (2002:45) quoting (Muslim, *ibid*; and Musnad Ahmad)).

⁵ In addition, as explained earlier, the exchange of different types of commodities or different grades of the same commodity should preferably be through setting a price for each through sale in the market. This aspect becomes clear from the following hadith, of the Holy Prophet, (SAW) narrated from Abu Sa'id and Abu Hurayrah (RA) "A man employed by the Prophet, (SAW), in Khaybar brought for him janibs [dates of very fine quality]. Upon the Prophet's (SAW) asking him whether all the dates of Khaybar were such, the man replied that this was not the case and added that "they exchanged a sa' [a measure] of this kind for two or three [of the other kind]". The Prophet, (SAW), replied, "Do not do so. Sell [the lower quality dates] for dirhams and then use the dirhams to buy janibs. [When dates are exchanged against dates] they should be equal in weight." (Usmani, I (2002:45) quoting (Bukhari, *Kitab al-Buyu'*, Bab idha arada bay'a tamrin bi tamrin khayrun minhu; also Muslim and Nasa'i)).

⁶ Usmani, I., (2002).

⁷ Mirakhor, A. (2001) p.31.

⁸ *Ibid*.

⁹ author's interpretation for the sake of clarity.

¹⁰ Mirakhor, A., (2001) p.32.

¹¹ Dr Monzer Kahf, (2002) in his paper "Allocation of Output to Factors of Production and the implicit Islamic Concept of Market Justice" (in seminar titled, "The functional Distribution of Income") states that according to the Neo Classicists, in the factors market, land and labour are measured in terms of their rewards (and pricing) but capital is measured in terms of price of securities i.e. the interest rates. He proposes that capital should not be measured in this manner. Instead, capital measurement should follow the pricing of the other two factors of production (land and labour).

¹² The capital structure irrelevance principle or the Modigliani-Miller theorem basically states that it is irrelevant whether a firm's capital structure is equity based (i.e. through issuance of stock) or has debt. These financing does not have an impact on the value of the firm. They suppose, no taxes, bankruptcy, and asymmetrical information, and assume an efficient market. (They also assert that the dividend policy of the firm is also irrelevant regarding the value of the firm.)

¹³ Ross, S., Westerfield, R., and Jaffe., (1999).

¹⁴ *ibid*, p.38.

¹⁵ *ibid*.

¹⁶ Similarly, the underlying assets cannot be debt or receivables.

¹⁷ The types of *shukūk*, as per the Shari'ah Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are 1) Certificates of ownership in leased assets, 2) Certificates of ownership of usufruct (a) of existing assets, b) of described future assets, 3) Certificates of ownership of services of a specified party, 4) Certificates of ownership of described future services, 5) *Salam* certificates, 6) *Istiṣnā'* certificates, 7) *Murābahah* certificates, 8) *Mushārahah* certificates, a) Participation certificates b) *Muḍārahah* *Shukūk* and c) Investment agency *Shukūk*, 9) *Muzārahah* (sharecropping) certificates 10) *Musāqah* (Irrigation) certificates, 11) and *Mughārasah* (agricultural) certificates.

Shari'ah Standard No 17, Investment *Shukūk*, page 295-313, Shari'ah Standards 1424H-May 2003, Accounting and Auditing Organization for Islamic Financial Institutions

¹⁸ The Water and Power Development Authority (WAPDA) is an autonomous Government monopoly in Hydel Power generation and distribution in Pakistan

¹⁹ Two comfort factors were provided to the *ṣukūk* issue. One was the guarantee provided to the issue by the Government of Pakistan. Secondly, the Financial Institutions were encouraged to invest in the *ṣukūk*, by making the *ṣukūk* investment as part of their Statutory Liquidity Requirement (SLR) .

²⁰ Such *Ijārah Ṣukūk* seem suitable for autonomous bodies and sovereigns because their own resources such as land or resources, which may be lying idle, buildings and machinery which may have almost no resale value out of site, in the case of WAPDA, are brought into use for a certain duration of time . These sales are not of a permanent nature but can be retrieved according to the contract at the end of the *ṣukūk* term (maturity). With the lease back arrangement these assets can be used by the principal originator, such as WAPDA in our example.

²¹ even if they are *Ijārah ṣukūk*

²² Furthermore, it also has the ability to make an economy stronger in terms of GDP /output /value addition, while increasing the employment level in an economy.

²³ The legal contracts' design (structuring) helps safeguard the rights and interests of the concerned parties. An advantage to the buyers and sellers/issuers in these transactions lie in the fact that most of them are big institutional investors and they eventually benefit from each other in the process, making strategic moves.

²⁴ Mirakhor, A., (2001)

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Enhancing The Role of *Ṣukūk* on Agriculture Sector Financing in Indonesia: Proposed Models

*Irfan Syauqi Beik** and *Didin Hafidhuddin***

ABSTRACT

Agriculture sector has a strategic and important position in Indonesia's economy. Central Bureau of Statistics of Indonesia (2006) reported that around 44% of labour force is working in agriculture sector. The land area used for agriculture is about 71.33% of the total land in the country. However, contribution of this sector towards national GDP is still small, which stands at a level of 13.4%. One of the basic problems faced by this sector is availability of credit (financing). Therefore, integration between Islamic capital market and agriculture sector is highly needed. This paper attempts to develop financing schemes based on ṣukūk that can be used for agriculture development. The paper proposes salam ṣukūk models and ṣukūk based on muḍārabah bil Istiṣnā' model that can be used to finance both small-scale and large-scale agriculture. However, a comprehensive set of regulations and policy support package is required.

1. INTRODUCTION

Islamic financial industry has been showing tremendous development for the last three decades. One of the innovative class of products that have recently been introduced is *ṣukūk*. Sometimes it is also referred to as Islamic bond or Islamic investment certificate.

We have witnessed the growing *ṣukūk* investment opportunities in many Muslim countries, although until recently most of trading in *ṣukūk* was largely confined to Kuala Lumpur, Malaysia. Prospect for *ṣukūk* market at global level are bright and it is predicted to grow further with more issues. According to one estimate, by end 2007 close to US\$ 12-15 billion of *ṣukūk* would be outstanding, and by 2008 approximately US\$ 30 billion of *ṣukūk* will be outstanding (Alvi, 2006). It is expected that through this fast growth of *ṣukūk*, Islamic capital market can be developed further and can eventually compete with its conventional counterpart.

Indonesia, being the most populous Muslim country in the world, is posturing to take part in the development of Islamic capital market and the new opportunities offered by *ṣukūk* products. Ministry of Finance has taken important action by proposing draft of *Ṣukūk* Act this year, which is believed to accelerate development of *ṣukūk* instruments as well as Islamic capital market in the country. It is also expected that *ṣukūk* can become one of the gates for investment opportunity in Indonesia as this country needs more investment, especially real sector investment, to overcome the perennial problems of unemployment and poverty. Hence, integrating capital market and the real sector development is in the interest of this nation.

This paper discusses the importance of integrating Islamic capital market with one of the most important sectors in Indonesia's economy, namely the agriculture sector, through *ṣukūk* instruments. Innovation of *ṣukūk*-based financing schemes for agriculture sector are highly needed. We propose here several models of it that can be implemented.

The paper consists of five sections, which includes introduction as the first section. Section two gives an overview of the agriculture sector and Indonesia's economy defining the nature of problem at hand. Section three proposes some models of *ṣukūk*-based agriculture financing as a solution, followed by section four which discusses the importance of regulation and policy support for the success of the proposal. Conclusions are provided in the last section.

2. OVERVIEW ON AGRICULTURE SECTOR AND INDONESIA'S ECONOMY

Agriculture sector has played and continues to play a very important role in Indonesia's economy. It is the largest absorber of the two main economic resources of the country – labour and land.

In terms of number of labour force working in the agriculture sector. The Central Bureau of Statistic of Republic of Indonesia (2006) reported that there about 95 million of Indonesians that are categorized as workforce. Out of this number, there is approximately 41.8 million working in agriculture sector. The definition of agriculture includes farming, forestry, hunting, fisheries, and animal husbandry. This sector accounts for 44% of the total national workforce. Furthermore, 18.9 million people, or 20%, are working in the sectors that include trade, retail, hotels and restaurants; and 11.6 million people are working in the processing industries.¹ These figures indicate that majority of Indonesian workers are adsorbed by the agriculture sector.

In terms of the size of land that is used by agriculture sector, it is reported by Central Bureau of Statistics, that 71.33% of the country's total land is used by agriculture sector. This is in its widest meaning and definition, which include: various types of gardening, crop growing industries, and so on.

These two indicators of labour and land, whether in terms of number of workers and land area or in terms of their percentage in the total, provides a strong argument that the development of agriculture is a strategic choice and must be given first priority in the country's national development. This means that Indonesia's development must be based on agriculture development since its success will significantly affect prosperity level of majority of the people.

Although agriculture adsorbs most of the labour and uses most of the land, its contribution towards Indonesia's GDP (Gross Domestic Product) is still small. In the year 2005 for instance, total GDP at constant prices was around Rp 1749.5 trillion.² Agriculture sector contributes only Rp 254.9 trillion or equal to 13.4% of total GDP. The sector that has biggest contribution towards GDP is non-oil and gas industries, which accounts for 23% of the GDP.³ Sub-sectors of food, drink, and tobacco processing industries are among the most important sectors other than oil and gas industries. They contribute 6.25% of total GDP.⁴ These sub-sectors are strongly related with agriculture since they use inputs which are produced by agriculture sector. If they are added to the agriculture contribution towards GDP, the total percentage will be 20% which is still less than the number of labour used in agriculture (that reaches 44%).

Agriculture basically has a wide dimension. According to the business scale dimension, this sector can be divided into two parts. First one is small scale agriculture, which is run normally by small farmers having no sufficient working capital, and the second one is medium and large scale agriculture, which is owned and managed by medium and large scale companies (Hafidhuddin, 2007). This second category usually has sufficient working capital. Most of the labour working in agriculture, particularly in Indonesia, is adsorbed by the first category. They occupy small size of land which is inefficient.

One of the biggest problems faced by agriculture sector, particularly small scale agriculture that also includes horticulture, fisheries and animal husbandry, is access to financing sources and market including marketing. Financial resources are needed in order to boost production. These resources act as sources of working capital and investment.

History of agriculture development in Indonesia has recorded that credit is one of the main financing sources which has played important role. Since agriculture development was started in 1960s, credit schemes have been provided by the government and financial institutions as part of development package. This package has given many benefits particularly for those who are small scale farmers. Such schemes provide additional capital which farmers need to start producing. They can also lower their dependence on money lenders who always charge high interest rates which eventually burden farmers' life. Many farmers become trapped in continuous poverty due to this condition. However, credit availability that can be used to finance agriculture sector is still limited.

For the last seven years, total credit allocated to agriculture sector by all the national banks in Indonesia, was still lower than total credit to other sectors such as trade, industries, and services. The average percentage of agriculture credit has ranged from 7.92% (2001) to 5.40% (March, 2007) from the whole credit allocation. Overall, it still less than 8%. The following table, perhaps, gives a more clearer picture of the situation.

Table 6.1 Credit Allocation of National Banking based on Economic Sectors 2001-2007

<i>SECTOR</i>	<i>Credit Allocation (in percentage)</i>						
	2001	2002	2003	2004	2005	2006	2007**
Agriculture	7.92	6.11	5.55	5.85	5.32	5.72	5.40
Mining	2.82	1.67	1.16	1.40	1.14	1.77	1.97
Industry	44.23	33.12	28.11	25.94	24.60	23.18	22.93
Trade	18.39	18.06	19.24	20.06	19.45	20.63	20.93
Services	1.86	16.69	20.35	19.48	19.57	20.03	11.56
Others	24.77	24.35	25.59	27.27	29.93	28.68	37.21
	100	100	100	100	100	100	100
TOTAL*	263,434	365,410	437,943	553,549	689,670	787,136	800.373

*Billion Indonesia's Rupiah

**As of March, 2007

Source: Annual Report of Bank Indonesia, 2001-2007

One of the main factors affecting this low rate of agriculture credit (financing) lies in the perception of most of bankers who consider agriculture as a high risk business. This perception needs to be corrected. Empirical evidence has shown that it was only agriculture that had positive growth during economic crisis which took place in 1997-1998. During that time, economic growth declined significantly from 4.7% in 1997 to -12% in 1998/1999. However, agriculture still grew by 0.38%.⁵

Therefore, the most effective way to promote higher productivity of agriculture sector is through granting the farmers more access to financing sources. However, conventional financing may face difficulties in assisting them. It is because in Indonesia, BI rate (Bank Indonesia rate) is greater than interest rate paid to the depositors. This has happened in recent years. Theoretically speaking, BI rate should have the lowest rate, smaller than the interest rate paid to depositors.

This condition encourages conventional banks and other conventional financial institutions to allocate its fund more on the purchase of government bonds, instead of allocating it to the real sector which includes agriculture. By purchasing government bond, they can earn interest-based income and at the same time they

are able to guarantee return to the depositors' money. Bank's profit is, therefore, also guaranteed.

Hence, the best solution is by increasing participation of Islamic banking and other Islamic financial institutions in financing agriculture sector. Islamic capital market should be integrated since this market has the potential to mobilize huge funds that can support agriculture development. One promising instrument that can be used in this regard is *ṣukūk*. In Indonesia *Ṣukūk* have been approved by the verdict of the National Shari'ah Council of the Indonesian Council for '*Ulamā*' (MUI – Majelis '*Ulamā*' Indonesia). The most challenging thing is to make agricultural sector attractive to investors so that they are convinced and be able to invest their funds through this instrument.

Utilization of *ṣukūk* to raise funds for agriculture financing will indeed be an innovation in the history of agricultural development in the country. There are several factors that indicate promising prospects of using *ṣukūk* instrument. They are as follows:

- (1) Bright future prospect of macroeconomic growth which requires more investment, especially investment in the real sector. This will give wide opportunity for Islamic financial institutions to take part in offering various financings based on Islamic schemes. *Ṣukūk* are predicted to be an attractive class of instruments given the experience that many private sector companies' *ṣukūk* have been consistently oversubscribed.
- (2) Islamic financial institutions have big potential which can be matched with government policy supporting small scale and medium businesses development.
- (3) Growing awareness of the Islamic financial products worldwide including *ṣukūk*.
- (4) Strong belief that Islamic financial products in general and *ṣukūk* in particular, offer fairer mechanism.
- (5) The *Ṣukūk* Act is expected to be promulgated at the end of 2007 in Indonesia. This act shall give legal foundation for issuance of *ṣukūk*.

3. *ṢUKŪK*-BASED AGRICULTURE FINANCING: PROPOSED MODELS

As stated in the previous section, availability of financial resources is the main problem that needs to be solved. Integrating Islamic capital market into agricultural development through *ṣukūk* instrument is one of the most suitable solutions. This section proposes some realizable models of *ṣukūk* that can be implemented. Before these models are elaborated, this section tries to divide agriculture based on financing perspective.

According to Hafidhuddin (2007), agriculture is divided into two groups based on financing perspective. The first is small-scale agriculture, which has gross revenue of Rp 50 million or below per annum, while the second one is large-scale agriculture, which has gross revenue above Rp 50 million per annum⁶. The term medium-scale is not used since it is included in the large-scale agriculture. The reason is that the treatment to the farmers or agricultural companies that have more than Rp 50 million gross revenue are the same, while treatment for those having gross revenue of less than or equal to Rp 50 million is also the same (Hafidhuddin, 2007).

There are two models of *ṣukūk* discussed in this section, one model for each group. For small-scale agriculture, issuance of *salam ṣukūk* is proposed. That is, *ṣukūk* which are based on *salam* contract. While for large-scale agriculture, a model using *ṣukūk* based on *mudārabah bil Istiṣnāʿ* contract will be explored.

3.1. Issuance of Salam *Ṣukūk* Scheme

This model is based on *bayʿ al-salam* contract. *Bayʿ al-salam* is usually defined as a contract where two parties (seller or farmer and buyer) agree to conduct a sale/purchase of an underlying asset (in the present case, an agricultural product) at a predetermined future date but at a price determined and fully paid for today, as has been approved by the Prophet Muhammad SAW (in a *ḥadīth* reported by Bukhari). This transaction must be performed with the condition that all criteria and features of the product are clearly specified.

There are two types of *salam ṣukūk* that shall be elaborated in this part. The first deals with Indonesia's international trade while the second one deals with the country's domestic trade. Let us discuss each model in detail.

In the first model, the government of Indonesia establishes a special purpose vehicle (SPV), its main duty is to issue *salam ṣukūk* in the international market and to finance small-scale farmers by using the funds raised. This SPV can either be in the form of newly established state-owned company or the National Logistic Body (or Badan Urusan Logistik – Bulog) that is given the authority to perform this task. Before this SPV issues *salam ṣukūk*, it must convince other countries about the quality of the product offered.

Furthermore, the SPV issues *salam ṣukūk* and all interested foreign countries and or individual investors can purchase this *ṣukūk*. In this scheme, the purchased *ṣukūk* will not be reimbursed at maturity date. Instead, those investors will receive the products at the agreed future date. The funds raised are then invested by the SPV to finance small-scale farmers, and in return, will receive the products from them. Subsequently, these products will be delivered to the buyers; in this case, foreign countries and or individual investors. The following Figure 6.1 portrays this mechanism.

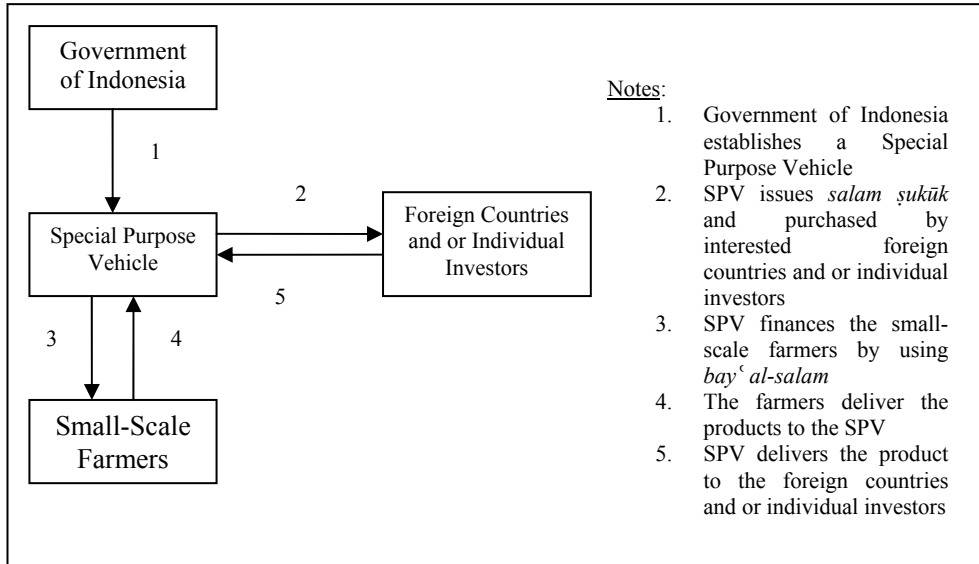


Figure 6.1 *Salam Ṣukūk* Scheme dealing with Indonesia’s International Trade

A question that may arise from this model is that how the SPV earns profit. There may be two possible answers in this matter. The first is it earns no profit. Since this SPV is established by the government and its main purpose is to open financing access for the small-scale farmers, the government may decide to bear all of its expenditure by allocating special budget. The second possible answer is that this SPV may take some portion of the fund earned as its income, so that it may be able to cover its expenditure. Eventually, the answer will highly depend on the government policy. The most important thing is that the farmers must get significant benefit from this scheme.

The second model deals with the country’s domestic trade. In this scheme, the issuer of *salam ṣukūk* are individual provinces and cities/districts that are agriculture producers, while the potential buyers are those provinces and cities/districts that are not agriculture producers but require the agriculture products to fulfil people’s need.

The provinces and cities/districts that have advantage in producing agricultural products (called producers), such as rice, corn, and tea, issue *salam ṣukūk* in the market. The provinces and cities/districts that need these products (called consumers) buy these *ṣukūk* and receive the product on the agreed future date.

The advantage of this scheme is that the producer can directly allocate the fund earned to the farmers. The farmers will be motivated since they have sufficient working capital. From the consumers' side, they get assurance that the products

they require will be delivered on the agreed date. Figure 6.2 below depicts this scheme.

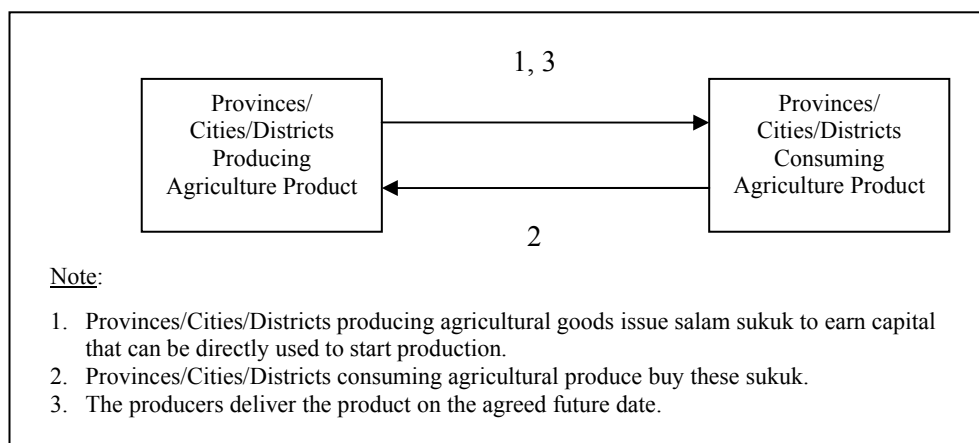


Figure 6.2 Salam *Şukūk* Scheme dealing with Indonesia's Domestic Trade

One of the issues that appears from this scheme is related with the role that can be played by local banks owned by provincial governments. Such banks can be appointed as the institutions who perform sale and purchase of *şukūk*.

3.2. Issuance of *Şukūk* based on *Muḍārabah bil Istiṣnā'* Contract

In this model, we shall not differentiate Indonesia's international trade and domestic trade since this model can be used either for domestic trade or for international trade or both directly. The scheme for both is the same and the *şukūk* buyers may be the local investors and or the foreign investors.

To start this model, the Government of Indonesia and/or an Islamic bank establishes an institution that acts as a special purpose vehicle (SPV) using *mushārahah* agreement. In this case, government cooperation with Islamic banks is not necessarily needed. It depends on the government policy whether or not the government includes Islamic bank in the scheme. It is assumed here that the government agrees to cooperate with Islamic bank in order to establish this SPV by using *mushārahah* agreement.

This SPV furthermore issues *muḍārabah şukūk* which is then bought by interested investors. After receiving the funds, the SPV allocates this fund to the agriculture-producing companies or large-scale farmers. In this case, the SPV uses *Istiṣnā'* contract. *Istiṣnā'* is basically a contract of sale and purchase where buyer (called *mustasn'i*) orders seller (called *sāni*) to produce certain product that has

specific criteria and requirement. It is actually a special case of *bay' al-salam* and it was initially discussed in the literature by Hanafī School. Islamic insurance can also be asked to be the guarantor of this financing.

After receiving the product, the SPV will sell it either to domestic market or export it or both. The profit earned will be distributed to *ṣukūk* holders according to the agreed ratio. At maturity date, certificates of *ṣukūk* holders will be reimbursed. The profit that becomes the part of SPV will be divided by the government and Islamic bank based on certain ratio that has been agreed in the beginning of this cooperation. Figure 6.3 below depicts this scheme.

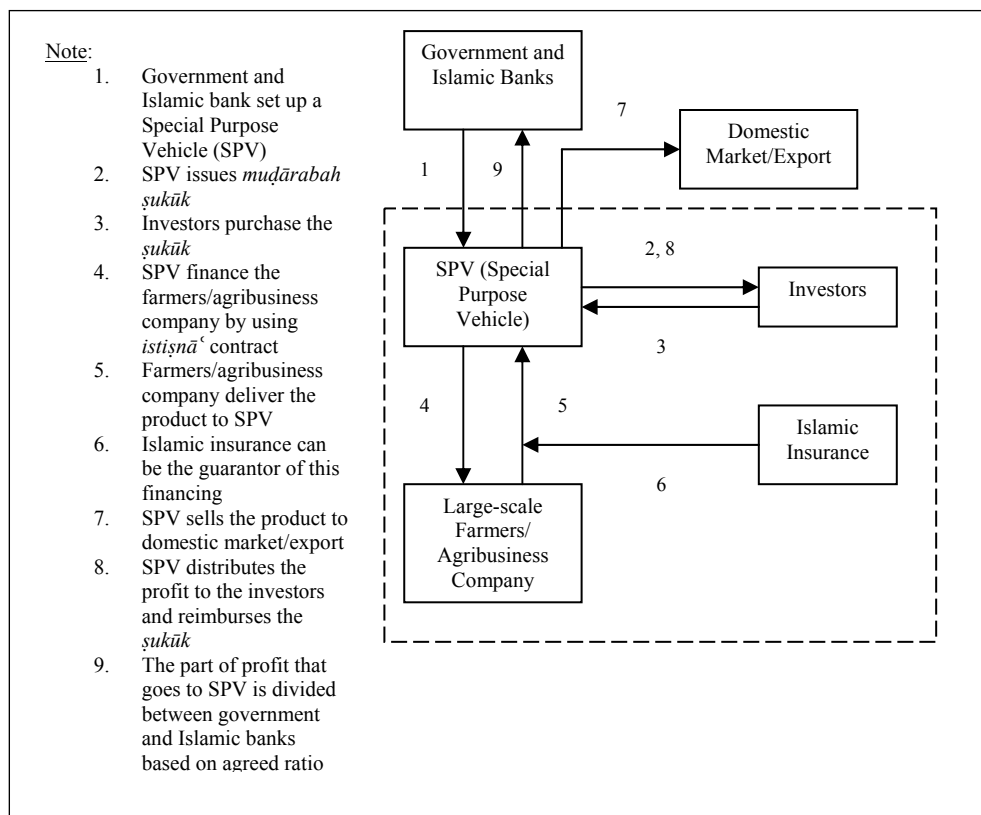


Figure 6.3 *Ṣukūk* based on *Muḍārabah bil Istiṣnā'*

4. REGULATION AND POLICY SUPPORT

One of the basic problems faced by Islamic financial industry in Indonesia is regulation and policy support. Islamic Banking Act and *Ṣukūk* Act are the drafts which are still discussed by the government and the House of the Representatives. It is expected that at the end of 2007, these Acts will be legislated and implemented. The importance of both acts has become an urgent need that can not be delayed anymore.

There are some other challenges that require full attention and commitment from the government and the parliament. The first one is related with infrastructure of Islamic financial industry. It is to be noted that Islamic financial transactions are fundamentally different compared to their conventional counterparts. All transactions in Islamic finance are based on real sector activity, while the same feature does not prevail in conventional finance. Hence, it requires relatively different treatment though both Islamic and conventional finance have similarities.

The second challenge is related to taxation policy. In the current taxation system and policy, the problem of double taxation exists and it becomes an obstacle that restrains development of Islamic financial industry in the country. This double tax occurs in two aspects. The first is tax on transaction and the second one is tax on transfer of ownership document. Therefore, it is in the interest of all stakeholders of Islamic financial industry to revise this taxation policy.

The third challenge is how to synchronize all rules and regulations that are related with establishment of special purpose vehicle (SPV) and issuance of *ṣukūk*. There are some other rules that need to be synergized. These rules are Law No. 19/2003 which states that establishment of company which involves state asset must be under the Ministry of State-Owned Companies, Law No 1/1985 which regulates establishment of limited companies, and other rules such as rental period for asset owned by the state which is only for a maximum of 5 years, and transfer process of state asset worth more than Rp 100 billion that requires approval from the House of the Representatives. These laws affect issuance of *Ṣukūk*, particularly State *Ṣukūk*.

The fourth challenge is related to availability of human resources with good knowledge and training in Islamic economics, banking and finance. Therefore, in order to successfully overcome these challenges, integrated and comprehensive regulation and policy supports are highly needed.

5. CONCLUSION

It is an undeniable fact that agricultural sector has played a very important role in economic development of Indonesia. This sector adsorbs most of the country's workforce (44%) and occupies most of the land available (71.33%). These are convincing indicators proving the importance of agriculture in Indonesia. However, agriculture contribution towards GDP is still standing at 13.4%.

Availability of credit (financing) for agriculture sector has become one of the main problems that need to be solved. For the last seven years, credit allocation of national banking industry towards this sector is still less than 8%. Integrating Islamic capital market with this sector can be one of the most suitable solutions since this market has the potential to mobilize the funds needed.

This paper has proposed some models that show this integration. The instrument which is used in this regard is *ṣukūk*. For small-scale agriculture, which

has gross revenue of Rp 50 million or below, this paper proposes two models that are related with both domestic and international trade. Those models are basically *salam*-based *ṣukūk*. Meanwhile, for large-scale agriculture having gross revenue of more than Rp 50 million, this paper has proposed issuance of *ṣukūk* based on *muḍārabah bil Istiṣnā*^c contracts. If these models can be realized, it will be a milestone for the agricultural development taking place in this populous Muslim country.

To realize this aspiration, synchronization and synergy of all rules and regulations are undoubtedly required. With a comprehensive policy package, which includes legislation of Islamic Banking Act and *Ṣukūk* Act, it is expected that integration process between Islamic capital market and agriculture sector in Indonesia will run smoothly. Therefore, government's commitment is highly needed.

Notes

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¹ Central Bureau of Statistic of Indonesia, 2006

² Central Bureau of Statistic, 2006

³ Ibid.

⁴ Ibid.

⁵ Central Bureau of Statistic, 1999

⁶ It is assumed that USD 1 is equal to Rp 9,000. Hence, Rp 50 million is equal to USD 5,555.55.

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[7]

Derivatives in Islamic Finance

*Andreas A. Jobst**

ABSTRACT

Despite their importance for financial sector development, derivatives are few and far between in countries where the compatibility of capital market transactions with Islamic law requires the development of Shari'ah-compliant structures. Islamic finance is governed by the Shari'ah, which bans speculation, but stipulates that income must be derived as profits from shared business risk rather than interest or guaranteed return. This paper explains the fundamental legal principles of Islamic finance, which includes the presentation of a valuation model that helps illustrate the Shari'ah-compliant synthetication of conventional finance through an implicit derivative arrangement. Based on the current use of accepted risk transfer mechanisms in Islamic structured finance, the paper explores the validity of derivatives from an Islamic legal point of view and summarizes the key objections of Shari'ah scholars that challenge the permissibility of derivatives under Islamic law. In conclusion, the paper delivers suggestions for Shari'ah compliance of derivatives.

1. INTRODUCTION

Financial globalization facilitates greater diversification of investment and enables risk to be transferred across national financial systems through derivatives. The resulting improvement in allocation of risks has made overall capital markets more efficient, while the availability of derivatives has increased liquidity in the underlying cash markets. Amid a compressed spread environment, lower risk premium have also encouraged investors to seek higher yields from emerging market assets as alternative investment. With increasingly market-determined emerging market interest rates and currencies, extension of emerging market yield curves, rapidly growing volume of international trade and capital flows, and increasing stock market activity, the local and foreign interest in emerging derivative markets is growing rapidly.

The development of derivative markets in emerging markets plays a special role in this context as more institutional money is dedicated to emerging markets, which requires the availability of financial instruments to manage market, credit and interest rate risks in largely underdeveloped local capital markets. Derivatives in general are financial contracts whose inherent value derives from, and exists by reference to, a pre-determined payoff structure of securities, interest rates, commodities, credit risk, foreign exchange or any other tradable assets, indices thereof and/or baskets of any combination of the above with varied maturities. Derivatives assume economic gains from both risk shifting and efficient price discovery by providing hedging and low-cost arbitrage opportunities.

While documentation standards and market practices that govern conventional derivative transactions in mature markets have reached a point of uniform application, derivative markets are still poorly developed in many emerging market countries due to the absence of enabling legal provisions and accounting standards specific to the trading and enforcement of derivative claims have inhibited a maturing of derivative markets.

Despite their importance for financial sector development, derivatives are few and far between in countries where the compatibility of capital market transactions with Islamic law requires the development of Sharī'ah-compliant structures. Islamic finance is governed by the Sharī'ah, which bans interest, short selling and speculation, and stipulates that income must be derived as profits from shared business risk rather than guaranteed return. Notwithstanding these religious constraints and legal uncertainty surrounding the enforceability of investor interest under Islamic jurisprudence, Islamic finance can synthesize close equivalents to equity, mortgages, and derivatives known in conventional finance. To this end, it relies on structural arrangements of asset transfer between borrowers and lenders to emulate traditional interest-bearing financial contracts.

This paper explains the fundamental legal principles of Islamic finance, which includes the presentation of a valuation model that helps illustrate the Sharī'ah-compliant synthetication of conventional finance through an implicit derivative arrangement. Based on the current use of accepted risk transfer mechanisms in Islamic structured finance, the paper explores the validity of derivatives from an Islamic legal point of view and evaluates key objections of Sharī'ah scholars challenging the permissibility of derivatives under Islamic law. In conclusion, the paper delivers suggestions for Sharī'ah compliance of derivatives.

2. THE TYPES OF ISLAMIC FINANCE

Islamic finance substitutes the costly temporary use of assets for a permanent transfer of funds as a source of borrower indebtedness. While interest payments in conventional finance represent the contractible cost for funds tied to the amount of principal over a pre-specified lending period, the central tenet of the Islamic financial system is the prohibition of *ribā*, which applies to any unlawful capital

gain derived from the quantitative inequality of the counter values of exchange or sales contracts.^{1,2} *Ribā* is generally classified into unlawful advantage by way of excess (*ribā al-faḍl*) and deferment (*ribā al-nasia*) respectively.³ Islamic law derives from (i) the Shari‘ah (or Shari‘ah), which comprises the Qur’ān and the sayings and actions of the prophet *Mohammed*, and (ii) the *fiqh*, which represents Islamic jurisprudence based on a body of laws deduced from the Shari‘ah by Islamic scholars. The Shari‘ah is frequently characterized as Islamic religious law, which is binding upon Muslims as a matter of religious mandate and also may be incorporated into the secular law of a given jurisdiction (Jobst, 2007b and 2007d).

Since only interest-free forms of finance are considered permissible in Islamic finance, financial relationships between financiers and borrowers are not governed by capital-based investment gains but shared business risk (and returns) in lawful activities (*ḥalāl*). Any financial transaction under Islamic law implies *direct participation in asset performance*, which constitutes entrepreneurial investment that assigns to financiers clearly identifiable rights and obligations for which they are entitled to receive commensurate return in the form of state-contingent payments according to an agreed schedule and amount relative to asset performance.⁴ The Shari‘ah does not object to payment for the use of an asset as long as both lender and borrower share the investment risk together and profits are not guaranteed *ex ante* but accrue only if the investment itself yields income.

In light of moral impediments to “passive” investment and secured interest as form of compensation, Shari‘ah-compliant lending requires the replication of interest-bearing conventional finance via more complex structural arrangements of contingent claims subject to the intent to create of an equitable system of distributive justice and promote permitted activities (*ḥalāl*) and public goods (*maṣlahah*). The permissibility of risky capital investment without explicit interest earning has spawned three basic forms of Islamic financing for both investment and trade: (i) synthetic loans (*debt-based*) through a sale-repurchase agreement or back-to-back sale of borrower or third party-held assets, (ii) lease contracts (*asset-based*) through a sale-leaseback agreement (operating lease) or the lease of third-party acquired assets with purchase obligation components (financing lease), and (iii) profit-sharing contracts (*equity-based*) of future assets. As opposed to equity-based contracts, both debt- and asset-based contracts are initiated by a temporary transfer of existing assets from the borrower to the lender or the acquisition of third-party assets by the lender on behalf of the borrower.⁵

“*Islamic loans*” create borrower indebtedness from the purchase and resale of an (existing or future) asset in lieu of interest payments. The most prominent form of such a “debt-based” structural arrangement is the *murābahah* (or *murābahah*) (“cost-plus sale”) contract. Interest payments are implicit in an instalment sale with instantaneous (or deferred) title transfer for the promised payment of an agreed sales price in the future.⁶ The purchase price of the underlying asset effectively limits the degree of debt creation. A *murābahah* contract either involves (i) the

sale-repurchase agreement of a borrower-held asset (“negative short sale”) or (ii) the lender’s purchase of a tangible asset from a third party on behalf of the borrower (“back-to-back sale”), which the borrower sells on to a third party to obtain funding.⁷ The resale price is based on original cost plus a pre-specified profit mark-up imposed by the lender so that the borrower’s future repurchase of the underlying asset or the sale of the asset to a third party to raise funds at the spot price involves a loss commensurate to the lender’s profit (“loss-generating contract”).

Different instalment rates as well as delayed repayment and asset-delivery schedules for “back-to-back sales” and “negative short sales” respectively create variations to the standard *murābahah* contract. The most prominent examples are *salam* (deferred delivery sale), *bayʿ bithaman ājil* (BBA) (deferred payment sale), *istiṣnāʿ* (or *istisna*, *istisnaʿa*) (purchase order), *qard al-ḥasan* (benevolent loan), and *musawama* (negotiable sale). As opposed to the concurrent purchase and delivery of an asset in *murābahah*, asset purchases under a *salam*⁸ or a *bayʿ bithaman ājil*⁹ contract allow deferred delivery or payment of *existing* assets. *Salam* closely synthesizes a conventional futures contract and is sometimes also considered an independent asset class outside the asset spectrum of *murābahah* (Batchvarov and Gakwaya, 2006). An *istiṣnāʿ* contract provides pre-delivery (project) finance for *future* assets, such as long-term projects, which the borrower promises to complete over the term of the lending agreement according to contractual specifications. A *qard al-ḥasan* signifies an interest-free loan contract that is usually collateralized. Finally, a *musawama* contract represents a negotiable sale, where the profit margin is hidden from the buyer.¹⁰

Analogous to conventional operating and finance leases, *al-ijārah* leasing notes¹¹ (“asset-based”) provide credit in return for rental payments¹² over the term of the temporary use of an (existing) asset, conditional on the future re-purchase of the assets by the borrower.¹³ The lease cash flow is the primary component of debt service. The lessor (i.e., financier) acquires the asset either from the borrower¹⁴ (*operating lease* or “sale-leaseback”/“lease-buyback”) or a third party at the request of the borrower (*financing lease* or “lease-purchase”) and leases it to the borrower (or a third party) for an agreed sum of rental payable in instalments according to an agreed schedule. The legal title of the asset remains with the financier for the duration of the transaction. The financier bears all the costs associated with the ownership of the asset, whereas the costs from the use of the asset have to be defrayed by the lessee.^{15, 16} If the *ijārah* transaction is a financing lease (*ijārah wa iqtināʿ*), such as an *Islamic mortgage*, the repayment through lease payments might also include a portion of the agreed resale price (in the form of a call option premium), which allows borrowers to gradually acquire total equity ownership for a pre-determined sales price.¹⁷ If the lessee does not exercise the call option at maturity, the lender disposes of it in order to realize the salvage value (put option).¹⁸ In an operating lease, the asset is returned to the borrower for the original sale price or the negotiated market price¹⁹ unless otherwise agreed.²⁰ In this case,

the lender's put option represents a repurchase obligation²¹ by the borrower (at the current value of outstanding payments), which is triggered upon certain conditions, such as delinquent payments or outright default.

In Islamic *profit-sharing contracts* (equity-based), lenders (i.e., investors) and borrowers (i.e., entrepreneurs) agree to share any gains of profitable projects based on the degree of funding or ownership of the asset by each party. In a trustee-type *mudāraba* (or *mudārabah*) financing contract, the financier (*rabb al māl*) provides all capital to fund an investment, which is exclusively managed by the entrepreneur (*mudārib*) in accordance with agreed business objectives. The borrower shares equity ownership with the financier (i.e., a call option on the reference assets) and might promise to buy-out the investor after completion of the project. At the end of the financing period, the entrepreneur repays the original amount of borrowed funds only if the investment was sufficiently profitable. Profits are distributed according to a pre-agreed rate between the two parties. Investors are not entitled to a guaranteed payment and bear all losses unless they have occurred due to misconduct, negligence, or violation of the conditions mutually agreed by both financier and entrepreneur.²² The equity participation and loss sharing in a *mushāraka* (or *mushārah/musyārah*) contract is similar to a joint venture, where both lender/investor and borrower (or asset manager/agent) jointly contribute funds to an existing or future project, either in form of capital or in kind, and ownership is shared according to each party's financial contribution. Although profit sharing is similar to a *mudārabah* contract, losses are generally borne according to equity participation.

Overall, the different basic types of Islamic finance combine two or more contingent claims to replicate the risk-return trade-off of conventional lending contracts or equity investment *without* contractual guarantees of investment return or secured payments in reference to an interest rate as time-dependent cost of funds. Such arrangements may become complicated in practice, once they are combined to meet specific investor requirements under Islamic law (El-Qorchi, 2005).

3. “IMPLICIT DERIVATIVES”: IDENTIFICATION AND EVALUATION

3.1 Islamic Finance and Put-Call Parity

From an economic point of view, “creditor-in-possession”-based lending arrangements of Islamic finance replicate interest income of conventional lending transactions in a religiously acceptable manner. The concept of *put-call parity*²³ illustrates that the three main types of Islamic finance represent different ways to re-characterize conventional interest through the attribution of economic benefits from the (temporary) use and original ownership of an existing or future (contractible) asset (see Figure 7.1).

In *asset-based* Islamic finance for investment or trade, the borrower leases from the lender one or more assets A valued at S , which have previously been acquired

from either the borrower or a third party. The lender entitles the borrower to (re-)gain ownership of A at time T by writing a call option $-C(E)$ with time-invariant²⁴ strike price E subject to the promise of full repayment of E (via a put option $+P(E)$) plus an agreed premium in the form of rental payments over the investment period. This arrangement amounts a *secured* loan with *fully collateralized* principal (i.e. full recourse). The present value of the lender's *ex ante* position at maturity is $L_1 = S - C(E) + P(E) = PV(E)$,²⁵ which equals the present value of the principal amount and interest of a conventional loan.

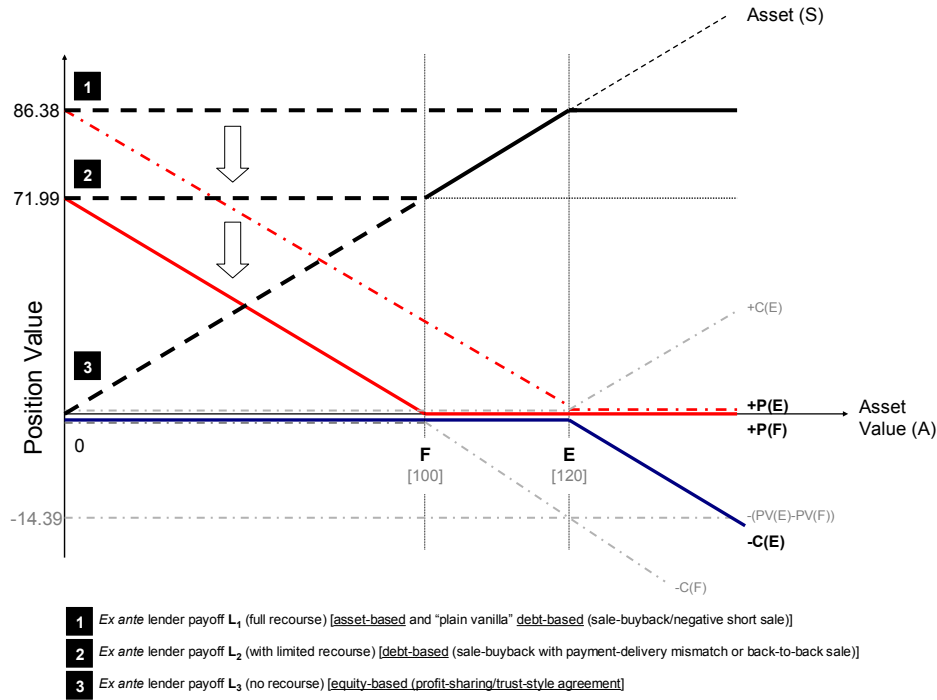


Figure 7.1 Pay-off Profile of all Three Basic Forms of Islamic Finance

In a more realistic depiction, the combination of a put and call option on the same strike price represents a *series of individual (and periodically extendible) forward contracts* on asset value S over a sequence of rental payment dates t , so that

$$L'_1 = S_T - \left(\frac{\sum_{t=1}^{T-1} C_{t,t+1}(E) - \sum_{t=1}^{T-1} P_{t,t+1}(E)}{\prod_{t=1}^T [(1+r_f)(1+\lambda)]^t} \right) = \underbrace{E [(1+r_f)(1+\lambda)]^{-T}}_{PV(E)}, \quad (1)$$

where r_f and λ denote the risk-free interest rate analogue and the market price of risk²⁶ implicit in the pre-specified repayment of the lending transaction. Overall,

the put-call arrangement of *asset-based Islamic lending implies a series of cash-neutral, risk-free (forward) hedges of credit exposure*. Since poor transparency of S in long-dated contracts could make the time value of $+P(E)$ appear greater than its intrinsic value, long-term Islamic lending with limited information disclosure would require a high repayment frequency to ensure efficient investor recourse. In *debt-based* Islamic finance, borrower indebtedness from a sale-repurchase agreement (“cost-plus sale”) of an asset with current value $PV(E)$ implies a premium payment to the lender for the use of funds over the investment period T and the same investor pay-off L_1 as asset-based Islamic finance.²⁷

However, some debt-based financing, such as *salam* or *istiṣnāʿ* imply counterparty and market risks from non-performance and/or lost recovery value due to delayed investor recourse. If we assume that these contingency risks would translate into a mismatch of strike prices F and E , premium payments in a *salam* contract could increase by $+(C(F)-C(E))$ in present value terms, while the put option value of investor recourse on some future asset in an *istiṣnāʿ* contract with deferred delivery may shed $-(P(F)-P(E))$. Hence, in the latter case, the reduced present value of repayment (or collateralization) for the desired funding limits the *ex ante* lender payoff to

$$L_2 = S - C(F) + P(E) = PV(E) - (PV(E) - PV(F)) + C(F) - C(E) \quad (2)$$

while a higher contingent claim of borrowers on the (re)purchase of the asset in the former case results in

$$L_2 = S - C(F) + P(E) = PV(E) - C(F) + C(E) \quad (3)$$

In Islamic profit-sharing (*equity-based*) agreements, the lender receives a payout in accordance with a pre-agreed disbursement ratio only if the investment project generates enough profits to repay the initial investment amount and the premium payment at maturity T . Since the lender bears all losses, this equity-based arrangement precludes any recourse in the amount $+P(E)$ in absence of enforceable collateral. In the simplest case, the discrete form *ex ante* payoff of an investor with 100% equity interest would be

$$L_3 = S_T - \frac{\sum_{t=1}^{T-1} C_{t,t+1}(E)}{\prod_{t=1}^T ((1+r_f)(1+\lambda))^t} = \underbrace{E \left(\frac{1}{((1+r_f)(1+\lambda))^T} \right)}_{PV(E)} - \frac{\sum_{t=1}^{T-1} P_{t,t+1}(E)}{\prod_{t=1}^T ((1+r_f)(1+\lambda))^t} \quad (4)$$

The lender pay-off L_1'' from a “rent-to-buy” asset-based financing lease, which is particularly prominent in Islamic mortgage finance, is similar to pay-off L_3 above. In such contracts, borrowers gradually acquire all of the equity interest S as part of their periodic rental payments while renting the portion of the asset the lender still owns. Therefore, the strike price E of a sequence of individual put-call based forward contracts declines over time as the partial equity ownership of

borrowers increases until they eventually acquire the underlying asset at maturity T , so that

$$L_1'' = S_T - \left(\frac{\sum_{t=1}^{T-1} C_{t,t+1} \left(E - t \frac{E}{T} \right) - \sum_{t=1}^{T-1} P_{t,t+1} \left(E - t \frac{E}{T} \right)}{\prod_{t=1}^T \left((1+r_f)(1+\lambda) \right)^t} \right) \quad (5)$$

$$= \underbrace{E \left((1+r_f)(1+\lambda) \right)^{-T}}_{PV(E)} - \frac{\sum_{t=1}^{T-1} P_{t,t+1} \left(t \frac{E}{T} \right)}{\prod_{t=1}^T \left((1+r_f)(1+\lambda) \right)^t}.$$

3.2 Application of the Black-Scholes-Merton (BSM) Framework

The representation of lender payoffs under put-call parity permits the identification and exact valuation of all constituent components of Islamic finance contracts as balance sheet identities within the standard Black-Scholes-Merton (BSM) framework of capital structure-based *option pricing theory* (OPT) (Black and Scholes, 1973; Merton, 1973 and 1974). In the following section, we show how to derive the fair market price of Islamic lending transactions if the underlying collateral conforms to a lognormal asset process.²⁸ In particular, this approach allows us to characterize the implicit interest rate of Islamic lending as a result of the premium payments (i.e., periodic rental or lease payments) received by the lender in return for the call position on assets held by the borrower in Islamic finance.

According to Merton's reduced-form model, a firm's outstanding liabilities constitute a bankruptcy level ("default threshold"). Owners of corporate equity in leveraged firms hold a call option on the firm value after outstanding liabilities have been paid off. They also have the option to default if their firm's asset value ("reference asset") falls below the present value of the notional amount of outstanding debt ("strike price") owed to bondholders at maturity. So, corporate bond holders effectively write a European put option to equity owners, who hold a residual claim on the firm's asset value in non-default states of the world. Bond holders receive a put option premium in the form of a credit spread above the risk-free rate in return for holding risky corporate debt due to the limited liability of equity owners. The value of the put option is determined by the duration of debt claim, the leverage of the firm, and asset-price volatility.

The BSM approach assumes that the firm's debt consists of a zero-coupon bond B with a notional value F and a maturity term of T periods. The firm's outstanding liabilities constitute the bankruptcy level, whose standard normal density defines the "distance to default" relative to the firm value. This capital-structure-based evaluation of contingent claims on firm performance under the risk neutral measure implies that a firm defaults if its asset value is insufficient to meet the amount of

debt owed to bondholders at maturity. Conversely, if the “distance to default” is positive, and the asset value of the firm exceeds the bankruptcy level, the call option held by equity holders on firm value has intrinsic value (in addition to its time value until the maturity of debt). The same logic can be readily applied to pricing singular Islamic finance transactions.

The BSM model assumes that market price S of the underlying asset evolves following the stochastic differential equation of asset price dynamics

$$dS_t/S_t = r_s dt + \sigma dW_t \quad (6)$$

with drift r_s and diffusion defined by a standard *geometric Brownian motion* (GBM) $\Delta W_t \sim \varphi(0, \Delta t)$ with Wiener process $z \sim \varphi(0, \sigma)$ of instantaneous asset value change. After application of Ito’s Lemma, the discrete form analogue of equation (4) for initial value S_0 can be written as a lognormal asset process

$$\ln S_t - \ln S_0 \sim \phi \left[\ln S + \left(r_s - \sigma_s^2 / 2 \right) t; \sigma_s^2 \sqrt{t} \right], \quad (7)$$

where $\phi(\cdot)$ is the standard normal density function. (7) defines the physical probability distribution of the end-of-period value S_T ,

$$S_T \sim S_0 \exp \left\{ \left(r_s + \sigma_s^2 / 2 \right) T + \sigma_s \sqrt{T} z \right\}, \quad (8)$$

based on

$$S_t = S_0 \exp \left\{ \left(r_s + \sigma_s^2 / 2 \right) t + \sigma W_t \right\}. \quad (9)$$

Analogous to firm leverage $d = De^{-rt}/V$ as the ratio of the discounted face value of outstanding debt D and the asset value V of the firm in the original BSM, we define the default barrier as the ratio $b = Ee^{-r_f t}/S$ of the future repayment amount E , discounted at the risk-free rate of return r_f , and asset value S .²⁹ Hence, the expected (*physical*) probability of default (or *expected default frequency* (EDF)) $P_t = \Pr(S \leq Ee^{-r_f t}) \approx \Pr(\ln S \leq \ln Ee^{-r_f t})$ at time t is defined as

$$\begin{aligned} P_t &= \Phi \left(\left(\ln Ee^{-r_f t} - \left(\ln S_t - \left(r_s - r_{div} + \sigma_s^2 / 2 \right) t \right) \right) / \sigma_s \sqrt{t} \right) \\ &= \Phi \left(\left(\ln b + \left(r_s - r_{div} + \sigma_s^2 / 2 \right) t \right) / \sigma_s \sqrt{t} \right) \equiv \Phi(-d_1) = 1 - \Phi(d_1), \end{aligned} \quad (10)$$

with an internal rate of return r_{div} (“dividend yield”), the standard normal cumulative distribution function $\Phi(\cdot)$, and the *distance to default* (DD) measure

$$\begin{aligned}
d_1 &\equiv \left(\ln \left(S_t / E e^{-r_f t} \right) + \left(r_S - r_{div} + \sigma_S^2 / 2 \right) t \right) / \sigma \sqrt{t} \\
&= \left(\ln(-b) + \left(r_S - r_{div} + \sigma_S^2 / 2 \right) t \right) / \sigma \sqrt{t},
\end{aligned} \tag{11}$$

whose probability density $\Phi(d_1) = 1 - P_t = \Pr(S > E e^{-r_f t}) \approx \Pr(\ln S > \ln E e^{-r_f t})$ defines the “survival probability”.

We expand equations (10) and (11) under the risk-neutral measure to take into account the asset-specific spread $\mu_S - r_f$ for the market price of risk (and asset volatility σ_S) in addition to the continuous time risk-neutral return r_f , which compensates for expected default. Thus, the *risk-neutral* probability of default (RNPd) is

$$\begin{aligned}
P_t^Q &= 1 - \Phi \left(\Phi^{-1}(\Phi(-d_1)) + (\mu_S - r_f) \sqrt{t} / \sigma_S \right) \\
&= \Phi \left(- \left(\Phi^{-1}(\Phi(-d_1)) + (\mu_S - r_f) \sqrt{t} / \sigma_S \right) \right) = \Phi(-d_1'),
\end{aligned} \tag{12}$$

based on the revised DD measure

$$d_1' = \Phi^{-1}(\Phi(-d_1)) + (\mu_S - r_f) \sqrt{t} / \sigma_S, \tag{13}$$

According to the continuous time CAPM,

$$\mu_S - r_f = \beta \lambda, \tag{14}$$

with asset beta

$$\beta = \text{cov}(r_S, r_m) / \sigma_m^2 = \rho_{S,m} \sigma_S / \sigma_m, \tag{15}$$

where r_S and r_m denote the continuous time rate of return on the asset and a comparable market portfolio, σ_m is the volatility of the return of the market portfolio, $\rho_{S,m}$ is the correlation between both asset and market returns, and “market risk premium”

$$\lambda = \mu_m - r_f, \tag{16}$$

where μ_m denotes the continuous time expected rate of return on the market portfolio. Thus, the combination of equations (14)-(16) above yields

$$\left(\mu_S - r_f \right) / \sigma_S = \beta \lambda / \sigma_S = \rho_{S,m} \lambda / \sigma_m = \rho_{S,m} SR, \tag{17}$$

where the market Sharpe ratio $SR = \lambda/\sigma_m$, i.e., the excess return per unit of market volatility for the market portfolio. After substituting (17) into (13), so that

$$d'_1 = \Phi^{-1}(\Phi(-d_1)) + \rho_{S,m} SR \sqrt{t}, \quad (18)$$

where $\rho_{S,m}$ is estimated as the square root of the residual sum of squares (R^2) of the linear regression of asset returns on market returns

$$r_S = \alpha + r_m + \varepsilon, \quad (19)$$

with constant α and error term ε .

If these conditions hold, default occurs if the asset value S falls below the repayment value E and the call option on future repayment E

$$C(E) = S_t e^{-\mu_1 t} \Phi(d'_1) - E e^{-\mu_2 t} \Phi(d'_2), \quad (20)$$

represents the fair market value of each rental or lease payment in debt- and asset-based contracts or the periodic profit pay-out in equity-based Islamic transactions at each time period t , where $\mu_1 = (1+r_{div})(1+\mu_S-r_f)-1$ and $\mu_2 = (1+r_f)(1+\mu_S-r_f)-1$ are the internal rate of return and the risk-free rate under the risk-neutral measure respectively and $d'_2 = d'_1 - \sigma_S \sqrt{t}$.

3.3 Application of adapted BSM to put-call parity

Since the present value $PV(E) = E e^{-\mu_2 t}$ and asset price S at time t are given, we can solve for $P(E) = PV(E) + C(E) - S_t$ under put-call-parity, and identify all components of an Islamic transaction, given

$$C(E) = \frac{E e^{-((1+r_f)(1+\mu_S)-1)t} - P(E)}{(\Phi(d_1) - b\Phi(d_2))^{-1} - 1}, \quad (21)$$

which implies the declining positive correlation of the call option value $C(E)$ and Islamic debt $PV(E) - P(E) = S_t - C(E)$ as $t \rightarrow T$. We finally derive the annual, continuously compounded interest rate as

$$r' = \frac{E}{\sqrt[T]{S_t - C(E)}} - 1. \quad (22)$$

Given lack of suitable market prices in Islamic finance, the current asset price S (and attendant return r_S and volatility σ_S^2) can also be derived from a *mark-to-market* (MTM) exercise, internal audits or some other verification process.

Similarly, the continuous time rate of return r_m and the volatility σ_m^2 of the market portfolio needs to be obtained from a pool of reference obligations, such as publicly quoted Islamic funds or other investments, which serve as pricing benchmark.

3.4 Numerical Example

We calculate the conventional rate of return r' under the risk neutral measure for a notional amount of $F=100$ of issued debt with future repayment $E=120$ and a tenor T of five years, discounted in continuous time at $\mu_2 = (1+r_f)(1+\mu_s) - 1 = (1.05 * 1.015) - 1 = 6.575\%$, so that present value $PV(E) \approx 86.38$ and $PV(F) \approx 71.99$ of full repayment and partial repayment of the principal amount only (see Figure 7.1). We assume risk-neutral return $\mu_s = 6.5\%$, standard deviation $\sigma_m = 10\%$ of market returns, and $\text{cov}(r_s, r_m) = 0.005$, so that asset beta $\beta = 0.5$, $\rho_{s,m} = 1/3$, and $SR = 0.3$. For asset value $S_0 = 100 = F$ (assuming that the firm is fully leveraged and firm value at inception $t=0$ is equivalent to the notional amount F) and a standard deviation σ_s of 15%,³⁰ the fair market price of the Islamic lending contract would be 89.93, which implies an annual interest rate of $r' = 6.18\%$ according to our OPT-based valuation model if we assume dividend yield $r_{div} = 0\%$.

4. ISLAMIC FINANCE AND STRUCTURED FINANCE

Based on the above put-call parity replication of state-contingent payoffs of underlying asset performance, any form of Islamic finance could be considered a structured finance transaction, which contains implicit derivative elements with unilateral deferral of settlement and a double coincidence of obligations.

Structured finance encompasses all financial instruments – other than individual (basic or exotic) derivative contracts – that serve to hedge any activity beyond the scope of conventional forms of on-balance sheet securities (debt, bonds, equity). They either (i) combine traditional asset classes with contingent claims, such as derivative claims on commodities, currencies or receivables from other reference assets, or (ii) replicate traditional asset classes through synthetization or new financial instruments (Jobst, 2007a). Structured finance offers the issuers enormous flexibility to create securities with distinct risk-return profiles in terms of maturity structure, security design, and asset types, which allows issuers to provide enhanced return at a customized degree of diversification commensurate to an individual investor's appetite for risk. Hence, structured finance contributes to a more complete capital market by offering any mean-variance trade-off along the efficient frontier of optimal diversification at lower transaction cost. However, the increasing complexity of the structured finance market, and the ever growing range

of products being made available to investors, invariably create challenges in terms of efficient assembly, management and dissemination of information.

The flexible nature of structured finance straddles the indistinct boundary between traditional fixed income products, debentures and equity on one hand and derivative transactions on the other hand. Notwithstanding the perceivable ostensible difficulties of defining structured finance, a *functional* and *substantive* differentiation informs a useful demarcation between the most salient properties of structured and conventional forms of finance as regards the role of Islamic finance. The following definition reflects such a proposition if we compare two cases:

- a) Investment instruments are motivated by the *same or similar financial objective* from both the issuer's and the investor's point of view, but *differ in legal and functional implementation* (transaction structure/security design/repayment profile) and substantive. They also might require a *different valuation*.³¹
- b) Investment instruments are motivated by the *same or similar financial objective* and are *substantively and functionally equivalent* (i.e. they share a close equilibrium price relation), but *differ in their legal classification*.

In the second case appeals to the characteristics of Islamic finance, which fall squarely within the domain of structured finance instrument whenever religious constraints require the replication of conventional interest-bearing assets through structural arrangements of two or more contingent claims in the form of "implicit derivatives". Although both Islamic and conventional finance are *in substance equivalent to conventional finance* and yield the same lender and investor pay-offs at the inception of the transaction, they require a different valuation due to dissimilar transaction structures (and associated legal enforceability of investor claims) and/or security design.

5. "EXPLICIT DERIVATIVES" IN ISLAMIC STRUCTURED FINANCE: CREDIT RISK TRANSFER

There is wide agreement that derivatives with the option of unilateral deferment (and attendant contingency risk), such as delayed payment contracts on existing assets (*salam*) or purchase order *murābahah* contracts on future assets (*istiṣnāʿ*), concur with Sharīʿah principles. However, the deferment of obligations by *both* parties to a future date is considered tantamount to a debt exchange without underlying asset transfer, which implies the possibility of profit-taking and excessive uncertainty (*gharar*) of a kind that is not permissible under Islamic law. However, the prevalence of Sharīʿah-compliant securitized issuance (in combination with hedging transactions) demonstrates the possibility of mutual risk transfer mechanisms with a view to foster *ḥalāl* in the spirit of distributive justice and the consideration of public interest (*maṣlahah*). In conventional structured finance, the two major asset classes of *capital market-based risk transfer* (except loan sales, asset swaps, and natural hedges through bond trading) include *asset*

securitization (which is mostly used for funding purposes) and *credit derivative* transactions (as hedging instruments), which permit issuers to devise almost an infinite number of ways to combine various asset classes in order to both transfer asset risk between banks, insurance companies, other money managers and non-financial investors in order to achieve greater transformation and diversification of risk.

Since most Islamic financial products are based on the concept of asset backing, the economic concept of asset securitization is particularly amenable to the basic tenets of Islamic finance. Asset securitization describes the process and the result of issuing certificates of ownership as pledge against existing or future cash flows from a diversified pool of assets (“reference portfolio”) to investors. It registers as an alternative, capital market-based refinancing mechanism to diversify external sources of asset funding in lieu of intermediated debt finance based primarily on the risk assessment of securitized assets. The implicit risk transfer of securitization does not only help issuers improve their capital management, but also allows issuers to benefit from enhanced liquidity and more cost efficient terms of high-credit quality finance without increasing their on-balance sheet liabilities or compromising the profit-generating capacity of assets. Investors in securitization have a wider choice of high-quality investments at their disposal, whose market valuation engenders greater overall efficiency and liquidity of capital markets. The tradability of securitized asset risk also facilitates the synthetic assembly and dynamic adjustment of asset portfolios via secondary markets according to investor preferences (Jobst, 2006a and 2006b).

In the wake of rapid growth of the Islamic finance sector³², structured finance instruments have been receiving increasing attention in Islamic countries owing in large part to enabling capital market regulations, a favourable macroeconomic environment, and financial innovation aimed at establishing Shari‘ah compliance. As one form of structured finance, Islamic securitization transforms *bilateral risk sharing* between borrowers and lenders in Islamic finance into the *market-based refinancing* of one of the three broad types of Islamic finance (asset, debt, and equity-based) as reference asset. In its basic concept, Islamic securitization allows originators sell existing or future revenues from lease receivables (asset-based), “sale-back profit” (debt-based) or private equity from a portfolio of Islamically acceptable assets to a *special purpose vehicle* (SPV),³³ which refinances itself by issuing unsecured securities to market investors, which assume the role of a “collective financier” whose entrepreneurial investment does not involve guaranteed, interest-based earnings. In this context, investors represent the “capital market corollary” to a singular lender in ordinary Islamic finance. Irrespective of religious conditions, Islamic securitization offers the same economic benefits conventional structured finance purports to generate, such as the active management of designated asset portfolio due to greater control over asset status, enhanced asset-liability management and term structure transformation, as well as

the isolation of certain assets in order to make them self-financing at a fair market rate (see Box 1).

Although the religious prohibition of the exchange of debt and the required conferral of ownership interest to participate in business risk still poses challenges to the development of Islamic securitization, the gradual acceptance of Islamic investment certificates, so-called *ṣukūk* bonds, represents a successful attempt to overcome these impediments based on the adequate interpretation and analogical reasoning of Shari‘ah principles applied in Islamic finance. *Ṣukūks* are Shari‘ah-compliant and tradable asset-backed, medium-term notes,³⁴ which have been issued internationally by governments, quasi-sovereign agencies, and corporations after their legitimization by the ruling of the *Fiqh Academy* of the *Organization of the Islamic Conference* in February of 1988.³⁵ Over the last five years, the *ṣukūk* has evolved as the most popular form of securitized credit finance within capital-market-based Islamic structured finance, reconciling the concept of securitization and principles of the Shari‘ah law on the provision and use of financial products and services in a risk-mitigation structure subject to competitive pricing.³⁶ The *Accounting and Auditing Organization of Islamic Finance Institutions* (AAOIFI) currently recognizes 14 different types of *ṣukūks*, which are traded on the *Scriptless Securities Trading System* (SSTS)³⁷ in Malaysia. Gross securitized issuance of these Islamic debt securities has nearly quadrupled over the past two years, rising from U.S.\$7.2 billion in 2004 to over U.S.\$27 billion in 2006 – but still only little more than one tenth of conventional securitized issuance of *asset-backed securities* (ABS) in emerging markets over the same time period. During the first half of 2007, greater standardization triggered a further up-tick of issuance volume to more than U.S.\$10 billion. According to recent market reports governments and corporates will raise about U.S.\$30 billion in *ṣukūk* over the next three years, bringing the size of the Islamic securitization market to U.S.\$100 billion.

Ṣukūk notes convey *equity* interest to (capital market) investors in the form of a *call option* on partial or complete ownership of underlying reference assets, including the right to some calculable rate of return as a share of profit (*secondary notes*) and the repayment of the principal amount (*primary notes*). *Ṣukūks* operate similarly to mortgage pass-through except investors own a portion of the underlying assets that collateralize debtor repayments. However, the scrutiny of securitized collateral is more complicated and less accurate when there is a requirement for Shari‘ah compliance of assets. Most Islamic finance products require issuers to originate own Islamically acceptable assets (rather than buy asset pools in the market) due to the absence of eligible collateral assets.³⁸ Moreover, the comparative paucity of historical data on defaults hinders reliable estimates for recovery rates used in pricing and rating tranching products, and leads rating agencies to use very conservative assumptions, especially if lender credit scoring and infrastructure are not up to the standards usually sought by the rating agencies.

Box 1. East Cameron Gas *Ṣukūk* - credit risk transfer and commodity hedging in Islamic finance

The first Islamic securitization transaction in the U.S. demonstrates the Sharīʿah-compliant use of derivatives in structured finance. In July 2006, *East Cameron Partners* (ECP), an independent oil and gas exploration and production company based in Houston, Texas, raised U.S.\$165.67 million from the issuance of a *ṣukūk al-mushārah* backed by natural oil and gas royalties.

Its two-tier securitization structure, which was designed by arrangers Beirut-based *Bemo Securitization* (BSEC) and *Merrill Lynch*, consists of a “purchaser SPV” (incorporated in Delaware), which acquires the underlying assets, and an “issuer SPV”, registered in the Cayman Islands, which funds the asset purchase by issuing investment trust certificates (*ṣukūk* notes). The relationship between both SPVs is governed by a “funding agreement”, which includes periodic funding repayments and the transfer of net profits. The funding agreement aims at materializing the contribution of the “issuer SPV” (as a *mushārek*) and (ii) conveying to the “issuer SPV” a certain risk and reward profile, which is passed on to the *ṣukūk* note holders, pursuant to the following provisions: (i) the purchase of *overriding royalty interest* (ORRI) from the originator for U.S.\$113.84 million, (ii) the payment of the development plan for U.S.\$38.28 million, (iii) the funding of the reserve account with an initial balance of U.S.\$9.5 million, and (iv) the acquisition of natural gas put options for U.S.\$4.05 million in a specific hedge agreement with an outside party. The commodity price hedge as part of the funding agreement to protect investor interest is remarkable in the context of Islamic finance. The hedge constitutes a Sharīʿah-compliant obligation (*iltizām*), since it confers true commercial value (rather than speculative interest).

Overall, Sharīʿah compliance of the transaction is established by the uncertainty of cash flows from the asset performance of permissible real economic activity with identified and direct investor participation, which does not imply the payment or receipt of any interest guarantee. While deferrals are possible, in the default event, investors have recourse to the underlying assets and can force the sale of the cash flow generating assets. However, legal risk from Islamic jurisprudence could affect the legal enforceability of the funding arrangement and the asset control of investors.

6. ASSESSMENT OF DERIVATIVES IN ISLAMIC FINANCE

6.1 Discussion of Current Legal Opinion

Amid weak reliance on capital market financing in many Islamic countries, risk transfer mechanisms, be it *ṣukūk* issuance or hedging tools, are subject to several critical legal hindrances that impact on the way derivatives redress perceived market imperfections and financing constraints. While “implicit derivatives” are essential to the replication of interest through profit generation from temporary asset transfer or profit-sharing in Islamic finance (see above), and thus are not deemed objectionable on religious grounds, the *explicit* use of derivatives remains highly controversial.

In the “implicit derivative” transaction underlying basic Islamic finance is tantamount to a forward contract. Nonetheless, the forward element of Islamic lending contracts – like conventional forwards – involves problems of double coincidence and counterparty risk due to privately negotiated customization. Parties to forward agreements need to have exactly opposite hedging interests, which coincide in timing of protection sought against adverse price movements and the quantity of asset delivery. Moreover, forward contracts elevate the risk of one counterparty defaulting when the spot price of the underlying asset falls below the forward price (i.e. the originally agreed upon price) prior to maturity, rendering the contract “out-of-the-money” and making deliberate default more attractive. Although the non-defaulting party does have legal recourse, the process of seeking contractual enforcement can be lengthy, cumbersome and expensive, especially in areas of conflicting legal governance as a *matter of form* (commercial law vs. Islamic law).

These obvious shortcomings of forwards create the economic rationale for futures, which are standardized forward contracts in terms of size, maturity and quality, and, thus do away with the constraint of double coincidence in forward contracts. However, generic future contracts appear to contravene Shari‘ah principles in the way they limit counterparty risk. Futures are generally priced *marked-to-market* (MTM)³⁹, which requires margin calls from the party that is out-of-the-money. Since the absence of underlying asset transfer renders MTM pricing unacceptable under Islamic law, a Shari‘ah-compliant solution to this problem could be the marginal adjustment of periodic repayment amounts in response to any deviation of the underlying asset value from the pre-agreed strike price at different points in time throughout the term of the transaction (see above).

But conventional futures still imply contingency risk. Options redress the exposure to discretionary non-performance in return for the payment of an upfront, non-refundable premium. Holders of a call option have the right (but not the obligation) to acquire the underlying asset, which could otherwise only be exercised by the purchase of the underlying asset at the prevailing spot price. Therefore, options do not only serve to hedge adverse price movements, but they also cater for contingencies regarding the delivery or receipt of the asset and offer the opportunity to take advantage of favourable price movements.

While the premise of eliminating contingency risk is desirable *per se* under Islamic law, the assurance of definite performance through either cash settlement (in conventional futures) or mutual deferment (in options) supplants asset recourse and implies a zero-sum proposition, which are not considered Shari‘ah-compliant. Instead, in Islamic finance, the bilateral nature and asset-backing *ensure definite performance* on the delivery of the underlying asset (unlike a conventional forward contract).⁴⁰ Since Islamic creditors hold legal title to the underlying asset, the sequence of periodic and maturity-matched put-call combinations preserves equitable risk sharing consistent with the Shari‘ah principles of unsecured

entrepreneurial investment due to certain asset delivery – without objectionable zero-sum gains. Unlike in conventional options, there are no unilateral gains from favourable price movements (e.g., “in-the-money” appreciation of option premia) in the range between the current and the contractually agreed repayment amount. Any deviation of the underlying asset value from the final repayment amount constitutes shared business risk. By virtue of holding equal and opposite option positions on the same strike price, both creditor and debtor are obliged to honour the terms of the contract irrespective of changes in asset value, without the opportunity of the creditor (debtor) to benefit from a higher (lower) asset price at maturity.

In the light of the Islamic principle of permissibility (*ibāḥah*), which renders all commercial transactions Sharī‘ah-compliant in the absence of a clear prohibition, current objections to futures and options constitute the most discouraging form of religious censure (*taqlīd*). Sharī‘ah scholars take issue with the fact that these derivatives are valued mostly by reference to the sale of a non-existent asset or an asset not in the possession (*qabd*) of the seller, which negates the *ḥadīth* “sell not what is not with you.” Sharī‘ah principles require creditors (or protection sellers) to actually own the reference asset at the inception of a transaction. The absence of a legalistic cause (*‘illah*) leading to contingency risk in forwards and futures has led commentators to dispute their general permissibility under Islamic law. That said, the prospect of failure to deliver (and the resultant notion that a purchase or sale cannot be effected for a future date) might have been more relevant to the condition of asset ownership in the past, when then simple, primitive and unorganized capital markets implied considerable counterparty risk on contractual performance.

Futures and options also continue to be rejected by a majority of scholars on the grounds that “... in most futures transactions delivery of the commodities or their possession is not intended” (Usmani, 1996), which would invalidate their use under Sharī‘ah law. Furthermore, derivatives almost never involve delivery by *both* parties to the contract. Often parties reverse the transaction and cash settle the price difference only, which transforms a derivative contract into a paper transaction without the element of a genuine sale. Thus, a key argument against the use of derivatives contents the valuation of derivatives based on the sale of a non-existent asset or an asset not in the possession (*qabd*) of the seller, which negates the *ḥadīth* “sell not what is not with you.” Sharī‘ah principles require creditors (or protection sellers) to actually own the reference asset at the inception of a transaction. The absence of a legalistic cause (*‘illah*) leading to contingency risk in forwards and futures has led commentators to dispute their general permissibility under Islamic law. That said, the prospect of failure to deliver (and the resultant notion that a purchase or sale cannot be effected for a future date) might have been more relevant to the condition of asset ownership in the past, when then simple, primitive and unorganized capital markets implied considerable counterparty risk on contractual performance.

Besides the lack of asset ownership at the time of sale, other areas of concern shared by Islamic scholars about Shari'ah compliance of derivatives have centred on: (i) the selection of reference assets that are nonexistent at the time of contract; (ii) the requirement of *qabd* (i.e., taking possession of the item prior to resale); (iii) mutual deferment of both sides of the bargain, which reduces contingency risk but turns a derivative contract into a sale of one debt for another; and (iv) excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs of both sides of the bargain (Kamali, 2007).

Although Khan (1995) concedes that even in the contemporary form of futures trading "some of the underlying basic concepts as well as some of the conditions for such trading are exactly the same as [the ones] laid down by the Prophet [Mohammed (*sallallahu 'alayhi wasallam*)] for forward trading," he attests to the associated risk of exploitation and speculation, which belie fundamental precepts of the Shari'ah.⁴¹ For the same reasons, several scholars also consider options in violation of Islamic law. Nonetheless, in one of the most comprehensive study on the subject so far, Kamali (2001) finds that "there is nothing inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it, and that options trading like other varieties of trade is permissible *mubah*, and as such, it is simply an extension of the basic liberty that the Qur'an has granted." With that in mind, strong opposition to derivatives seems to be inherited from a pathology of religious interpretation that turns a blind eye to the fact that derivatives are a new phenomenon in an Islamic context. The governance of derivatives has no parallel in the conventional law of *muamalat*, and should therefore be guided by a different set of rules.

6.2 Legal Uncertainty

Derivative transactions in Islamic financial systems are beset by legal uncertainty from the heterogeneous assessment of Shari'ah compliance, which entails procedural and substantive difficulties. The absence of practical and hard-wired guidance on Shari'ah compliance affects the legal integrity and restitution interest of parties to derivative transactions. Islamic jurisprudence is not definite or bound by precedent and still lacks of homogeneous interpretation and universal recognition. Legal opinions of Islamic courts may deviate from previous decisions made by other Shari'ah scholars. Since Islamic law itself is divided in different juristic schools of thought (*madhahib*), which provide guidance on the interpretation (*ijtihad*) or analytical reasoning (*qiyas*) of the general principles of the Shari'ah, there is no consistent ruling of Islamic courts on the religious compliance of the eligibility of certain assets and transaction structures for securitization. For instance, even though the *hanbali* school is dominant in Saudi-Arabia, a Shari'ah board has considerable discretion in the interpretation of Islamic law and may choose any other school of thought to inform their decision-making process. Therefore, it is hardly surprising that the adjudication of derivatives under Islamic law varies greatly and differ in terms of individual interpretations of the

Sharī'ah and the fundamental understanding of the economic purpose of the respective instrument (and transaction structure) under discussion. The resultant inconsistency of legal opinions has raised doubts about the general permissibility of derivative instruments in Islamic finance, which bear the potential of flouting the Sharī'ah ban on speculation and capital gains without underlying asset transfer.

6.3 Investor Protection

Islamic investors are not only concerned with the compliance of derivative transactions with the Sharī'ah, but also their legal enforceability under contract law. So from an investor's perspective, Islamic derivatives need to satisfy *two* legal regimes: applicable commercial law as well as Islamic law. Eventually, the question of whether Islamic law governs a transaction by *substance* or *form* determines the investment risk from religious encroachment on the economic logic of the security design and the legal enforceability of commercial interests. If Sharī'ah compliance is treated as a *matter of substance* and upholds in spirit what was created in form (as defined by commercial law), the violation of any religious precepts is likely to temper investor interest and affect liquidity, but would not preclude legal enforceability of investor claims. However, if Islamic law is the governing law as a *matter of form* (i.e., the transaction is governed solely by Sharī'ah law), the opinion of Sharī'ah courts could override commercial legal concepts and re-qualify the legal nature of derivative contracts. For instance, the *ex post* legal interpretation of certain security features carries the possibility of bankruptcy courts or insolvency officials in Islamic jurisdictions to invalidate post-default settlement protocols under commercial law or "re-characterize" a derivative transaction as speculation or debt exchange without transfer of legal title to the lender, which, in turn, interferes with the premise of asset transfer in Islamic finance. Either outcome would undermine the economic purpose of derivatives, compromise investor protection, and upset the carefully constructed profit and loss sharing amongst investors, which effectively defines the transaction structure. Such legal uncertainty is amplified by that fact that bankruptcy and dispute resolution processes of Islamic securities are largely untested due to scarcity of default cases.

6.4 Possibilities to Establish Sharī'ah Compliance of Derivatives

The heterogeneity of scholastic opinion about the Sharī'ah compliance of derivatives is largely motivated by individual interpretations of the Sharī'ah and different knowledge about the mechanics of derivative structures. Many policy makers, market participants and regulators are frequently unfamiliar with the intricate mechanics and the highly technical language of many derivative transactions, which hinder a more comprehensive understanding and objective appreciation of the role of derivatives in the financial system and their prevalence in a great variety of business and financial transactions.

While Islamic regulators have a natural interest to err on the side of caution when attempting to resolve religious impediments to the use of derivatives under

Islamic jurisdiction, they have come to realize the numerous benefits of derivative markets. Risk diversification through derivatives improves stability at all levels of the financial system and enhances general welfare. Derivatives also contribute to continuous price formation, enhance liquidity management and supplement cash markets at lower funding cost. Last but not least, as a critical element of capital market development, derivatives ensure an efficient transmission of funds from lender to borrowers while enhancing sound financial planning and financial stability. The absence of suitable risk transfer mechanisms under Islamic law, however, deprives financial institutions of this array of these advantages.

In principle, futures and options may be compatible with Islamic law if they (i) are employed to address genuine hedging demand on asset performance associated with direct ownership interest, (ii) disavow mutual deferment without actual asset transfer, and (iii) eschew avertable uncertainty (*gharar*) as prohibited sinful activity (*harām*) in a bid to create an equitable system of distributive justice in consideration of public interest (*maṣlahah*). Shari‘ah-compliant derivatives would also maintain risk sharing between contract parties by forgoing the zero-sum proposition of many conventional derivative transactions in favour of win-win situations from changes in the value of the underlying asset. For instance, the issuance of stock options to employees would be an ideal candidate for a Shari‘ah-compliant derivative. By setting incentives for higher productivity firm owners reap larger corporate profits that offset the marginal cost of greater employee participation in stock price performance. However, the *de facto* application of many derivative contracts is still objectionable, mainly because of the possibility of speculation (or deficient hedging need)⁴² and the absence of entrepreneurial investment violate of the tenets of distributive justice and equal risk sharing subject to religious restrictions on the sale and purchase of debt contracts as well as profit taking without real economic activity and asset transfer.

7. THE PROSPECTS OF ISLAMIC DERIVATIVES

Recent efforts of regulatory consolidation and standard setting have addressed economic constraints and the legal uncertainty imposed by both Islamic jurisprudence and poorly developed uniformity of market practices. Therefore, market inefficiencies caused by heterogeneous prudential norms and diverse interpretations of Shari‘ah compliance are expected to dissipate in the near future. In the area of banking regulation, the first signs of supervisory harmonization emerged in 2002, when central banks and national monetary authorities of Islamic countries inaugurated the *Islamic Financial Service Board* (IFSB) in Malaysia as an international standard-setting body to ensure stability and soundness of Islamic financial services industry by developing new, or adapting existing, international finance standards consistent with Shari‘ah principles and harmonization of practices within the Islamic finance service industry.⁴³ Moreover, the IFSB has established a taskforce for the development of supervisory guidelines related to

Shari'ah-compliant capital market transactions, including the regulatory governance of *ṣukūk*.

At the same time, private sector initiatives, such as an Islamic primary market project led by Bahrain-based *International Islamic Financial Market* (IIFM) in cooperation with the *International Capital Markets Association* (ICMA), have resulted in the adoption of a memorandum of understanding on documentation standards and master agreement protocols for Islamic derivatives. Further work is also being done on issues regarding the tradability of *ṣukūk* and the standardization of Islamic treasury *murābahah* contracts. Moreover, greater importance of the *Accounting and Auditing Organization of Islamic Finance Institutions* (AAOIFI), the *General Council for Islamic Banking and Finance Institutions* (GCIBFI), and the *Islamic International Rating Agency* (IIRA) will add consistency to Shari'ah rulings, while the retention of conventional finance market practice and the supremacy of a bankable governing law as a matter of form remain essential to maintain investor confidence in a rapidly growing structured finance market.

Also national solutions are gaining traction. While the IIFM was still working on the development of a *Master Agreement for Islamic Derivatives*, for which it had established an alliance with the *International Swaps and Derivative Association* (ISDA) in summer 2006, Malaysia's only fully-fledged Islamic banks, *Bank Islam Berhad* and *Bank Muamalat Malaysia Berhad* had already broken new ground by agreeing to execute a derivative master agreement for the documentation of Islamic derivative transactions in November 2006 (Jobst, 2007c). This standardization initiative was sponsored by the *Malaysian Financial Market Association* (Persatuan Kewangan Malaysia) with the participation from both Islamic and conventional Malaysian banks in a bid to create more liquidity and enhance transparency with a view to elevate Malaysia's aspirations of becoming a centre of Islamic finance as the largest *ṣukūk* market in the world, while more specific regional initiatives provide a valuable platform for drawing further attention to derivatives as an important element of local capital market development. Nonetheless, derivatives remain complex and frequently opaque instruments that might be used by market players to take on excessive risk, avoid prudential safeguards, and manipulate accounting rules. While the problem of misuse is perceived to be more acute where prudential regulation, transparency, and risk management practices are not fully developed, religious qualifications add an additional layer of contingency risk to be considered by policy makers and regulators in Islamic countries as derivative products receive greater acceptance.

As Islamic finance comes into its own and companies turn to means of hedging their exposures more efficiently, financial institutions in Bahrain, Kuwait and Malaysia have been gearing up for more Shari'ah-compliant financial instruments and structured finance – both on the asset and liability side. Financial innovation will contribute to further development and refinement of Shari'ah-compliant derivative contracts. For instance, the development of Islamic derivatives bodes

well for the Islamic insurance (*takāful*) industry,⁴⁴ whose Sharī'ah compliance has traditionally resulted in overdependence on equity and real-estate investment, restricting the potential of risk diversification from a wider spectrum of available assets.

Notes

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¹ The general consensus among Islamic scholars is that *ribā* covers not only usury but also the charging of interest and any positive, fixed, predetermined rate of return that are guaranteed regardless of the performance of an investment (Iqbal and Tsubota, 2006; Iqbal and Mirakhor, 2006). Besides interest earnings on money lending, Islamic law also prohibits (i) *ḥarām* (sinful activity), such as direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment, (ii) speculation, betting, and gambling (*māisir*), including the speculative trade or exchange of money for debt *without* an underlying asset transfer, (iii) the trading of the same object between buyer and seller (*bay' al-inah*), as well as (iv) preventable uncertainty (*gharar*), such as all financial derivative instruments, forward contracts, and futures agreements for speculative (rather than hedging) purposes.

² While the elimination of interest is fundamental to Islamic finance, Sharī'ah-compliant investment behaviour also aims to eliminate exploitation pursuant to Islamic law. *Ribā* applies to any transaction purporting to effect the profitable exchange of two or more species (*anwa*) that belong to the same genus (*jins*) and are governed by the same efficient cause (*'illah*).

³ The prohibition of *ribā* is upheld if the rate of exchange between two objects is unity and no gain is permissible to either party and if deferred settlement is disallowed, which ensures that the transaction is settled on the spot by both parties.

⁴ The underlying asset transfer of Islamic lending arrangements provides collateralization until the lender relinquishes ownership at the maturity date. In equity-based Islamic investments, lenders do not have any recourse unless pre-mature termination enables the lender to recover some investment funds from the salvage value of project assets.

⁵ In a debt-based *synthetic loan*, the borrower repurchases the assets from the lender at a higher price than the original sales price, whereas borrowers under a *lease-back agreement* repurchase the assets at the same price at the end of the transaction and pay quasi-interest in the form of leasing fees for the duration of the loan.

⁶ The so-called commodity *murābahah* is a frequently used form of wholesale debt-based Islamic finance between a bank and its client to replicate short-term money market deposits and medium-term syndicated loans. Such a contract involves the sale on a deferred payment basis of a commodity, usually metals, at the market price plus an agreed profit margin to

the borrower, who raises the required funds by immediately selling the asset to a broker or a financial institution.

⁷ The distinction of asset origin is critical in the assessment of the degree of collateralization of debt-based Islamic finance. If the purpose of the contract involves the repurchase of the contractual reference asset (if the asset was originally held by the borrower), the lender has full recourse; however, if the asset was originally held by a third party and the borrower plans to acquire any asset (with the reference asset representing the loan value), collateralization depends on the rate of deferment of ownership interest transferred by the lender.

⁸ *Salam* contracts are mostly used in agricultural finance.

⁹ A *bay' bithaman ājil* (BBA) contract is primarily used for long-term financing and does not require the lender to disclose the profit margin.

¹⁰ This form of *murābahah* is only permitted for merchant banks, as in the case of *Kuwait Finance House's* in-house car dealership.

¹¹ An *ijārah* lease fulfils the functions of either a finance or operating lease. It is increasingly used in aircraft finance by lessees in Islamic countries and in operating lease-back transactions, which combine conventional lending with Islamic investment. Note that Islamic scholars make no distinction between operating and financial leases as to the classification of profits from the use of assets against the prohibition of interest.

¹² However, rental payments and their adjustment to changing market conditions (for floating-rate financed assets) cannot be expressed by reference to an interest rate. Lessors pass down the risk of rate fluctuations by subjecting the rental payable to adjustments by reference to provisions in other documents (e.g., an adjustment letter linking rentals to LIBOR) or by cross-reference to another non-Islamic lease signed at the same time and the same rentals.

¹³ Besides the option to (re)purchase the asset, the lessee can be given the right to sublet the asset. Moreover, the terms of the lease must be clearly identified, and the lease needs to be renewed for every rental payment if the rent is linked to LIBOR or some other market interest rate.

¹⁴ If the underlying assets were originally held by the borrower, this arrangement represents a lease-back agreement over the term of the financing agreement to the borrower, who has the option to acquire the equipment after the lease expires.

¹⁵ Possible ways of *ijārah*-compliant relief of the responsibility for the maintenance and insurance of leased assets by the lessor are: (i) the lessor agrees to perform insurance and maintenance, and to an increase of rental payments to recover insurance premium and appointment of lessee or third party as agent to acquire the insurance in return for a fee commensurate to the insurance mark-up; or (ii) the lessor appoints the lessee or third party to discharge these duties for a fee. The degree of transfer of maintenance responsibility is reflected in the lease payments.

¹⁶ Also note that in a headlease-sublease *ijārah* transaction the legal title remains with the borrower, who leases the assets to the lender. This form of asset retention implies similar counterparty risk as with some types of debt-based Islamic finance (see below) unless the borrower enters into a guarantee agreement to repay the exercise price of the transferred asset on a dissolution event.

¹⁷ This structural feature has been applied especially in Islamic mortgage deals in the U.S.

¹⁸ In Figure 7.1, the temporary retention of asset ownership by lender in a lease contract represents a put option with a strike price on the present value of transferred assets.

¹⁹ In contrast, debt-based contracts require a higher re-purchase price, which includes quasi-interest payments.

²⁰ The temporary transfer of stock ownership from borrower to lender pursuant to a repurchase agreement within a lease contract implies full collateralization if its value at the time of transfer equals the present value of the borrowed amount repayable at some future date. The lower the present value of the reference asset being funded by the contract, the lower the degree of collateralization.

²¹ The repurchase obligation insulates the lender from the performance of the underlying asset.

²² This equity-based arrangement implies a non-recourse debt feature (see Figure 7.1).

²³ The relationship between the put and call values of a European option on a non-dividend paying stock of a traded firm can be expressed as $PV(E)+C=S+P$. $PV(E)$ denotes the present value of a risky debt with a face value equal to exercise price E , which is continuously discounted by $exp(-rT)$ at a risk-free interest rate r over T number of years. In our case of a lending transaction, the share price S represents the asset value of the funded investment available for the repayment of terminal value E .

²⁴ This assumption contrasts with asset-based contracts that function as financing leases (e.g. Islamic mortgages), where the borrower reduces E by gradually acquiring complete equity interest over the duration of the transaction (see below).

²⁵ The lease payments received from the borrower wash out in this representation.

²⁶ We assume unity between the individual risk premium and the market price of risk in this case, i.e., the underlying asset is perfectly sensitive to changes of the market risk premium.

²⁷ However, some debt-based financing with deferred payment of future claims on existing assets (*salam*), pre-delivery finance for future assets (*istiṣnāʿ*) or the deferred cost-plus sale of a third-party held asset imply counterparty and market risks from lost recovery value, which could translate a lower strike price F on the call or put option respectively.

²⁸ Note that the use of the BSM framework appeals to universal recognition, but fails to generate accurate option prices in times when extreme outcomes occur amid periods of high volatility unless the normality assumption of asset price dynamics underpinning the “default trigger” of the distance to default measure (see below) is altered.

²⁹ The repayment obligation is defined as the discounted the future value of repayment E of face value F and all coupon values in line with the conventional application of BSM.

³⁰ Empirically, the value of the assets of the firm can be estimated using by discounting the expected cash flows from the assets at the cost of capital.

³¹ *Pure credit derivatives* are clear examples of structured products, which allow very specific and capital-market priced credit risk transfer. Credit insurance and syndicated loans share the same financial objective; however, they do *not* constitute an arrangement to create a new risk-return profile (and possibly unfunded) from existing or future reference assets. In the same vein, *mortgage-backed securities* (MBSs) and (*Pfandbrief*-style) covered mortgage bonds represent different functional and legal methods of securitization with the same financial objective. Although both refinancing techniques convert homogenous pools of mortgage claims into negotiable securities, they represent two distinct forms of debt securities issued on the same type of underlying reference asset either off-balance sheet (*asset-backed securitization*) or on-balance sheet (covered mortgage bond).

³² The outstanding stock of shariʿah assets worldwide has been increasing by an average of 15 percent a year since 2003 and stood at about U.S.\$500 billion at end-2006, about half of which is held by Islamic banks. Global volume could increase even faster in response to

surging demand from Muslim investors flocking to the growing number of competing Islamic investment products.

³³ In conventional securitization, a SPV is set up solely for the purpose of the securitization and might be a trust, limited liability company, partnership, or a corporation. In Islamic securitization, the objectives set out in the constitutional documents of the SPV also must not infringe on the prohibition of *ribā* and *ḥarām* under Islamic law.

³⁴ “Investment *ṣukūk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activities.” (AAOIFI Standard No. 17).

³⁵ Although there is no formal obligation of compliance associated with the ruling, it carries considerable weight with most Islamic financial institutions.

³⁶ Only appropriate Islamic bodies, so-called Sharī‘ah boards, may adjudicate the sharī‘ah compliance of the terms of any *ṣukūk* issuance.

³⁷ The SSTS is a system operated by the *Bank Negara Malaysia* (BNM)’s real time gross settlement/delivery-versus-payment system through which sovereign and unlisted corporate bonds are registered, cleared, and settled via the *Real-time Electronic Transfer of Funds and Securities* (RENTAS), Malaysia’s scripless book-entry securities trading and funds transfer system. SSTS also maintains securities accounts for financial institutions.

³⁸ This would make Islamic ABS a secondary tool and not primary tool to service/underwrite third-party financial institutions; however, it holds the prospect of restructuring non-Sharī‘ah-compliant assets into permissible investments.

³⁹ MTM defines the process of constantly monitoring the variations to contingencies (e.g. market conditions, micro and macro economic indicators, price volatility, quality considerations, political risk, etc.) pertaining to a forecasted spot price (i.e., expected future price) of an asset on a specified delivery date in order to price a derivative contract. For instance, if the asset price falls below (increases above) the contracted strike price a call option would be “out-of-the-money” (“in-the-money”).

⁴⁰ In a multilateral set-up with many market participants, nonetheless, only options, which offer the right (but not the obligation) to sell or buy an asset at an agreed strike price until the maturity date, cater for contingent scenarios.

⁴¹ Khan (1995) substantiates the permissibility of futures contracts based on “clear sayings” of the Prophet Mohammed, which stipulate that a forward trade (*salaf*) should be completed for a specific quantity, specific weight and for a specific period of time – much like a modern day futures contract.

⁴² In a world of constantly evolving financial instruments, the design of prudential regulations that create incentives for market participants to use derivatives only for hedging purposes remains one of the biggest challenges for regulators in conventional capital markets – and by extension to Islamic financial systems on the merits of prohibited excessive risk taking (*gharar*). Many countries have introduced documentation standards for genuine accounting hedges based on the identification of the primary position subject, the type of instrument, the nature of risk, the risk strategy, and a measure of the effectiveness of a hedge (e.g., the hedge ratio).

⁴³ On March 15, 2005, the IFSB issued exposure drafts of prudential standards on risk management and capital adequacy for the Islamic financial service industry, and preparations are underway to issue an exposure draft of standards on corporate governance by the end of 2005. In April 2005 the IFSB also started preparing standards on the supervisory review process as well as transparency and market discipline.

⁴⁴ The concept of *takāful* is similar to mutual insurance. Customers pay a certain amount of finances into a collective pool of funds and withdraw money when a claim is made. Administrators of *takāful* insurance charge a shari‘ah-compliant fee in the form of a “donation” and distribute any funds left over at the end of the year among the original contributors.

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Intangible Asset: A New Asset Class to Structure Islamic Financial Products

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ABSTRACT

Most of the existing Islamic financial products in the capital market are asset-based and structured using tangible assets. Going forward, is it possible to consider an intangible asset as māl in Islamic jurisprudence? If the Shari‘ah permits and recognises the validity of intangible assets, it could be widely promoted as another form of asset class in structuring Islamic financial products. This paper argues that the Islamic jurisprudence has recognised an intangible asset as an asset.

1. INTRODUCTION

Since its inception almost three decades ago, Islamic finance has demonstrated rapid growth, acceptance, viability and robustness. Even though Islamic finance is at the infancy stage compared with its conventional counterparts which have evolved more than 200 years (Ferguson 2000), it has played an important role in mobilising and channelling funds to productive investment activities and bringing significant benefits to economic growth.

The tendency for corporate sector to seek funds through Islamic methods is becoming a new trend. This is evident from the significant increase of *ṣukūk* (Islamic bonds) vs. conventional private debt securities issued in the Malaysian market. In 2006, *ṣukūk* constituted more than 55% of the total private debt securities approved by the Securities Commission (Securities Commission Annual Report 2006:6-38).

Based on previous *ṣukūk* issuances in the Malaysian capital market, the most dominant structures in the market have been the use of tangible physical asset as a basis to get funding as evident from *ṣukūk* structured under Shari‘ah principle of *ijārah* (lease and buy back) and *murābahah* (cost plus). However, since 2005 *mushārahah* (profit and loss sharing) structure has becoming a preferred structure compared to others (Thani 2007). In 2006, this structure became the most popular

as 70% of *ṣukūk* approved by the Securities Commission of Malaysia was *mushārah* (Securities Commission Annual Report 2006: 6-45).

Today, the demand for *ṣukūk* significantly exceeds the supply. The size of Islamic funds is now said to be in excess of US\$ 1.3 trillion, whereas the supply stands at US\$ 50 billion, indicating a substantial gap to be filled. This shows that even though the Islamic financial market is growing at the average rate between 12 and 15 percent a year, there is still enormous scope for further growth, hence demand far outstripping supply.

Due to the constraint on the availability of tangible asset, there is now a need to explore intangible assets as underlying assets in structuring Islamic financial products. This is because the Sharī'ah requires all the issuance of the *Ṣukūk* should be backed by the assets (Guidelines Islamic Securities July 2004).¹

Therefore, practitioner should explore other opportunities and types of assets to create a wider base of Islamic financial instruments. This is consistent with 21st century new trend towards de-capitalising business, moving away from a focus on physical asset investments to intangible assets (Clements et al.2004:44-45).

2. INTERPRETATION OF ASSETS AMONG THE SUNNI SCHOOLS OF LAW

The term *māl* as in most Arabic dictionaries denotes anything owned by someone and remains in his ownership, whether in the form of real property or usufruct. The existing four Sunni schools of law defined *māl* in great details according to their methodologies adopted by each school. This paper explores the main perspective of the four Sunni schools of law on *māl*.

2.1. The Definition of *Māl* by the Hanafi Jurist

According to al-Sarakhsi, *māl* is anything which is created, beneficial to humans, valuable and can be kept (Mabsut1989:11:79). Furthermore, Al-Taftazani gave two definition of *māl* (1996:1:412). First *māl* is anything to which humans are inclined naturally and can be kept (*al- iddikhar*) to be used whenever it is required. Second, *māl* is anything which is beneficial to humans and would decrease in its value and become worn out after usage. The limitation of *al-iddikhar*, as defined by Al-Taftazani, exclude *al-manfa'ah* (usufruct). This is because according to the Hanafi school, usufruct can be owned, but cannot be categorized as *māl*.

According to Al-Taftazani (1996:1:321), ownership refers to the object that can be utilised and it includes usufruct, whereas *māl* is anything that can be utilised and kept until the time when it is required. This clarification suggests that utilisation is not an important characteristic of *māl* but it must, together with attribute, be reserved for use when required. It also indicates that the Hanafis believed that usufruct cannot be categorised as *māl*, even though it is owned by someone.

Nevertheless, al-Kasani(1982:7:385), a Hanafi jurist, views it differently as he defines *māl* to include usufruct as an integral part of it. He indicates in his book, in the chapter of Will and Testament, that will is an affirmation of ownership to the heir, and the place of the ownership is *māl* and *māl* is either corporeal or usufruct.

According to al-Haskafi (1998:3:4), *māl* denotes an object that can be used commonly and corporeal that people endeavour to acquire it. On this ground al-Haskafi clarifies that a seed of wheat, carrion and blood cannot be treated as *māl* because the attribute of these materials are despised. In addition, such items cannot normally be exploited and be of benefit to the people. He emphasises that *māl* usually applies to valuable things, which are valued by money and are tradable. Hence, based on acceptance of the public as an object for trade, it is easier to indicate the type of object as *māl* or otherwise. It is common that selling is invalid for non-valuable things. Therefore, it is important to note that according to the definition given by al-Haskafi, *māl* applies to corporeal which can be preserved until required and is not applicable to usufruct (Ibid.).

Ibn ‘Abidin outlines that an object can be classified as *māl* if it has the attributes of several elements, namely:

- (a) *Māl* is anything to which humans are naturally inclined to and can be kept to be used whenever required(Ibn ‘Abidin1979: 5:51 and 4:51);
- (b) *Māl* can be determined if people, either all or some of them, use the object to capitalise or generate economic activities (Ibid.:4:51);
- (c) Anything that cannot generate economic activities or be capitalised on by either all people or a few of them, is not considered *māl*, even though the object is permissible under the Shari‘ah (Ibid.); and
- (d) For an object to be *māl*, it must be physical in nature, and hence, usufruct cannot be treated as *māl* (Ibid.:5:52).

Al-Haskafi indicates value as an important attribute of *māl*. Ibn ‘Abidin clarifies further the difference between *māl* and *al-taqawwum* (valuable things). This clarification is essential because certain objects can be classified as *māl* even though they have no value according to the Shari‘ah. As previously explained, the status of *māl* can be verified as an object if either all the people or a few of them can utilise it. Valuable things can be verified in the same way, but the usage must be permissible according to the Shari‘ah.

Based on the definitions given by the Hanafi jurists above, *māl* covers only tangible things but not intangible ones, such as usufruct and rights. However, al-Kasani viewed that *māl* covers both the tangible and intangible items. Therefore, whatever properties, goods, usufructs and rights can be classified as *māl*.

2.2. The Definition of *Māl* by Maliki Jurist

According to al-Shatibi (1975:2:17), *māl* means anything that can be possessed, and the owner has an exclusive legal rights of possession of the object when he owns it. Hence, in order for an object to become *māl*, it will depend on the relationship between the owner and the object, as the need to own and use the object is based on the fact that the object is beneficial to the owner (al-‘Abbadi:2000:201).

2.3. The Definition of *Māl* by Shafi‘i Jurist

Al-Suyuti(1994:409) quoted that according to Al-Shatibi an object cannot be classified as *māl* unless it is valuable and can be sold. In addition, someone has to be accountable for the object if it is damaged. Al-Shatibi further clarified that the object can still be classified as *māl* even though it is in a small amount, such as a coin or any equivalent for it, because people are still interested in owning it.

According to Imam al-Shafi‘i in his Chapter *Luqatah* (lost property), the valuable things should have two criteria: first, they should be beneficial to people. Second, in general, their values will increase when the prices rise (Ibid.).

Al-Zarkashi (1985:3:222) defines *māl* as anything beneficial, that is, the object is ready to be used to gain its benefits. He explains further that the object can be in physical form (something immovable or movable) or usufruct. An immovable object normally can be recognised as *māl*, whereas movable are divided into two categories. The first category is the type of animals that cannot be used to gain benefits, such as mosquitoes, lice, flies, insects, etc. and these animals cannot be recognised as *māl*. The second category is animals that are beneficial to us and they can be further divided into two categories. The first category is fierce and wild animals, such as lions, foxes etc. and these type of animals also are not *māl*. The second category is animals which are naturally subservient to humans such as livestock and these animals, however, can be classified as *māl*.

2.4. The Definition of *Māl* by Hanbali Jurist

According to al-Hijawi(2:59), *māl* is anything beneficial and permissible according to the Sharī‘ah and the permissibility to use it should be under normal conditions. Al-Hijawi defines normal condition as *darurah* or *hajah* circumstances, where Sharī‘ah provides exceptional application as special treatment to ease hardship.

According to al-Buhuti (1996:2:7-8), *māl* is anything which is absolutely beneficial or anything which is permissible to possess under normal circumstances. He clarified further that anything which is not beneficial or prohibited to be consumed under the Sharī‘ah law is not *māl* such as unbeneficial insect and intoxicant. He also explained that anything which is permissible under *hajah* circumstances is also excluded from the *māl* category such as a dog used as a guard. He clarified further that anything is permissible under *darurah*

circumstances is not *māl* such as an animal not slaughtered according to the Sharī‘ah.

2.5. Conclusion on *Māl*

In conclusion, the Hanafis view that the scope of *māl* covers only tangible things but not intangible ones, such as, usufruct and rights. However, al-Kasani stated that *māl* covers both the tangible and intangible items. Therefore, whatever properties, goods, usufructs and rights exist can be classified as *māl*.

Compared to the Hanafī jurists, the Jumhur comprises from three Sunni schools of law; al-Malikiyyah, al-Shafi‘iyyah and al-Hanabilah defined *māl* in its widest context which covers tangible and intangible matters.

3. INTANGIBLE ASSET FROM SHARĪ‘AH PERSPECTIVE

Based on the above discussion, it can be comprehended that the classical scholars do not directly deal with intangible asset, but they provided the basic principles which can embrace the attributes of the intangible asset. The principles of *ḥuqūq* and *manafī‘* as well as the principle of the formation a new contract affiliated with stipulation are considered related to the subject.

3.1. The Scope of Intangible Assets

As discussed, the Jumhur gave a wide scope of classification on assets where it covers the tangible and the intangible asset. Based on the scope of *māl* as defined by the Jumhur, it can be understood that they upheld intangible assets as anything that worth money. Hence, it is not new under the Sharī‘ah law that intangible asset is valuable even though it is non-figurative. However, further discussion is needed to determine the extent to which the Sharī‘ah approves intangible assets as valuable and saleable like tangible assets. Corporate intellectual property (items such as patents, trademarks, copyrights, business methodologies), goodwill and brand recognition are all common intangible assets in today's market place (Investopedia, 17/7/2007). Based on the corporate perspective, intangible assets are assets of a corporation which are not physical. They are considered to enhance the company position in the market. Such assets include goodwill, trademarks, patents, intellectual property, copyrights, franchises, leases, licenses, permits, as well as research and development (Iqbal:1997:215).

3.2. Goodwill as Intangible Assets

As previously mentioned in brief, goodwill is one type of intangible asset; this is because, in practice, goodwill involves expectation of return which is to be estimated from the entire business. In practice, expectation can be estimated by looking at a successful business in building substantial goodwill. Goodwill represents the value of a corporation name, customer service, employee morale and other such factors that are anticipated to translate into higher earning power. This paper will discuss the status of corporation name which is type of goodwill.

3.3. Goodwill from Sharī'ah Perspective

Classical Islamic jurists did not directly discuss the legality of goodwill, as the issue did not exist in their time. Contemporary scholars are convinced that, even though the classical Islamic jurists did not precisely deliberate this theme, it has however provided the basic principles which can embrace the attribute of goodwill, which is discussed in modern economic activities.²

Based on discussion by the contemporary scholars, this kind of asset can be viewed through the tenet of *māl* and *milk* (ownership) in Islamic *fiqh* which includes the discussion of *ḥaq* (right) and *manfa'ah* (usufruct). This is because both *ḥaq* and *manfa'ah* are intangible. Even though there are disagreements on its value among the scholars, they validate that both can be categorised as *māl*. Therefore the characteristic tenet of *ḥuqūq* and *manfa'ah* need to be explored on how both can be suited with the characteristic of goodwill as intangible assets.

3.4. The Status of *Ḥuqūq* as *Māl*

Classical Islamic jurists defined *ḥaq* as right in general which is established in the Sharī'ah, either for humans or for Allah. However, the definition did not distinguish between financial right and natural right or individual right. With regard to *ḥaq Allah* (a right of Allah s.w.t.), even though the name of the right is related to Allah s.w.t. but there is no any benefit return to Him as a God. The aim of this right basically is to furnish benefits to the community at large and not to a particular individual. For instance, an act of devotion and worship, including *salah*,³ *siyam*,⁴ etc. are acts which are beneficial to all.

Another type of right in general which is established in the Sharī'ah is *ḥuqūq al-ʿibad* (the right of fellow human being). This type of right is specifically related to the interest of mankind. For example, acts that exclusively consist of the rights of human being such as the right to enforce a contract, or the right to compensate for loss.

Compared to the classical scholars, contemporary scholars such as al-Zarqa' and al-Durayni have provided a wider scope of interpretation on *māl* which includes *ḥaq*. These interpretations are more appropriate to the new challenges of expansion in economic activities in the modern perspective (al-Zarqa' 1967:3:10; al-Durayni :119).

Al-Sanhuri (5:62) observed that the *fuqahā'* among the four *Sunni* schools of law, are in agreement, but some divisions of *ḥuqūq* cannot be categorised as *māl*. For instance, *ḥuqūq* such as *ḥaq al-wilayah* (right of custody) and *ḥaq al-hadanah* (right of guardianship of an infant) are classified as *ḥaq mutlaq* or *ḥaq mahdah* (absolute right) and established by *Shar'* over the individual and are not related to *māl* (al-Khafif:28-30). The *fuqahā'* also agree that some kind of *ḥuqūq* can be owned. The ownership gives the owner an exclusive right to use the utility of a thing in any way that is not legally forbidden. *Ḥuqūq* such as *ḥaq al-murur* (right-

of-passage), *ḥaq al-ta'alli* (right to upraise), *ḥaq al-shurb* (right of water supply) and *ḥaq al-masil* (right of sanitation and drainage) are known as *ḥuqūq al-irtifāq* (easement rights) (Shalabi1985:352-5). These types of rights are associated with immovable property and assigned to another immovable property belonging to another owner. It will be permanent as long as both immovable properties exist regardless of owners (Zaydan:196).

Unlike Jumhur *fuqahā'* comprising Malikis, Shafi'is and Hanbalis, the Hanafis classified *ḥaq* related to property into two different circumstances. First, this kind of *ḥaq* cannot be classified as *māl*. Second, it can be categorised as *māl* however the treatment is not the same as for a tangible object.

For the first, the *ḥaq* cannot be classified as *māl* as an independent subject. The Hanafis ruled that *ḥaq* could not be classified as *māl* even if the *ḥaq* is related to property. The basis of the ruling on *ḥaq* is attributed as intangible and may not be preserved. They also argued that the *ḥaq* is not permitted to be sold, because the conditions to make a sale valid is that the subject matter of sale, must be of legal value, whereas *ḥaq* with its own entity does not have this kind of attribute (al-Kasani:5:140).

However, in the second type, the Hanafis ruled that *ḥaq* could be classified as *māl* provided that the *ḥaq* should be attached to the property. In other words, whenever the *ḥaq* is attached to the property, the *ḥaq* is *māl* and if detached, the status of *ḥaq* ceased to be *māl*.

For instance, if someone wants to sell his land which is attached with *ḥuqūq al-irtifāq*, he can sell it together with the *ḥuqūq* attached to the property, such as sell the land with *ḥaq al-murur* (right of passage), *ḥaq al-masil* (right of sanitation and drainage), etc. Al-Kasani emphasised that the person is not allowed to sell easement rights separately because these rights are not allowed to be sold separately. He indicated that it is permissible if the owner of the property sells his land together with *ḥaq al-murur*. Similarly, in the case if someone leasing his land, he is not permitted to lease only the right, which is associated with the land as a separate entity, because it is not allowed to lease the right separately. The ruling is based on theory of ownership in the Hanafi school, where *ḥaq* and property, if attached together are appropriate to be owned; nevertheless *ḥaq* in a separate entity is unlikely to be owned (Ibn 'Abidin1979:5:78-80).

In contrast, the Jumhur *Fuqahā'* from Malikis, (Sahnun:4:289-290) Shafi'is (al-Ramli1984:3:397-8; al-Bayjuri:1:353) and Hanbalis (al-Buhuti1996:2:5 and 147-8) ruled that any *ḥaq* which is related to property can be categorised as *māl*. The treatment of this kind of subject is the same as corporeal even though it is intangible. Thus, *ḥaq māli* can be sold and can be given as a gift.

Al-Zarqa'(3:114-8) commented that the Hanafis has been influenced by the theory of materiality on their ruling. Therefore it is not surprising the Hanafis did not recognise *ḥuqūq al-irtifāq* as *māl* if it is separated from the attached property.

3.5. The Status of *Manfa'ah* as *Māl*

As mentioned previously, the theme of intangible assets can be explored in the tenet of *ḥaq* and *manfa'ah* (usufruct) in Islamic *fiqh*. The scope of *ḥaq* has been discussed and afterwards the discussion will focus on *manfa'ah* whether Islamic *fiqh* classifies it as valuable.

The jurists differ on categorising *manfa'ah* as *māl* because it has attributes of intangible assets. There are two groups with opposing opinions as follows:

3.5.1. The View of the Hanafis on *Manfa'ah*

The Hanafis classified *manfa'ah* as not *māl*. This is because they seem to be more influenced by tangibles theory based on its characteristics that are touchable and present compared with *manfa'ah* which does not exist physically. On the other hand, *manfa'ah* can be presented only from time to time and depends on a contract. This kind of attribute is not like *'ayn* which is present at all times. The *Hanafis* support their view with evidence classified as follows:

a) *Manfa'ah* Treated as Valueless

The Hanafis argued that *manfa'ah* cannot be kept, which is an important part of the attribute of *māl*. Al-'Abadi (1:213) indicated the opinion of the Hanafis by citing that according to Sadr al-Sharī'ah that *manfa'ah* cannot be categorised as *māl* because it is not *mutaqawwam* (valuable).⁵ *Manfa'ah* does not attribute *māl* since it cannot be kept and cannot remain in supply when needed. Based on the view given by Sadr al-Sharī'ah, it is clearly indicated that *manfa'ah* could not stand alone as a valuable thing, which may be buying and selling to fulfil the demand. In that sense, al-Taftazani (1996 1:321-2) described the attributes of *manfa'ah* that it is contingent upon the existing physical embodiment, which cannot be preserved its utilisation whenever it is required. Therefore anything that carries out that particular attribute is not valuable and cannot be categorised as *māl*.

b) The Difference Between *Manfa'ah* and *'Ayn*

According to the Hanafis, *'ayn* is a tangible (physical) asset that exists, and that *manfa'ah* and *'ayn* are different because *manfa'ah* comes into existence depending on *'ayn*. Al-Sarakhsi (1985 11:8) of the Hanafis clarified that since *'ayn* is physical, it can appear and be present at any time. In the event of damage on *'ayn*, compensation is not based on *manfa'ah* but it will be dependent on the nature of the damage of *'ayn* itself. This is different in the case of *manfa'ah* when destruction occurs; the compensation is not absolutely dependent on *manfa'ah* itself but will be based on *'ayn* of the *manfa'ah*. This is because the equality of the use of *manfa'ah* is dependent on the same nature of *'ayn*, hence the different nature of *'ayn* will effect the utility of *manfa'ah*. Therefore, different nature of the damage on *'ayn* will affect the utility of *manfa'ah*.

c) The Consideration of *Manfa'ah* as *Ma'dum*

Ma'dum literally means non-existence. If there is a contract of sale involving a *ma'dum* object, technically it denotes the object, which is not seen nor perceived by either party to the contract or where the object of the contract is present but hidden from view (Iqtisad Al Islamy: 26/07/2007).

With regard to *manfa'ah*, al-Sarakhsi insisted that *manfa'ah* is non-existent; therefore there is no ground to discuss any rule on it because to decide a ruling on something without a basis is not permitted. However, al-Zayla'i of the Hanafis indicated that even though *manfa'ah* cannot be legally considered as *māl* but *ijārah* can change it into *māl*. The change is based on an exceptional rule by applying methodology of *istihsān* (an exception from a general rule) and based on *nas* (explicit text)⁶ as well as *'urf* (custom) among people according to their custom. The clarifications from al-Zayla'i seem to be contradicted by al-Sarakhsi where he does not recognise *manfa'ah* as *māl*.

3.5.2. The View of Jumhur on *Manfa'ah*

Unlike the Hanafis, another Sunni school of law among the Jumhur comprising Malikis, Shafi'is and Hanbalis are in consensus that *manfa'ah* can be considered as *māl*. They argued it is not essential to become *māl*, it can be possessed, preserved or identified by its own right. However existence and custody of the underlying is sufficient to classify a subject as *māl*. Al-Khafif (27) confirmed that on such cases *manfa'ah* can be considered as *māl*. As an example, if someone possesses a car, he is the only one who can benefit from using the car which others are not allowed to use without consent and hence, the ownership of the car is related to the *manfa'ah* (ibid.).

Based on discussions above, the Jumhur affirms the view that *manfa'ah* is *māl*. Ibn 'Arafah of the Malikis indicated that *māl* connotes tangible and intangible assets (cited in al-'Abadi:1:216). Another scholar among Shafi'is, such as al-Zarkashi shares the same view, as he clarifies that *manfa'ah* of the house is *māl* according to al-Shafi'i and the status is not dependent on the making of a contract because the status of *manfa'ah* as *māl* is the same as a tangible thing (al-Zarkashi 1985:3:197-8).

Further to strengthen the evidence that *manfa'ah* is *māl* is the Shafi'is' view, as indicated by al-Nawawi (5:207-8) that *ijārah* (contract of renting) is *manfa'ah*. He clarified that the contract of *ijārah* is a contract to possess *manfa'ah* by exchange. In other words, the tenant pays the rent to acquire benefit in using *manfa'ah* in *ijārah*. Therefore it is clear in this case that *manfa'ah* is *māl*; otherwise, *manfa'ah* will be valueless.

According to Hanbalis, *manfa'ah* is *māl*. Ibn Qudamah (4:327) indicates that a permissible *manfa'ah* is allowed to be a subject of utilisation; hence it is permitted for *manfa'ah* to take indemnity and permit the other to pay some money to acquire

the subject to fulfil their needs. In that sense *manfa'ah* has consistency with other things that are permitted under the Sharī'ah to buy and sell.

Ibn Najjar (1:338) of the *Hanbalis* viewed that *manfa'ah* can be categorised as *māl*. He indicated that besides objects with physical attributes which could be sold, other items like *manfa'ah mubahah* (permissible utility) could also be sold.

Jumhur from *Sunni* schools of law in general argued that *manfa'ah* is *māl*. Their evidence to support the view is as follows:

a) *Manfa'ah* as the Corpus

Jumhur viewed that *manfa'ah* and the corpus both are *māl* and any impairment or destruction on both items is subject to compensation. This is because, *māl* is created for the benefit of man and *manfa'ah* fulfils the same function. In general, the status of *māl* on the subject can be known when people use it in trade and business, and undoubtedly people usually involve *manfa'ah* in their transactions (al-Ramli 5:169). In relation to this, the Malikis maintain that *manfa'ah* is a price subject and can be compensated. Further, an equal treatment in ruling can be given on *manfa'ah* as a corporeal object (al-Dusuqi 3:442). In strengthening the argument, Jumhur said that *manfa'ah* is allowed to be set as a dowry, since dowry is supposed to be valuable for the bride, hence, it becomes strong evidence that *manfa'ah* is *māl*.⁷ Other evidence is the permissibility of taking a payment on the use of *manfa'ah* in *ijārah*. According to *ijārah* agreement, the tenant is required to pay the price of *manfa'ah* subject to the length of time he needs to use it and this agreement is subject to compensation, if there is mistreatment (Zaydan1989:185-6). This practice is common among the people as part of daily economic activities. All of the evidence above shows that *manfa'ah* is *māl* and has the same status as a physical thing.

b) *Manfa'ah* is Valuable Subject

Jumhur also argued that *manfa'ah* is a valuable subject. It was recognised that any valuable matter secured with the value of the *manfa'ah* in its physical embodiment becomes valuable and thus, it is impossible for an item to become precious without having *manfa'ah* associated with it. The *manfa'ah*, in practice, can be owned through a contract and it will be subject to compensation if any mistreatment occurs after the contract is prepared, such as violation of the contract or when the contract is invalid. Therefore it can be concluded that *manfa'ah* is *māl*, because usually, if a certain object to be owned needs to use a contract and is subject to compensation when there is mistreatment, then it is a valuable thing as this will not apply for valueless things (al-Sarakhsi1985:11:28).

c) *Manfa'ah* is *Māl* According to 'Urf

According to 'urf in general and based on market and business transactions, people recognise *manfa'ah* as an object of transaction. Considering the utility of a building or transport as an example, people negotiate a price or terms using

manfa'ah when they need to fix a bargain price to seal an agreement in their *ijārah* contract. The price of utility is a floating increase and decrease subject to market forces of demand and supply⁸. This is strong evidence showing that *manfa'ah* indeed has a commercial value.

3.6. Conclusion on *Ḥaq* and *Manfa'ah*

In conclusion the *Hanafis* stated that *manfa'ah* and *ḥaq* are not *māl*. They seem to be influenced more by the tangibles theory, which emphasises on the aspect of being touchable and having a physical existence. As such, they apply this belief to *manfa'ah* and *ḥaq* which physically does not exist. Nevertheless the *Jumhur* from among three other *Sunni* schools of law are in agreement that *manfa'ah* and *ḥaq mālī* can be categorised as *māl*. Owing to the fact that it is not essential to become *māl*, the subject should have a physical attribute. The status of *māl* on *manfa'ah* and *ḥaq mālī* can be recognised because people need it in their trade and business.

4. AN ANALYSIS OF A CORPORATION NAME AS A TYPE OF GOODWILL

The word “corporation” derives from the Latin *corpus* (body), representing a “body of people”; that is, a group of people authorised to act as an individual. A “corporation” is a legal entity⁹ (distinct from a natural person) that often has similar rights in law to those of a natural person (Hornby, *Oxford* 2003 279).

A corporation can be a large business company, such as Toyota Motor Corporation, (Toyota 26/07/07) which engages in the production and sale of automobiles worldwide and Mitsubishi Corporation (Mitsubishi 26/07/07) which is one of the world’s most diverse enterprise. This diversity is manifested in over 600 subsidiaries and affiliates, as well as a network of 36 offices in Japan and 105 overseas.

Another legal entity involved in business is called a company. It is, in general, any group of persons united to pursue a common interest. The term is, thus, synonymous with association, but more often it is used specifically to identify associations formed for profit, such as the partnership, the joint-stock company, and the for-profit corporation. A company is not necessarily a corporation, and thus, may not have a separate existence from its members. A company might also not be able to sue or be sued in its own name and thus, would not be considered to be a legal person. Whether a company has either of these characteristics depends on the law of the jurisdiction.

For example, in UK law, a company is a legal person with a separate identity from its members and thus, would be a form of corporation. A minimum of two people are required to form such a company, usually one director and one secretary. Both directors and secretaries can be either individuals or corporate entities, and there are almost no nationality and residence restrictions, although

there must be an office within the UK, registered with Companies House. The most important legislation governing company law is found in the *Companies Act 1985* and to a lesser extent the *Companies Act 1989*. (Wikipedia, Company 26/7/07)

According to al-Nashami (3:2274), the name of the company is very significant for a business because the owner uses it to distinguish itself from others, who might provide the same products and services. The customer, on the other hand, is able to recognise a company according to its products and services, as well as distinguish it from its competitors based on the quality of services and products. Therefore, a company and the location, where it is based, become well known among the people who are attracted by and depend on the services and products.

There is a relation between the name of the company and the popularity of the business. Whenever certain locations and companies gain popularity it will have a positive effect on the attitude of the people towards their product and services. The more popularity gained by the place and name of the company because of customer satisfaction, the more the value it generates. Therefore strategic locations, quality of product, attentive courteous services, honesty and fairness in dealing with the customers are several factors that give effect to the positive value of the business (ibid.).

The owner of the company enjoys privilege of ownership, because the owner has exclusive power to control the resources and direct the affairs of the company by doing trade and business, using the name of his company. Others are not allowed to use his company for the purpose of dealing in trade and business or infringement in any way; the treatment for the ability to use the resources of a company and its name legally is the same as ownership of a tangible property, even though the ownership of the company is in the type of right authorised by law (ibid.).

According to al-Nashami, the characteristics of *ḥuqūq* are very clear, with regard to the name of the company. This can be understood as the relationship between products and services provided under the banner of the company. The effect of quality and commitment from the owner of the company can create a level of trust for the customer with regards to the quality of its product. The company gains popularity through product and services marketed under its name.

To be more successful in business, it is not enough for the entrepreneur to feel satisfied by just having a company and then selling the product and services without focusing on customer satisfaction. However, the entrepreneur should determine the best methods for promoting his business and providing quality products and services. The entrepreneur is supposed to have innovative ideas, and be prepared to work hard to provide quality products and services to keep the customer satisfied. This will give better value to the customer and give the entrepreneur an edge in the competitive market environment. Whenever the entrepreneur succeeds in winning the confidence of customers for his products and

services, he can create customer loyalty to sell even more products and services in the future. This success is considered as value added to the company and increases its value and popularity.

Al-Nashami emphasised that the success achieved by the entrepreneur, based on his hard work, creativity, full commitment, dedication and incurred costs, made his business well known among the public if there was something special and distinct for the owner. Without such differentiation, his business would just be a name of a company and nothing more. Al-Nashami also made an analogy between a good and failure company. It is evident that a bad company, which does not have the above characteristics, will make its products and services less attractive and cause lack of interest from the customer on using its goods and services. This will affect the value and the price of products and services offered normally and will force the company to offer lower prices, probably to attract customers using their goods, which will become a reason for substantial losses (ibid.:2341-2).

Another contemporary scholar, al-Buti (3:2397-2416), indicated that the company name can be considered as a type of *al-ḥuqūq al-maliyyah*. The view is based on the scope of *al-ḥuqūq* in Islamic law, which is a legal privilege to the owner. Al-Buti also related this subject with a theory of *al-ʿurf*. According to Islamic law, acceptance of practice among specific environments can be considered as a rule, if the practice is not repugnant to Islamic principles. In this case, it occurs in the business environment, in practice, a company name can be accepted as something valuable, then it can be a strong support to permit a company name as *ḥuqūq al-māl*.

Al-Buti added other evidence to strengthen the view that a company name can be considered as *māl*. He assessed this subject in the principle of *al-manfaʿah al-qimiyyah*, which is valuable usufruct or *al-thamarah al-maliyya* (valuable utility). The company, whenever registered and recorded by the authority, becomes legally approved to run a business. It is undeniable that the owner will use his creativity and endeavour to ensure the survival of his company in the competitive business environment. The creativity presented is the type of production of the company, which is indeed valuable and material, and at the same time can be utilised and priced. Therefore, according to al-Buti the outcome from the company can be materialised and separated. This outcome is valuable and can be traded according to the market system and rules.

As production of the company in the form of valuable goods can be traded, thus the equipment used in the production can be considered valuable items as well. As such, the production equipment, creativity, skills and even technical knowledge are considered privileged rights to the owner of the company. Even though the latter are in intangible form, they are significant factors to ensure the production of the company becomes a reality and the way to translate the taking of possession of such a subject is to confine it to the name of company.

Al-Amin (3:2499-2505) another contemporary scholar, explored the selling of a company name to assess several principles, which were discussed among the classical scholars in *Sunni* schools of law. According to him, the principles seem to be related to the theme and theory of *ḥuqūq*, conditions in *mabi'* on objects of sale and theory of *māl*. He found that even though the principles, which already indicated by the classical scholars, seem to be related to the theme, there is no explicit evidence showing that the classical scholars have discussed this subject. Hence al-Amin concluded that this subject is totally new and needs to be decided depending on new circumstances. The issue can be considered as *'aqd jadid*, which means a new type of contract or transaction outside of the standard type of contract. According to the Shari'ah, its validity can only be determined by a new *ijtihad*.

Al-Amin explored the scope of *bay'* (a sale contract) and *mabi'* (object of sale) which have been discussed by the Shafi'is and Hanbalis. This is because both schools of law provide related discussions on the theme of selling a company name in the two topics above.

On the scope of *bay'*, al-Shirbini (2:2-3) of the Shafi'is indicated that some scholars defined it as a contract of exchange of property to take possession of *'ayn* (material) or *manfa'ah*, (usufruct) in perpetuation, then they explained an example related to usufruct is to include the sale of *ḥaq al-murur*, which is a right of passage. The sale of *ḥaq al-murur* is considered as the selling of intangibles. Furthermore, they explained, even though contracts *bay'* involve *manfa'ah* as an object of sale, the clause "*al-manfa'ah al-mu'abbadah*" is in the definition of *bay'* to exclude a contract *ijārah*, the lease contract, because the objective of *bay'* is the transfer of ownership in perpetuation and not for a temporary basis, whereas in *ijārah* the use of usufruct is provisional within a stipulated time, hence *ijārah* is not *bay'*.

The scopes of *bay'* according to some scholars as mentioned by al-Shirbini include the validity of sale on *al-manfa'ah al-mu'abbadah*. This attribute, as indicated in the definition, is related with the theme of selling a company name, because the clause *al-manfa'ah al-mu'abbadah* includes the validity of sale on useful intangible subjects. This involves transfer of ownership in the kinds of usufruct in perpetuation.

With regard to the conditions of *mabi'* (object of sale), the Hanbalis validates *al-manfa'ah al-mubahah* to become the object of sale. Furthermore, the Hanbalis classified *māl* to include *a'yan* (materials) and *manafi'* (usufructs) – in the kind of immaterial(al-Buhuti 2:5) This basis can support the validity of selling a company name, because the Hanbalis validated selling an intangible subject if it is valuable, useful and does not go against the Shari'ah principle. Thus, because of a company name carrying the same attribute; it is valid to be an object of sale. Therefore corporation name can be categorised as *māl*.

5. CONCLUSION

Based on the above discussion, apparently the name of the company and corporation could have a distinguished value as a result of quality product, creativity, endeavour, skills and even technical knowledge, offered by the owner of the company. The circumstances can be concluded as *'urf tijāri khas*, which means a specific custom in a business environment. This custom grows and spreads among the business community and becomes a maxim and reference, which is accepted in Islamic law as indicated in *Majallah al-Aḥkām*: “a thing known amongst merchants is a thought fixed by stipulation between them” (Tyser, *The Mejelle* section 44) and indicated in another section: “a thing known by common usage is like a stipulation which has been made.” (*The Mejelle* section 43). The evidence supported by *'urf* as strong evidence supported by *nas* which is the text of the law as indicated: “what is directed by custom is as though it is directed by law” (*The Mejelle* section 45). According to circumstances in the business environment, the name of the company and corporation can be considered as part of *ḥuqūq*. This is because the company or corporation is registered and approved by law and becomes a privilege of the owner.

As indicated by al-Amin (3:2499-2505) buying and selling of a company or a corporation name is considered a new phenomenon in the modern economy. Therefore, it seems that no similar theme can be found in a standard type of contract. However the principle of *'urf* can be a basis to support the valid buying and selling activity as current practice.

With regard to the status of a company name or a corporation name being valid to be considered as *māl* or otherwise, as discussed among the scholars, it can be valid as *māl* based on the principle of *'urf* and the theory of *al-ḥuqūq al-maliyyah* (valuable rights). Even though the classical view, especially among the Hanafis, validated the rights as *māl* it depends on the condition that the object should attach to the property, but the *Jumhur fuqahā'* viewed that *al-ḥuqūq al-maliyyah* can be *māl* separately without being attached to the property and valid as the object of sale. The *Jumhur* strengthened their view based on evidence from *'urf*, as indicated in the *Majallah al-Aḥkām*: “what is directed by custom is as though directed by law.” This shows the authority of *'urf* as a proof as strong as *nas*, the text of law, if *'urf* does not go against the Sharī'ah principle.

Based on the discussion above it is clear that even though goodwill is an intangible asset in nature, it can be accepted as a new asset class according to Islamic jurisprudence. Therefore, this type of asset is potential to be developed in structuring Islamic capital market products, especially in issuing *ṣukūk*.

Notes

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¹ Securities Commission's *Guidelines on the Offering of Islamic Securities* indicated the requirement to disclose the identified underlying assets and value as asset back for the issuance of Islamic securities.

² Al-Durayni (*Haq al-Ibtikar* 1987, 7-8) explored *Haq al-Ibtikar fi al-Fiqh al-Islami* or the legality of intellectual property according to the Sharī'ah law, he found that there was no specific analysis and discussion among the classical Muslim scholars pertaining to this kind of theme. He concluded that the different circumstances might cause this problem to occur.

³ The benefit and interest of *salah* to all is indicated in the Qur'ān: "Indeed, prayer prohibits immorality and wrongdoing, and the remembrance of Allah is greater." (29: 45).

⁴ Even though when Muslims perform *siyam*, they will stop eating and drinking and other things which prevent the *siyam* from invalidating the benefit to all from doing this kind of devotion is to achieve the ultimate goal of *siyam* which is to become righteous. This goal is mentioned in the Qur'ān: "O you who have believed, decreed upon you is fasting as it was decreed upon those before you that you may become righteous." (2: 183)

⁵ *Mutaqawwam* also connotes that its use is lawful under the Sharī'ah. An example is that wine is not *mutaqawwam* for Muslim, even though it is *mal* for non-Muslims since they may buy and sell it.

⁶ Such as stated in the Qur'ān: "One of the women said, O my father, hire him, indeed, the best one you can hire is the strong and trustworthy." (28: 26). There are some *ḥadīth* stated on *ijārah* such as reported by Ibn 'Umar and collected by Ibn Majah that the Prophet s.a.w. instructed to pay "*ujrah*", the hire, before the sweat dried. (Zayla 'i:4:129).

⁷ This is based on the Qur'ānic verse: "And lawful to you are [all others] beyond these, provided that you seek them [in marriage] with gifts from your property, desiring chastity, not unlawful sexual intercourse." (4:24). There is *Ḥadīth* reported by al-Bukhari and Muslim that the Prophet SAW arranged a marriage among his companions and the dower is to teach the bride several verses of the Qur'ān. (al-Shawkani 2000 6:557-8).

⁸ In *Ijtihād* Jumhur, they classify that *manfa'ah* and corporeal are alike. If corporeal of merchandise as an example when the sale price is dependent on market forces of demand and supply, it is the same for *manfa'ah* when it goes to the market. See discussion on *manfa'ah* (al-Zarqa' 3:204-10).

⁹ A "legal entity" or "artificial person" is a legal construct with legal rights or duties, such as the legal capacity to enter into contracts and sue or be sued. It is an entity, usually an

organisation, such as a corporation or a government ultimately composed of natural persons that the law treats for some purposes as if it were a person, distinct from the natural persons of which it is composed; the “legal personality” of an artificial person, including its rights, duties, obligations and actions, is separate from any of the other artificial or natural persons which compose it. Thus, a legal liability of the legal entity is not necessarily a legal liability of any of its natural persons. For example, a properly executed contract in writing on behalf of a legal entity only affects the rights and duties of the legal entity; it does not affect the personal rights and duties of a natural person who executes the contract on behalf of the legal entity. However, a legal entity only operates in lieu of its natural persons. Thus, for example, a legal obligation involving a tort that a corporate incurs while acting in his capacity as an agent for the corporation may be an obligation both of the officer personally and of the corporation. There are some legal possibilities that are available only to natural persons, not to legal entities; for example a legal entity cannot marry, vote, or be elected President. (Wikipedia, Legal Entity 26/07/2007). In the US a corporation is a legal entity that can exist separately from its owners. Creation of a corporation occurs when properly completed articles of incorporation (called a charter or certificate of incorporation in some states) are filed with the proper state authority, and all fees are paid (Wikipedia, corporation 26/07/2007)

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Sharī'ah Alternatives to Non-Sharī'ah Elements in Modern Commodity Futures Trading

*Mohammed Saleh Ali Ayyash**

ABSTRACT

The rapid development of commercial and financial institutions has increased the need for developed financial markets including the commodities futures. However, current market practices in futures markets do not conform to Sharī'ah. While a number of scholars advocate the use of al-salam contract as a typical alternative, there is a substantial gap in the existing literature on how to effectively utilize this contract to create Islamic commodity futures. This paper is an attempt to fill this gap. It advocates creation of Islamic commodity futures that are based on al-salam sale concept and yet tradable. As part of this broader agenda, the present paper identifies the non-Sharī'ah elements in the modern commodity futures. It brings to fore the differences and similarities between salam and futures. It also verifies the ability of al-salam sale concept to reform and replace the impermissible elements of commodity futures. The paper stresses a major advantage of salam based commodity futures market. That is, 'it cannot be used for' and 'will not lead to' pure speculation; rather, it will promote production and trade. Adherence to Sharī'ah guidelines of exchange is essential for realization of the benefits from the use of salam based futures towards the development of Muslim economies.

1. INTRODUCTION

Islamic Sharī'ah forbids 'taking usury', 'inserting ignorance', 'treating gambling', 'making exploitation', and 'practicing uncertainty' in commercial and financial businesses irrespective of their nature or purpose. Islamic Sharī'ah, alternatively, regulates the ways and means of concluding/conducting commercial and financial contracts/activities beside supplies dealers with a variety of modes that can be variously utilized for the benefit of money receivers/investors and money advancers whether at individual, societal, regional or international level. However, the present-day resurgence of fundamental Sharī'ah values has not yet been touched extensively the varied activities of financial markets and hence the efforts of contemporary Islamic economists in steering the direction of those markets to operate on Islamic lines are of considerable significance because the

objectives of financially helping the producers, economically enhancing the exchange of commodities and promoting output, and generally improving economic growth and development for a society are the economic and financial features of such markets.

After studying the legality of theoretical roots and practical aspects of mainstream commodity futures trading contracts, as a result, the contemporary Islamic economists and jurists have passed a prohibitive judgment on those contracts. In fact, the disapproval of modern practices of such trading contracts led current Islamic economists and jurists to regard the establishment of an Islamic replacement of those contracts is an important legal obligation in Islamic societies. Simultaneously, they unanimously advocated the use of *al-salam* contract as a typical Islamic alternative to those contracts, although this paper notices that no study, up to the limit of the researcher's knowledge, has discussed or elaborated on how the concept of *al-salam* contract can be utilized in place of these financial derivative instruments. This notice is largely important because of showing no considerable progress has taken place in the literature on *al-salam* contract as an advocated alternative to those contracts.

In response to both non-Islamic practices of modern futures trading contracts in commodity markets and the demand of Islamic scholars/institutions in benefiting from the legal practical consequence of *al-salam* sale contract, consequently, this paper attempts to make an initiative towards building a model of commodity futures trading businesses on the basis of *al-salam* sale contract which is in continuous rise in modern times. But the first and necessary step on constructing the way to the desired model in this respect is to identify non-Shari'ah elements of modern commodity futures contracts followed by the clarification of whether the conceptual framework of *al-salam* sale contract is capable to replace the existent non-Shari'ah elements in those contracts and how this could be done if the answer is positive to establish eventually the appropriate conceptual framework of the commodity futures trading businesses based on Islamic Shari'ah guidelines.

This paper, accordingly, is composed of nine sections. The general introduction to the topic of this paper transpires in the first section to introduce the basic points upon which the substance of this paper generate in addition to highlight the way of organizing the present paper. Section two sheds light on the statement of the problem that creates the key motivator for this paper. The objectives and significance of this paper are clarified in the third and fourth section respectively. The fifth section clarifies the legal framework of *al-salam* sale contract. In this section, the paper displays the pillars and conditions for the valid application of *al-salam* contract and shows in the form of tables a general summary of the views of jurists on the general, economic, and financial issues of the application of commodity futures trading businesses-based *al-salam* sale concept. Section six thereafter outlines an overview of modern futures markets while section seven depicts the authentic Shari'ah problems-based investing in modern futures markets

for commodities. The Shari'ah replacement of non-Shari'ah factors available in the current practice of commodity futures trading contracts is uncovered and explained in section eight. The final section exposes the conclusion of the present paper.

2. STATEMENT OF THE PROBLEM

One of the conventional economic activities in financial markets is a commodity futures trading, which can be defined as "A commercial contract calling for the purchase or sale of fixed quantities of goods of defined quality at specified futures dates to a price agreed today, but a small pre-determined percentage of the total price is only payable at the time the contract is entered into". This economic activity in modern times is greatly important for the exchange of commodities and economic development which are interrelated components to formulize a cycle of economic progress for a society and thus deemed as an integral part of contemporary economic businesses. On the other hand, this paper observes that the Islamic economic system makes a particular reference to the institution of exchange for commodities. To this effect, *al-salam* sale contract, among others Islamic modes of financing, considers as a trading mechanism and hence is capable to play a substantial role in Islamic institutions of exchange for commodities to achieve the same economic objectives of that of conventional futures markets for commodities. This contract is defined as "A sale contract whereby the seller undertakes to supply a specified quantity of a well-defined commodity of precisely described quality deliverable to the buyer at a greed-upon future date in exchange of an advanced price paid fully to the seller at the time of effecting the sale".

On this basis, this paper finds that the underlying economic objectives of conventional commodity futures trading activities are not inconsistent with the principles and teachings of Islamic Economics but the conceptual structure or the essence of those activities are derived from non-Islamic economic system, that is to say, the approach and outlook of western commodity futures trading contracts in modern financial markets are foreign to Islamic Shari'ah or not operating on Islamic lines. And this phenomenon remains dominant in Islamic societies despite the similarity of conceptual definition between *al-salam* sale contract and the conventional commodity futures trading contracts. In other words, despite the theoretical idea of *al-salam* sale contract is similar to the theoretical idea of conventional commodity futures contracts, *al-salam* sale has not yet been revived and used for the purpose of having modern Islamic financial markets for commodities, that is to say, for the purpose of originating an Islamic commodity futures trading on the ground of *al-salam* sale contract. In fact, the importance of looking at this phenomenon is augmented when some of the underlying basic concepts as well as some of the conditions of such trading contracts are exactly the same as were laid down by the Prophet Mohammed (peace be upon him) for *al-salam* sale contract.

This paper as a consequence will unveil the accurate harmonization of advocating *al-salam* contract as a viable substitute to modern futures trading contracts in commodity markets to purposely smooth the way for replacing the existent authentic Sharī'ah problems of modern practices in futures markets for commodities.

3. OBJECTIVES OF THE PAPER

The principal objective of this paper is to generally elucidate the importance of revitalizing the use of *al-salam* sale contract to innovate the commodity futures trading contracts from an Islamic economic perspective in order to smooth the way for developing similar institutions to that of modern financial markets for commodities. To pursue primarily the above objective, this study will:

- 1 Identify non-Sharī'ah elements of modern commodity futures trading contracts.
- 2 Show the potentiality of the conceptual framework of *al-salam* sale contract to legally replace non-Sharī'ah elements-based investing in modern futures markets for commodities.

4. SIGNIFICANCE OF THE PAPER

It is noticeable that most of the present applied economics and finance rely on values, norms and laws derived from conventional economics. Consequently, Islamic economic researchers have tried to work diligently to produce more vital research to 'Islamize' or 'replace' the instruments and applications of mainstream economics. Islamic institutions also found themselves in a position that requires them to diversify the applied Islamic modes of financing in their different economic and financial projects. The efforts of contemporary Islamic economists and institutions are highly useful, but they only focus on a few directions in contemporary economic and financial activities and they greatly confine their efforts, whether in research or practice, to some particular modes of financing, although Islamic *Fiqh* contains other various modes that are quite beneficial for which they have been enacted.

Al-salam sale contract, in fact, is one of the neglected modes of finance among the applied modes of present-day commercial and financial institutions, despite it was permitted by the Prophet of Allah Mohammed (peace be upon him) and also was implemented and practiced during his lifetime (peace be upon him) as a means to economic development-based Islamic economic system. The recent theoretical studies of *al-salam* contract, moreover, compared to other Islamic techniques are quite limited. Most of them are briefly formulated with no link to modern economic and financial issues and functions, that is to say, they are no more than abstract ideas and hence a long list of *al-salam's* practical economic and financial issues remain unexplored or undeveloped. Thus this paper is expressly attempting

to pay the attention of Islamic commercial and financial institutions to the feasibility of the legal use of *al-salam* contract for the purpose of generally revitalizing the utilization of this contract in their financial and commercial businesses and particularly activating this contract to replace non-Islamic components of modern commodity futures trading in financial markets.

On the other hand, providing viable Shari'ah replacements of mainstream financial markets activities is not the subject of much discussion and studies by contemporary economists and jurists. This paper, accordingly, is oriented in general towards revitalizing the concern of financial markets as a multi-functional institution that could provide economic benefits at individual and societal level. By attempting to use *al-salam* sale contract as a pure Islamic alternative to commodity futures trading contracts will promote the concept of an Islamic mode of finance to suggest a creative response to some multi-faceted issues in mainstream financial markets activities.

In addition, the heavy reliance on non-Islamic modes of financing by Muslim countries leads non-Islamic societies to create plenty of criticisms of the Islamic economic system, alleging that it has no role to play in financing the projects of economic development because Islamic Shari'ah is incompatible with modern economic and financial developments. These criticisms could be eradicated, as a final target, only if the Islamic economic and financial studies are organized by reference to an Islamic economic and financial guidelines and approaches, as a pure path, for getting acceptable Shari'ah findings applicable to commercial and financial challenges. The concept of the present paper, in fact, is an attempt to satisfy this condition that could serve as best alternative solutions to usury-based financing and development-based western economics in futures markets for commodities.

5. THE LEGAL FRAMEWORK OF 'AQD BAY' AL-SALAM

The concern of this section is to show the legal-theoretical aspects of *al-salam* sale contract to be used as a guiding conceptual framework in making both a sound construction for the objectives of this paper in general and a legal judgment on the commercial and financial functions of this contract in particular.

To be more specific, the legal parameters for the valid execution of *al-salam* contract will be clear after presenting the pillars and conditions of this contract. Indeed, *al-salam* sale contract, as an Islamic economic mode of financing, contains important 'pillars' or 'essential requirements' for the legal performance of this contract in commercial and financial activities. Each 'pillar' of *al-salam* contract has different essential conditions and therefore each 'pillar' can only be validated when its conditions are realized. Beside the implementation of 'pillars' of *al-salam* sale, on the other hand, some 'conditions' need to be fulfilled to create a binding legal contract and control the valid application of this contract. These 'conditions' are treated under three main categories, which are: (1) 'conditions' pertaining to

the price of the commodity sold and the commodity sold, (2) 'conditions' pertaining to the commodity sold only, and (3) 'conditions' pertaining only to the price of the commodity sold. Considering them all helps the dealers to fulfill the requirements of Islamic Sharī'ah when they conduct their economic transactions in various activities.

Since *al-salam* sale has regarded as a typical alternative to the modern commodity futures trading contracts, which are not operated in the context of Islamic Sharī'ah parameters, then it is instructive to display all issues related to the application of commodity futures trading-based *al-salam* sale concept. These issues might emerge before or during the conclusion of *al-salam* contract or at the end of the contract period. These issues may be related to either the price of the commodity sold or the commodity sold and may be pertaining to the contracting parties or one of them. Some of these issues indeed appear either due to the changing life circumstances of both parties, to a change in the economic prospects or in the investment plans of the dealers, to a change in the desires of the contracting parties, or to a change in the international or national economic and financial situations. Some issues also subject to appear either because of the seller's delinquency and default in meeting his deadline or because of the death of either of parties. This section as a consequence will mention in the form of tables the name of general, economic, and financial issues relating to the execution of commodity futures contracts-based *al-salam* sale concept and will shortly summarize up the views of jurists on all of them.

The mentioned issues in this section, accordingly, will comprehensively supply the theoretical orientations and foundations to smooth the way for the reader to visualize the potentiality of *al-salam* sale concept in innovating not replicating the Islamic commodity futures trading in financial markets. This means in other words that the profound appreciation of the mentioned issues plays a main role to conceptually replace the authentic Sharī'ah problems-based investing in modern futures markets for commodities which be stated and treated later in the seventh and eighth section respectively.

The paper in the coming pages will summarize up the legal framework of *al-salam* sale contract in the form of four tables. The first table will cover the 'pillars' and 'conditions' of *al-salam* sale contract followed by the second table to sum up the general issues of commodity futures trading-based *al-salam* concept. The economic issues of commodity futures trading-based *al-salam* concept are recapitulated in the third table leaving the fourth table to outline the financial issues of commodity futures trading-based *al-salam* concept. These four tables are as follows:

Table 9.1 A General Summary of the Pillars and Conditions of Al-salam Contract as Muslim Jurists Unanimously Lay them Down

No.	Pillars of <i>al-salam</i> sale contract	Conditions of the pillars of <i>al-salam</i> sale contract	
1	al-Sighah (The wording)	<ol style="list-style-type: none"> 1. Clarity of the offer and the acceptance 2. Conformity between the offer and the acceptance 3. Connection of the offer with the acceptance 	
2	al-'Aqidan (The two contracting parties)	<ol style="list-style-type: none"> 1. Both of them should have full capacity of performance 2. Both of them should have full authority over the contract 3. Both of them should have no defects of capacity whether pertaining to reason or not 	
3	al-M'qudi 'Alihi (The object/s contracted for)	(A) Conditions of the price and the good sold	<ol style="list-style-type: none"> 1. Both of them should be permissible things 2. Both of them should be free from the effective cause of sales usury
		(B) Conditions of the good sold	<ol style="list-style-type: none"> 1. The good sold should be accurately described 2. The good sold should be a debt well-defined in the seller's liability 3. The good sold should be generally available at the delivery date 4. The quantity of the good sold should be known 5. The delivery of the good sold should be deferred 6. The delivery date of the good sold should be fixed
		(C) Conditions of the price	<ol style="list-style-type: none"> 1. The price should be known 2. The price should be advanced at the time the contract is entered into

Table 9.2 A General Summary of the Views of Jurists on the General Issues of the Application of Commodity Futures Trading-Based *Al-salam* Sale Contracts

No.	General Issues of <i>al-salam</i> Contract	The Views of Jurists			
		Shafi'i	Hanafi	Hanbali	Maliki
1	Conducting <i>al-salam</i> contract using the modern communications means				
2	Documentation of <i>al-salam</i> contract in witnessing and writing	Lawful	Lawful	Lawful	Lawful
3	Documentation of <i>al-salam</i> contract by mortgage or security	Lawful	Lawful	Lawful	Unlawful
4	Making <i>al-Iqālh</i> for the whole <i>al-salam</i> contract	Lawful	Lawful	Lawful	Lawful
5	Making <i>al-Iqālh</i> for the part of <i>al-salam</i> contract	Lawful	Lawful	Lawful	Unlawful
	Utilizing <i>Khiyār al-Majlis</i> in <i>al-salam</i> contract	Lawful	Unlawful	Lawful	Unlawful
6	Utilizing <i>Khiyār al-Majlis</i> in <i>al-salam</i> contract when using the means of modern communications				
7	Demise of either of both parties during the duration of <i>Khiyār al-Majlis</i> in <i>al-salam</i> contract	<i>Khiyār al-Majlis</i> does not end by the death of one party and is transferred to his heirs		<i>Khiyār al-Majlis</i> ends with the death of its owner, and is not moved to the heirs.	
8	Utilizing <i>Khiyār al-Sharṭ</i> in <i>al-salam</i> contract	Unlawful	Unlawful	Unlawful	Lawful
9	Duration of using <i>Khiyār al-Sharṭ</i> in <i>al-salam</i> contract				Not more than three days
10	Demise of either of both parties during the duration of <i>Khiyār al-Sharṭ</i> in <i>al-salam</i> contract	<i>Khiyār al-Sharṭ</i> does not end by the death of one party and is transferred to his heirs		<i>Khiyār al-Sharṭ</i> ends with the death of its owner, and is not transferred to the heirs.	<i>Khiyār al-Sharṭ</i> does not end by the death of one party and is transferred to his heirs
11	Utilizing <i>Khiyār al-'Ayb</i> with regard to <i>al-salam</i> sale price	The seller can either 'revoke the contract and return <i>al-salam</i> price to the buyer' or 'substitute completely the defective money' or 'accept the faulty price, but reduce the amount of goods sold according to the size of defect in <i>al-salam</i> sale price'.			

Shari'ah Alternatives to Non-Shari'ah Elements

12	Utilizing <i>Khiyār al-'Ayb</i> with regard to the goods sold of <i>al-salam</i> sale	The buyer can either 'revoke the contract; return the goods sold to the seller and take back his price' or 'accept the goods sold with the obvious defect without monetary compensation for that', but if the return of goods sold is impossible, then the buyer could accept the defective goods with a monetary compensation for the defect.	The buyer can 'revoke the contract; return the goods sold to the seller and take back his price' or 'accept the goods sold with a monetary compensation equivalent to the quantity of defect in the goods sold itself'.	<ol style="list-style-type: none"> 1. In case of a simple defect, it is negligible and forgiven. 2. In case of a medium defect, the buyer can accept the goods sold with a monetary compensation if the defect is linked to the assets, but if it is linked to anything else, the buyer then has two options; 'revoke the contract; return the goods sold to the seller and take back his price' or 'accept the goods sold with a monetary compensation equal to the quantity of defect in the goods sold itself'. 3. In case of a major defect, the buyer can 'revoke the contract; return the goods sold to the seller and take back his price' or 'accept the goods sold without monetary compensation'. 	
13	Demise of either of both parties during the duration of <i>Khiyār al-'Ayb</i> in <i>al-salam</i> contract	<i>Khiyār al-'Ayb</i> does not expire after the death of its owner; rather it moves to his heirs.			
14	Demise of the seller before fulfilling his promise in <i>al-salam</i> contract	The contract is revoked and the buyer takes back his price. The buyer can 'revoke the contract and take back his price or 'wait until the maturity date'.	The goods sold must be instantly given to the buyer.	The contract is revoked and the buyer takes back his price. The buyer can 'revoke the contract and take back his price or 'wait until the maturity date'.	The inheritance of the seller must not be distributed until the maturity date. The buyer, accordingly, can take his due from the inheritance of the seller at the time agreed upon in <i>al-salam</i> contract.

Table 9.3 A General Summary of the Views of Jurists on the Economic Issues of the Application of Commodity Futures Trading-Based *Al-salam* Sale Contracts

No.	Economic Issues	The Views of Jurists						
		Shafi'i		Ḥanafi		Ḥanbali		Maliki
1	Stipulating the existence of the goods sold when conducting the contract	Is not a condition		Is a condition		Is not a condition		Is not a condition
2	Specifying the delivery place of the goods sold in <i>al-salam</i> contract	Is a condition	Is not a condition	Is a condition	Is not a condition	Is not a condition		Is not a condition
3	Conducting the contract on usufruct	Lawful		Lawful		Lawful		Lawful Unlawful
4	Making the contract in the fruit of a specific farm or village	Unlawful		Unlawful		Unlawful		Lawful
5	Submitting the goods sold in installment at fixed dates	Lawful	Unlawful	Lawful		Lawful		Lawful
6	Concluding the contract based on various goods	Lawful	Unlawful	Lawful		Lawful		Lawful
7	Selling the goods sold before its possession	Unlawful		Lawful	Unlawful	Lawful	Unlawful	Lawful
8	Substituting the goods sold after concluding the contract	Lawful	Unlawful	Unlawful		Lawful	Unlawful	Lawful
9	Participating in the goods sold after concluding the contract	Unlawful		Unlawful		Unlawful		Lawful
10	Transferring the ownership of the goods sold after concluding the contract	Unlawful		Unlawful		Unlawful		Lawful

Shari'ah Alternatives to Non-Shari'ah Elements

11	Practicing parallel <i>salam</i> -based original <i>salam</i> contract						
12	Instant delivery of <i>al-salam</i> sale commodity	Lawful	Unlawful	Lawful	Unlawful	Unlawful	
13	Concluding the contract based on samples or patterns of goods	Lawful	Unlawful	Lawful	Unlawful	Lawful	Unlawful
14	Marketing-based <i>al-salam</i> contract						
15	Submitting the goods sold before the due date agreed upon in the contract	The buyer has to get the goods sold from the seller if he has no reasons to refuse them	The buyer has not to get the goods sold from the seller	The buyer has to get the goods sold from the seller if he has no reasons to refuse them	The buyer has to get the goods sold from the seller only if he fully wishes to do so		
16	Submitting the goods sold after the due date agreed upon in the contract	The buyer has to get the goods sold from the seller			1) The buyer has to get the goods sold from the seller only if he desires to do so 2) The buyer has to get the goods sold from the seller		
17	Inability of the seller to submit fully the goods sold because of A'SAR	The buyer is not allowed to ask his money back from the seller					
18	Inability of the seller to submit fully the goods sold because of EFLAS	1) The seller's debt has to be paid on a given date agreed upon 2) The seller's debt has to be paid on the spot and not on a given date agreed upon	The seller's debt has to be paid on a given date agreed upon	1) The seller's debt has to be paid on a given date agreed upon 2) The seller's debt has to be paid on the spot and not on a given date agreed upon.	The seller's debt has to be paid on the spot and not on a given date agreed upon		

19	Inability of the seller to submit fully the goods sold because of an emergency circumstance	<ol style="list-style-type: none"> 1) The buyer can take back his price or await the goods to be given later to him 2) The contract must be instantly revoked after the buyer takes back his exact price 	<ol style="list-style-type: none"> 1) The buyer can only wait the seller to make the goods sold in order to be given to him next year 2) The buyer can take back his price or await the goods to be given later to him 3) The contract must be instantly evoked after the buyer takes back his exact price
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Table 9.4 A General Summary of the Views of Jurists on the Financial Issues of the Application of Commodity Futures Trading-Based *Al-salam* Sale Contracts

No.	Financial Issues	The Views of Jurists							
		Shafi'i		Hanafi		Hanbali		Maliki	
1	Practicing financial penalty as a method of <i>al-Ta'zir</i> ¹	Unlawful		Lawful	Unlawful	Lawful	Unlawful	Lawful	Unlawful
2	Using financial penalties in <i>al-salam</i> contract								
3	Conducting <i>al-salam</i> contract on currency	Lawful		Unlawful		Lawful	Unlawful	Lawful	
4	Considering a debt owed to the buyer as <i>al-salam</i> sale price	Lawful	Unlawful	Lawful		Lawful		Lawful	
5	Postponement of <i>al-salam</i> sale price	Unlawful		Unlawful		Unlawful		Lawful, but according to the duration of <i>Khiyār al-Sharṭ</i>	
6	Participating in <i>al-salam</i> sale price after its payment								
7	Getting back <i>al-salam</i> sale price after its payment								

6. AN OVERVIEW OF MODERN FUTURES MARKETS

The present age has witnessed an increasing demand of financial markets but the gist of such markets is in line with the western economic system. Before this paper proceeds to the next section to offer an insight into non-Shari'ah elements available in the modern practice of commodity futures trading contracts in financial markets, a general clear picture about the nature of western futures markets will be briefly demonstrated. This overview highlights the activities and development of such markets with the passage of time. It is summarized (Khan 1995) in the following points:

1. The modern concept of futures originally was introduced in 19th century in the form of forward trading for the marketing of agricultural commodities. The objective originally was to improve exchange and market operations of

agricultural commodities and provide an opportunity to farm producers to hedge against the possible losses arising out of seasonal price fluctuations in the market, but no payment was made in advance by the buyer to the seller at the time the commodity forward contract is entered into. The payment was subject to the delivery time.

2. The prices of agricultural goods at the time of making production decisions are high because of being an off-season for these goods. But the farmers/producers know that when they will harvest their crop and bring it into the market, the price will be much lower because of the abundance of supply. The more they produce or the better is the weather, the more will be the supply in the market and lower will be the price and they may end up not making the break-even point. In order to protect them against the seasonal fluctuations of such goods, producers (as well as consumers) started buying and selling for forward delivery. These dealings (which became known “to arrive” contracts) were in fact a starting point for the modern futures markets.
3. Originally the forward sale contracts were not traded in the secondary market. Only actual commodities were marked after their delivery has been made and received. Later on, however, these contracts found a secondary market for them. The forward sale contracts started getting bought and sold without waiting for delivery. The emergence of this element generated the concept of what is now known “Futures”. As a consequence of that, the conversion of the forward trading into the modern futures market is only a recent phenomenon starting from mid-seventies. This means that the concept of making a futures contract based on a small pre-determined percentage of the total price payable beforehand but without getting involved in actual production or delivery of any commodity was introduced later on along with the establishment of the clearing house, which in turn led to a tendency in pure speculation activities in such markets.
4. With the passage of time, the scope of the futures markets expanded to include more commodities but they got themselves confined to the commodities that have short-term volatility in prices. As a result, there are goods whose prices may be known to be stable or may not be fluctuating in a certain time frame but they cannot be produced unless there is a definite demand for them. Infrastructure products, buildings, houses etc. fall into this category. These projects may take a long period to be produced. A concept of futures trading to help in the production of such commodities is non-existent.
5. The speculators entered into the market to benefit from the possible gains arising out of their good guesses of futures prices of the goods rather than the profits arising out of the actual sale of the physical goods. The role of speculators is increasing at accelerated rate upon which the producers or

farmers were forced to compete with them. In addition, when the segregation of futures market from cash market transpired, it served more the purpose of speculators than of producers interesting in hedging. While speculators make profit by confining themselves to futures markets only, the producers have to deal in cash market and futures market to get the benefit of hedging. Being an integral part of cash markets, the forward sale contracts were expected to be constrained by the production capacity of the producers, but the modern futures markets do not face such constraints. The process of contract creation can go on and on indefinitely as long as buyers find sellers and vice versa irrespective of the actual supply of the commodity in question.

6. The concept and spirit of hedging are available in the modern futures market whereby the farmers and producers can sell futures markets simply as a hedging device. This means that in the framework of the modern futures markets, they, i.e. farmers or producers, aim to hedge against any unexpected decline in the cash market, but in search of hedging themselves against the uncertainties of future prices in the cash market have to assume another risk in the futures markets which is supposed to compensate them a large extent for any loss in the cash market if the prices in cash and futures markets moved in unison. But since futures markets and cash markets are independent, a farmer or producer will hardly be a good player in the futures markets. His entry in the futures markets thus will not be so much to make money out of the futures markets as to avoid losing the reward of his productive efforts in the cash markets. This independence also is quite likely to give wrong signals to the farmers/producers and farmers/producers not being players of the futures markets and having forced to compete the professional speculators, they may often end up being exploited by the wrong signals.
7. No doubt cash and futures prices have a tendency to adopt to each other during the delivery period at the delivery points because of the pressure caused by deliveries in the expiring futures, but at any particular point they may not move in a perfect relationship and hence the loss in cash market may not be fully compensated the gains in the futures market. It is believed that the existence of speculation is essential for futures markets because speculators are supposed to provide bridge between hedger X who wants to sell now and hedger Y who wants to buy later.
8. A further development that has taken place in the modern concept of futures trading, is the list of goods not only to include industrial and metallurgical products but also to include financial instruments (like bonds, bills, mortgages, and shares), financial assets, foreign currencies, and stock indices. Inclusion of foreign currencies can be assigned some rationality under the western system because foreign currency is a sort of real goods (as it gives command over a certain basket of goods of a foreign currency) and

the risk in their trading was required to be reduced as their prices (exchange rate) too fluctuated widely and frequently. While the futures trading of stock indices simply provide an extra base to the pure speculations to make income merely on their speculations. The necessity to include financial assets in the scope of the futures markets arose out of the same reason as for goods and of foreign exchange, i.e. wide fluctuations in the prices. The fact is that financial instruments futures markets, also known as interest-rate futures markets, provide an easy source of income that does not involve any real economic activity. This is reflected in the fact that trading volume in the interest-rate futures markets is much greater than the corresponding trading volume in the cash market.

9. Consequently, the only rationality or the key element for including of any item in the scope of modern futures markets is the possibility of volatile uncertain fluctuations in its prices. The risk management became the objective rather than means. On the other hand, the innovations are continuing to further expand the scope of futures markets. Introduction of options on futures contracts is one such innovation.

On this basis, the present paper defines futures trading contracts in modern commodity markets as “a commercial contract or an economic activity calling for the purchase or sale of fixed quantities of commodities of defined quality at specified futures dates to a price agreed today, but a small pre-determined percentage of the total price is only payable at the time the contract is entered into”.

In spite of the economic advantages and merits obtainable by investing in modern futures markets for commodities, the gist of such markets is derived from non-Islamic economic system and hence the commodity futures trading in such markets is not operating on Islamic lines. Consequently, one of the present paper’s essential concerns is to uncover the authentic Sharī‘ah problems-based investing in modern futures markets for commodities to be concurrently replaced in the context of this paper on Islamic lines of *al-salam* sale contract. The revelation of those Sharī‘ah problems is the issue to which the present paper turns next.

7. NON-SHARĪ‘AH ELEMENTS-BASED INVESTING IN MODERN COMMODITY FUTURES TRADING

At this juncture, this paper will not only highlight the authentic Sharī‘ah problems-based investing in modern futures trading contracts in commodity markets, but also, and more importantly, will show the legitimate justifications and economic logical reasons beyond the Sharī‘ah judgment on those contracts. The following rationales for commodity futures contracts prohibition emerge from the debate of jurists and economists over the invalidity of modern practices of futures markets for commodities, which are:

1. Trading in futures contracts involves some forbidden elements, namely gambling (*qimār*), ignorance (*jahālah*), exploitation (*istighlal*), uncertainty (*gharar*), and unlawful devouring of the property of others (*akl amual al-nas bil-baṭil*). The existence of these prohibited elements is insufferable because the legal rules of their prohibition are both invariable throughout the ages and changeless over times. The explanation of the meaning and of the existence of these elements is as follows:
 - Uncertainty: This element exists when there is uncertainty as to whether the seller will deliver the objects sold or not (i.e. goods that have been bought by the buyer). This is particularly when the seller initially concludes the contract without the intention of delivering the objects sold at maturity or he usually sells what is not with him and does not know whether the commodity sold is obtainable or not. As well, the existence of pure speculation activities in financial markets creates another form of uncertainty (illustrated below).
 - Gambling: This element relates to the risk taken in the hope of getting good results. The job of gamblers in financial markets is to make profits out of the purchase and sale of risk, but gamblers merely depend on luck to make their profits. Gamblers, hence, have no commercial interests in the commodities being exchanged in futures markets, meaning that they are unwilling to have real economic businesses in such markets.
 - Unlawful devouring of the property of others: This element denotes that the contract of commodity futures in financial markets passes from party to party starting from the first seller who sells items he does not have and the subsequent buyers selling without acquiring possession of the commodities. By so doing, the contract is bought and sold several times until the settlement day, even though the contract is frequently divorced from the product. Buying and selling through this method leads to unlawful exchange by which every party takes the money of other party hoping to get benefits out of nothing, i.e. without the involvement in a real economic activity. This is unjust taking or consuming of others' property and wrongful creating of gains.
 - Exploitation: This factor means, in financial markets, the strong dealer exploiting the weak, where one is obligated to deliver the commodity is not given a chance by speculators to hedge against loss and simultaneously speculators might insist on delivery of a particular grade whose stocks are small. The exploitation also occurs when monopolists make large sales and purchases of contracts not only to stock goods with the intention of causing a shortage in the markets and pushing up the price, but also leading weak dealers to have a loss and financial difficulty over time and ultimately excluding them out of the market. Weak dealers, as a result, would bear the negative financial consequences for a mere exploitation and monopoly and not for something else.

- Ignorance: This factor regards another form of *gharar* but relates to unfamiliarity with different material aspects of the dealings. It transpires partly because of unawareness of whether the contract will end in physical delivery or not and partly because of the parties' lack of knowledge regarding which grade of a commodity will be delivered because the dealers in financial markets are permitted to conclude their trading dealings in a number of alternative grades of a commodity. This element is also available because of non-clarity in quantifying potential profits or losses since the full price 'is not' and 'will not be' advanced on the spot and on the settlement day respectively.
2. The sellers and buyers in financial markets equate paying the full price with having a clear pricing of the good sold without the intention of receiving a delivery. While the latter often comes before the former, i.e. for making an actual payment, but in reality the dealers in such markets stick to pay only a small pre-determined percentage of the total price, after having a clear pricing, of the good sold. In addition, the pre-determined percentage forms a margin account which is marked to the market value of the contract every day, but more deposit is required in this account if value falls below a certain margin and market interest rate is charged or earned on the margin account balance.
 3. In futures markets for goods, in addition to the above second point, the net difference between the prices of the two goods to be exchanged is paid in a daily settlement. Because the futures prices are reset daily, as if money is traded as a commodity, and hence the contract buyer gains cash if the rest price is higher than the previous day's price, and loses cash if it is lower. The price's increase and decrease is attached to the decrease and increase of interest rates respectively. The point is that the concept of the financial institutions dealing only in money to generate money is foreign to Islamic Sharī'ah, so the dealers shall have to deal in goods if they want to earn *halāl* profit. In other words, no profit is allowed in Islam on advancing money (i.e. the price) only as an economic activity which forms pure usurious treatments. In contrast, money can be validly traded only at spot with actual delivery and it should be generated out of real economic activities.
 4. The concept of the following legal maxim {الغنىم بالغرم} "Linking lawfulness of gain to risk-taking" is inapplicable amongst dealers of commodity futures contracts². The existence of this maxim, as a legal economic principle, is important for the valid application of those contracts. Futures markets for commodities, hence, have no the objective of distributing the trading risks amongst dealers; meaning that 'there are no risk-sharing activities' or 'dealers are not equally bearing the risk in their trading activities' and thus the gain of one party is certainly the lose of the other. This means that acquiring gains out of risk-less economic activities, for the benefit of one of

the contracting parties only, are unjust. This is why fixing the price in advance for commodities, in modern financial markets, without paying it up immediately serves the interest of speculators/gamblers more than the interest of producers. The negligence of this maxim generates also the elements of uncertainty and exploitation which make Islamic transactions null and void. The existence of these elements in turn creates dispute amongst parties that ultimately mars the transaction too.

5. Futures contracts involve buying and selling commodities before they are received, which means that the dealers in financial markets have no intention of taking delivery but only of liquidating their contracts against the price discrepancies of the commodities sold. The fact is that futures markets for commodities that emerged out of the concept of enhancing the trade of primary commodities have ended up not doing any trade at all.
6. Futures markets permit trading in a number of grades of a commodity to protect hedge sellers from being 'cornered' by speculator buyers. Since a number of alternative grades can be tendered, the futures markets are not suitable for the acquisition of the physical commodity, which means that the futures markets provide solely an exchange of unreal deals for the purpose of speculative profit-making, i.e. gains arising out of the price movements of goods when speculators relying on their guesses (i.e. based on their trading discernment) and they are unwilling to take actual delivery, that is to say, they are not willing to make profits out of the actual sale of the physical goods.
7. The seller of futures contracts neither owns nor possesses the commodity he sells; the contract that is concluded is, therefore, said to be no more than a paper transaction. For this reason, physical delivery of the commodities in fulfilment of the futures contract generally does not take place and thus does not lead to increase valuable economic activities and that is legally forbidden. Indeed, if futures contracts are allowed to grow on the basis of increasing volume of transactions in the interest-rate futures markets, they will increase their turnover in paper dealings to the extent that cash or physical trading will not only be adversely affected but that the market in the commodity may even be put out of business altogether.
8. Futures sales include the sale of debt for another debt that is invalid in the eyes of Islamic Sharī'ah, which means neither the commodity sold nor the price of that commodity is existent or advanced at the time the contract is entered into.
9. A monopoly develops through futures trading contracts in commodity markets by making large sales and purchases of contracts only to force smaller dealers to suffer a loss and suffer hardship accordingly. This action in turn leads to an artificial expansion in the volume of transactions, creates

an unnecessary heat in the market, and generates erratic fluctuations in prices because futures dealers sell something they cannot consume or use in their business, upon which they perform no work and to which they add no value.

8. SHARĪ‘AH REPLACEMENT OF NON- SHARĪ‘AH ELEMENTS AVAILABLE IN MODERN COMMODITY FUTURES TRADING

At the end of this paper, it is of considerable consequence to elucidate the Sharī‘ah meaningful solutions to the authentic Sharī‘ah problems derived from the investment approach of modern commodity futures trading contracts in financial markets. This means that offering Sharī‘ah alternatives to non-Sharī‘ah elements of modern commodity futures trading on the basis of *al-salam* sale contract originates eventually Islamic commodity futures trading-based *al-salam* sale concept. From this perspective, the following rationales of Sharī‘ah replacements for non-Sharī‘ah components in those modern trading contracts emanate from the legal framework of *al-salam* sale contract formerly mentioned, which are:

1. Trading in Islamic commodity futures contracts is safeguarded against the existence of impermissible elements, namely uncertainty (*gharar*), gambling (*qimār*), ignorance (*jahālah*), exploitation (*istighlal*), and unlawful devouring of the property of others (*akl amual al-nas bil-baṭil*). Non-existence of these prohibited elements is clear, in Islamic futures markets for commodities, as the following explanation shows:
 - Uncertainty: This element does not exist in Islamic futures markets for commodities because fixing the delivery date of the commodity sold is a condition for the valid application of commodity futures trading-based *al-salam* contract. The seller, thus, is contractually and legally liable to deliver the objects sold (i.e. goods that have been bought by the buyer) on term day. This element also is non-existent because the agreed-upon commodity sold, in exchange of the advanced payment, should be generally available in the markets at the date of delivery as another condition for the valid application of commodity futures trading-based *al-salam* contract. The seller, hence, initially does not conclude the contract without the intention of delivering the objects sold at the maturity date. He, therefore, is not selling what is not with him but rather he knows whether the good sold is obtainable or not.
 - Gambling: This element does not transpire because the job of purchasers in Islamic futures markets for goods is to make profits out of real purchase of goods, while the job of the sellers is only to keep to their contractual obligations and meet their deadline. They are, in fact, not buying or selling the risk in the hope of getting good results, but rather they have commercial interests in the commodities being exchanged in futures markets, meaning that they are willing to have real economic businesses in such markets. Above all, advancing the purchase price of the commodity sold at the time of

effecting the contract is a condition for the valid application of commodity futures trading-based *al-salam* sale. The availability of this condition excludes gamblers from the markets since paying the price on the spot is not in line with their interests. This is because their job is to make profits out of the purchase and sale of risk in the hope of getting good results, i.e. depending merely on their luck. Gamblers thus are unwilling to have real economic businesses in such markets.

- Unlawful devouring of the property of others: This element will not take place in Islamic futures markets for commodities because the contracts of commodity futures trading-based *al-salam* sale will not pass from party to party to be bought and sold several times before the settlement day. In addition, the fulfilment of contractual undertakings of such contracts is legally and conditionally binding on both parties, that is to say, the contracts, that are concluded, are always not divorced from the product. Unlike modern commodity futures trading contracts, the sellers in Islamic futures markets are not permitted to sell their contractual undertakings to others whatsoever. Although the buyers in Islamic futures markets are permitted to dispose of their goods sold before the delivery date, but they are bound to meet certain legal conditions in this regard to keep their contractual undertakings with the sellers intact. Hence, there is no existing method in such markets leads to unlawful exchange (i.e. every party takes the money of other party hoping to get economic gains without the involvement in an real economic activity). This is why the delivery date of the commodity sold should be mutually determined in *al-salam* contract as a valid condition for the application of this contract.
- Exploitation: This element has no room in Islamic futures markets for commodities because there will be nothing called strong dealers or weak dealers. Because the dealers in such markets have to meet several conditions, either related only to the commodity sold or related only to the purchase price, before signing the contract of commodity futures trading-based *al-salam* sale. Therefore, either party or the contracting parties will have no way to get around these conditions and if they fail to realize them, then the sale contract becomes legally null and void. This clarification denotes, on the other hand, that the structure and the outlook of Islamic futures markets for commodities generate no motivation for speculators and monopolists to play their exploitative role in such markets unlike the case in western financial markets. Because the existent of speculators, as strong dealers, in western financial markets powerfully entitles them to exploit the weak dealers by not giving them the chance to hedge against loss and simultaneously they might force them to deliver a particular grade of goods whose stocks are small. The exploitation also occurs in western financial markets when monopolists make large sales and purchases of contracts not only to stock commodities with the intention of causing a shortage in the markets and pushing up the

price, but also leading weak dealers to have a loss and financial difficulty over time and ultimately excluding them out of the market. So, weak dealers would bear the negative financial consequences for a mere exploitation and monopoly and not for something else because the institutional arrangements of western futures markets for commodities allow most of the dealers, including speculators and monopolists as a part of them, to bypass the legal provisions of actual delivery through the provisions of the reversing contracts. As well, such institutional arrangements in reality have no enforcement clause to force the dealers in western futures markets for goods to pay the price in full in the event of the exchange of goods which pave an additional way for pure speculators and monopolists to play their exploitative role in such markets.

- Ignorance: This element is not available at all in Islamic futures markets for commodities because the contacting parties in such markets have the full familiarity of all material aspects of the contract of commodity futures trading-based *al-salam* sale before their signature. Therefore, the commodity sold should be well-defined and accurately described as well as ‘the quantity’, ‘the quality’, ‘the delivery date’, and ‘the price’ of the commodity sold should be known as well as stated in the contract as conditions for its validity. Automatically, the contract will end in physical delivery and ownership of the commodity sold by which the dealers in such markets, as a result, will have approximately a comprehensive clarity in quantifying potential profits or losses for their own interests.
2. The buyers in Islamic futures markets for goods are legally obliged to submit the full purchase price of the goods sold to the sellers, which reflects their inward intention of having commercial interests in the goods being exchanged in futures markets before receiving them. They, hence, have no choice to pay only a small pre-determined percentage of the total purchase price of the goods sold. Therefore, no place for the margin account to be marked to the market value of the contract every day as it is the case in western futures markets for goods. Non-existence of the margin account in Islamic futures markets for goods leads to have no market interest rate, which is available in western futures markets to be charged or earned according to the decrease or increase of the margin account balance.
 3. As a consequence of the above point, calculating the net difference between the prices of the two goods to be exchanged in order to be paid in a daily settlement is no longer existing in the structure of Islamic futures markets for goods because of advancing the full purchase price on the spot as a condition for the valid execution of the contract of commodity futures trading-based *al-salam* sale. In such markets, hence, the prices will not reset daily, the money will not be treated in exchange for money, and the price’s increase and decrease will not be attached to the decrease and increase of interest

rates respectively, as it is the case in western commodity futures contracts. In addition, the concept of the financial institutions dealing only in money to generate money is inapplicable in the institution of Islamic futures markets because the dealers will have to deal in goods to earn *halāl* profit. Indeed, in Islamic Economics, money can be legally traded only at spot with actual delivery and it should be generated only out of real economic activities.

4. The concept of the following legal maxim {الغنم بالغرم} “Linking lawfulness of gain to risk-taking” is applicable amongst dealers in Islamic futures markets for goods as a legal economic principle for the valid application of the contract of commodity futures trading-based *al-salam* sale. The implementation of the concept of this maxim realizes the objective of distributing the trading risks amongst dealers; meaning that ‘there will be risk-sharing activities’ or ‘dealers are equally bearing the risk in their trading activities’ in Islamic futures markets for goods. This means that the price is legally paid in full beforehand in such markets as a valid condition for the execution of the contract of Islamic commodity futures trading to circumvent unjust and bias towards either party. This is why fixing the price in advance for goods without paying it up instantly, as it is the case in modern futures markets for goods, serves the interest of speculators/gamblers/traders more than the interest of producers.
5. Trading in Islamic commodity futures contracts-based *al-salam* sale does not involve buying and selling goods before they are received because the dealers will have the intention of taking delivery not of liquidating their contracts against the price discrepancies of the commodities sold. Delivering and taking the commodities sold at maturity, indeed, is a condition for the valid execution of commodity futures trading contracts-based *al-salam* sale, meaning that the goals of such contracts will not be broken because upon which Islamic futures markets will be established and operated. This clarification emerges the following two points:
 - Islamic futures markets for commodities will have no the purpose of speculative profit-making, i.e. gains arising out of the price movements of goods whereby speculators are unwilling to take actual delivery, that is to say, they are not willing to make profits out of the actual sale of the physical goods. Added to this is the point that advancing the purchase price of the commodity sold at the time of effecting the contract as a condition for the valid application of the contract of commodity futures trading-based *al-salam* sale excludes speculators from the markets since this condition is not in line with their interests. This is because their job is to make profits out of the purchase and sale of risk in the hope of getting good results, i.e. depending merely on their trading discernment.
 - The dealings in Islamic futures markets for commodities will end in physical delivery of the commodities sold and hence absolute paper transactions will

be out of the structure and the outlook of such markets. Islamic futures markets for commodities, consequently, will lead to increase valuable economic activities, i.e. they will not increase their turnover in paper dealings, to protect the markets from collapse/falling down. In addition, the transactions in such markets will not include the sale of debt for another debt, which means neither the commodity sold nor the price of that commodity is existent or advanced at the time the contract is entered into. This in turn, most important of all, leads the buyers (price advancers) not to have the intention of reaching the monopoly purposes in the Islamic commodity futures trading-based *al-salam* concept because of their adherence to Islamic economic moral values as an indispensable requirement, for the whole dealers, when conducting the economic activities in Islamic financial markets.

9. CONCLUSION

This paper has proved that there have been multiple proposals available on contemporary literature recommended the use of *al-salam* sale contract as a best viable Islamic alternative to the western types of commodity futures trading contracts in financial markets. But there was a substantive gap of contemporary literature on how to effectively utilize this contract as a typical mode of financing in place of modern commodity futures contracts to be operated on Islamic lines. The subject matter of the current paper, hence, could be driven ahead as a key position towards the arena of elaborating the recommendation/suggestion of the present-day jurists and economists in order to develop the conceptual framework of commodity futures trading contracts-based *al-salam* sale concept. This paper was confined to identify non-Sharī'ah elements in modern commodity futures trading contracts and eventually to show the potentiality of the conceptual framework of *al-salam* sale contract to legally replace non-Sharī'ah elements-based investing in modern futures markets for commodities.

The substance of this paper, consequently, appeared as a combination of theoretical general, economic, financial, and legal issues of *al-salam* contract to utilize them symmetrically for originating the conceptual framework of Islamic commodity futures trading contracts-based *al-salam* contract. This was clear by avoiding to imply a carbon copy of western commodity futures trading contracts but through providing pure Sharī'ah replacements of non-Islamic elements in those contracts.

It is evident from the foregoing explanation in this paper that there is a need for Muslim societies to study the availability of organizing a futures market for commodities to operate on Islamic lines to financially help the producers, economically elevate the exchange of commodities and promote production/trade, and generally improve economic growth and development upon which the economic welfare and prosperity depend. From this perspective, this paper would

confirm that the economic and financial features/objectives of modern commodity futures trading are the brainchild of principles of Islamic Economics and hence the concept of *al-salam* sale contract for futures trading in commodities is more logical to be used in this regard than the western concept of modern commodity futures contracts. This is because, as it was clear in the comparative analytical manner provided in this paper, *al-salam* sale concept cannot be used for pure speculation and monopoly purposes, but only for promoting actual productive, trading, and exchange purposes.

This paper, as a result, reflected the essential differences between the Islamic commodity futures trading and the modern commodity futures trading to be substantially as follows:

1. The Islamic commodity futures trading includes the options of condition, session, and defect and its contractual obligations are binding on both parties to end up in physical delivery and ownership of the commodity sold.
2. The Islamic commodity futures trading can be concluded in various goods either of a specific place or of a general one and the full price is either paid in advance or postponed but not more than the duration of the option of condition.
3. The price, in the Islamic commodity futures trading, is recoverable and it can be either a currency or a debt owed to the buyer by the seller or services of real assets, while the commodity sold can be either a currency or a fungible commodity or services of real assets.
4. The commodity sold, in the Islamic commodity futures trading, can be delivered either instantly or at maturity or in instalment at fixed dates and it can be substituted only by mutual agreement amongst parties.
5. In the Islamic commodity futures trading, only the buyer, before the due date, can sell the commodity sold or transfer its ownership to a third party, make an independent parallel *salam* contract based on the original *salam* contract, and bring another person to become his partner.
6. In the Islamic commodity futures trading, there are viable legal solutions in case of the seller's delay because of justifiable emergency situations, his default because of unavoidable emergency situations, his delinquency or his default with no reasons, his *A'SAR*, his insolvency, and his death.
7. In the Islamic commodity futures trading, both an instant *salam* and a deferred *salam* form Islamic marketing techniques and they are revocable, either partially or totally, but only by mutual contentment amongst parties.

In short, introducing the concept of *al-salam* sale contract as 'a viable production mechanism' or 'a powerful financial instrument' or 'a practical trading vehicle' to replace the present-day commodity futures trading contracts requires

serious attention for discovering the possibility of developing an appropriate method to benefit from the conceptual structure and legal framework guidelines of *al-salam* sale contract as a starting point to construct Islamic financial markets institutions. This paper, on this basis, stresses that only strict adherence to Islamic Sharī‘ah guidelines of exchange will lead the realization of the usefulness of *al-salam* sale concept to make fruitful contributions to the Muslim economies either in Islamic futures markets for commodities in particular or in commercial and financial institutions in general. By so doing, the application of Islamic Economics’ teachings and principles become dominant and the flexibility of Islamic Sharī‘ah and its consideration for the needs of mankind will be applicable.

Notes

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¹ It is of considerable importance to clarify at this juncture that practicing financial penalty as a method of *al-Ta‘zir* does not incur additional amounts on the original debt of the defaulting debtor in *al-salam* sale contract. However, practicing financial penalty here is to compensate the creditor for the actual damages verifiable by him in case of the debtor’s default or delay in fulfilling the agreed upon-contractual commitments of *al-salam* contract.

² Linking lawfulness of gain to risk-taking, {الغنم بالغرم}. This maxim means that disadvantage is an obligation accompanying enjoyment, that is to say, a person who enjoys a thing must submit to the disadvantages attaching thereto (Hooper 1933). Indeed, the consideration of this maxim when concluding commercial and financial transactions is of consequence, as a legal economic principle, for the valid application of those transactions. The negligence of this maxim in turn generates the elements of uncertainty and exploitation which mar those transactions. The existence of these elements also creates dispute amongst parties that ultimately leads those transactions to be null and void too. Therefore, Islamic economic system replaces usury-based loans, interest-bearing debt instruments, and unlawful gains-based economic activities with ‘risk-sharing modes’ or ‘risk-sharing economic activities’ in which both parties should equally bear the risks and share the profits according to the nature of each contract or economic activity that is dealt with.

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Rate of Return Risk Management in Islamic Finance: Challenges and Propositions

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ABSTRACT

Risk is an unavoidable element in day-to-day life. Within the context of Islamic commercial law, risk plays even more important role as the idea of gain (profit) is associated with the risk one is willing to take. Consequently it is paramount that the Islamic banks and finance institutions adopt suitable methods of managing the rate of return risk. One of the methods of managing rate of return risk is the ability of a financial institution to clear its balance sheet from debts by selling them to another party. This approach is a challenging one in Islamic banking due to unacceptability of sale of debt. However, the paper argued that sale of debt is not totally rejected. The rule of Islamic law accommodates some sort of sale of debt on condition such a sale does not lead to ribā, uncertainty and inability to deliver. Rate of return risk may also be managed by a number of Shari‘ah financial techniques. The paper argued that some of these techniques are subject to further researches in order to come up with globally acceptable mechanisms for managing rate of return risk.

1. ISLAMIC LAW AND RISK MANAGEMENT

“No risk no gain” is an age-old axiom. Indeed, risk is inherent to all, including the banking and finance activities, both the conventional and Islamic ones.

Risk, in the context of banking and finance, represents probable events as the events, whether or not can be anticipated, have the potential to impact adversely to the institution’s income and capital.¹

The association of risk with return, which is the gain for a bank or financial institution, is central to Islamic banking and finance. It is notably of more importance to Islamic banking and finance as compared to their conventional counterparts due to the maxim “*al-kahraj bay‘ al-ḍamān*” or “*gain is associated with risk*”.² The maxim, in simple terms, requires that in commercial transactions, benefits (returns) and liabilities (risk) go together.³

The principle, that one may earn a profit if he bears some risks, underlies all forms of financial contracting in Islamic commercial law. A logical reflection of this maxim is observable in many situations: in the prohibition of positive returns on zero-risk assets or in the need to eliminate *ribā*; in the inadmissibility of a partnership contract where the partners agree to share in profits only and not in losses; and in the requirement that the lessor, in an *ijārah* contract, who is entitled to receive the rentals must bear the losses arising out of destruction of the asset. Those prohibitions highlight the requirement that a party in a financial contract is entitled to returns only if he bears risk.

While the above are straightforward instances of the application of the maxim, the required link between risk and return may not be as easily intelligible and explicit in composite financial structures. Investment activities of Islamic banking is said to operate on the basis of the doctrine of risk (*mukhātarah*). Without the element of risk, the process of investment would involve *ribā* which is prohibited by the Sharī‘ah.⁴ In the loan facility as practised by conventional banking, the lender is guaranteed the return of his money and additional sum in lieu of time. The borrower therefore takes the burden of guaranteeing the capital of the lender plus additional amount of money. That may give rise to this question: how one can justify that Islamic banking is inseparable from risk in view of the fact that Islamic principles of investments affirm that there is no such thing as a guaranteed return on investment.

The explanation to that is this: profit is the effect of investment which is closely related to the property of investment. This profit is in lieu of trade risk or, in financial terminology, residual risks that are normally associated with businesses irrespective of techniques of risk management. Any separation of primary trade risk (residual risks) and gain is contrary to the tradition cum maxim that says: “*gain is associated with risk*”. Therefore, passing or assuming residual risks in business activities would amount to, in one way or the other, a situation of *ribā*, uncertainty and/or sale of what one does not own, all of which are prohibited in Islam, and thus the prohibition to guarantee the return on the capital meant for investment.

In a nutshell, the principle of ‘profit is associated with risk’ as per the Sharī‘ah forbids one party to take profit while the risk is borne solely by the other; it requires that the parties involved in the business share residual or inherent risks in order to deserve profit. This is the basic distinction that draws the difference between an Islamic and a conventional financing.⁵

However, the principle of profit is associated with risk does not mean that the parties in Islamic banking or finance transaction should put no importance to manageable risks using risk management techniques. The lender or creditor is required to emphasis on debt security measures and manage mismatches of returns and exposure to risks arising out of delay in performance and market fluctuations. The lender or creditor is also required to manage risk of delay in payment and

actions or events that may threaten the well being of the business. Proper management of risk is required and introductions of acceptable measures and tools to protect businesses are encouraged as they serve one of the vital purposes of Islamic law, i.e., to protect wealth.

In addition to the general principles referred to earlier, i.e., the prohibition on *ribā*, prohibition on dealing in uncertain property or a property one does not own, the Islamic commercial laws also require professionalism in management and handling of wealth. Within such a context, for example, the Islamic commercial law recommends not to release the property (wealth) to the minors until they have had sound judgment.⁶ The reason is simple as that the risk of doing so is beyond residual or inherent risks and withholding the minor's wealth against his consent affirms the Islamic commercial laws' acceptance of risk management. Another instance is that a *mudārib* is liable, as per the Islamic commercial laws principles, when investing without due diligent required from professional person in the normal course of business and investment.⁷

Risk management targets at identifying, measuring, monitoring and controlling the running of an institution so that it can be managed in a well-directed, integrated and sustainable manner and is exposed, as far as possible, only to normal risk.⁸ While Islamic banks and financial institutions will have to identify, assess, measure and monitor the risks that are usually faced by their conventional counterparts, the characteristics of risk management in Islamic banking and finance are different than the former. That is due to the facts that, in addition to knowing the techniques to manage the risks which are usually adopted in the conventional banking and finance activities, an Islamic institution needs to ensure that its risk management process is Shari'ah compliant.⁹

The ultimate objective of this paper is to put forward some recommendations that an Islamic bank or an Islamic financial institution may want to consider as the means to manage the risk factors inherent in Shari'ah-compliant bank/finance institution, particularly in long-term Islamic debts. A clear understanding of the relevant Islamic instruments will provide the foundation for the discussion.

2. ISLAMIC DEBT CREATION INSTRUMENTS

The relationship of Islamic banks or Islamic financial institutions and their clients is, on one hand: creditor and debtor relationships. This relationship is observed in debt-based contracts. On the other hand: there is an investment partnership that is manifested in participatory contracts. In both these relationships, Islamic banks are exposed to rate of return risks when the investment profit, revenue or income, does not equal interest rate movements, especially if this is in the interest of the depositors.

Islamic instruments that create short and long term debts include the followings:

1. *Bay' al-Mua'jjal*;

2. *Murābahah*;
3. *Ijārah* and *Ijārah Muntahia bay' al-tamleek*;
4. *Salam* and parallel *Salam*; and
5. *Istiṣnā'* and parallel *Istiṣnā'*

To have the clear understanding on the above, let us briefly examine those instruments.

2.1. *Bay' al-Mua'jjal*

The Mejelle provides that the term 'bay', which in English is literally translated as 'sale', "is to change for property".¹⁰ *Al-Mua'jjal* means deferred. Thus, *bay' al-Mua'jjal*, also commonly known as *bay' bi thaman al ājil* simply means a sale with deferred payment.¹¹ The Report of the Pakistan Council of Islamic ideology defined *bay' ājil* as a "sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments." It is a commercial relationship that triggers debt if the object of the sale is deferred against an obligation to provide the price, wholly or partially, at a future fixed time or during mutually agreed periods.

The validity of this kind of transaction is generally accepted on the basis that the sale of any permissible thing is permissible and that the parties are bound by their conditions.¹² Specifically, Article 245 of *the Mejelle* stipulates that "[a] sale for a deferred payment or for payment by instalment is good." The subsequent provisions stipulate that in such a transaction, it is necessary to make the payment time known and fixed;¹³ that such time is known and fixed in the minds of the two parties;¹⁴ and that if the payment time is not fixed the transaction is *fasid*.¹⁵

In principle, the sources of Islamic law favour the validity of sale on deferred basis,¹⁶ provided repayment time is specified. In the *Hidaya*, al-Marghinani said:¹⁷

A sale on cash or deferred basis is valid provided a promised time of repayment is fixed, because of the unrestricted words of the Qur'ān, 'but Allah hath permitted trade and forbidden usury' and also, because it was reported that the Prophet (pbuh) have purchased a garment from a Jew and promised to pay at a fixed future time, pledging his coat of mail for the performance of it. However, it is indispensably requisite that the period of payment be fixed, as uncertainty in this respect might occasion a contention and be preventive of its execution, since the seller would naturally demand the payment of the price soon, and the buyer would desire to defer it.¹⁸

Without any intent to further the *fiqh* discussion on the matter, it suffices to say that the dispute among the jurists does not lie in the aspect of the validity of sale with deferred payment per se; rather the dispute lies in the aspect if in a sale, there is a difference between on spot price and deferred price.

As for the purpose of this paper it is important to note that the rate of return risk in this instrument is exemplified in the fact that once the price is fixed it is not subject to change upwardly. The parties may agree for rescheduling of payment without any additional payment. For this reason, this instrument is not in favour of Islamic banks if the market rate on loans and conventional financing changes from now and then.

2.2. *Murābahah*

In its original Islamic connotation, *Murābahah* simply is a sale. It refers to a transaction whereby a seller agrees with a purchaser to provide the purchaser a specific commodity on a certain profit added to the seller's cost. Its distinctive feature is that the seller discloses to the purchaser the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. The concept, thus, does not restrict the time within which the payment is to be affected; it can be either paid on the spot or at any subsequent date as may be agreed between the parties. However, Islamic banks are using *Murābahah* as a debt creation instrument in order to meet the financing requirement of clients.

Most of the operations of Islamic banks are based on this instrument due to its flexibility and being relatively risk free.¹⁹ Nevertheless, since its underlying operations fall under the category of debt, it is associated with some predicaments. Chief among these are enforcement of the promise to buy, default on payment, rate of return risk (due to issue relating to sale *murābahah* debts) and some operational risks.²⁰ The rate of return risk caused by this instrument is exemplified in the fact that a client may default on performance after the bank owns the goods. The bank faces a situation to resell the goods in which case the selling price may not commensurate with the rate of return expected by the bank when entering into the transaction. Secondly, *murābahah* transaction causes a rate of return risk in the case of default on payment by the debtor. The default situation may cause mismatch of the expected income to pay investors as to cash flows. This amounts to liquidity problem for an Islamic bank.

2.3. *Ijārah* and *Ijārah Muntahia Bay' al-tamleek*

Article 405 of the *Mejelle* specifies that *ijārah*, in the technical language of the *fiqh*, is used to express the sale of a known benefit in return for its known equivalent.²¹ *ijārah* is typically an exchange of human service and money or the sale of usufruct (*manfa'ah*) of assets. The second usage is more relevant as far as forms of debt transaction are concerned and because it is generally used as either a form of investment (operating lease) or a mode of financing, which is simply known as *ijārah muntahia bay' al-tamleek*. In this lease, the parties agree, in principle, on terms and conditions of lease and the lessor will promise to transfer the leased assets to the lessee at the maturity of the lease agreement provided all payments are made on time. The transfer may take place in the following manner:

- Lease contract must remain separate throughout the lease period until the date of transfer of the leased property to the lessee;
- The transfer should take place with new contract;
- If the leased property is destroyed during the lease period, the lessor is obliged to return the rental paid to the lessee; and
- All ownership risks must be borne by the lessor.

Ijārah muntahia bay' al-tamleek is a rapidly growing instrument of financing and investment which triggers rate of return risks where mismatches arise between income to be generated or generated from leased assets and demands of investors.

2.4. Salam and Parallel Salam

By definition, *salam* transaction is the purchase of a commodity for deferred delivery in exchange for immediate payment of the price.²² If the bank finances the seller through *salam* and enter into another *salam* contract with a third party to acquire goods, the specification of which corresponds to that of the commodity specified in the first *salam* contract in order to fulfil its obligation in the second *salam* contract, then this is called parallel *salam*.²³ Usually, Islamic banks operate on the basis of parallel *salam*. Therefore, *salam*, from the perspective of the seller, is “asset-based debt” or an obligation to deliver goods and not payment of receivables. *Salam* creates rate of return risk in the event of failure to deliver on time or as per agreement. This is because the bank may calculate the rate of return, taking into account the time of delivery and market conditions. A failure to deliver on time alter rate of return calculation because at the date of delivery, the market price of the delivered products might be cheaper than the contract price paid to the seller on *salam* basis. Again, even if the advance payment is repaid on the date of failure to deliver, there is a rate of return risk here because the advance payment did not make any growth, which means the amount is stranded for the period of the *salam* contract.

It is, however, associated with some predicaments including delay in delivery by the seller, especially in view of the fact that some jurists rejected the idea of compensation for default of delivery. This is because, it is argued, the price in the possession of the seller is already an established debt (receivables) that cannot be increased due to delay in payment. Hence, the only remedy left for the buyer is either to take back an equivalent of his price or wait until the goods becoming available.²⁴ Therefore, the buyer in a *salam* contract is faced with default and rate of return risks without being compensated because *salam* principal is an established that cannot be traded prior to taking possession of the subject matter of *salam*. However, the delivery price in a *salam* contract is the spot price minus discount. This is because the ultimate purchaser must be compensated for his or her exposure to rate of return risk (not credit risk) as well as some performance

flexibility available to the seller relating to the acceptable range of grades for the delivered items.

2.5. *Istiṣnāʿ* and Parallel *Istiṣnāʿ*

Istiṣnāʿ and parallel *istiṣnāʿ* are among financing instruments of Islamic banks. They are largely used in project financing, either on deferred payment basis or on the basis of the concept of Build Operate and Transfer (BOT). *Istiṣnāʿ* is an agreement with a particular manufacturer or developer to manufacture or construct certain goods or equipments. This agreement creates a future liability or claim and the manufacturer would have to manufacture the described goods or equipments according to the description. Article 124 of the *Mejelle* stated that “*istiṣnāʿ* is to make a contract with a skilled person to make something”.²⁵ A contract in this way according to article 392 of the *Mejelle* is binding upon the parties.²⁶ In such a case, it cannot be cancelled after commencement of work or construction unilaterally. This is because a refusal to take goods requested on description will harm the manufacturer since the manufacturer may not find any one who is interested in such kind of asset. The rules of *salam* contract apply generally on *istiṣnāʿ* contract.²⁷ The potential of *istiṣnāʿ* in Islamic banking is that it can be used to finance certain transactions, especially in the real estate and manufacturing sector and public related projects, such as BOT. Due to its fixed price nature, *istiṣnāʿ* involves a rate of return risks. This is an Islamic bank in using *istiṣnāʿ* has tied itself to a price that will not be affected by any fluctuation of any benchmark.

While the above discussed instances are not the only available Islamic concepts that have been applied by Islamic banks and financial institutions as the debt creation instruments, they are among the most common ones. As explicated earlier, we briefly discussed those to ease the understanding on the matter and now let's see the challenges of rate of return risks posed specifically to the banks and financial institutions operated on Islamic basis.

3. CHALLENGES OF RATE OF RETURN RISK IN ISLAMIC BANKS

It is noted that debts form an essential part of the assets of both conventional and Islamic banks. However, the nature of Islamic debts remains different from the debts of conventional banks as far as rate of return risk is concerned. The Islamic banks faced daunting challenges in managing rate of return risks due to many Shari'ah related factors, including the following:

1. Mismatching of Returns and Profits Payment to Investors;
2. Unacceptability of Debt Rescheduling for Premium;
3. Common Perception as to the Unacceptability of Debt Trading/*Bayʿ Al Dayn*;
4. Unacceptability of Conditional Discount for Early Payments; and
5. Nature of Instruments and Contracts

3.1. Mismatching of Returns and Profits Payment to the Investors

In a system of fixed return due to prohibition of interest, there will be mismatch risk between the return on financing assets and the profit to be paid to investors and depositors. If this mismatch is not managed properly, there is a potential risk of mass switch to conventional floating rate loan mechanism when rate of return increases in a particular period. This is because investors and depositors are not risk tolerant. They cannot afford to lose part of income that otherwise they may earn from the interest-based mechanism. In the absence of concrete Sharī'ah-compliant instruments to manage this risk, the Islamic banks would be in a displaced commercial risk that needs to be managed accordingly.

3.2. Unacceptability of Debt Rescheduling For Premium

By adopting the Sharī'ah principles of investment, trade and adherence to rules of debt transactions, Islamic banks and financial institutions do not resort to usurious practices as do the conventional financial institutions in imposing premium for rescheduling of debt and matching the movement of interest rate in order to meet the demands of investors.

In addition and in relation to that, the majority of modern Islamic banking scholars refuse to accept the idea of imposing a penalty on default on payment of debt created by any of the instruments discussed earlier.²⁸ Even those who accept the imposition of penalty are of the view that the Islamic banks are only allowed to do so when the penalty is to be channelled to charity fund and will not be treated as an income to the bank.²⁹

The above scenario may affect the future of Islamic banking as the existing position might give an impression that one may delay in performing his contractual obligations in relation to Islamic facilities without any corresponding liabilities. It is an established fact that no banking system could tolerate withholding of its capital by default clients as much as it is also a fact that default on payment might disharmonise the banking sector and result in poor credit delivery. Therefore, a method other than imposing interest has to be developed to manage rate of return risks associated with the nature of Islamic banks' long-term receivables. In this context, compensation for delay in payment is suggested as a mechanism to minimize the rate of return risks in cases of delay in payment.³⁰ This will be possible under the principle of *ilhaqat al-uqud*, as will be discussed in the later part of this paper.

3.3. Unacceptability of Debt Trading or *Bay 'al-Dayn*

The ability of a bank or financial institution to transfer its receivables to another party or entity is an additional benefit for managing long-term receivables. In conventional finance, debts are bought and sold. A financial institution in a conventional system may choose not to wait for the maturity of the debt. Rather, the institution may package these receivables and sell them in the market at lower

price for immediate payment. In that way the rate of return risk is transferred to a large number of investors. This is not possible under the Islamic system of banking and finance. In Islamic banking and finance, sale of debt to a third party at a price less than the value of the debt is said to be unlawful. This closes the door for trading in debts. In other words, Islamic banks may not deal with discount houses because this leads to *ribā*. Also, Islamic banks, unlike their conventional counterparts, cannot securitize their receivables, a concept which is very important for managing rate of return risk in long-term debts. Thus, a bank whose majority assets form debts may not be able to enhance and manage its assets portfolio efficiently in the absence of its ability to sell its receivables to third parties. If sale of debt is not allowed, as in the case of Islamic banking today, then Islamic banks would not be efficient to manage their rate of return or liquidity risks.³¹

The question to be asked is whether sale of debt is in all circumstances unacceptable. After explaining forms of sale of debt and the debate of the jurists on sale of debt, one prominent modern jurist of Islamic banking and finance concluded that sale of debt is acceptable so far as the sale does not involve impermissible factors, such as leading to *ribā*, inability to deliver and uncertainty. This is because there is no explicit authoritative injunction that disapproves sale of debts; while on the other hand, sale of debt serves lucid interest of the contracting parties; hence, it should not be rejected.³² Within the line of such argument, there is a need to show how sale of debt does not lead to any of the elements that may render sale of debt unacceptable. Among the acceptable forms of sale of debt, as will be discussed in the later part of this paper, is the exchange of the debt against equity or tangible assets.³³

3.4. Unacceptability of Conditional Discount for Early Payment

When a client knows in advance that on early payment he may secure discount, he will be encouraged to settle his debt prior to the date his debt will become due. Such a condition, i.e., to provide some rate of discount in cases where the debtors pay sum amount prior to its maturity date, will allow financial institutions to receive a large portion of their long-term debts prior to the maturity date while allowing the debtors to secure a discount. However, the prevailing views of the classical jurists do not allow putting a condition on such discount at the time the debtor-creditor relationship is being created.³⁴ The bank may only offer such discount on the date of early payment, and not to agree on that any time earlier because a prior agreement on a discount is similar to involving additional payment for the extension of time. This makes it more difficult for Islamic banks to manage rate of return risks.

However some scholars such as Ibn al-Qayyim, Ibn Taimiyyah and Ibn Abidin are of the view that conditional rebate is acceptable between the contracting parties. Ibn Abidin argued that some jurists of the Hanafi school are of the view that rebate ought to be given, in commensurate with the elapsed period, when *murābahah* price is paid prior to maturity. This is firmly true, Ibn Abidin argued,

when the debtor demises prior to maturity date and the heirs want to make payment.³⁵ This view is strongly supported by Sheikh Mustafa al-Zarqa. He argued that the price in the instalments sales is higher than the price for spot sales. Thus, it is unfounded for one to argue that the creditor is entitled to ignore the time factor associated with the transaction and request payment of undue instalments without giving a rebate. It is also argued that rejection of rebate in early recovery is an injustice.³⁶ Thus, adopting the mechanism of rebate for early payment may assist Islamic financial institutions to manage displaced commercial risk accordingly.

3.5. The Nature of Instruments and Contracts

The unique nature of contracts and instruments used in Islamic finance contribute to rate of return risks. Islamic financial institutions used partnership instruments, such as *muḍārabah* and *mushārah* for accepting and investing deposits of the investors. The fund under management using these instruments may be used in long-term investments or under performance investments. When investments are channelled into long-term deals, there would be a mismatch relating to investment period committed for investors. This is because a large number of deposits in Islamic banks are based on short-term *muḍārabah* accounts. This creates a liquidity problem to match depositors' investment payments. Islamic financial institutions may be under pressure to pay a return on investment that exceeds the rate that has been earned on assets financed by Islamic financial institution when the return on assets is under-performing as compared to the conventional institutions' rates.

The rate of return risk is thus associated with the participatory instruments in the sense that Islamic financial institutions are not allowed to guarantee certain return on investments while the investments may under-perform. This creates a problem of mismatch between distributable returns by Islamic banks and the depositors' need to liquidity or profits higher than expected due to market conditions.³⁷ This potential situation may encourage investors to withdraw their funds in order to place them where they are guaranteed good return based on the current market conditions. Thus, hereinafter are the propositions to address such issue.

4. POSSIBLE SHARĪ'AH TOOLS FOR MANAGING RATE OF RETURN RISK

Islamic law is a system that encompasses solution for issues that humanity face at any time in any aspect. Financial transactions are no exception. That is reflected in verses that say: "...*We have sent down to you the book explaining all things...*",³⁸ and "*Nothing we have left unexplained or omitted from the book*".³⁹ The explanation of Islamic principles can either in form of a clear-cut text to be understood by way of inferences. The holy Qur'ān explains wither in details or in general terms all rules relating to religious aspect and social life of human beings. In addition, the relationship of humans with other creatures is explained. The areas

that are explained in general terms suggest the willingness of the Lawgiver, Allah, the Almighty to allow humans to exercise intellectual discourse, within acceptable parameters, to resolve current human dealings. That being said, there are certain *fiqh* related principles or concepts that may be employed or researched further to manage rate of return risks in Islamic financial institutions. They are, among others, as follow:

1. Swapping of Usufructs;
2. Variations of Future Profit Ratios;
3. Receivables Trading Against Assets;
4. Combination of Securitisation, *Hawālah* and *Tawarruq*;
5. Lease Back and Releasing;
6. Converting Diminishing *Mushārakah* into Shares;
7. Return Protection *Waqf* Fund;
8. Waiver of Right to Profit; and
9. Conditional Rate of Return Investment.

4.1. Swapping of Usufructs

Usufruct swaps means an exchange of the subject matter of *ijārah* contract. Each party shall benefit from the usufruct of the assets of the other party in a particular jurisdiction or a particular time. In this respect, a mechanism of property swap may be developed to deal with long term debts. For example, a party who owns a property that generates a floating rental may exchange it with the party whose property generates a fixed rental. When the party wants to match the profits or earnings of its investors, it may then look for a floating rate rental and exchange it with fixed rate rental on *ijārah* basis.

This mechanism may be categorized under the concept of “rental swaps” whereby each party will take the other party’s property on lease. The benefit of one property is consideration for using the other property for a particular period, after which each property will be returned to the owner together with its usufruct. This is similar to the *fiqh* concept of making payment for usufruct with another usufructs or *qarḍ al-manafī*.

The Hanafis allows exchange of usufructs as rental provided the exchanged usufructs are not related to the same asset category. A usufruct of building may be used as rental for using a land for cultivation, but not as rental for using another building, because that may lead, according to them, to deferred *ribā*.⁴⁰ Al-Suyuti does not see the validity of *qarḍ al-manafī*.⁴¹ However, Ibn Taimiyya, as opposed to famous view in the Hanbali school, argued that a person may use usufruct as rental for using another party’s assets.⁴²

4.2. Variation of Future Profit Ratios

In order to manage rate of return risks, it is suggested that Islamic financial institutions determine and vary future profit ratios according to the expectation of the market conditions. This mechanism is termed as Islamic Variable Rate (IVR).⁴³ In this concept, it is anticipated that the rate of return will change upwardly in the future. For this reason, the rate is adjusted higher than the current market price. At a later stage the profit will be readjusted to offer discount when need arise.

However, there are some issues with this concept that need to be sorted out in order to gain global acceptance. One issue is the rebate after the conclusion of the contract. In other words, if the clients will sign on a contract that gives a right to rebate, it will then fall under the scholarly debate on the concept of conditional rebate. The majority of the *fatwās* of the Islamic banks do not favour an agreement on rebate or a rebate which occurrence is known in advance. It is however agreed that an Islamic bank may offer a rebate at its own discretion. Its own discretion though will not encourage clients to seek finance from Islamic banks.

But an examination of the *fiqh* literature shows that the concept of future profit variation may fall well under the principle of *izalat al-ghabn*. *Izalat ghabn* concept requires adjustment of the earned profit to reflect actual amount that should be charged when it appears that the purchaser was cheated. An adjustment of profit in the future may also be supported by the principles of *al-ilhaqat bi al-uqud* concept. It is noted that the jurists will consider an adjustment made either to the price or the sold item, after the conclusion of a contract, as part of the original contract as if the parties intended so on the date of the contract. Thus, any additional amount or discount shall be regarded as a review of the original sale contract and shall not be treated as *ribā*.⁴⁴

4.3. Receivables Trading Against Assets

The concept of receivable trading against assets is another mechanism for trading in debts without contravening the rules of *ribā*. To apply this to the Islamic banking and finance activities will be very useful as the rate of return risk involved is easily manageable.

The concept of receivables trading against assets or, as one Muslim economists called it, “embedded options”⁴⁵ is based on sale of debt against real assets or against equity participation or *qalb al-dayn ila mushārahah*. It is argued that trading receivables against assets is acceptable even if the price of the asset is higher than the value of the receivables. The same rule applies whether the intention of the buyer is to sell the purchased assets for liquidity (*tawarruq*) or to keep them.⁴⁶ The Malikis argued that it is permissible to sell debt to a third party other than the debtor against assets even if the value of the assets is higher than the debt. The only condition for the permissibility of this transaction is to ensure that one of the counter-values (assets or receivables) is presented at signing of the

contract of sale.⁴⁷ Ibn Rajab, a Hanbali jurist, argued that Imam Ahmad allowed sale of securities for assets.⁴⁸

The concept is workable either through equity participation or creation of debt-assets secondary market.

4.3.1. Equity participation

In order to manage rate of return risk, Islamic banks may use their long-term debts to acquire equity in the financed companies. This may be made possible with the concept of embedded option where an Islamic bank obtained an option to convert the debt when the company is doing well.⁴⁹ By this way, an Islamic bank may be able to off load its balance sheet and manage its investment portfolio accurately without undue market pressure.

4.3.2. Creation of debt-assets secondary market

The acceptability of debt-assets exchange is relevant for the development of debt-assets secondary market for trading debts and managing risks of long-term debts. The creation of the debt-assets exchange secondary market is possible by the fact that the value of the commodities may be less than the value of the debts.

In this secondary market, receivables are sold in consideration for assets. The assets may be crude oil whereby owners of receivables create a "Receivable Trading House" ("RTH") and the market provides the assets in lieu of these receivables. The RTH will then sell or appoint a broker to sell the crude oil or commodity in the market on immediate payment basis. The received cash is then distributed among the participants in RTH each according to the volume of its receivables. The RTH will make money by acting as an agent to purchase and sell on behalf of the participants and manage payment collection for the seller of crude oil or any commodity. This process will continue as far as there are receivables in RTH. Through such a process Islamic banks' short-term liquidity requirements are accomplished and the Islamic banks will be able to match the short-term demands with long-term debts.

4.4. Combination of Securitisation, *Hawālah* and *Tawarruq*

The concept of securitisation is a structured mechanism that is used by conventional banks to manage rate of return risks. Debts are packaged in a bond form and sold in the market on the basis of a discount. The majority of modern Islamic banking scholars do not endorse an advance agreement on a debt discount except to the same debtor because such a discount leads to *ribā* transactions.⁵⁰ However, the bank may put the debts in a certificate form. These certificates may be exchanged with tangible assets in accordance with the Maliki school and some Shafi'i jurists. The Malikis argued that it is permissible to sell debt to a third party other than the debtor against assets even if the value of the assets is higher than the debt. The only condition for the permissibility of this transaction is to ensure that one of the counter-values is presented. In this case, the process of selling long-

term debts shall be possible by transferring the debt to another party using the following process:

When the debt-based financing is concluded, a certificate may be drafted which shows the bank is the creditor of (A). If the bank needs liquidity to make payment to its investors prior to maturity of debt payment, the following mechanism could meet the need of the bank:

- the bank buys assets from a third party - note that the value of the assets may be lesser than the debt which will make it attractive - in which case the certificate will be presented as payment for the price of the assets; hence a *hawālah* relationship is created. In such case, the certificate will be endorsed in the name of the seller who will collect the price at the maturity from the client of the bank.
- The buyer-bank will then be able to sell these assets in the market for immediate payment with lower price and get the required liquidity. With this, the bank may be able to manage its long-term debts easily depending on its ability to sell assets in the market.
- Since the client has no experience in conducting these forms of transactions, the bank may act as agent to do the transaction on behalf of the client.

This mechanism of managing risk of long-term debts is approved by some Shaī'ah Boards on the following conditions:⁵¹

- The Execution agreements should be separate from each other in such a way that each contract stands alone, i.e. the performance in one agreement is not connected to the performance in the other agreement.
- These structure and agreements should not be fictitious. They have to be real and are concluded on available assets in which case the rules of sale and purchase are met.
- Each party should be aware of its liabilities and obligations in respect to the concluded transactions.
- The structure to sell debt in consideration for assets should not be dubious for the sake of circumscribing the rules of *ribā* prohibition.
- In this process, the concept of *hawālah* is applicable for which the rules of *hawālah* should be observed especially rules relating to consent of the three parties involved the transactions, i.e. the transferee, the transferor and the payer.
- If this is done in an organized form through a company, it is then preferable that the arrangement is carried out on a fee-based agency principle.

4.5. Lease Back and Releasing

In Islamic finance, the flexible instrument for managing rate of return risk is the concept of *ijārah*. It is possible in *ijārah* to connect the future rentals to a certain benchmark due to the need to match depositors' investment demands when prices

change. However, it is a condition that the rental of the first period of *ijārah* is fixed while the parties may agree that the future rental is on the basis of a floating rate.

In the fixed rental period, the Islamic bank may also face some mismatches. In this respect, the concept of Lease Back and Releasing (“LBL”) will play a cardinal role to assist the Islamic bank to deal with this mismatch.

Generally speaking, LBL serves the objective of the concept of bonds repurchase (repo) and is based on the *fiqh* concept of re-renting or *ia'adat al-ta'jir*. This concept suggests that the lessor may lease back the leased property from the lessee for a rental which may be equal to, less or more than, the previous rental. This is the view of the Maliki and Shafi'i. It is also a view attributed to Imam Ahmad. The advocates of re-renting to the lessor differ on whether or not re-renting is possible prior to submitting the leased property to the lessee. Another issue here is whether it is permissible to re-rent the leased assets to the lessor without having it changed hand.

The Malikis and the Shafi'i's argued that the re-rent to the lessor may take place without transferring the leased property to the lessee. This is also one of the views of the Hanbali jurists. Some jurists in the Hanbali school and the Shafi'i school argued that re-renting would not be valid if the leased property is not transferred to the lessee, because it is not permitted to conclude a contract on usufructs that are not possessed.⁵² The majority of the modern Islamic banking scholars supported the view that allows renting to the lessor without the requirement of acquiring the physical possession.⁵³

If we were to apply this concept, the scenario will be as this: the Islamic bank leases assets for a certain period. In our example, the first one year rental has been fixed, say at \$1000 per month. This amount would not change in the lease period, but the rental rate in the market may change drastically during this period. In this case, the Islamic bank may look for another client who is willing to take the same property on lease basis at a new rental rate that matches the required profit distribution ratio to investors during the said period. The bank may then lease back the property from the lessee for 1100 and rent it to the potential client for \$1400. In that way the bank makes \$200 increase which commensurate with the current increase of rentals. This will help the bank to successfully manage rate of return risk and meet the requirement of the depositors who expect additional profit due to the increase in the market.

4.6. Converting *Diminishing Mushārah* into Shares

In *diminishing Mushārah*, the client promises to gradually acquire the ownership of the financing institutions until the whole property is transferred to the client. At certain point, the client may not be able to execute purchase agreement as had been agreed upon. In order to manage its rate of return risk, the bank may convert its *diminishing mushārah* into shares in the client's company, sell such shares, recover the debt on time, and make payments to the investors.⁵⁴

4.7. Return Protection *Waqf* Fund (RPWF)

Return Protection *Waqf* Fund is a mechanism to protect investment and returns. In this concept, the investors may be required to set-aside a percentage of profits of rainy years in a fund as donation. This money shall not be used except in situations of lower returns as compared to competitors' rate. The investors should clearly agree based on investment deposits terms and conditions that the bank is assigned to distribute the accumulated amount to the investors. It must be noted that investors on *muḍārabah* or *mushārah* basis do change from time to time. That necessitates that the investors also agree that, when investment is liquidated, the surplus in the fund should be channelled to charity course. This money does not belong to the bank, except its management fees.

4.8. Waiver of Right to Profit

Another mechanism that may manage the rate of return risk is "Right to Profit Waiving". In this mechanism, the Islamic banks are entitled to waive their rights to part or all of *muḍārib* share in the profits in favour of the investors in order to maintain the reputation of the organization. This mechanism is acceptable by the modern scholars of Islamic banking under the principle of gift or good gesture which is encouraged by the sources of Islamic law.

4.9. Conditional Rate of Return Investments

Conditional Rate of Return Investment (CRRI) is a mechanism that is suggested in investing *muḍārabah* funds or investment agency arrangement. In order to ensure that investment earns the required rate of return, the investor, usually a sophisticated investor, makes it conditional that the entrepreneur invests only in transactions that earn certain percentage of profit rate. The CRRI concept is endorsed by some Islamic forums and some Islamic banking scholars. The resolution in one of the Dallah al-Baraka Economic Forum concluded that it is permissible, within the context of restricted *muḍārabah*, to stipulate that the *muḍārib* should not do business except in transactions that earn by customary practice certain profit percentage.⁵⁵ The concept of conditional rate of return is discussed by the jurists under the concept of *muḍārabah*. The Hanafis and Hanbalis argued that the capital provider is entitled to stipulate certain specific conditions which violation shall make the *muḍārib* liable to fulfil the agreement. One scholar argued that conditional rate of return is acceptable when profit ratio is clearly determined and there are, in the place of investment, transactions that make profits not less than the stipulated percentage of profit.⁵⁶ Thus, if the *muḍārib* or investment agent fails to meet the required percentage of profit when all indications show that the *muḍārib* should have earned such profit, the *muḍārib* will be liable to pay the required profit.

5. CONCLUSION

To manage the rate of return risk is a real challenge to Islamic financial institutions. This is attributable to the fact that a number of Islamic finance instruments are debt-based instruments despite the fiduciary nature of Islamic partnerships. The rejection of sale of debt and guarantee of investment are deemed as basic principles of modern Islamic banking. Such situation creates a number of balance sheet exposures to rate of return risks which necessitates urgent Shari'ah complaint solutions.⁵⁷ This is because one of the methods of managing the rate of return risk is the ability of a financial institution to clear its balance sheet from debts by selling them to another party. However, this is problematic in Islamic banking due to opposition to sale of debt. It is argued that sale of debt is not totally rejected. There is place to say that sale of debt is acceptable provided this sale does not lead to *ribā*, uncertainty and inability to deliver. A debt may be sold in consideration for assets. In this case, Islamic banks may use their debt-based finances to acquire equity stake in the financed companies on the basis of embedded options. Rate of return risk may also be managed by a number of Shari'ah related tools, although some of these tools are subject to further researches in order to come up with globally acceptable mechanisms for managing rate of return risk. We feel that there is room to come up with viable and practical solutions for managing rate of return risk. However, this will not be achieved unless a mechanism of cooperation and interaction between Shari'ah scholars and practitioners is in place.

Notes

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¹ See: Karim, Adwarman A. (2005), at p. 249.

² This *ḥadīth* is narrated by Ayisha (r.a) and is reported in all books of *Sunan*.

³ See: Tyser, C.R. (trans.)(2001), *The Mejelle: Being an English Translation of Majallah El-Ahkam-I-Adliya and a Complete Code on Islamic Civil Law*, Kuala Lumpur: the Other Press, Articles 85-6, at p. 14.

⁴ For the discussion on *ribā*, see: Usmani, Muhammad T. (2000).

⁵ See El-Ghazali, Abdel Hamid (1994), pp. 22-30.

⁶ “Make trial of orphans until they reach the age of marriage; if then ye find sound judgment in them, release their property to them; but consume it not wastefully, nor in haste against their growing up” Al-Qur’ān (4:6). See also Article 957 of *the Mejelle*, at p. 150.

⁷ See Articles 1414, 1421-2 of *the Mejelle*, at pp 234-6. See also Article 1413 read together with Articles 763, 777-8 and 787 of *the Mejelle*, at pp. 234, 115, 118-9 and 121 respectively.

⁸ Karim (2005).

⁹ For further discussion on the matter, see Karim (2005), at pp 250-253.

¹⁰ *The Mejelle*, article 105, at p. 16.

¹¹ Muhammad Taqi Usmani defines it as ‘a sale in which the parties agree that the payment of price shall be deferred. See Usmani (1998), p. 102.

¹² It is narrated by Abu Hurayrah that the Prophet (PBUH) said: “Conciliation between Muslims is permissible.” The narrator Ahmad added in his version: “except the conciliation which makes lawful unlawful and unlawful lawful.” Sulayman ibn Dawud added: The Prophet of Allah (PBUH) said: “Muslims are on (i.e. stick to) their conditions.” – reported in Sunan Abu Daud, book 24: number 3587.

¹³ *The Mejelle*, article 246 at p. 35.

¹⁴ *The Mejelle*, article 247 at pp. 35-6.

¹⁵ *The Mejelle*, article 248 at p. 36.

¹⁶ See, Abu Ghuddah (1999), at pp. 19-30.

¹⁷ al-Marghinani (1985), *The Hidayah*, translated by Charles Hamilton, vol. 2, at p. 364; al-Sarakhsi (1986), *al-Mabsut*, vol. 12, pp. 124-125.

¹⁸ The translation has been altered from the very structure of the Arabic version in order to convey a more appropriate meaning of the text.

¹⁹ See, al-Ba‘li, Abd al-Hamid, *Asasiyat al-Amāl al-Masrafi al-Islami*, at p. 26.

²⁰ Usmani, Taqi, *An Introduction to Islamic Finance*, p. 131.

²¹ *The Mejelle*, at p. 60. For the conditions to form a contract of letting, see Articles 433-43 of the *Mejelleh*, at pp. 63-5.

²² Article 380 of *the Mejelle* specifies that purchase by payment in advance, like a sale, becomes a concluded agreement by offer and acceptance. Article 381 puts the condition that *salam* is good only in respect of things the quantity and quality of which can be fixed. See *the Mejelle*, at p. 56.

²³ See AAOIFI, Shari‘ah Standards on *Salam* and Parallel *Salam*.

²⁴ al-Qaffal al-Shal, *Hilyah al-‘Ulamā’ fi Ma‘rifah Madhāhib al-Fuqahā’* (1988), vol. 4, Jordan: Maktabah al-Risala al-Ḥadīthah, at pp. 387-402; Vogel and Hayes (1998), at p. 146.

²⁵ *The Mejelle*, at p. 18.

²⁶ *The Mejelle*, at p. 57.

²⁷ As expressly recognized in article 389 of the *Mejelle* at p. 57.

²⁸ However, we argued in another place, in line with the views of some renowned scholars, that compensation for default on payment is acceptable provided certain conditions are met. If this view is put into practice, then there will be some relief for managing risk of return due to default on payment. See, Arbouna (2004), pp. 399-443.

²⁹ For the support of this view, see, Usmani, Muhammad Taqi (1998), at pp 137-40. The authors, however, do not share the same argument on the basis that such an approach merely tackling the issue from the perspective of the receiver being not allowed to use the penalty received, ignoring the fact that the payer is still required to make the ‘extra’ payment. Regardless whether the imposed penalty will be consumed or otherwise, such extra is still, arguably, amounting to *ribā*. Therefore such an alternative is not better than the compensation for default on payment. See Arbouna (2004).

- ³⁰ See, Arbouna (2004). For the authorities both in support and against the proposition, see Usmani (1998), at pp. 131-7.
- ³¹ See, Al-Gari (2002b), at pp. 5-34.
- ³² Al-Darir (2000), pp. 13-70.
- ³³ Al-Darir (2000), at pp. 47-50.
- ³⁴ For more discussion on the matter, see: Usmani (1998), at pp. 141-3.
- ³⁵ See Ibn Qudama, *al-Mughni*, vol. 4, p. 489; Ibn Abidin, *Hashiya Ibn Abidin*, vol. 5, at p. 160.
- ³⁶ See al-Zarqa (2001), "Hawla Jawaz Ilzam al-Madin al-Mumatil bi Ta'wid li al-Da'in", p. 32; al-Misri, Rafiq, *Al-Jami fi Usul al-Riba*, at p. 323.
- ³⁷ See al-Gari, Mohammed Ali (2002a), at pp.1-16.
- ³⁸ See Surah al-Nahl: 89.
- ³⁹ See Surah al-An'am: 38.
- ⁴⁰ Ibn Nujaim, *al-Bahr al-Ra'iq*, vol. 7, 298.
- ⁴¹ See al-Suyuti, *al-Ashbah wa al-Nadha'ir*, p. 523.
- ⁴² See al-Almardawi (n.d), *al-Insaf*, vol. 5, p. 125; Ibn Muflih (1418H) *al-Furu'*, vol. 4, p. 151.
- ⁴³ Bank Negara Circular on Compensation for Default on Payment (2002).
- ⁴⁴ See al-Kasani, *Bada'i al-Sana'i*, vol. 5, p. 261.
- ⁴⁵ It is called embedded option due to the fact that this solution will not work without some form of gentleman option agreement. See, Khan (1999-2000).
- ⁴⁶ Al-Darir (2000), pp. 13-70.
- ⁴⁷ See AAOIFI, Shari'ah Standards 2004-2005, p. 290.
- ⁴⁸ See al-Baghdadi (2004), *al-Qawa'id fi al-Fiqh*, p. 240.
- ⁴⁹ See, Khan (1999-2000).
- ⁵⁰ This is the view of the majority of scholars.
- ⁵¹ See, Aa'yan Leasing and Investment Company (n.d), *al-Fatawa al-Shari'ah 1999-2002*, Fatwa No. 56 at p. 89.
- ⁵² See Kuwait Finance House (1993, 27-29 April), *A'mal al-Nadwa al-Fiqhiyya al-Thalitha*, at pp. 35-101.
- ⁵³ See, Aa'yan Leasing and Investment Company (n.d), *al-Fatāwā al-Shari'ah 1999-2000*, at p. 190.
- ⁵⁴ Bank Tadamon al-Islami (1997), *Al-Fatwa al-Shari'ah li Bank al-Tadhamun al-Islami*, at p. 50.
- ⁵⁵ See Abu Ghuddah and Khoja (edit) (n.d), p. 16.
- ⁵⁶ Al-Darir (n.d).
- ⁵⁷ Among the issues that need to be looked into is the possibility of "Overnight *Mud'arabah* Fund". Another area that is not investigated is the concept of *I'arah mu'aqata* or temporary assets borrowing for Shares in order for the Islamic banks to keep it and earn the profit at a particular period to match liquidity requirement. The AAOIFI Shari'ah standards disapproved *ijarah* of shares for profits in consideration for fee. However, if we look at the shares as assets which benefits are revolving in the form of profit or margin, then it may be possible to compare this with Ibn Taimiyah's view on leasing well for use of water and tree for use of its fruits. This is because the benefit of well and tree is revolving for which the concept is similar to shares for benefiting from the profit without the right to sell them. This is because selling the shares would violate Islamic principles of lease.

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Sharī‘ah’s Drive Against Derivatives

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ABSTRACT

The capital markets across the world are evolving, leading to inventions of new generation financial instruments, with an aim of having investment portfolio with highest possible returns and minimum possible risks. Some of these tools happen to be called as ‘Derivatives’. The past decade has witnessed explosive growth in the use of financial derivatives by a wide range of corporates as a cheap source of funds. Derivatives are supposed to be balancing overall risk of the business unit while also improving level of earnings. Weekly derivatives market trading volumes exceed trillions of US dollars. Dealing in derivatives business has become the epicentre of heated arguments in the financial circles between the people who are in favour and against derivatives; nevertheless people involved in the derivative trading are learning to live with them. The derivatives trading mechanism and there overall long term results need to be analyzed to make a comprehensive resulting conclusion. Derivatives are a set of tools and just as a saw can build a house; it can also cut off one’s arm if it isn’t used properly. Derivatives can turn out to be financial weapons of mass destruction (WMD). Therefore there is urgent need to analyze the working and affect of derivatives within the Sharī‘ah (Islamic Law) parameters.

1. INTRODUCTION

A derivative is a generic term for specific types of investments from which payoffs over time are derived from the performance of assets (such as commodities, shares or bonds), interest rates, exchange rates, or indices (such as a stock market index, consumer price index (CPI) or in index of weather conditions). In other words derivative is a risk-shifting agreement, the value of which is derived from the value of an underlying asset. Derivative transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, financial derivatives, options, caps, floors, collars, forwards and various combinations there of. The underlying asset could be a physical commodity, an interest rate, currency or virtually any other tradable instrument upon which two parties can agree. The main use of Derivatives is

supposed to be either to remove risk or take on risk in the hope of making a profit. The diverse range of potential underlying assets and payoff alternatives lead to a huge range of Derivatives contracts available to be traded in the market.

We use a number of tools to manage our investment portfolio for the highest return, while minimizing risk. One of the most popular tools among them is derivatives. If one were to look at the complete chronological events of derivatives trading, one would observe that derivatives ill affects overwhelm the benefits. But since people involved in derivatives trading are addicted to short term gains, they are still trading. Otherwise people who have not only suffered burnt fingers, but have burnt themselves are simply keeping away from derivatives. The critical objectives of the paper are to outline the key necessary elements of financial derivatives contracts and briefly analyze the mechanism involved in the use of these financial instruments.

Attempts have been made in this article not to strike down the derivatives just because there are against the etiquettes of Islam. But the long-term, affects have been analyzed and the ill affects of derivatives illustrated with an appeal for the people not following Islam which is a natural religion given by the Almighty. Efforts have shed light on working of derivatives by examining derivatives within reasonable confines of contractual dimensions while trying to give possible suggestions to make derivatives benefit to all parties. Since the critical importance is attached to commercial transactions, in the generation of wealth and the prospects of productivity in countries world wide, new research on issues of the conventional law of commercial transactions is essential to ascertain the viability and success of economic development and prosperity desired. In recent decades, research interest in the commercial law has been increasingly getting focused on specific themes and the development of new operative formulas to stimulate profitable business in the market-place. Financial Derivatives trading is one such theme wherein original, independent juristic reasoning is evidently required to enhance the prospects of economic success, especially in farming agro-based industries and metals along with budding service sector in many developing countries.

Financial markets are by nature extremely volatile and hence the risk factor is an important concern for financial agents. To reduce this risk, the concept of derivatives comes into the picture. Derivatives are products whose values can also be derived from one or more basic variables called bases and have no intrinsic value. These bases can be underlying assets (for example Forex, equity, etc), bases or reference rates. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. The transaction in this case would be the derivative, while the spot price of wheat would be the underlying asset

2. DEVELOPMENT OF EXCHANGE-TRADED DERIVATIVES

Original, derivatives have probably been around for as long as people have been trading with one another. Forward contracting dates back at least to the 12th century, and may well have been around before then. Merchants entered into contracts with one another for future delivery of specified amount of commodities at specified price. A primary motivation for pre-arranging a buyer or seller for a stock of commodities in early forward contracts was to lessen the possibility that large swings would inhibit marketing the commodity after a harvest. But as the time passed financial wizards with selfish lusts have hijacked the whole system for their own fancies.

3. GLOBAL DEVELOPMENTS

Growth in the over-the-counter OTC derivatives market slowed in the second half of 2006 to a pace in line with the long-term average rate of increase of the market. Notional amounts of all types of OTC contracts rose by 12% to \$415 trillion at the end of December 2006. Another survey reported by BIS, the Derivatives market is growing at 20%. Of the world's largest 500 companies, 92 percent use derivatives to insure against moves in borrowing costs, currencies or commodities. According to the International Swaps and Derivatives Association, interest-rate contracts grew 20 % to \$121.8 trillion from Jan-June, 2006 & as per BIS its US\$ 170 Billion.

4. WORKING MECHANISM OF DERIVATIVES

Derivatives are believed to be new complex, high-tech financial products created by capital or money market wizards and are basically considered as speculative and highly leveraged instruments. Derivatives are considered simply as a latest risk-management fad that takes money out of productive processes and never puts anything back. They are supposed to hedge the risk of owning things that are subject to unexpected price fluctuations, e.g. foreign currencies, bushels of wheat, stocks and government bonds. There are mainly two types of financial derivatives or contracts for future delivery at a specified price, and options that give one party the opportunity to buy from or sell to the other side at a prearranged price. Derivatives' trading is also used by food processors, merchants and manufacturers as a means of ensuring sales and purchases in advance, without them having to face the uncertainties of marketing at a later occasion, that is, after harvesting or production as the case may be. We can take the case of oil-rich Middle East countries, the phenomena in the recent decades has been that of flow of surplus funds from these countries to the West, largely due to the lack of adequate investment facilities leading to use of this money for commodity trades to the tune of US \$50 Billion. Derivatives are supposed to be low-cost effective method for users to hedge and manage their exposures to interest rates, commodity prices, or exchange rates. The need for derivatives as hedging tool was felt first in

the commodities market. Agricultural futures and options helped farmers and processors hedge against commodity price-risk.

5. FEASIBILITY OF USING DERIVATIVES AS JUSTIFIED BY THE PROPONENTS

Justification for the use of financial instruments cannot be determined by socio-economic, political or business environment only, but analysis from ethical and commercial point of view is also required. There are many financial investment vehicles and instruments that are explicitly accepted such as transactions in spot market - leasing, selling contracts etc., Derivatives are one of these financial instruments and option is one of the derivatives. The debate regarding the fruitful use of derivative instruments would not matter much if one considers them to be at the periphery of the spectrum of financial products/ instruments. The growth and extensive use financial derivatives in conventional finance cannot act as a testimony to the meagre benefits that handful of business organizations derive from the use of financial derivatives. But some modifications in the working financial Derivatives is a necessary to keep the momentum because the true worthiness of an instrument can be ascertained over a ample period of time involving all parties. As per a Shari'ah scholar approximately a period of about 40 years would be required to really gauge the end results of a financial instrument.

6. PARTICIPANTS LOOK FOR THE FOLLOWING IN A DERIVATIVES MARKET

- Hedgers use futures or options markets to reduce or eliminate the risk associated with price of an asset.
- Speculators use futures and options contracts to get extra leverage in betting on future movements in the price of an asset. Speculators try but fail to increase both the potential gains and reduce potential losses by usage of derivatives in a speculative venture.
- Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in two markets to lock in a profit.

7. FACTORS DRIVING THE GROWTH OF FINANCIAL DERIVATIVES

- i) Increased volatility in asset prices in financial markets,
- ii) Increased efforts for integration of national with the international financial markets all of which is getting complex by the day.
- iii) Marked improvement in communication facilities and sharp decline in their costs.

- iv) Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
- v) In the name of innovations in the derivatives markets, Jp Morgan Stanley has spent billion of US\$, in an effort to combine the risks and returns over a large number of financial assets leading to higher returns, reduced risk. Along with lesser transactions costs as compared to individual financial assets, but nothing concrete is taking shape.

8. CHARACTERISTICS OF CONVENTIONAL DERIVATIVES IMPLIED

- Speculation - *Maysir*
- Uncertainty & Ambiguity - *Gharar, Jahālah*
- Exploitative – (Zero sum game) - *Zulm*
- High leverage (Interest) - *Ribā*

9. MYTHS BEHIND DERIVATIVES

IN LESS than three decades of their coming into vogue, derivatives markets have become the most important. As if today, derivatives have become part of the day-to-day life for ordinary people in most parts of the world. Financial derivatives came into the spotlight along with the rise in uncertainty of post-1970, when the US announced an end to the Bretton Woods System of fixed exchange rates leading to introduction of currency derivatives followed by other innovations, including stock index futures. The financial markets in the world started undergoing radical changes due to breakdown of this system. This period was marked by remarkable innovations in the financial markets, such as introduction of floating rates for currencies, increased trading in a variety of derivatives instruments, and on-line trading in the capital markets. There are many apprehensions about derivatives though the reality is not indifferent with exceptions of to some extent the exchange-traded derivatives which are regulated to the tightest safety mechanism. Derivatives increase speculation and do not serve any economic purpose, studies have led to a broad consensus on this both in the private and public sectors, (that derivative do not provide substantial benefits to the users).

10. HYPE ABOUT DERIVATIVES

Despite the proponents of derivatives fighting tooth and nail, the other side of the picture has public and the shareholders with help of some good media coverage were able to zero-in that trading in derivatives is the culprit of the whole global financial mess. The simple reason being, the extreme complexity involved in derivatives strategies, while organizational weakness and the failure to observe fundamental business precautions can be the secondary factor. Global markets in

commodities, currencies, stocks and bonds have witnessed large-scale volatility during the past two decades. As a result, Corporate's are often exposed to risks that they may not be comfortable with, risk management products that are an outcome of a sophisticated process of financial engineering which can enable companies to share, transfer and avoid partially or fully "unwanted" risks. Derivatives allow market participants at a micro-level to avoid undesirable risks. Derivatives make it possible to transfer risks to other participants who would like to bear them. Designing and dealing in such products has become an important activity for financial services providers. The enormous size of the financial Derivatives market dwarfs bank capital, thereby a situation may be created making derivatives trading an unsafe and unsound banking practice. The use of derivatives can be largely preferable by the selfish multinational corporations and large banks looking for easy money because the development of derivatives was brought about by a need to isolate risk. Derivatives tend to link market participants more tightly together, thereby increasing systemic risks, which cannot be manageable to reasonable proportion. Derivatives are supposed to offer a method of breaking risk into component pieces and managing those components independently as the derivatives hedge against specific risks. Almost every organization--whether a corporation, a municipality, or an insured commercial bank--has inherent in its business and marketplace a unique risk profile which ought to be decreased and that it can be better managed by illusion of derivatives trading. The top management of corporates have failed to understand the nature of this product being used in their treasuries or trading operations making derivative's an, 'Art and Not a Science of Risk Management'.

11. ANTI DERIVATIVES MANIFESTO

Financial experts like LiPuma and Lee in their article fear that derivatives have led to the "commoditization" and "objectification" of risk and thereby have impoverished developing nations by inflicting on them a new form of violence. Their portray financial derivative markets as common threads that link national and international economic crises (real and financial) to wild financial price swings and the negative effects of globalization of Derivatives is not source of capital and that derivative prices are endogenously derived from the prices of underlying assets. Their reluctantly believe that Derivatives are a major exogenous cause of the development and movement of international capital flows. In an another financial expert's opinion which is largely focused on the gross, nominal size of the Derivatives market, has observed it to be a gigantic figure, but the actual market value, is much lower in real terms. The conventional financial experts also claim that the construction and combination of derivative-induced capital flows would create a "newly minted and determinative conception of risk and feel that financial Derivatives determine the availability, cost, velocity, and value of capital itself.

The job of a Derivatives trader is like that of a bookie once removed, taking bets on people making bets. The description above comes from 'Into the Fire', a novel

about fraudulent trading in derivatives, by Linda Davies. Ethics of commercial law must be singled out as it is the most important area of contemporary research in relevant economic studies and ought to be given overall high priority on par with even a highly rated research in applied sciences or medicine. Financial Derivatives and options are highly geared or leveraged transactions and therefore traders or investors are able to assume large positions - with similar sized risks - with very little up-front outlay. By their very nature derivatives tend to encourage those with higher degrees of speculation so that derivatives traders behave like a bookie. The potential reward is that such a technique designed to reduce risk is all too often treated as a gambler's tool.

Credit derivatives may create risks to the financial markets if events prompt all investors to exit at the same time, as per European Central Bank President Jean-Claude Trichet, it is feared that investors may react in a way that can suddenly lead to dangerous herding behaviour or a situation may be created from a systemic liquidity viewpoint. These concerns were raised at annual meeting of the International Swaps and Derivatives Association (SDA), which represents 750 banks and securities firms, an organization which reads the pulse of the industry.

SDA report further gave details that credit derivatives were the fastest growing financial market, surpassing bonds and loans as a cheaper way to speculate on credit quality. The market has doubled in size every year since 2003, with outstanding contracts covering US\$34.5 trillion of securities. The decade-old market hasn't been "stress tested" in a crisis, there is potential for "counterparty risk" if investors were to seek to exit at the same time as stated earlier. Potential herd-like behaviour could reduce market liquidity and affect the ability of a "significant" market participant to finance its business. Such problems are low-probability events, but a huge threat exists inevitably. The consensus view is that derivatives help efficient risk management, but if liquidity were to fall, then the potential loss to the financial system would be great, while there is also fear that a large proportion of market participants may have become excessively complacent.

12. THE DERIVATIVES BUBBLE

The \$125-150 trillion world derivatives bubble is inter-linked across countries and markets--bonds, stocks, currencies, commodities, etc. A failure in one part of the market can trigger the disintegration of the global financial system. Reverse leverage will make this process happen with lightning speed, which is very much possible due to derivatives. Derivatives are believed to be purely speculative highly leveraged instruments, designed to capture spreads, or pricing differences between different interest rates, currencies, or commodities. Some critics believe that derivatives create risks that are uncontrollable and not well understood with possible rates of return on financial derivatives can vary from 10-15 percent, up to 2,000 percent, and even higher. If one thinks of making money through derivatives then he is wrong, as it is not actually money but just computer-generated increases

in computer-generated accounts. For some, derivatives are instruments of financial warfare that are deployed against nations and the populations in much the same way as the commodity market short-seller who can bankrupt a farmer.

13. FIGHTING ON THEIR TURF

As stated earlier Derivatives are the financial instruments that have both proponents and opponents because on surface there are some but sharp conflicts between purposes and working of financial Derivatives system. Derivatives are said to be valueless because they require no productive labour and are devoid of any material resources. Organizations that are risk-seeking only should use Derivatives since the risks associated with financial Derivatives are new and unknown. Derivatives are priced largely by replication, based on the prices of underlying assets that are traded in the domestic and as well in the international markets.

- Those who oppose financial Derivatives, fear a financial disaster of tremendous proportions, a disaster that could paralyze the world's financial markets and force governments to intervene to restore stability and prevent massive economic collapse, all at taxpayers' expense. Some critics liken derivatives to gene splicing: potentially useful, but certainly very dangerous, especially if used by a neophyte or an eccentric without proper safeguards.
- The issue that is matter of concern is the huge trading volume of derivative's market all of which indicates the possibility of extensive speculation the market attracts and accentuates speculative behaviour while cash settlement may also lead to undesired over speculation. The other issue that causes uneasiness among critics is the fact that a large portion of those trading in derivative markets have no intention of either making or taking delivery of the underlying asset even in the case of genuine hedgers.

14. ILLUSIONS OF DERIVATIVES

- Market efficiency
- Risk sharing and transfer
- Low transaction costs
- Capital intermediation
- Liquidity enhancement
- Price discovery
- Cash market development

- Hedging tools
- Regulatory savings

15. FACTS OF DERIVATIVE MARKETS

- More leverage
- Less transparency
- Regulatory arbitrage
- Rising CP exposure
- Hidden systemic risk
- Tail-risk future exposure
- Weak capital requirements
- Zero-sum transfer tools

Derivatives have also been associated with some of the most spectacular financial shocks & failures in the world. Rice Financial Products Co., an investment bank and broker of derivatives for U.S. states and municipalities, agreed to settle allegations that it defrauded a Los Angeles-area water agency on two interest-rate swaps the agency entered into in 2001 and 2003. The settlement calls for Rice and the West Basin Municipal Water District, which provides water to 900,000 residents in some Los Angeles County cities, to start a new swap on \$220.6 million of underlying bonds. Rice also agreed to pay West Basin \$500,935 accrued under previous swaps.

- The large failures of U.S. savings banks in the '80s & Baring bank in 1995.
- The LTCM (Long Term Capital Management) 1998 – the effect of the fund's speculative activities was that its capital fell from \$4.8 billion to about \$600 million. Company's debacle had such an impact that world stock markets fell by 11% on the announcement of the news. The collapse nearly brought down many counter parties but a FED sponsored rescue plan saved the day with the injection of about US\$3.6 Billion into the company by a consortium of banks.
- Enron – was a large user and promoter of derivative contracts and its demise in 2001 raised significant concerns about counterparty (credit) risk and financial reporting. Shares of Italease, a provider of lease financing for cars, real estate, and equipment, had plunged 46 percent as its clients suffered mounting potential losses on derivatives contracts sold by the company. The possible losses swelled to 600 million euros (\$800 million) from 400 million euros.

16. AN UNDER-EXPLORED FRONTIER OF DERIVATIVES (HARD FACTS)

- In September 2006 Amaranth Advisors, the US-based hedge fund lost \$6 billion because it suffered enormous losses while trading in natural gas financial derivatives
- Another case that came to light in January 2006 was when Anshul Rustagi, a London-based Derivatives trader at Deutsche Bank was suspended after allegedly overstating profits on his own trading book by £30 million. He was subsequently dismissed.
- During October 2005 Refco one of the world's largest Derivatives brokers was forced to freeze trades due to ir-regulations.
- In Nov 2004, China Aviation lost \$550m in speculative trade which is the largest of a company in Singapore due to betting on Derivatives, since N Leeson and Barings case.
- During August 2004 Citigroup traders led by Spiros Skordos made €15 million by suddenly selling €11 billion worth of European bonds and bond derivatives, and buying many of them back at a lower price.
- Jan 2004 NAB admitted losing A \$180 million, as four foreign currency dealers of the NAB, Australia were said to have run-up the losses in 3 months of unauthorized trades.
- 2003 terrorism financial derivatives plan dropped, as the US Defence Department had thought that such a market would improve the prediction and prevention of terrorist outrages, but the plan simply fell apart due to no concrete mechanism.
- In 2002 AIB lost \$750 million, John Rusnak of AIB used fictitious options contracts to cover loses on spot and forward foreign exchange contracts.
- In March 2001 a Japanese court fined Credit Suisse First Boston 40 million yen because a subsidiary had used complex Derivatives transactions to conceal losses
- In 2001 Enron went bankrupt, the 7th largest company in the US and the world's largest energy trader made extensive use of energy and credit derivatives was the biggest firm to go bankrupt in American history after systematically attempting to conceal huge losses.
- May 2000, mispriced options were used by NatWest Capital Markets to conceal losses and the British Securities and Financial Derivatives Authority concluded its disciplinary action against the firm. Since

Derivatives can be deliberately mispriced in order to conceal losses or to make profits by fraud

- The January 1991, failure of the Bank of New England (BNE), which had until its collapse been one of the 10 largest bank holding companies in the United States, provides a good example of the way federal regulators have propped up the banking system, and of the risks faced by banks which play in the world Derivatives markets.
- Long Term Capital Management (LTCM), had to be rescued at a cost of \$3.5 billion dollars as it was feared that its collapse could have a disastrous effect on financial institutions around the world with Merton and Scholes who had received the Nobel Prize for their work a hedge fund being its share holders.
- In an article 'In Seeing Tomorrow: rewriting the rules of risk', by Ron S. Dembo and Andrew Freeman, a case was stated in which "clever but criminal staff got inside an options pricing model and used tiny changes to skim off a few million dollars as profits for themselves". The culprits were not prosecuted because the bank feared that the revelation could wipe out hundreds of millions of dollars of its overall value.

17. ECONOMIC FUNCTIONS A DERIVATIVE MARKET IS PRESUMED TO PERFORM

- i) Derivatives are supposed to be transferring risks from risk adverse to risk oriented people.
- ii) Derivatives are supposed to be helping in the discovery of future as well as current prices.
- iii) Derivatives are supposed to catalyze entrepreneurial activity
- iv) Derivatives are supposed to be helping to increase the volume traded in markets because of participation of risk adverse people in greater numbers
- v) Derivatives are supposed to be to increase savings and investment in the long run.

All of which has turned out to be a big hoax if we observe the long term affects of derivatives.

'Boom Times'

Boom times can turn out to be a nightmare soon, the world's largest user of derivatives and the second-biggest U.S. bank (Bank of America) had derivatives with a face value of \$33.1 trillion, according to the U.S. government's Office of the Comptroller of the Currency report. The total compares with \$14.2 trillion at Bank

of America Corp. and \$12.8 trillion at Citigroup Inc. The notional value of gold derivatives fell 4 percent and gross market value dropped 22 percent in the period. The gold price was on a dramatic rollercoaster ride through the first half of 2003. There was ``continual and extensive producer de-hedging, with extremely low interest rates, producers earned less on proceeds of forward sales of gold.

18. ISLAMIC POINT OF VIEW ON DERIVATIVES

Sharī‘ah scholars have been very accommodating in terms of bringing new concept in to Islamic finance and allowing some of the use of derivatives in the structuring of those funds. Conventional derivatives may be to some extent being able to play the role of a product which is fulfilling certain business needs but that only is not enough for its need. Now there are around 200 Islamic banks as well as Islamic indices and proposals to launch the first Islamic hedge fund. Therefore, risk management requirements and considerations for competitiveness should force the *Ṣukūk* structures to further evolve and offer Sharī‘ah compliant alternatives to traditional derivatives. Ultimately, the aim is to put forth *Ṣukūk* structures, which can be competitive without utilizing derivatives.

19. CHARACTERISTICS WHICH MAKE DERIVATIVES GET TRIMMED IN SHARĪ‘AH SPACE

We need to see what are the prerequisites for Islamic derivatives? The non-existence of interest rates in Islamic finance apparently makes the need for derivative instruments redundant in Islamic markets. Other pre-requisites are that the prohibition of interest and *Gharar* does not close the room for financial engineering in compliance with the Sharī‘ah. Second, *Ṣukūks* cannot avoid being competitive if they are to operate in traditional financial markets. Third, the positive aspects of derivative markets can be beneficial for developing capital markets if replicated in the emerging markets.

20. ISLAMIC CAPITAL MARKETS

The Islamic Capital Market (ICM) should refer to markets where activities are carried out in ways which does not conflict with the principles of Islam. The ICM should represent an assertion of religious law in conventional capital market transactions where the market is free from prohibited activities and elements such as *ribā* (usury), *maisir* (gambling) and *gharar* (ambiguity). The growing awareness of and demand for investing in accordance to Islamic principles on a global scale has created a flourishing Islamic capital market, more so today due to increasing wealth in the hands of Muslims worldwide who are actively involved in corporate and business activities.

21. ANTICIPATING NEW DEVELOPMENTS (FEELING THE PULSE OF ISLAMIC MARKET PLACE)

- The Muslim population of the world today is estimated at about 1.5 billion, representing a sizeable 24% of total world population of 6.3 billion
- Latent Islamic funds in global financial institutions is said to be at US\$1.3 trillion and Islamic financial market is estimated to be US\$230 billion in size, with an annual growth rate of 12-15%.
- There are over 250 Islamic financial institutions currently operating in about 75 countries worldwide, with more than 100 Islamic equity funds managing assets in excess of US\$5.0 billion. Indeed, the pace of development in the Islamic financial market has gathered momentum with the formation of various international Islamic organizations to study and promote this alternative market. These organizations include the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Table 11.1

DERIVATIVES	ŞUKŪK
Based on rights and claims	Assets are based & continue to carry asset risk directly even when traded.
Have no intrinsic value	Have intrinsic value. Attached to the title or beneficial ownership of an asset
Multiple generations of distinctive contracts are created from the basic underlying contract.	Şukūk relate to only one contract and maintain asset linkage at all times

Şukūk are different from bonds, shares and derivatives but is the same as conventional securitization. According to another source of information it is estimated that the global Shari'ah compliant assets are about US\$ 400 billion, while S&P puts the potential market for financial services to be around US\$ 4 trillion.

Hedge funds use leverage, derivatives etc - all of that is *ḥarām* (prohibited) which is not only not *ḥalāl* (legal). Others argue that hedge fund strategies have great potential for Islamic finance, which is hamstrung by a shortage of instruments to manage risk, especially long-term risk. Many hedging strategies have their origins in risk reduction, which is in the spirit of Islam's prohibition on gambling, taking examples of farmers acting to reduce their exposure to fluctuations in

commodity prices. The Islamic finance industry's ability to provide fixed-rate mortgages, underwrite life insurance or finance long-term infrastructure projects is hampered by its inability to manage the risk of long-term exposure, Islamic derivatives advocates say.

Of impending concern for the managers and investors in derivatives is their ability to protect themselves from different types of risks. The next logical step in the evolution of Islamic finance is the provision of risk management mechanisms that replicate the functions of conventional instruments in a way compliant with the Sharī'ah. The Sharī'ah does not recognize financial options as a form of wealth. Hence these options cannot be traded. The very nature of options entails uncertainty. Call options reward the investor on the upside movement of the asset value whereas put options payoff with respect to the downside movement of the underlying asset value. This degree of uncertainty is determined by Islamic jurists to essentially amount to *Gharar*.

22. VISION AND STRATEGIES ISLAMIC LAW

It should be kept in mind that half knowledge is always dangerous. Even in the light of *Aḥādīth* we come across that ayahs from Qur'ān should be quoted without making any minute of minute changes. Therefore having an outsider's perspective, people who have not attended a formal Islamic Montessori should not be taken as harbingers. Especially when the arguments of such people are based on the access they get to English papers written on the subject. Thereby one gets an impression there is inconsistency in arguments and opinion from such scholars.

23. EFFORTS ON TO GET AN ISLAMIC ALTERNATIVE MECHANISM

Due to economic and financial liberalization and advancement of technology more and more financial products requiring risk management are being introduced. No doubt Islamic derivatives can be used to meet the goal of having high levels of trading volumes and liquidity with aim to have minimum risk and transaction cost in the capital market. There is a strong need to work towards innovative Islamic financial products with due importance given to integration of individual national Islamic financial systems within the international Islamic financial architecture. The anchoring point is that there should be fine balance between benefits of having active trading in robust capital market with derivatives without endangering the fair and eternal rules laid down by the Sharī'ah. The critical objective of derivatives playing the role of hedging and risk management tools should be achieved without treading the Sharī'ah limitations, i.e. customers should be able to hedge profit rates risks whilst enhancing their balance sheet management. The derivatives contract should offer the buyer of a good to make a deposit whereby if he decides to buy the specified product in the future he will pay the difference between the full price and the deposit. If circumstances dictate he will not buy the commodity then the seller keeps the deposit. In a sense, the *Urboon* contract ostensibly replicates the

functions of a conventional call option. While according to the OIC Academy an option contract is not tradable. Firstly, the option contract amounts to investing in something intangible. Secondly, the uncertainty involved in the contract is tantamount to *Gharar* making it invalid within the sphere of Shari'ah.

The permissibility of the contract within Islamic doctrines is debated and much of debate is with regards to historical records of the use of the contract during the time of the Prophet Muhammad. Several schools of thought are in the impression that the uncertainty arising from the use of the contract amounts to *Gharar* and is thus unfair on the seller. On the other hand, other schools of thought uphold the contract citing inaccuracies in the historical records of its alleged reproach. The applicability of the contract is particular to the condition that commodity in question is specified and unique to the contract. According to Shari'ah, the *Urboon* cannot be used for generic commodities which hinder its possibility to fully replicate the functions of conventional option contracts that are on unspecified underlying assets.

24. BASIC SHARĪ'AH PRINCIPLES FOR ISLAMIC FINANCIAL PRODUCTS AND SERVICES

The underlying fundamentals of Islamic financial transactions form the basis of the difference between conventional and Islamic financial instruments. Modern Islamic finance began with the emergence of Islamic banking, where products and services are not based on *Ribā* (interest). As the industry grew, many other financial products in the insurance and capital market sectors were adapted to incorporate Shari'ah compliant aspects. Product innovation has been significant in the Islamic financial services industry over the last decade, resulting in a wide array of Islamic instruments being introduced in the market. Shari'ah compliance rules have been developed for equity, debt and securitization products are many in the process of being extended to structured products and examined for derivatives as well. Rules to determine Islamic compliant operations have also been developed for the banking, broking, investment management and advisory services.

In fact we can say that the Islamic financial market runs parallel to the conventional financial market and provides investors with an alternative investment philosophy that is rapidly gaining acceptance. The fact that the Islamic financial market does not prohibit participation from non-Muslims creates unlimited upside to the depth and breadth of this market offer today, clearly an authoritative body is required to define and provide guidance on what is and is not permissible under Islamic law. It is imperative that this body must possess adequate infrastructure to enable the system to operate and function efficiently and effectively. Towards this end, the Islamic Capital Market Unit within the Securities Commission's Market Policy and Development Division has to be mandated to research and develop products and activities pertaining to the Islamic financial markets globally.

25. SHARĪ‘AH PARAMETERS: (QUALITATIVE)

The general criteria in evaluating the status of Sharī‘ah-approved securities are that the companies are not involved in the following core activities:

- Financial services based on *Ribā* (interest)
- Gambling
- Manufacture or sale of non-*ḥalāl* products or related products
- Conventional insurance
- Entertainment activities those are non-permissible according to Sharī‘ah
- Manufacture or sale of tobacco-based products or related products
- Stock broking or share trading in non-Sharī‘ah approved securities
- Other activities deemed non-permissible according to Sharī‘ah.

26. FUTURES

The futures contracts are unlawful because, as per one of the principles of the Sharī‘ah which states that purchase or sale cannot be affected for a future date. Therefore, all forward and futures contracts are invalid in Sharī‘ah; secondly, because in most futures transactions delivery of the commodities or their possession is not intended. In most cases the transactions end up with the settlement of the difference in price only, which is not allowed in the Sharī‘ah. Whereas some other scholars who are proponents of futures argue that in the modern degenerated form of futures trading, some of the underlying basics concepts as well as some of the conditions for such trading are exactly the same as were laid down by the Prophet (PBUH) for forward trading. They take support from some *Aḥādīth* in which there are sayings of the Prophet (PBUH) that he who makes a *Salaf* (forward trade) should do that for a specific quantity, specific weight and for a specified period of time.

27. OPTIONS

Same is the case of Options contract, a number of Sharī‘ah scholars have found option contracts also to be invalid. While the proponents argue that there is nothing inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it, and that options trading like other varieties of trade is permissible *mubāh* and as such it is simply an extension of the basic liberty that the Qur’ān has granted.

The overall picture gives the impression that most scholars having in-depth knowledge of Sharī‘ah are not in same wave length with the modern day ill-informed scholars that in principle, futures and option contracts are compatible with Sharī‘ah principles. The simple reason being that they have found application

of these contracts in the marketplace in certain instances, involves speculation and exploitation of certain counterparties. It is possible that the objections of the learned scholars may differ in accordance with their individual interpretation of the Shari'ah and their understanding of the instruments discussed above. Just because a business is deprived of array of benefits and is at disadvantage in short run one cannot ratify and appreciate any business mechanism. It is possible that things may appear to be legal from Shari'ah point of view but isolated instances are not the remedy but a concerted effort may be necessary to address the social disadvantages derivatives are placing on such businesses in today's global economy.

28. POSSIBLE HASSLES OF SHARĪ'AH COMPLIANT FINANCIAL INSTRUMENTS (LACK OF EXPERTISE)

Many firms face the challenge of recruiting enough staff with the appropriate degree of expertise and experience. As firms have expanded their commodities investment activities, or have entered these markets for the first time, they have struggled to recruit staff with the Shari'ah products necessary experience. Some firms are transferring staff from the fixed income areas of their business, or staff with experience of conventional derivatives but not specifically Islamic derivatives requirements. Firms are training staff in this area but there is inevitably a time lag before these staff gain enough experience. If the sector continues to grow, this will become an even more pressing matter. Stories of unqualified derivatives traders receiving substantial recruitment inducements indicate the extent to which demand exceeds supply in the market. The FSA's Financial Risk Outlook 2007 identifies this as huge a risk and it is something that concerns ordinary investors the most. If inexperienced traders don't fully understand the nature of the commodities markets they operate in, this could harm the interests of both individual firm and the markets as a whole.

29. SUGGESTIONS FOR SAFE SMOOTH WORKING OF FINANCIAL DERIVATIVES MARKETS

Therefore from the above analysis and inferences we can conclude that conventional derivatives cannot be used safely and successfully despite applying best possible sensible controls and management strategies. Detailed analytical exercises, sound appreciation of qualitative market and industry trends and sound organizational setup, infrastructure and controls are not enough and there should be some form of Shari'ah anchoring:

- a. Preliminary descriptive analysis of financial derivatives from all party perspective needs to be carried out.
- b. Opinion polling by the world's top financial wizards who are abreast with Shari'ah requirements recommendations should be adhered.

- c. Propose permissive, rules and regulations that could be drawn up in the form of bills and legislations to be passed by Consultative Assembly or Parliament of individual Muslim populated countries.
- d. Upon enactments, the Islamic economic council body that oversees major economic related decision- makings should give a go ahead by issuing permits on individual product basis
- e. Check feasibility of options & derivatives contracts from shareholders point of view as the prime criteria within in Sharī‘ah principles.
- f. Comprehensive study of derivatives contracts mechanism for choosing appropriate ones to suit Islamic world’s circumstances.
- g. Set up and organize a team of Sharī‘ah financial experts and traders to handle contracts and transactions of derivatives.

Notes

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Investment In Stocks: A Critical Review of Dow Jones Shari‘ah Screening Norms

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ABSTRACT

Investment in stocks is permitted by Shari‘ah scholars, however the investors have to ensure that the invested company’s activities and structuring are not repugnant to Shari‘ah. Due to exigencies of modern business and particularly the pervasiveness of interest transactions, fully Shari‘ah-compliant equities are extremely rare. Therefore, Shari‘ah scholars have arrived at minimum compliance criteria. In the present paper the authors have reviewed the norms set by Dow Jones Islamic Market Index. A critical and analytical assessment of the criteria follows. Empirical data of the five hundred companies included in the BSE500 index of the Bombay Stock Exchange is used to assess the impact of the norms.

1. INTRODUCTION

When investing in any avenue, Islamic investors need to take into account the structure of the transaction and the nature of the counter party. An investor in the share capital of a company becomes technically a part-owner of the company and therefore responsible for its internal structuring as well.

In case of investment in equities traded on the stock exchanges, the investor needs to consider issues such as company’s involvement in Shari‘ah non-compliant activities. Due to high prevalence of Shari‘ah non-compliant practices, initially Shari‘ah scholars tended to completely rule out investment in stocks. Over time however, with an aim to remove the hardship realisation has seeped in that a more balanced view needs to be taken. Hence, the consensus is now veered towards accepting a certain degree of compromise. The Shari‘ah boards of various organisations, official regulators and market intelligence providers have put forth various criteria to define the maximum degree of compromise which could be considered acceptable under Shari‘ah, given the current business environment.

In this paper, the Shari‘ah norms set by Dow Jones, USA for screening purposes has been assessed critically in an objective fashion.

The published data of the companies included in the BSE-500 Index of the Bombay Stock Exchange for the years ended March 31st 2001 to March 31st 2005 has been used to provide an empirical back-drop to the discussion and to assess the relevance and degree of stringency implied in the parameters.

In the study it is found that considering the objective (i.e. Sharī'ah compliance) the pervasive use of market capitalization in the screen ratios has not been apt. Also in the screens for level of debt and level of liquid assets, it has been argued as well as proved from the statistics cited, that the defined levels of acceptability tend to be on the liberal side and thus need to be tightened. The screen used to assess the level of receivables is shown to have little relevance to the actual objective sought.

2. DATA BASE AND RESEARCH METHODOLOGY

The basic rationale behind formulating screening norms is to provide Islamic investors a reasonably wide choice of selection of Sharī'ah compliant equities.

In this paper, the Dow Jones norms for Sharī'ah compliant investment has been studied in the context of the Indian stock market.

Share trading in India is dominated by the BSE and NSE. The three bellwether indices for the Indian stock market are the BSE Sensex; the BSE 500 index and the S&P CNX Nifty. The first of these tracks mere 30 scrips listed on the BSE and the last S&PCNX Nifty (50 scrips) quotes on the NSE whereas the BSE500 index, which we have chosen, is based on a sufficiently large yet manageable 500 from the BSE.

In terms of trading volumes and number of listed scrips the Bombay Stock Exchange (BSE) has a pre-eminent position in the world. This is borne out by the statistics shown in the annexure one.

Data for companies included in BSE500 Index is used for studying the Dow Jones screening norms. The overall period selected is April 1, 2000 to March 31, 2005. Data for the selected period was obtained from the database of the Centre for Monitoring Indian Economy (CMIE), a prestigious private sector data base provider which counts India's top corporates as well as the country's central bank, the Reserve Bank of India (RBI) among its clients.

The database provided covered accounting (balance sheet and income & expenditure) data as well as average market capitalization for each of the companies included in BSE500 index over each of the twelve-months periods included in the overall period. As banks and other financial institutions such as non-banking finance companies, housing finance companies etc. are heavily involved in interest based transactions, 45 such companies have been excluded from the 500 index scrips. Further, certain accounting figures appear as denominators either in the screening norms or in the ratios used in the analysis. Hence some scrips from the BSE 500 index have been excluded as one or more of

such accounting figures for them in one or more of the years covered were less than zero or unavailable. This has mainly been either on account of listing in later years or negative income or net worth in some years.

Table 12.1

Year ending 31 st March	No. of Cos. in Sample
2001	400
2002	401
2003	411
2004	421
2005	444

Apart from the exclusion as above, no other companies have been excluded from the BSE 500 population on the grounds of non-sharī‘ah compliant (other than substantial interest earnings) activities. The table below gives the final number of companies included in the sample for the different years.

All data used was designated by CMIE in million US\$ using the relevant INR/USD conversion rates as per the RBI norms.

3. EQUITY SHARES AND EQUITY FUNDS AS SHARĪ‘AH-COMPLIANT INVESTMENT AVENUES

In assessing whether a specific investment proposal is compliant with sharī‘ah stipulations, it needs to be examined from two angles, i.e. the nature of the instrument / transaction itself and the nature of the contracting (counter) party. For instance a trading transaction can be considered from two aspects:

- a) whether there is any *gharar*, *ribā* etc. involved in the structuring of the transaction, and
- b) the nature of the counter-party (business).

3.1 Equity Shares

In case of investment in equities, the structuring of the transaction itself appears unobjectionable as equities do not confer any assured benefits on the holder. Nor does equity investment necessarily involve the element of randomness and uncertainty associated with gambling and games of chance. The rights and obligations of the parties too are clearly defined and do not involve exploitation or injustice.

Thus, in many different milieus share investment represents a viable major (in some cases only) non-interest based investment avenue for sleeping investors. Moreover, with the modern advances in computing, communications and

information dissemination, even lay investors can now easily invest on the stock exchanges.

In the absence of sufficiently safe and pure modes of genuine profit-sharing avenues, equity markets represent an important investment alternative that is close to the Islamic profit-and-loss-sharing investment ideal. There is therefore a strong element of *maṣlahah* (public benefit) in permitting equity investment under Shari'ah, provided the nature of the business and the way it is carried out are such that even in case there is a violation of Shari'ah stipulations, it is kept within certain limits.

3.2 Equity Funds

Equity funds or equity-based mutual funds are the financial institutions which mobilize investments from the public against the units of their fund and invest all these funds in listed equity shares. Thereafter, they calculate the NAV (Net Asset Value) of the fund units on a daily basis and may allow investors to exit or enter the fund at or around NAV. The expenses of the fund and the remuneration of the fund manger are defrayed from the earnings of the fund. A mutual fund unit thus closely resembles an equity share in that it too does not guarantee any fixed returns to the investors or an assurance of return of any part of the initial investment.

In addition, it gives an individual investor the benefit of a diversified investment portfolio and the services of expert investment advisors, in spite of a modest investment outlay. The downside for him from an Islamic point of view is that his investment goes into shares of a large number of companies engaged in different businesses and with varying types of financials, over the selection of which he has no control, except to the extent the offer document of the fund defines the investment policy of the fund.

4. SCREENING NORMS FOR SHARĪ'AH COMPLIANCE

Norms for screening equities are used by different sets of users. These could include portfolio managers, providers of market intelligence and regulators. Different users have different objectives and hence the screening norms they use reflect their objectives. Thus the primary concern of portfolio managers is likely to be to select a portfolio of shares that provides a good return on their assets.

Similarly, organisations which provide index information will have their own norms. Their concern is primarily to provide a feedback about the overall state of the market. Hence their selection criteria and weightings are likely to be in favour of the more intensely traded and higher market cap stocks. Their intention is to provide investors a measure to judge the current state of the market as against that prevailing on an earlier day or that likely to prevail in the future. Their indices also enable investors to assess how a particular stock is doing in the market in relation to the overall market. Hence the primary measure for them is the market price of the share and therefore the market capitalisation. The higher the market

capitalisation of a share, the greater its importance to them. Then, if the idea is to provide an Islamic Index, they need to add some Sharī'ah-compliance criteria to weed out those companies which deal in non-Sharī'ah compliant products/services or function in non-Sharī'ah compliant ways.

Market regulators, on the other hand seek to ensure a healthy and steady development of the market without sudden and wild swings and to enable it to grow in terms of depth as well as number and diversity of scrips offered. At times national policy may also dictate promotion or curtailment of certain industry segments or holdings by certain type of investors. In such a situation, the market regulator may monitor those industry segments or investor types and provide appropriate regulatory concessions or safeguards to promote the policy objectives.

On the other hand, when we consider defining screening norms to identify Sharī'ah-compliant equities, our concern has to be to select those stocks from the share market universe which function within the minimum realistically acceptable deviations from Sharī'ah stipulations, keeping in mind the nature of the environment. Thus the focus of such screening norms has to be on selecting shares which meet the above objective.

5. SOME ISSUES IN SHARĪ'AH COMPLIANCE

In judging the Sharī'ah compliance of the counter-party (the company invested in) one has normally to consider the nature of the business it is engaged in. However, when the transaction is one of investment in equity, the investor is also responsible for the way business is structured.

5.1 Business of the Enterprise

The Sharī'ah categorizes certain commercial activities as impermissible or *ḥarām* for Muslims. Hence investment in the shares of any company engaged in such *ḥarām* activities as its main business, is clearly impermissible under the Sharī'ah.

Besides, there would be instances of business firms which are not primarily engaged in *ḥarām* activities but a part of their operations may indulge in activities that are not permissible according to Sharī'ah.¹ Alternatively, a firm involved in a permissible activity may have a subsidiary or have an investment in another company, which may be involved in non-Sharī'ah compliant businesses.

The most conservative Sharī'ah scholars ('*ulamā'*') do not permit investment in the equity of a company which is invested in *ḥarām* business to any extent.² Others allow investment in equities of companies which derive a minor part of their income from *ḥarām* activities, provided such activities are not their main area of interest.³ Yet other '*ulamā'*' agree to such relaxation only if the same can be justified on grounds of *maṣalahah* i.e. public interest. Yet others make an exception if the *ḥarām* activities are so pervasive in the society as to be a

commonly prevalent evil, difficult to avoid.⁴ An instance of the former may be the serving of alcoholic drinks in planes of a national carrier, whereas earning interest through treasury management is an instance of the latter.

5.2 Structure of the Enterprise

While studying the structure of the business from a Sharī'ah viewpoint the three aspects that need to be considered are:

- a) debt availed by the company;
- b) interest and other suspect earnings of the company;
- c) extent of cash and receivables with the company.

5.2.1. Indebtedness of the enterprise

In the modern world, most organized businesses rely on banks to part finance their activities. Partly this is due to the need for fluctuating working capital and ready availability of bank capital for financing and maintaining ongoing trade and its expansion in the face of unforeseen exigencies of business. Apart from working capital needs, banks also finance acquisition of fixed assets in case of major expansion and diversification of business.

Due to fluctuating conditions it becomes almost inevitable for even a moderately-sized enterprise to access bank capital, at least for working capital purposes. This is accentuated by the fact that with Islamic banking still in its infancy, there is often no viable Islamic alternative to bank capital. But bank finance is interest-based and therefore, *ḥarām*. Hence, while investing in these equities and becoming part-owner of such a company may be, strictly speaking, against Islamic norms, the principle of *maṣlahah* may permit some degree of flexibility and allow investment in equities of companies in which debt is below a certain level.

The measure conventionally used to assess the level of indebtedness of a company is the debt: equity ratio. There is no reason the same ratio should not also be used to assess the indebtedness of the company in terms of its compliance with the Sharī'ah. And indeed many institutions do use it in such a context. Alternatively, one can use the related ratio, debt: total capitalization. The Dow Jones uses the ratio, debt: market capitalization.

5.2.2. Earnings from impermissible (*ḥarām*) activities

Banks play a major role in facilitating transactions in modern times. All cash flows of the enterprise are routed through banks. As a result all businesses have to maintain accounts with banks. These accounts attract some nominal interest. In addition, at times enterprises have to keep security deposits with banks and others to cover performance-guarantees and assurances. These accounts too fetch the enterprise some interest.

The enterprise may also, at times when it is flush with funds, deploy excess short-term liquidity in bank deposits and securities as a measure of treasury management. For an outsider investing in the equity of an enterprise, it is difficult to judge, whether, and to what extent interest accruing to a company is inadvertent and involuntary and to what extent planned and deliberate. It is not feasible to expect the investor to investigate this aspect.

At the same time, to ensure that the interest-earnings of a company do not substantially contribute to its revenue, it is essential to set certain limits to the proportion of interest- earnings to the total revenue of the company. For this purpose, the measure used is interest (and other *ḥarām* income) earned as a percentage of total revenue (income). Various Shari‘ah boards fix this percentage at different levels, generally between 5% and 15%.⁵

5.2.3. Cash and receivables/payables of the enterprise

Finally, there is the Shari‘ah stipulation that cash and debts cannot be traded except at par value. It appears that in applying this ruling to the valuation put on a company’s shares, the Shari‘ah scholars have considered a company as the bundle of assets and liabilities (reported on its balance sheet), including fixed assets, investments, cash, inventory, receivables, payables and debts. The traded price of its equity can hence be considered as representing value paid for the underlying assets and liabilities. If the fixed assets and investments of a company are negligible (as happens for trading companies), then the remaining assets and liabilities mainly comprise of debts, deposits and stocks. In equity trading, the price of scrips traded is driven by future expectations of prices and not by the book value of the company. Hence, if stocks (inventories) are valued at market prices, one can end up with a residual value for the cash and debts of the company which can be way out of line with their par values.

The measure or parameter most commonly used to judge compliance on this score is percentage of current assets or receivables or net current assets to total assets (or total capitalisation) of the company. Alternatively, the numerator can be net receivables instead of net current assets. The cut-off value of the parameter is usually set in the range of 40 % to 50 %.

6. DOW JONES ISLAMIC MARKET INDEX CRITERIA

The criteria used by Dow Jones are depicted in the figure and explained in the following sub-sections:

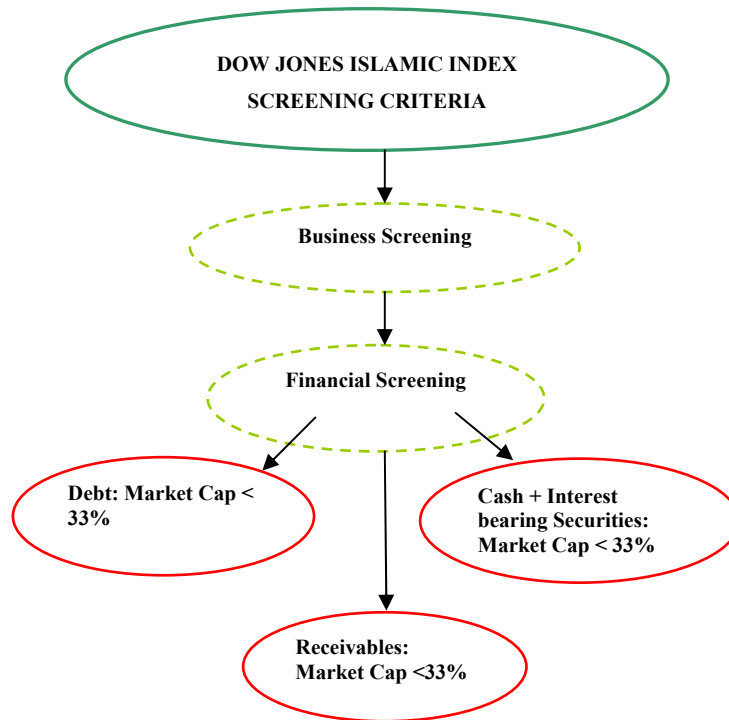


Figure 12.1 Dow Jones Islamic Market Index Screening Criteria

6.1 Screens for Acceptable Business Activities

Activities of the companies should not be inconsistent with Shari'ah precepts. Therefore, based on revenue allocation, if any company has business activities in the Shari'ah inconsistent group or sub-group of industries it is excluded from the Islamic index universe. The DJIMI Shari'ah Supervisory Board established the following broad categories of industries as inconsistent with Shari'ah precepts: alcohol, pork related products, conventional financial services (banking, insurance, etc.), hotels, entertainment (casinos/gambling, cinema, pornography, music, etc.), tobacco, and weapons and defence industries.

6.2 Screens for Acceptable Financial Ratios

After removing companies with unacceptable primary business activities, it

removes companies with unacceptable levels of debt, liquid assets and receivables by applying the following screens:

6.2.1. Debt to market cap

Exclude companies for which Total Debt divided by Trailing Twelve Month Average Market Capitalization (TTMAMC) is greater than or equal to 33%. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).

6.2.2. Liquid assets to market cap

Exclude companies for which the sum of Cash and Interest-Bearing Securities divided by TTMAMC is greater than or equal to 33%.

6.2.3. Receivables to market cap

Exclude companies if Accounts Receivables divided by TTMAMC is greater than or equal to 33%. (Note: Accounts Receivables = Current Receivables + Long-Term Receivables).

Companies passing the above screens are qualified to be included as components of the Dow Jones Islamic Market Index.

7. ASSESEMENT OF DOW JONES SHARĪ‘AH SCREENING NORMS

There would probably be a consensus among scholars that the primary screen for identifying Sharī‘ah-compliant businesses has to be about the nature of the business. No extent of compliance with Sharī‘ah otherwise can substitute or compensate for a falling off from compliance on this issue. Hence the norm in this regard has to be sufficiently stringent.

Among the non-permitted areas documented in the Dow Jones is very exhaustive and may be considered quite comprehensive.⁶

Among the industries included in the list, the rationale for excluding real estate holding and development is not readily apparent; probably it is due to the generally high levels of leverage prevalent in the industry.

It appears that the Dow Jones criteria has resorted to extra caution resulting in not letting through even some Sharī‘ah-compliant units in an industry if most units in that industry may not be compliant. Hotels and media and broadcasting for instance, do not have anything intrinsically objectionable about their activities. However, as a prevalent practice hotels do serve non-*ḥalāl* foods and alcoholic beverages. Similarly, media coverage and broadcasting may include material with nudity or obscene images. Not all food wholesalers and retailers too may trade in non-*ḥalāl* food items. However, for a provider of market information it may not be easy or feasible to obtain and keep abreast of such details about operations of

specific units in such industries where most units tend to be Shari'ah non-compliant.

Probably the better solution would be to have a secondary list of industries from the excluded list, from which specific units could be included in the permitted (Shari'ah-compliant) list if specific information from time to time indicates that it does not indulge in objectionable practices. The onus for providing such regular updates could be placed on the reporting units themselves and the same could be periodically or randomly audited by the screening and certification organizations for a suitable fee.

There are also some important omissions in the Dow Jones list, going by the apparent logic of their selection. These are air and sea passenger transportation. Most units in these sectors serve alcoholic drinks and non-*halal* foods to their patrons. If hotels are on the excluded list, it is difficult to understand why air and sea passenger transportation are not excluded as well. Further, these industries usually operate with exceptionally high leverage too.

7.1. Screening of Business Activities

Dow Jones provides an exhaustive list of different types of industries which its shari'ah advisory board has classified as non-compliant.

For example, among the prohibited business the Dow Jones list includes industries engaged in the business of (conventional) finance and insurance, liquor, non-*halal* foods, entertainment and gambling, hotels, broadcasting & media, defence and real estate and property developments.

From the above it can be deduced that Dow Jones is very conservative in excluding non-compliant business activities.

7.2. Screening on the Basis of Financial Ratios

Apart from the business screens Dow Jones has laid down screens relating to financial ratios. These are the level of indebtedness of the unit, the level of liquid assets and the level of receivables.

7.2.1. Norm for level of debt financing

The acceptable level of indebtedness is set at less than 33% of market capitalisation. Dow Jones uses debt: market capitalization as its measure. Whereas, the ratio of debt: total assets would have been a more rational approach which Dow Jones was using earlier. It gives a measure of how much of the operations of the company are being financed by the Shari'ah non-compliant debt component. Such a ratio therefore clearly follows from the objective sought.

Because of the conventional financial wisdom that requires companies to consciously rely on moderate debt levels to leverage profitability. While selecting

Islamic screening norms, we need to set the tolerance levels on the basis of how much debt could be unavoidable. The ideal ratio is 0:1.

Shari‘ah scholars tend to plumb for a debt: equity ratio of 30:70 or 33:67 (equivalent to a debt: total assets ratio of 24% to 28%) on some tenuous argument that the Prophet (p.b.u.h.) is reported to have said: “one-third and one –third is too much”. We must not forget that here we are making concessions and the actual ratio should be zero.⁷ The concession should be mainly based on working capital requirements (i.e. for financing net current assets).

Considering the BSE 500 aggregate data, we find that the net current assets: total assets ratio works out to an average of 12.8% (varying between 16.9% and 11.1%) and the Debt: Total Asset ratio to an average of 26.2% (varying between 31.2% and 22.6%). This implies that the investment requirement for net current assets is about 13% only whereas the actual borrowing is about twice of that. The balance of the borrowing is being used to finance a part of the fixed assets of the companies. It is to be noted that the percentages quoted are based on the aggregates of a sample of companies operating in a conventional manner with no inclination of avoiding debt. For those looking for companies operating close to Islamic norms, the ratios should be far more stringent.

At the same time we must accept that companies differ in their capital structuring, depending on the sector in which they operate. There may be a case for setting differential ratios for the debt: total assets ratio depending on the industry segment. If this is not feasible, a debt: total assets ratio of <20% or 25% appears a realistic tolerance limit to be set.

Considering the BSE 500 index data and applying the Dow Jones screens to the data we find that:

- a) The aggregate borrowings vary between US\$ 43.70 billion in 2001 to US\$ 55.71 billion in 2005, aggregate total assets correspondingly vary between US\$ 140.13 billion in 2001 to US\$ 246.57 billion in 2005 and the aggregate market capitalisation varies between US\$ 119.99 billion in 2001 to US\$ 269.79 billion in 2005.
- b) As the ratio of aggregate total assets: aggregate market capitalization is mostly (except for 2005) greater than 1.0 (varying from a high of 1.63 for 2002 to 1.09 for 2004), the cut-off level (of 33% of market cap) of the Dow Jones criteria appears conservative.
- c) The mean deviation of total assets values is lower than that of the market cap values. As a result even in 2005, though the aggregate of total assets at US\$ 246.57 billion is lower than that of market cap at US\$ 269.79 billion, still the number of companies individually qualifying on a screen of 33% (at 294).
- d) Consequently the number of companies qualifying on the Dow Jones

criteria are 152 to 253 (38% to 57%) of the sample).

7.2.2. Level of liquid assets

Currently the Dow Jones index sets the acceptability limit for the ratio of receivables to market capitalisation at 33%. Earlier its limit was 45% and the denominator was total assets instead of market capitalisation. It also stipulates another ratio, i.e. of cash and interest-earning securities to market cap with a ceiling of 33%, presumably to put a cap on the level of liquid assets.

Classification of data with CMIE does not give a clear breakdown of investments into interest bearing and non-interest bearing investments, as well as into liquid and illiquid investments. Instead the available classification of data gives the breakdown of investments into other categories. The different categories and the percentage of investments in each category over the period of study is given below.

Table 12.2 Category-Wise Breakdown on Investments

Investment Category	As Percentage of Investments
Investments in group companies	47% to 58%
Investments in mutual funds	10% to 12%
Investments in government securities	Negligible
Investments in approved securities	Negligible
Investments in assisted companies (by banks)	Not applicable
Investments in debentures/PSU bonds	4% to 10%
Investments in shares (by banks)	Not applicable
Other investments	19% to 29%

From the above it can be seen that the categories drawing the bulk of the investments are “group companies” and other “other investments”. It is not clear what part of these investments is interest-earning and what part is liquid. Investments in group companies could be in the form of shares or loans, similarly mutual funds invested in may be growth funds (equity based) or income funds (securities based). This latter category of investments will however, be liquid.

Apart from the “investments” head, the other account head which gives the quantum of liquid and/or interest –earning funds is “cash and bank balances”. The bulk of these comprise fixed (time) deposits with banks which earn interest but can be withdrawn at short notice, albeit with some loss of interest. However, the ratio of “cash and bank balances” to “investments” varies from 0.44 to 0.61, i.e., the quantum of “cash and bank balances” is only about half of that of “investments”. Hence the only definite conclusion that can be drawn is that the 4% to 10% in

“debentures/PSU bonds” is interest-earning, and the 10% to 21% in mutual funds liquid.

Analyzing the Dow Jones norms through the BSE 500 data, gives the following empirical findings:

- a) The aggregate values for receivables vary between US\$ 37.38 billion to US\$ 60.79 billion.
- b) Dow Jones criteria of Receivables to market cap as even the ratio of “cash and bank balances” plus “investments” (liquid as well as illiquid) to receivables is consistently lower than 1.0 (varying between 0.5 and 0.9).
- c) On the “Receivables Criteria” applied at the BSE 500 set between 101 companies (in 2002) to 263 (in 2005) qualify.

7.2.3. Level of cash + interest bearing securities

The Dow Jones screen does not stipulate a separate screen for interest income. Rather its screen is based on the ratio of cash and investment in interest-based securities to TTMAMC. This screen is really for screening liquid assets and therefore not suitable for screening out companies on the level of interest income (or for that matter, level of interest earning assets). As interest can accrue on assets which are not necessarily securities, we think the absence of a separate screen for interest income in the Dow Jones set is a grave omission.

Coming to an empirical validation of our recommendation, the BSE 500 aggregate data shows:

- a) Aggregate Interest: aggregate total income ratio varies from 0.93% (in 2001) to 0.64% (in 2004).
- b) With a screen ratio of 5% for this criterion almost 94% to 98% of the companies qualify whereas with a ratio of just 1% still 72% to 81% qualify.
- c) Separate figures for interest-earning investments are not available in the database. Making allowance for non-interest earning investments, such as in equities of associate companies and subsidiaries in growth oriented mutual funds and strategic and portfolio investments, it appears reasonable to assume that the aggregate investment in interest-earning assets is likely to be a minor (25 % to 40% say 33%) part of the aggregate total investments. Adding to this, the amount in bank deposits, the ratio for interest-earning investment to total assets is found to vary from 6.0% in 2001 to 7.2% in 2002 & 2003, 8.6% for 2004 and 13.9% for 2005.
- d) As the proportion of cash in the “cash and bank balances” aggregate figures is quite minor (varying between 4% and 12%), the ratio for the Dow Jones criteria of cash + interest earning securities as % of market cap is also not

likely to cross the 10% level except in 2005. Hence the Dow Jones benchmark for this screen appears too liberal.

- e) On the basis of the Dow Jones parameters, (assuming interest-based investments as 33 % of total investments), 87% to 97% of the companies qualify. Hence it may be concluded that this screen is too liberal.

7.2.4. Level of receivables

Dow Jones stipulates certain maximum ratios of receivables or liquid assets as one of the screens for checking Shari'ah compliance.

As discussed earlier that it is wrong to treat a company in the modern world whose equity is publicly traded as simply a bundle of accounting assets and liabilities, defined on its balance sheet. For a start, some very vital and valuable assets of the company may not figure on its balance sheet at all. Marketing assets such as brands, distribution networks and logistical arrangements, as well as licenses, quotas, permits, access to lucrative but protected markets, etc. do not normally appear on balance sheets. Even intellectual property such as patents, formulae, source codes of software, etc. are assets, which even if assigned a book value in terms of research costs are sometimes actually worth thousands of times more. Even fixed assets either appear at historical costs or are re-valued only at infrequent intervals.

Then there are other intangibles such as the company's public image, the value of key individuals in the company's top management, marketing, production and research teams. Similarly access to markets, raw materials, power and other utilities in times of shortages can impinge on the value of a company's share price. Since here the argument concerns the value paid for a company's share in relation to the composition of its assets and the value paid for a publicly traded equity is driven by market expectations of the future, there is no connection between the assets of non-negotiable value (as per Shari'ah) and the market price. The market price movements do not, even in a minute way mirror the price assigned by the market to the company's receivables, payables and cash balances.

Hence it can really be futile to place a figure on the share of a company only or mainly on the basis of its balance sheet assets. A company such as a trading company can have negligible assets other than receivables and payables, and some inventory and yet due to its intangible strengths it could command a huge premium in the market on its break-up value. This is not because it is able to sell its receivables and cash at a premium or liquidate its debts at a discount (as the reasoning of the Shari'ah scholars requires). It is because of its inherent or intangible strengths.

Conversely, a company may own valuable real estate assets. As a result in the event of liquidation of its assets, the break-up value of its share could be several times its traded value, if it is not performing well. This is because the normal

market players have a short-term investment horizon and know that the company management does not have an immediate intention of closing shop. Hence they view the company as a going concern and not as spoils to be shared out.

Hence the very basis for the stipulation regarding limiting the level of receivables appears to be misconceived and invalid. In addition to it, the Dow Jones stipulations being based on the market capitalization and therefore suffering the additional weakness inherent in using TTMAMC as a measuring quantity, is even more unsuitable.

7.2.5. Suitability of market capitalisation for use in screening ratios

In the Dow Jones screens one of the financial measures used to assess the value of ownership of a company and used in some screens is market capitalization.

Dow Jones uses market capitalization as a denominator in all the ratios it uses for screening. Which financial terms and what kind of ratios are to be used should follow from the objectives sought to be gained. But does market capitalization fit the bill.

It is claimed that market capitalization gives the true worth of a company and hence it needs to be used as a basis for the financial ratios. While such a contention is far from the truth, even if that was the case, its use in all the ratios is not relevant or appropriate for some of them have nothing to do with the worth of the company. It needs reiteration that use of a specific term or ratio depends on the objective for which that term or ratio is being used.⁸ Then again, fundamentally screening norms need to focus on the company itself and its activities and assess them on objective criteria. How the market perceives a company is not relevant to the Islamicity of its activities. The market price of the share is not the amount invested in the company's assets; it is the price settled for the share of the company by buyers and sellers, independent of the company.

Also, it is almost impossible to sell or buy all the shares of a company, on the stock exchanges in a few days or even a month. The final price (even average price) of the shares being sold or bought over the period of purchase or sale could be vastly different from that prevailing when the exercise was initiated.

There is also often no definite rationale behind the way share prices fluctuate. The only definite statement that can be made about price movements on the equities market is that they are largely driven by sentiments about future earnings and movements. What creates those sentiments on a particular day is a different matter. It could be past performance, news of current performance, expectations of future results, market manipulations, a result of demand-supply imbalances, government policies, political developments, international price movements, even the state of health of a national leader or finance minister or even the holding of a major match of a sport the nation is fanatical about.

Thus, often in the span of a few weeks or a couple of months, the share price of an equity share can skyrocket or nosedive. The IT boom and bust of a few years ago is a case in point. In a wild jacking up of share prices, new IT start-ups with no revenue stream to talk about (leave alone a profit stream) reached astronomical heights only to plummet back to the price of scrap paper. Even ignoring such extreme scenarios, it is not unusual to find over a year's interval share prices rising to more than double or sinking to less than half their original values, when there is no apparent change in their underlying fundamentals.

A practical problem of using market capitalization also is that with sudden market movements, a company which was considered Shari'ah-compliant one day, has to be considered Shari'ah non-compliant the next day, if there is a downward price fluctuation. As a result Islamic investors would have to compulsorily exit, leading to further downward pressure on its price, thus destabilizing its price. Similarly an opposite movement could lead to a corresponding (though more muted) upward move too. And all this with no change in the company's operations. Such market destabilization would also be an unhealthy and wholly avoidable consequence of involving market capitalization in the screening norms.

8. CONCLUSION & SUGGESTIONS

A suggestion has been made that organisations undertaking screening on the basis of Shari'ah-compliance norms should put in place a system requiring compliant companies in industries such as hotels, shipping, etc, which generally tend to fail on one of the criteria for compliance, to regularly report their results and activities to the screening organisation for a fee so that investors could gain a wider choice and the reporting companies not get automatically excluded from the list of Shari'ah-compliant companies communicated to potential investors.

The use of market capitalisation in the screening ratios is inappropriate and should be replaced by other relevant balance sheet items, notably total assets.

The value of the ratio normally set for compliance regarding level of debt should be scaled down by at least 20 percentage points.

Screening norm for controlling the level of cash and receivables (or net receivables) on the rationale that these can only be traded at par. A higher proportion of these assets in the total assets, could lead to an infringement of this Shari'ah requirement. It has been shown in the paper that the entire reasoning behind this screen is flawed. Such a screen does not serve any purpose at all as the level of market price of a share is not due to a corresponding value for the company's cash hoard or receivables and payables.

Notes

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¹ Instances of such companies are hotels, or airlines which may sell or serve alcoholic drinks as part of their operations though their main activity is providing accommodation and transportation respectively, to travelers.

² For more details on this issue please see, Yaqubi, Nizam, *Participation and Trading in Equities of Companies whose Main Business is Primarily Lawful but Fraught with some Prohibited Transactions*, Paper presented to the Fourth Harvard Islamic Finance Forum, October 2000.

³ *Ibid.*

⁴ See for example, SEC Malaysia criteria which is devised by its *Shariah* Advisory Council.

⁵ Op. cit. Yaqubi, Nizam, 2000.

⁶ The non-compliant sectors (after consolidating similar ones) in the given list are: weapons and defense, distilleries & vintners, food products, food retailers & whole sellers, bars & restaurants, hotels, tobacco, recreation products & services, gambling, media agencies, broadcasting and entertainment, banks, various types of finance and investments services, providers of various kinds of insurance and insurance brokers, real estate holding and development.

⁷ It is interesting to note that the same “one third” rule is not applied in the case of the other screening ratios (for interest income and receivables). In fact the tolerance limits in those cases are very different. Why? One needs a rational basis rather than cosmetic justifications.

⁸ For instance, while calculating *zakāh* on one’s holding in listed equities, one does need to use the market value of the shares. This is because the market value of the shares as on a given day is the best approximation to the worth of the holdings of an ordinary investor with limited holdings (the same may not be necessarily true for an investor with a substantial holding). The ordinary investor can in most cases if he wants, get for his holdings about the same value as the market price indicates and he is also potentially able to realize the worth of most of his shares in a single day’s trading. It is not just a theoretical figure. Hence his *zakāh* calculation would have to be based on the market value of his shares.

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Managing Risk of Islamic Equity Investments: Initiatives and Strategies

*Kassim M. Mohammed** and *Rasem N. Kayed***

ABSTRACT

A remarkable feature embedded in Islamic financing is the principle of Profit-and-Loss Sharing (PLS) where investors share the risk, as well as the rewards, associated with their investment activities. On the other hand, Islam deems some (business) activities as being unlawful on the ground that they are too risky and speculative, thus are strictly prohibited. Building on these canons of business principles, this paper aims to provide a framework for the concept of “just risks and fair returns” within the context of Islamic financing, and to draw the line between excessive risk taking and rational risk sharing in accordance with the readings of the Islamic business code of conduct. The main objective is to probe the characteristic of Equity Investment Risk within the PLS investments in order to devise strategies and working policies to manage anticipated risk and consequently minimise its negative implications.

If there is one key feature that has an equal presence in both the Islamic and Conventional Financial System, it must be the presence of Risk

(Bacha, 2007)

1. INTRODUCTION

Although the Holy Qur’ān did not specifically address the issue of equity financing, it was definite and firm in denouncing and in forbidding all forms of interest-based financial transactions - regardless of any terms or pretexts that might be illicitly employed to justify or validate their use, or to suggest that they are, somehow, Islamic. The literature on equity investments tends to equate equity investments with the stock market. While the majority of scholars in Islamic financing did not question such a definition of equity investments, some have argued that equity investments also comprise financing small business start-ups through *muḍārabah* (Silent partnership) and *mushārahah* (joint-venture profit-sharing). They further enforced their position by pointing out that Islam is a developmental religion, and rightly arguing that these instruments are

developmental in nature since they seek to mobilise financial resources in order to create new business entities, and to expedite other forms of business and trade. However, analysis and discussions in this paper are bounded by the generally accepted definition of equity investment as being investment in the stock market.

This study aims to identify and put forward strategies and initiatives for managing risk in the Islamic financial equity investments and is organised in three distinct sections. The first section demonstrates the concept of equity investment and the Islamic attitude towards risk and returns in the equity market. The second section examines areas of risk, including types, forms and sources of risk, in the Islamic equity market. In the third section, initiatives, methods and strategies for dealing with and managing equity investment risks, with consideration of Islamic conditions, are highlighted and discussed.

2. EQUITY-BASED INVESTMENT: RISK AND RETURN

Many financial scholars, whether those who are specialised in Islamic financial systems and investments (i.e., Iqbal and Mirakhor, 2007; Choudhury, 2001), or those who research in conventional financial investments (i.e., Lasher, 2000; Charles, McGuigan & Kretlow, 2006), have a propensity to focus on stock markets when they discuss investments in equity. For example, although Iqbal and Mirakhor (2007: 234) state that equity investments involve “private equity investment and equity participation in specific projects or syndication investment”, their interest is focused on the stock market. Similarly, the term equity in literature is, habitually, used to describe these investments which are associated directly with the “funds applied to business by their owners”, more specifically “equity means buying stock” (Lasher, 2000: 35; 235).

In general, financial investments are classified into two main types: debit-based and equity-based investments (Lasher, 2005; Venardos, 2005). Differences between these two types lie in the degree of risk and in the expected rate of return. In general, this relationship between these two variables is positively correlated. The comparatively lower rate of return on debit investments (such as bonds and fixed-interest rate savings’ accounts) is expected and justifiable considering the low degree of risk embedded within this type of investment. On the other hand, risk and the consequent expected return from investing in equity (stocks) are high (Gitman, Juchau & Flanagan, 2002).

Risk is seen as a result of two main elements: the uncertainty and unfavourable outcomes. Borge (2001: 4), for example, explains risk in terms of “being exposed to the possibility of bad outcomes”. However, any financial transaction, as well as anything we do or intend to do, has in one form or another some degree of risk. Ansell and Wharton (1992: 3) note, “It is simply not possible to avoid taking risk. In every human decision or action the question is never one of whether or not to take a risk but rather which risk is to choose”. Indeed, risk is a feature of human daily life, as there is no single outcome that is absolutely certain. Any action,

activity or behaviour may involve undesired impacts as well as desired and positive consequences. The connection between risk and uncertainty is seemingly intertwined, and for many researchers there are no boundaries or differences between both terms. Adams (1995: 25), for example, declares that “distinction between risk and uncertainty is frequently blurred and words are used interchangeably”. Jorion and Khoury (as cited in Khan & Ahmed, 2001: 26) state that “risk arises when there is a possibility of more than one outcome and the ultimate outcome is unknown. Risk can be defined as the variability or volatility of unexpected outcomes”. Therefore, risk “is usually measured by the standard deviation of historic outcomes” (Khan & Ahmed, 2001: 26).

However, avoiding or taking risk is no longer a non-negotiable matter, as whenever the risk becomes evident it should be avoided or reduced. Risk should be evaluated in terms of results. Mehr and Hedges (cited in Bannister & Bawcutt, 1981: 4) make the point that “some risks are worth taking; others are not”. In addition, some writers such as Drucker (as cited in Bannister & Bawcutt, 1981: 7) see successful risk taking as a catalyst for success. Drucker states, “...Economic progress is defined as the ability to take a risk” (as cited in Bannister & Bawcutt, 1981: 7). In addition, Ansell and Wharton (1992) find that taking risk is a reason of achieving benefits, thus “profit is viewed as a reward for risk taking” (Ansell & Wharton, 1992: 184). Despite the above, risk management is generally concerned with circumstances in which no gain is probable (Fox, 1999).

In the financial sector, especially in the investment field, researchers differentiate between the general concept of risk as something that is extensively used to describe the probability of undesired outcomes, and risk as uncertainty. So, risk for some scholars is not a negative event by itself, rather it is a measurement tool and an indicator of uncertainty. The Institute of Internal Auditors (2003:1) notes that:

Risk... is simply a measure of uncertainty, the chance that some event will have an impact on objectives. Risk is most commonly thought of as having negative consequences- harm, loss, danger, and hazard- when in fact it may just as easily involve opportunities.

The deviation from expected results may be something good as well as bad, and risk taking may carry gains as well as losses (Mayer, Mcguigan & Kretlow, 2003). Accordingly, risk is viewed and classified in relation to potential outcomes from two angles: whether it is pure or speculative. If the outcome carries some benefit (more than the expectation) risk is termed as speculative risk, whereas, pure risk is one that produces negative or nil consequences only. Nader (2002: 99) argues “speculative risk... is a term applied to describe all risky situations that, in addition to carrying the possibilities of loss, also carry the possibility of gain to the party at risk”. In contrast, pure risk is “any risk which can only result in a loss or no loss, but can never generate any gains to the party at risk” (Nader, 2002: 88). An example of the first type is investment of resources (e.g. stocks and shares),

whereas earthquake is an example of the latter. Accordingly, ‘pure risk’ is beyond the scope of this study and the term “risk” is used to denote those risks that having the possibilities of incurring losses and the opportunity of sustaining gains, but not carrying excessive risk which by all means is against the principles of Shari‘ah.

In terms of investments, the question is not whether or not to take risk; it is rather to what extent investors are willing to take more risk with the anticipation of higher return, against being content with the low rate of return associated with a low degree of risk. Thus, the main concern of the risk management process is to identify to what extent it could be possible to minimise risk and maximise potential return or profit. Researchers, such as Waring and Glendon (1998), define risk management as a two-part process: minimising pure risk and maximising benefits of speculative risk. They view risk management as “a field of activity seeking to eliminate, reduce and generally control pure risk... and to enhance benefits and avoid detriment from speculative risks” (Waring & Glendon, 1998: 3). Indeed, this issue is usually the key factor for choosing which portfolio to invest in: debit-based or equity-based funds (stock markets).

In general, individuals and organisations tend to invest in lower-risk investments when the expected return between low and high risk investments is equal or does not have tangible difference. For example, the majority of investors may deposit their money in banks and accept 5 or 6% return without taking, at least theoretically, any risk other than to invest in the stock market where expected returns are about the same or little higher. Consequently, people could choose to invest in businesses that involve high-expected return, although the risk is high. Al-Refai and Khan (2000) note that balancing between reward/return and risk taking is a general attitude among all financial investors, and point out that:

Even though investing in a venture is an acceptable financial transaction... A Shari‘ah] compliant structure aims to balance the risk/reward benefits to all parties involved in a deal. As such, any financial instrument that acts like a debt security where the investor can get a “riskless” reward is prohibited. However, if the burden of risk is tilted unevenly towards the investor, the investor will lose the incentive to participate in an unexpectedly high-risk venture (Al-Refai & Khan, 2000: 10)

2.1. Islamic Perspective of Equity Investment

The phenomenal growth of the Islamic financial system undoubtedly has had positive implications on the Islamic investment equity market. The Islamic investment equity funds market – despite being in the development stage – is regarded as “one of the fastest growing sectors within the Islamic financial system” (Arab Banking Corporation, 2007). Compared with less than 10 Islamic equity funds in 1995, currently there are about 100 Islamic equity funds worldwide managing in excess of US\$5 billion and are growing by 12-15% annually. Al-Refai (1999) divided these Islamic equity funds into six types, namely: Global funds,

Regional funds, Sector funds, Country funds, Hedge funds, and Index funds. However, it is highly expected that more diversified funds will emerge in light of the increasing global interest in the Islamic financial products and services. The main concern of Islamic financing is to spread fairness and socio-economic justice, to encourage actual economic activities and to promote productivity among Muslim communities (Iqbal & Tsubota, 2006; Farooqi, 2006). These noble objectives could be achieved through the implementation of an Islamic equity-based investment model.

Investing both in the Islamic as well as in conventional equity markets certainly is subject to a diverse set of risks. Ahmed (2001: 26-28) emphasized the fact that the degree of risk varies considerably between funds and identified several risk categories as common for all Islamic Equity Funds (IEFs)¹. However, the risk of adherence to Al-Sharī'ah guidelines, which prevents Muslim investors from participating in certain business activities, even if these activities are deemed economically viable, is unique to the Islamic equity investment portfolio. Sharī'ah compliance risk is divided into two types: the first type is caused by the failure to conform to Sharī'ah rules by investing in the shares of some companies that conduct business in prohibited goods and/or services; companies that have high debit/equity ratio (> 33%); and companies where their income from interest comprises an unacceptable level (> 5%). The second type of risk specific to IEFs is most likely to be caused by a lack of standardised practices, regulations and contracts amongst Islamic financial markets in different Islamic jurisdictions. This risk could be explained by the fact that the Islamic financial market is a relatively young and evolving industry (Ahmed, 2001; Iqbal & Mirakhor, 2007, Venardos, 2005).

The index that differentiates between the legitimacy (being *ḥalāl*) and the illegality (being *ḥarām*) of any Islamic fund is its categorical conformity with Al-Sharī'ah investment laws and regulations. The first step towards meeting this challenge necessitated the creation of Al-Sharī'ah advisory boards by either the fund's initiator (sponsor) or the fund manager to ensure that Islamic funds are indisputably Al-Sharī'ah compliant². The basic condition to Al-Sharī'ah compliance entails that any Islamic investment fund should be free of any fixed interest-based financial transactions and its business does not involve prohibited products such as alcohol, tobacco, and pork; outlawing services such as immoral leisure and entertainment, and illicit activities such as gambling (Venardos, 2005; El Qorchi, 2005).

Avoiding a fixed or pre-determined interest rate does not mean or imply that investors adhering to the Islamic investment protocol should ignore the risk factor or market variables that may have an adverse impact on returns. Islam does not only urge but also commands Muslims to avoid excessive risk, and to assess expected outcomes before undertaking any activity. The Glorious Qur'ān and the noble *Sunnah* unmistakably prohibit embarking on excessive risk and consider it as

a form of gambling. This is called in Islam *Bay' Al-Gharar*.

2.2. Islamic Financial Investment Instruments in Equity

“Shari‘ah invokes an extensively participatory form of profit-sharing system that in turn can replace interest-based financial instruments. Such modes of investment are traditionally termed as profit and loss sharing instruments, called *muḍārabah*, and equity participation with both profit and loss sharing, called *mushārah*” Choudhury (2001: 1). *Muḍārabah* refers to the contract between the provider of the capital (Islamic financial institution) and the investor (entrepreneur) who uses his/her skills, time and energy to invest the money in an economically viable and socially acceptable business enterprise. The generated profit from the business is shared between both parties according to agreed upon pre-determined ratios. However, if the business venture turns out to be a failure and loss is incurred, then the financial institution loses all its money while the entrepreneur’s loss is limited to his/her time and effort. Financial institutions are generally reluctant to be actively involved from *muḍārabah* financing because they consider such investments to be very risky since the financier (bank) has no control or any executive role in running the business (Siddiqi, 1985 as cited in Choudhury, 2001; Suleiman, 2005).

Mushārah contracts function along the lines of *muḍārabah* in the sense that it is a partnership agreement between the Islamic financial institution and the entrepreneur but differs in the fact that both parties contribute capital to the business, thus share the risks as well as the rewards of the business. Net profit (after deducting the entrepreneur’s management fees or compensations) is shared according to a prearranged agreement between the parties. Losses on the other hand are shared in proportion to partners’ contribution to the starting capital. What distinguishes *mushārah* financing is that both the financier and the entrepreneur enter into a real business partnership where both have the right and the opportunity to manage the business and contribute to its success (or failure). This active partnership relationship forces both partners to take greater interest in the business, thus increasing its prospect of success. As investment by means of *mushārah* is subject to the normal risk associated with any business undertaking, it tends to minimize the risk, by sharing its burden (Choudhury, 2001; Al-Refai, 1999). However, *mushārah* involves many forms and types. The two most recognized types of *mushārah* are: *shirkah al-milk* (non-contractual) and *shirkah al-uqood* (contractual partnership) which is familiar in equity investments (Al-Harran, 2003).

3. SOURCES OF RISK IN EQUITY INVESTMENT

There are two main sources of return from stock investments: dividends and capital gain/loss. The issuing companies’ managerial and financial performance and the external market dimensions, whether in the current situation or in the future, have the major role in identifying the future price of shares, as well as the expected dividends from them. In this regard, Lasher (2000: 239) defines risk as

follows:

Risk for an investor is the chance (probability) that the return on an investment will turn out to be less than he or she expected when the investment was made... this definition includes more than just losing money. If someone makes an investment expecting a return of 10%, risk includes the probability that the return will turn out to be 9%, even though that's a positive return

This description of the risk concept is familiar in Islamic financial investment, as the return is, usually, unidentified and unknown. Risk from investing in equities could come from two ways: an actual loss or less-than-expectation revenue. Both of these possibilities are related to the uncertainty of revenue due to various factors that affect the movement of stock upwards or downwards. In contrast to the investment in debits, such as saving and deposit accounts in non-Islamic financial organisations, and in bonds as well, the investment in the stock market means a high degree of risk compared with investment in debits. From the risk management perspective, risk could be due to the down movement of stock. The common forms of risk from investing in the equity market are (Lasher, 2000):

- No Dividend, or dividend is less than expectations
- No capital gain, capital loss when the stocks' prices drop to be less than purchasing prices, or capital gain is less than expectations
- The current level of revenues/growth is less than other stocks in the market. In other words, the level of performance of invested stock is not competitive compared with the performance with other shares (this is also known as opportunity cost).
- The risk from issuing additional shares due to need of additional funding.

In addition to these types and forms, there are other two types of risk that are related to all financial investments, including the equity market, and have a direct and indirect impact on the financial investments and on the equity market performance. The first type is called market or systematic risk and "associated with the overall market or the economy" (Khan & Ahmed, 2001: 27). Systematic risk takes many forms such as interest rate risk, inflation risk and the international and local public political financial and monetary policies. For example, the movement of interest rate, whether up or down, has a significant impact on prices of stocks and on the equity market in general, as in the case of high interest rate investors may tend to sell their shares to invest their money through depositing in banks. Although investors in the Islamic equity market are usually Muslims that do not deal with *ribā*, the movement of other stocks could influence the performance of

the overall market. The other type of risk is unsystematic risk that is “linked to specific asset or firm” (Khan & Ahmed, 2001: 27).

3.1. The Islamic Perspective

Suleiman (2005: Para 4) summarised the conventions that govern the Islamic investment behaviour in the following four rules:

- *the absence of interest-based (ribā) transactions;*
- *the avoidance of economic activities involving speculation (gharar);*
- *the introduction of an Islamic tax, (zakāt);*
- *the discouragement of the production of goods and services which contradict the value pattern of Islam (ḥarām).*

Critical review of relevant literature reveals that there are three specific risk-related conditions that distinguish Islamic equity investments from conventional equity investment: Muslim investors can not invest in: a fund where the stock-issuing organisation engages or invests in prohibited (*ḥarām*) activities/sectors; stocks that have an excessive degree of risk; and in funds that guarantee fixed return regardless of the financial performance of shares and the market, namely preferred stock (Venardos, 2005; El Qorchi, 2005).

Firstly, Muslims are prohibited to buy and invest in organisations and companies that trade in prohibited products, such as pork and tobacco, or have doubtful activities, such as money laundering. The type of risk that could arise here is the possibility of the stock-issuing company changing its activities or products to include prohibited (*ḥarām*) products, or simply invest in such sectors/fields through buying the shares of another organisation that trades in products that are forbidden by Al-Sharī‘ah. This stipulation is the cornerstone for any investment in order to be in-line-with the guiding principles of the Islamic equity investments.

Secondly, although the Islamic economic system is based on PLS and disallows a fixed interest rate (*ribā*), Islam also forbids investing in business dealings or stocks that involve an excessive degree of ambiguity/uncertainty, in which the possibility of incurring loss or realising negative outcomes is extremely high, even if the expected return is very high. Islam considers this behaviour as being a type of gambling rather than investment; in literature this risk is called unacceptable risk. Unacceptable risk, therefore, is the risk which lies above the market norms in terms of the level of risk. Fischhoff, Lichtenstein, Solvic, et al. (1981) propose some factors that determine the acceptable level of risk, such as severity of risk, the compensation that could be given against risk, and other alternatives that are associated with risk such as potential losses and benefits. Islamic finance focuses on the severity of risk as a genuine issue that determines the authenticity of the equity investment.

The third distinctive feature of equity investment from the Islamic perspective is that the type of stock should also comply with rules of Al-Sharī‘ah. Equity, in general, involves two types: common and preferred stocks; the major difference between these types is in the revenue of the stock. In common stock, dividends (or losses) are not pre-determined and they are subject to the performance of the organisation and its revenues. In case of preferred stock, although the price of stock is determined by the market, “an investor purchases a share of preferred stock receives constant dividend forever” (Lasher, 2000: 225). Thus, preferred stock is a combination of common stock and bonds. This pre-determination of revenue is based on a specific amount of money rather than a particular percentage of profit/loss, same as a fixed interest rate, is prohibited in Islam as it contradicts the guidelines of Shari‘ah and works against the “equity participation with both profit and loss sharing” (Choudhury, 2001: 1). The core of the investment system and economic activities in Islam is *Muḍārabah* and *Mushārahah*. Both of these forms are based on Al-Sharī‘ah in which raising and mobilising resources are guided by interest-free instruments” (Choudhury, 2001: 1). So, equity investment according to the Shari‘ah means investing in common stock not in the preferred stock market, “hence, what is forbidden in Islamic is a predetermined return” (Suleiman, 2005: Para 4). Al-Refai and Khan (2000: 10) explained that “the structure of preferred stock and shares that act like a debt instruments” are prohibited.

4. EQUITY INVESTMENT RISK MANAGEMENT

4.1. The Concept

If risk is something ingrained in equity investments, do investors have to accept risk at any level or do they practice risk management in responding to these risks? Management is a decision-making process and if people review their reaction toward risk, thus their decisions and selections of investing in a particular business or fund, they will notice that all of them create a way of their own choosing to deal with risk, or take a risk-decision unconsciously. This means that people are dealing with and taking action about risk, but at the same time that does not mean they are managing it. Some people adapt with risk or transfer it, but do not try to study or analyse risk to handle and manage it in a proper way. This compares to the employees who deal with the organization’s many problems, but only a few of them manage these problems.

4.2. Rewards versus Potential Risk

Managing risks in the equity market means identifying potential risks and finding and implementing suitable strategies to control or prevent the unfavourable impact or the possibility of undesired outcomes. Deloach (cited in Barton, Shenkir and Walker 2002: 5) defines risk management as “structured and disciplined approach that aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the uncertainties”. Avoiding risk whenever present as a strategy for dealing with risk is no more an acceptable technique,

especially in the financial market where a risk-free situation is impossible and opportunities come through taking risk. Therefore, although managing risk is, frequently, identified as a “decision-making process by which an organization or individual reduces the negative consequences of risk” (Pritchett, Schmit, Doerpinghaus & Athearn, 1996: 26), many researchers argue that “risk management can help you to seize opportunity, not just to avoid danger” (Borge, 2001: 4).

Managing risk related to equity investments becomes a scientific process that involves a chain of systematic procedures and steps to identify, manage and deal with potential risks, as well as a dynamic and complicated process. Conrow (2003: 22) considers risk management as “the act or practice of dealing with risk. It includes planning for risk, assessing (identifying and analyzing) risk issues, developing risk, handling options, monitoring risks...” However, the main difficulty of risk identification is that it is not easy to identify exactly the probability of unwanted outcomes, as well as the meaning and the accepted level of undesired results.

Adams (1995) mentions that when people deal with risk as something purely negative this leads to the development of a culture of fear from risk and thus, habitually, people will avoid risk without considering opportunities. Furedi (2002) refers to dealing with risk as a pure harm only in what he calls ‘the culture of fear’. Therefore, lack of balancing in dealing with equity investments risk leads to irrational decisions that affect the expected revenue of investments. Adams (1995: 181) describes this issue as follows: “exchange an interest in attaining the good for concern to prevent the worst”. Therefore, managing equity investment risk should be built on the idea that a risk-free situation is impractical in the equity market, thus the overprotection process of risk could lead to another risk; that is risk of opportunity cost or risk from losing benefits. Therefore, effective financial risk management needs to take in consideration another dimension –the reward of risk-taking. According to Adams (1995: 2), “every day...every one of us must face and manage a wide variety of risks. Every such decision involves balancing the uncertain rewards of actions against the potential losses”.

4.3. Processes and Steps

Factors that affect the movement of stock upwards or downwards are varied and diverse, and the risk management framework involves many activities and functions that are essentially used for making a rational decision to choose the most appropriate funds to invest in, so as to achieve some sort of equilibrium between potential losses and expected return. The failure in taking such a decision turns the investment to a source of risk rather than an opportunity for gaining. Khan and Ahmed (2001: 26) presume that “the objective of financial institutions is to maximize profit and shareholder value-added by providing different financial services mainly by managing risks”. They tend to describe risk management through the following definition of Cumming and Hirtle (2001, as cited in Khan &

Ahmed, 2001: 27) “risk management refers to the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces”.

In the following section the main functions and steps of equity investment risk management from an Islamic perspective will be demonstrated. The following discussion is based on the problem-solving model and the decision-making process as advocated by many researchers³, and addressed by the Islamic literature dealing with equity investment risk⁴.

4.3.1. Identifying types and forms of financial equity investment risk

The first step of risk management is to identify potential types and forms of risks. Risk management, in general, refers to

A logical and systematic method of identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process in a way that will enable organizations to minimize losses and maximize opportunities (AS/NZS, 1999)

This includes defining risks, analysing their components, determining their sources and types, and ranking them according to their degree of risk, potential outcomes, likelihood and consequences, and the overall objectives. Bacha (2007:7) explains that

Risk management, refers to the process/techniques employed in reducing the risks faced in an investment. It generally involves three broad steps;

(i) Identifying the source and type of risk.

(ii) Measuring the degree or extent of the risk.

(iii) Determining the appropriate response or methods to be used.

Defining risks require extensive efforts to find out and specify all risks to which the organization may be exposed. According to Barton, Shenkir and Waiker (2002, p.13) “to manage effectively in today’s business environment, companies should make a formal, dedicated effort to identify all their significant risks”. This involves considering internal and external factors and the environment of the organisation (Frame, 2003). In terms of investments in the stock market, identifying potential risk at the right stage and before committing to the investment, can save much later effort, cost and time (Conrow, 2003), as well as it gives the opportunity to manage deviations before they grow out of control. Any potential risk is important and should be considered, as risks that seem less apparent at the time of analysis, may become major hazards in the future. “Many large risk-related problems begin as very small problems. They often grow and intensify because they are not managed early in the identification process” (Banks, 2002: 103). Therefore, these types,

forms and sources of risk, as described in the previous section (Sources of Risk in Equity Investment), should be identified and addressed as the first step in the risk management process.

4.3.2. Evaluating and ranking risk

The second process of the management of risk of Islamic equity investments is to evaluate the investment in particular shares in terms of risk through assessing potential loss, probability and frequency and size of loss, as well as the fitness or contradiction with Al-Shari'ah. The assessment of the investment and the potential risk of investment as well, shall "comply with Al-Shari'ah rules and principles" (Said, Shafqat & Zahid ur Rehman, 2007: 40). These factors allow investors to weight each risk, whether technically or Islamically, and determine its main features, and then rank risks according to the degree of harm, without neglecting expected gains. According to Frame (2003, p.19) "the more throughout you are in conducting this step [examining risk impacts], the more aware you are of the likelihood and impacts of different risk events".

Risks are usually classified and ranked according to their potential outcomes or the possibility to occur in four categories: serious or severe risks, major risks, minor risks and insignificant risks (Culp, 2001). Prioritizing risk, or ranking risks, enables investors to allocate resources and direct their investments toward balancing potential risks and expected return. The main step in evaluating types and sources of risk is the scanning and assessment of these sources and types.

Sources of risk in the equity investment field are varied and come from different external and internal factors. Indeed, any decision or action (whether politically or financially and whether it is related to the equity market forces and regulations or to the technical and psychological factors) has influences on the stock market and the price and dividends of shares. Therefore, scanning all these factors is essential for effective management and controlling of risk in the equity market. This enables investors to evaluate stocks in terms of potential risks and expected return, and to assess stocks and the issuing organisation in term of Al-Shari'ah strategic management of uncertainty, thus risk which "arises from environmental dimensions prompt organizations to find out information and to scan the factors that exist in and have influence on the equity market" (May, Stewart & Sweo, 2000: 405). These factors and dimensions are categorised into three main sets: external general environment/market dimensions; external task/operational environment dimensions (See Figure 13.1); and internal environment of stock-issuing organisation.

The external general environment of the equity market, as well as all other types of markets, is the outer layer of the environment. It involves interrelated and interactive dynamic dimensions that have a direct influence on the entire environment, business and markets in general, including the financial market, and an indirect influence on the equity market as a part of the overall environment. This

environment as illustrated in Figure 13.1 typically involves the following factors: international; socio-cultural and demographical; economic; legal and political; and technological factors (Wheelen & Hunger, 2004; Samson & Daft, 2005).

The fact that the equity investment market does not function in isolation from its environment underscores the need to identify and scan these factors as being a fundamental strategic procedure for effective management of risk. This procedure should involve the direct and indirect impact of historical, statistical and technical data about the trend of these factors, and follow up, review and assess any changes in them. Potential risk that may affect the equity investment (both Islamic and conventional) could come as a result of one or more of these factors. For example, Vogel (as cited in Venardos, 2005: 99) explains that “although parties may agree by contract to abide by Islamic precepts, they cannot alter the surrounding legal system which in the end enforces their agreements”. Another example is the currency exchange rate. If a company that issued shares is an export-business company, the more the possibility that the exchange rate of the domestic currency will increase, the more the possibility that share prices and dividends will be influenced negatively. This is because a high currency exchange rate usually means an increase of the export price, thus creating low demand. This will affect profits/returns of the organisation and then this will reflect negatively on shares’ dividends and capital prices.

The task environment, on the other hand, involves those factors that affect the business/organisation environment directly. It typically consists of factors such as consumers, competitors, suppliers, labour market, trade/industry, and financial resources (Samson & Daft, 2005). The importance of analysing this environment, in terms of equity investment, is that any change, development or deficiency in these factors, could have direct impact on the organisation’s profits, thus on the price and dividends of its stocks. For example, the shortage in the labour force could increase the labour cost and therefore affect the total cost and net profit of the organisation. Unfortunately, this will affect the distributed dividends negatively. Therefore, analysing the task environment factors of the organisation that issued shares before investing in these shares will help in assessing the expected outcome and potential losses/risk of these shares.

Finally, the internal environment of organisations composed of these factors that are related to the particular organisation’s capabilities, resources, policies and management system, and are associated with the organisation’s strengths and weaknesses. These factors and dimensions are key issues in identifying and assessing the ability of the organisation to compete, survive and grow in the market, thus its capability to attain profitability. In general, analysing internal factors is carried out in terms of: the needs of the target market and core and distinctive competencies of the organisation; customer orientation; marketing and production process; sales activities; and available financial and human resources. The relationship between these factors and managing risk in equity investments lies

in the fact that internal factors have a major role in anticipating the expected performance of the organisation and its business, including the price and dividends of its shares. Therefore, recognising these factors enables investors to determine the expected return/loss from the organisation's stocks before investing in such stocks. The internal policy of the organisation toward dividend distribution is another example of internal factors that affects returns and distributed dividends, which affects the capital gain of shares.

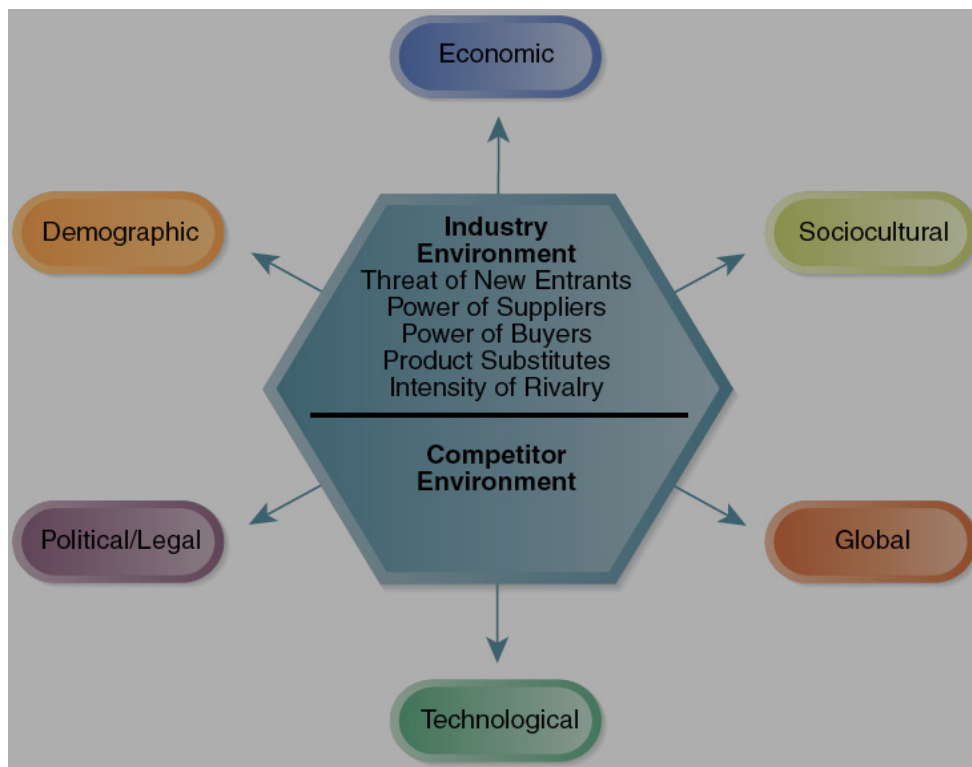


Figure 13.1 The External Environmental Factors

Source: Hitt, Ireland and Hoskisson (2004)

Analytical Tools of Sources of Risk

- SWOT analysis: SWOT is a short form that used to describe Strengths, Weaknesses, Opportunities, and Threats that are related to the external and internal strategic factors of a particular organisation, firm or industry. This analysis, although it has direct and indirect influences on the organisation's performance and the decision making process, also gives strong indications regarding potential risks (losses)/opportunities (gains) from investing in shares of this organisation. Indeed, the significant impact of these factors on the

organisation that issues stocks, as are demonstrated by a SWOT analysis, would affect the price of shares or their dividends, thus the equity investment’s decision.

SWOT analysis is an important step for managing equity investment risks as it enables the investor to set an expectation of the performance of the shares-issuing organisation’s performance, thus the expected return (capital gain/loss and dividend) of such shares in future. It involves (see Chart 1) evaluating the organization’s potential capability to develop and grow (strengths), the internal limitations (i.e., resources) of the organisation (weaknesses), potential external chances for the organization to grow (opportunities), and potential external hazards that may affect the business of the organisation negatively (threats) (Wheelen & Hunger, 2004).

Chart 13.1 SWOT Analysis Chart

Internal environment	External environment
Strength	Opportunities
Weaknesses	Threats

- Technical and fundamental analysis: technical analysis is the study and review of historical data about the equity market through analyzing price fluctuations and financial performance charts of stocks (Murphy, 1999). Such analysis help in anticipating price trends, and enable investors to identify potential risks, their sources and causes; their types and forms; and methods to avoid or control them, and consequently to take informed investment decision. Furthermore, these analysis help in evaluating whether or not the market price of shares is reasonable, enabling investors, through these historical data about the price movements, to forecast the price reliability and movements.

Fundamental analysis, on the other hand, involves analysing all surrounding factors, including financial position and business performance, of the organisation, its business, and its industry (Lasher, 2000). He further explained the link between fundamental analysis and managing equity investment risk as follows: “fundamental analysis involves learning the fundamentals of a business and applying that knowledge to forecasting its future cash flows” (Lasher, 2000: 228). Fundamental analysis is associated strongly with internal environment factors of the organisation as it depends, mainly, on analysing some internal statements and financial reports, such as profit and loss statement and the balance sheet.

- Measurement of risk: although risk is usually viewed as something subjective (Sharder-Frechette, 1990), as it is an uncertain issue, many researchers in the financial investments field, such as Said, Shafqat and Zahid ur Rehman (2007), tend to quantify risk to facilitate evaluating risk profile on objective basis. Statistically, the most commonly methodology used to measure risk is Value-

at-Risk (VaR) (De Nederlandsche, 2003). Khan and Ahmed (2001: 43) describe this approach as “a simpler parametric method can be used to estimate VaR by converting the general distribution into a standard normal distribution...that indicates how much a firm can lose or make with a certain probability in a given time horizon”⁵.

4.3.3. Setting and assessing possible alternatives and solutions

The next step in the risk management process is the adoption of the most appropriate technique to control a given risk. Investors should strive to identify all possible alternatives for dealing with risks, analyzing each alternative in terms of its effectiveness and efficiency and the required resources for its implementation, and then ranking them along with their usefulness in controlling risk successfully. In all these steps the Islamic conditions of equity investments as they mentioned earlier should be considered and given a priority in any decision or selected strategy. The main techniques that are usually considered as appropriate for dealing with equity investments risks are: risk retention; adaptation; avoidance; reduction; and transference. In this regard, Khan and Ahmed (2001: 27) note that “financial institutions face the following three types of risks: risks that can be eliminated, those that can be transferred to others, and the risks that can be managed by the institution”.

- **Retention:** accepting risk as part of the investment or business without any intervention is a technique that is sometimes used by the investors in dealing with potential risk. It is “an acknowledgement of the existence of a particular risk situation and a conscious decision to accept the associated level of risk, without engaging in any special efforts to control it” (Conrow, 2000: 28). Some types of equity investment risks are minor or the degree of their potential losses fits with acceptable level of risk, therefore, investors take the form of a decision to do nothing. For some investors, risk is considered acceptable if it involves an acceptable level of occurrence within their set line, and they do not accept risk if it lies above this line. Fischhoff, Lichtenstein, Solvic, et al. (1981) propose some factors that determine the line of acceptable level of risk, such as severity of risk, the compensation that could be given against risk, and other alternatives that are associated with risk such as potential losses and benefits. However, in some instances, the retention option is adopted involuntarily as some kinds of risks are out of control, but, “even where there is only one course of action but you can decide to do nothing, then there is a choice open to you and hence a decision” (Dickson, 1989: 46).

According to the Islamic economic and financial system which, as mentioned earlier, is based on risk taking and profit/loss sharing, as well as prohibiting fixed interest rates; principally this strategy does not have contradiction with Al-Shari‘ah. However, if the risk was avoidable and manageable without losing benefits, then this risk should be avoided. In addition, if risk was very high, regardless the expected returns or whether or not the investor is happy to

accept it and carry out the purchasing process of shares, Al-Sharī‘ah considers this type of investment as a sort of gambling and thus it is prohibited. Therefore, this strategy, accepting risk, should be evaluated in terms of these two issues to fit with the Islamic system of dealing with equity investment risks.

- **Adaptation:** In some instances where risk cannot be managed or avoided as the risk is outside boundaries of controlling, the investors may choose adaptation as a strategy. For example, investors are not in a position to influence the inflation rate in a specific stock market or country; however, they can adapt with this risk and mitigate its adverse impacts through investing in other Islamic equity markets, such as markets in other countries. Also, if the fluctuation exchange rate of a certain currency is usually unstable, the investors may choose to trade in equity by using other currencies that are more stable. Islamically, if the equity investment and stock market fit with Al-Sharī‘ah, there is no reservation to invest in it, whether it is national or international market/stocks.
- **Risk avoidance:** avoiding risk involves not being exposed to potential risks (Frame, 2003). In some instances, the possibility of risk or its potential hazards and harm are very high, so the investor tends to avoid risks completely regardless the opportunity cost. From the Islamic perspective, in some instances when risk level of dealing with and invest in particular stock markets is very high, Muslims investors are not allowed to invest in such markets, as unacceptable level of risk turns the investment to a form of gambling. However, avoiding risk as a strategy of dealing with risk in the equity market does not mean investing in fixed or pre-determined return such as preferred stocks, as these types of equity investments, as mentioned earlier, is not allowed in Islam.

Some scholars in the Islamic financial markets, such as Khan and Ahmed (2001), point to the standardisation of activities and to implement an incentive/accountability system for risk avoidance and controlling. Khan and Ahmed (2001: 27) highlight that “risk avoidance techniques would include the standardization of all business-related activities and processes, construction of diversified portfolio, and implementation of an incentive-compatible scheme with accountability of actions.”

- **Reduction:** if the elimination of risks is not possible, as “it will always be elements of risk in what we do” (Ritchie & Marshal, 1993: 20), then the optimal technique is to contain risks and reduce them to a minimal level or at least to an acceptable level. Risk reduction could involve “steps to lessen the likelihood that a risk event will arise” and/ or involves “steps to lessen the negative impacts resulting from untoward risk events” (Frame, 2003: 138). An examples of reducing risk is risk sharing. Organisations issue stocks for many reasons, one of these reasons is to participate and share with others from

outside the organization the negative impact of loss if it occurs. This, indeed, an objective of the Islamic investment system, which aims to encourage actual economic activities where all parties participate and share in profit and losses. One way for reducing risk (or even to avoid some undesired impacts or factors of risk as in the previous point) is through Portfolio.

Portfolio is frequently viewed and described by researchers as being the most familiar form of managing equity (Bacha, 2007; Lasher, 2000; Khan & Ahmed, 2001). This strategy of managing risk in the equity market depends, simply, on diversification (Bacha, 2007). In the high-uncertain investments, such as in the equity market, where the fluctuation is very high, and in many instances difficult to be anticipated, investors tend to invest in stocks from different firms, organisations or even markets and countries, to avoid potential losses if the price of a particular stock falls down. However, inappropriate management of the stocks portfolio could add another risk factor to the investment, and thus turn the profit from some shares to loss in the total revenue of the investment when losses in some stocks exceed the profit of other stocks. Lasher (2000: 252) states that “each stock in a portfolio has its own expected return and its own risk. These are the mean and standard deviation of the probability distribution of the stock’s return. As might be expected, the total portfolio also has its own risk and return”.

Transferring: another form of controlling risk is to mitigate the adverse impact of risk by transferring it to a third party. When risk management selects to go to insurance companies, for example, it works to shift potential losses from the organization to another party. According to Borge (2001, p.69) “if you cannot prevent or avoid an unwanted risk, you may be able to sell it”. This means taking small risk (cost of insurance) and transferring large risk, in case that undesired outcomes occur. Other forms of risk transferring may include contracts and warranties (Vaughan, 1997). In Al-Shari‘ah, transferring risk to others, through a quick selling of stocks to others who do not know the risky dimension of stocks for example, is not allowed as it involves harm to others and to the society as a whole (Metwally, 1997). Suleiman (2005: Para 4) states that according to the Islamic law, “an immediate sale in order to avoid a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large”. Another way that investors could follow it to transfer risk is through conventional insurance companies. Insurance according to the majority of Islamic scholars (*Jamhoor Al-‘Ulamā’*) is prohibited. Therefore, this strategy (conventional insurance to transfer losses to another party) is inapplicable according to the Islamic risk management of equity investments. Instead, the Islamic alternative of conventional insurance is based on the principle of *Al-Takāful*⁶.

4.3.4. Selecting and implementing course of action

The selection of an optimal measure for managing risk depends on criteria such

as: the available resources, type of risk, probability and frequency of risk, potential adverse impact and outcomes, and overall cost and benefits. According to Vaughan (1997: 37)

In attempting to determine which technique to use in dealing with a given risk, the risk manager considers the size of the potential loss, its probability, and the resources that would be available to meet the loss if it should occur

Al-Sharī‘ah compliance is the main criteria in Islamic equity investments. The selected strategy should fit with the Islamic investment rules and regulations of equity. As discussed earlier, some familiar strategies in conventional equity investment markets, such as transferring or reducing risk through insurance or invest in preferred stocks, are prohibited in Islam; thus inapplicable and unaccepted to be considered as alternatives or strategies. However, risk management of organisations or financial institutions should work to provide and allocate necessary and required resources, effort, time and staff to assure that the identification, evaluation and analysis process of potential risks as well as strategies and techniques are effective. Also, a plan of completion and a timetable of operations should be set to guarantee the effectiveness, running and performance of a strategy.

According to the Islamic investment system, managing risk requires some essential factors; these involve (Said, Shafqat & Zahid ur Rehman, 2007; Banks, 2002; Khan & Ahmed, 2001) the following:

- Monitoring and auditing risk regularly and independently. Those who are considered a potential source of risk should not be those people who review and monitor risk.
- Effective communication, reporting and feedback system, as well as, documentation and filing procedures.
- Training programs to enable and empower employees’ workers and managers, to understand and deal with risk effectively and successfully.
- Incentive system to encourage safe attitude and behaviour.
- Penalty systems for those who repeatedly don not follow risk control’s policies and procedures.

The above strategies regarding managing equity risks from the Islamic perspective are summarised in the following chart (Chart 13.2).

Chart 13.2 Risk Management Strategies of Islamic Equity Investments

Strategy	Description	Islamic Perspective
Retention	Decide to do nothing, and accept risk without any intervention to control it.	<p>If the risk was avoidable without losing benefits, then this risk should be avoided.</p> <p>If the risk was very high, regardless the expected returns or whether or not the investor is happy to accept it and carry out the purchasing process of shares, Al-Sharī'ah considers this type of investments as a sort of gambling.</p>
Adaptation	There are some instances where risk falls outside the controllable boundaries, thus can neither be avoided nor managed (such as the risk caused by inflation and currency fluctuation). Investors in such cases may choose adaptation as an interim operational strategy.	In such a case, the Muslim investor could re-direct his/her investment by investing in more stable markets and less volatile currencies, as there is no restrictions to invest in any equity market or currency, if such an investment fits with Al-Sharī'ah principles and guidelines.
Avoidance	Avoiding risk involves not being exposed to potential risks, as the possibility of risk or its potential harm is very high.	In some instances when risk level of dealing with and investing in particular stock markets is very high, Muslims investors are not allowed to invest in such markets or stocks (i.e., preferred stocks).
Reduction	Risk reduction involves steps to lessen the likelihood that a risk event will arise, and/or steps to lessen the negative impacts of risk (i.e., portfolio).	Investors could invest in stocks from different firms, organisations or even markets and countries, to avoid potential losses if the price of a particular stock falls down, if there is no contradiction with Al-Sharī'ah.
Transferring	Mitigating the adverse impact of risk by transferring it to a third party (i.e., insurance).	Islamic insurance companies (<i>Takāful</i>)

4.3.5. Auditing and reporting

The final stage in the process of managing risk involves the continuous and periodic reviewing and auditing of the movement of stocks and financial market in general, as well as all external and internal environmental factors and dimension. Financial markets in general and equity market in particular are dynamic and sensitive markets. Regular and systematic auditing and monitoring of these variables, as well as, reviewing previous decisions and considering feedback and data from different sources with proper and accurate follow-up are necessary to avoid unfavourable situations and unforeseen conditions that affect the equity investment negatively.

Overall, the Islamic approach in managing risk of equity investments is, simply, any strategy that the investor selects to follow except those initiatives and strategies that contradict with Al-Sharī'ah. Almighty Allah says (what is roughly translated to): "It is not for a believer, man or woman, when Allah and His Messenger have decreed a matter that they have any option in their decision" (Qur'ān 33:36). Principally, options such as risk avoidance, acceptance and reduction do not contradict and are legitimate if they are to be applied in accordance with the Islamic investment rules and regulations. For example, reducing potential risk of equity investment through investing in preferred stocks, conventional insurance or quick sale of shares when loss is perceived (*Bayea Al-Gharar*), all of them are prohibited (*ḥarām*) strategies in Islam (Suleiman, 2005).

5. CONCLUDING REMARKS

If there is only one value that the Islamic financial system endeavours to inspire, that value would be the integration of fairness into the reward structures with the ultimate aim of spreading socio-economic justice amongst Muslim communities. Thus, the need to reconcile investors' tendency for risk evasion against their inclination for excessive risk-taking to an (acceptable) level, by sharing the risk as well the rewards of business investments, falls within the boundaries of this righteous principle.

Risk in equity investment is varied and diverse and involve many types and forms, and multiple sources. The management of equity investment should have an overall view of risks to which the equity investment may be exposed. This requires developing an effective risk management system to identify, evaluate and assess sources and types of risk, as well as factors that affect prices and dividends of stocks. This also involves establishing a structure that addresses options and alternatives to dealing with potential risk. However, there is no specific or standardised model for dealing with these risks. Islam endorses any strategy designed to manage risk associated with equity investments and sanctions the legitimacy of any model as long as there is no contradiction with Al-Sharī'ah. Therefore, abiding by Al-Sharī'ah rules and regulations of equity investment must

be monitored and considered in each step and/or process of investment and risk management of equity.

Notes

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¹ See Ahmed (2001: 26-28)

² The advisory board is an independent body, typically consists of unbiased jurists who are specialists in *fiqh al-mu'āmalāt* and/or Islamic jurisprudence, and experts in the field of Islamic financing. It is crucial that members of the board do not have conflict of interest as they bear the responsibility of establishing guidelines and procedures that define Shari'ah compliant investments.

³ See (Trieschmann, Hoyt, & Sommer, 2005; Fischer & Green, 2004; Frame, 2003; and Ritchie & Marshal, 1993).

⁴ See (Iqbal & Mirakhor, 2007; Al-Refai & Khan, 2000; Said, Shafqat & Zahid ur Rehman, 2007; and Khan & Ahmed, 2001).

⁵ For more details, see Khan and Ahmed (2001).

⁶ For more on the Islamic Insurance (*Takāful*), please see (IIBI, 2000; Wahab, Lewis & Hassan, 2007)

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Practice and Prospect of Islamic Real Estate Investment Trusts (I-REITs) in Malaysian Islamic Capital Market

*Asyraf Wajdi Dusuki**

ABSTRACT

One of the recent investment opportunity introduced in Islamic Capital Market in Malaysia is the Islamic Real Estate Investment Trusts or I-REITs. Islamic REITs funds invest their portfolios in listed real estate securities that own and operate real estate such as residential, commercial, and retail properties, storage facilities, warehouses and car parks. Islamic REITs differ from conventional property funds mainly due to the requirement to strictly observe Islamic investment guidelines and Shari'ah principles. Thus it provides new investment opportunity for investors who wish to invest in real estate through Shari'ah-compliant capital market instruments. This paper provides insights into the practice and prospect of Islamic REITs in Malaysia. The application and mechanics of Islamic REITs are examined in the light of Islamic REITs Guidelines issued by Malaysian Securities Commission. As will be evident in this paper, this instrument has its own advantages and value added which would make it the instrument of choice in meeting specific investment interests and needs.

1. INTRODUCTION

Malaysia has always been in the vanguard of global initiatives and efforts to establish a viable, sustainable and feasible Islamic Capital Market catering the needs of Muslims and also ensuring that its products and services are attractive to all investors and issuers regardless races or religions. Malaysia is also poised to be a global Islamic financial and capital hub, as envisaged in the Capital Market Master Plan launched by Malaysian Securities Commission in 2001.

Essentially, the development of a vibrant Islamic capital market requires the creation of a broad spectrum of innovative Islamic financial instruments and the infrastructure to promote active trading so as to enhance the breadth and depth of the market. An efficient capital market is also expected to provide opportunities for constructing well-diversified portfolios and to meet investors' demand in accordance with their risk and return preferences (Iqbal & Mirakhor, 2007).

In order to help propel the expansion of Islamic capital market in Malaysia, Securities Commission has recently introduced a new investment opportunity in the Islamic Real Estate Investment Trusts or I-REITs. To facilitate its development, the Securities Commission has issued the Guidelines on the Issuance of Islamic REIT. This guideline is the first guidelines on Islamic REITs in the global Islamic financial sector, essentially providing Shari'ah guidance on the investment and business activities on Islamic REITs.

Since the introduction of REITs, the Securities Commission has approved a total of 11 issues with market capitalisation of over three billion ringgit (Yakcop, 2007). Al-'Aqar KPJ REIT was the first Islamic REITs listed on the Main Board of Malaysian Bourse and believed to be the world's first Islamic REITs with a total market value of RM481 million (Idris, 2006).

This paper provides insights into the practice and prospect of Islamic REITs in Malaysia. The application and mechanic of Islamic REITs are examined in the light of Islamic REITs Guidelines issued by Malaysian Securities Commission. As will be evident in this paper, this instrument has its own advantages and value added which would make it the instrument of choice in meeting specific investment interests and needs.

The remainder of the paper proceeds as follows. The next section illuminates the nature and operation of REIT. Section three then delineates the characteristics of Islamic REITs as implemented in Malaysian Islamic Capital Market. Two case studies of Islamic REITs are offered in section four. Section five discusses the prospect of Islamic REITs in Malaysia, whilst the final section contains the concluding remarks.

2. NATURE AND OPERATION OF REIT

The Securities Commission of Malaysia defines REIT as "an investment vehicle that proposes to invest at least 50% of its total assets in real estate, whether through direct ownership or through a single purpose company whose principal asset comprise real asset"(Securities Commission, 2005b). Different countries adopt different approach in determining the requirement for a REIT especially with regards to ratio of investing in real estate. In United States for instance, the main requirement for a REIT is that it must invest at least 75% of company's total assets in real estate. As for Korea and Singapore, 70% is used as the minimum ratio of investing in real estate (Vincent, 1999). Thus, REIT is an entity that accumulates a pool of fund from investors, which is then used to buy, manage and sell assets in real estate industry.

REIT offers investors the opportunity to diversify and invest their portfolios in listed real estate securities that own and operate income generating from real estate such as residential, commercial, retail properties, plantation land, storage facilities, warehouses, car parks and others, which otherwise expensive if they were to invest

direct. The owner of one REIT unit is actually buying a portion of a managed pool of real estate. This pool of real estate then generates income through renting, leasing and selling of property and distributes it directly to the REIT on a regular basis. Hence, an investor may receive returns either in the form of dividend or capital gain for the asset holding duration.

In essence, REIT operates like any other trust funds involving stakeholders like management company, trustee and unit holders. The relationship of these parties is outlined and governed by a trust deed. The trust deed is essentially a formal document outlining the objectives and principles of REIT, and rights and responsibilities of a management company and a trustee respectively. The REIT must be managed and administered by a management company approved by the Securities Commission. Under the Guidelines on REIT, the management company must be "a subsidiary of either a company involved in the financial services industry in Malaysia; or a property development company; or a property-investment holding company; or any other institution which the Securities Commission may permit" (Securities Commission, 2005b). Among the main functions of REIT manager include setting up the strategic direction of the REIT, recommending to its trustee on the possible acquisitions, divestments or enforcements of assets and ensuring compliance with applicable regulations.

The REIT is also required to have a trustee who acts as the custodian of the assets of the fund and to safeguard the interests of the unit holders. This requires continuous supervision and monitoring of the funds managed by the management company so that it complies with the objectives and the deed of the fund and all related regulatory requirements and guidelines set by laws and the Securities Commission. In Malaysia functions of a trustee can only be assumed by a trust company which registered under the Trust Companies Act, 1989. The trustee earns trustee's fees for its functions in holding the assets for the benefits of the unit holders.

Another important stakeholder of REIT is property manager who provides property management services and in return, earns property management fees. The main functions of property manager include managing and controlling the assets of the REIT, preparing budgets and maintaining financial records for the properties and advising on sale and purchase decisions. Figure 14.1 summarises and illustrates the roles and functions of various parties involve in REIT operation.

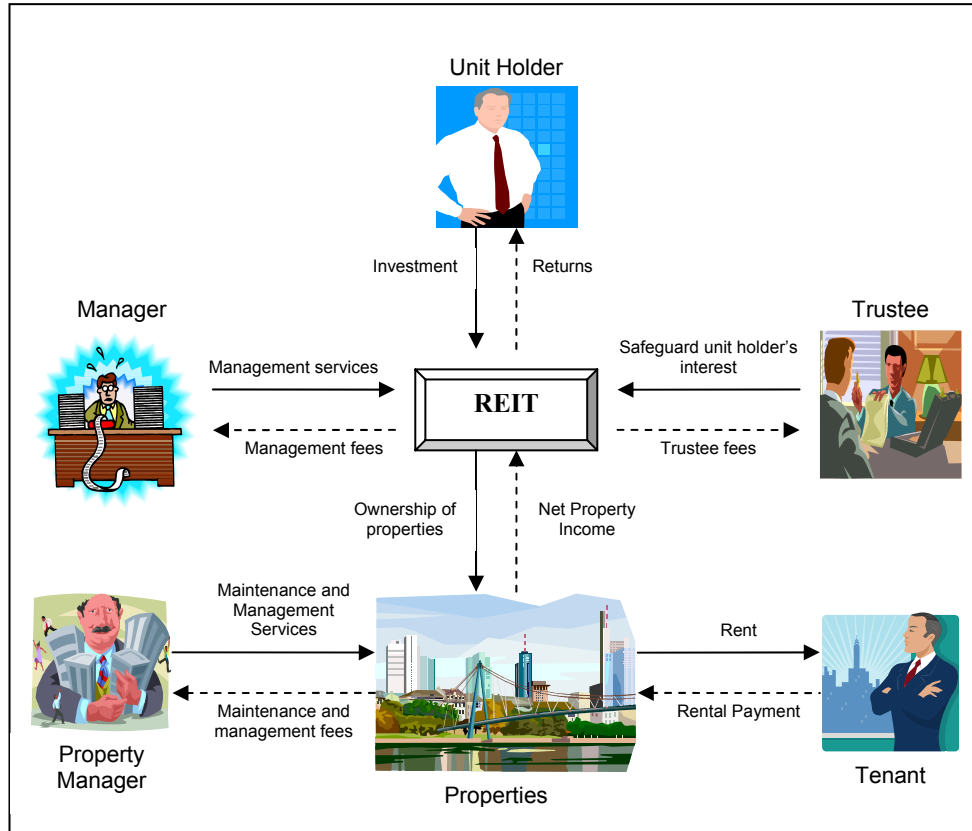


Figure 14.1 Stakeholder in REIT Operation

Literature has generally categorised REITs into three types, namely Equity REITs, Mortgage REITs and Hybrid REITs (Allen, Madura, & Springer, 2000; Obaidullah, 2005; Park, Mullineaux, & Chew, 1990). A brief description of each type is discussed below:

I. Equity REITs

Equity REITs own and operate income-generating real estate which involves a wide range of activities including leasing, development of real properties and tenant services. A distinctive feature of equity REITs is that it acquires and develops the real estate properties with the intention to manage them as part of its portfolio rather than resell them once they are developed.

II. Mortgage REITs

Mortgage REITs primarily hold long-term mortgages, but many also engage in short-term construction financing (Park et al., 1990). This type of REITs offers interest-based loans to real estate owners, operators or developers. It involves greater risk since mortgage REITs tend to be more sensitive to volatility in market

interest rates. This is due to the fact that mortgage REITs hold mortgages whose prices move in the opposite direction of interest rates.

III. Hybrid REITs

As the name implies, hybrid REITs are a combination of equity and mortgage REITs. In other words they own and operate real estate at the same time extend loans to real estate owners and operators.

Out of these three types of REITs, equity REITs is the most common type of REITs traded in the securities market. It also has the acceptable features which are more compliant with Shari'ah since its basic structure does not involve in the prohibited elements such as *riba*. The Shari'ah issues shall be discussed further in the sections to follow.

3. CHARACTERISTICS OF SHARI'AH-COMPLIANT REITS

The introduction of Islamic REITs is viewed as one of the most significant initiatives to broaden and deepen the product base of Islamic capital market in Malaysia. It can also help to enhance competitiveness of Malaysian Islamic capital market by attracting global Islamic investors who wish to diversify their investment portfolio which are Shari'ah compliant. This section provides an overview of Shari'ah rules and principles used in determining the Islamicity of REITs as outlined in the Guidelines for Islamic REITs issued on 21st November 2005 by Securities Commission (Securities Commission, 2005a).

Compliance Assessment Process

The Shari'ah-compliant assessment is undertaken by Shari'ah committee or advisor. This Shari'ah committee is responsible to oversee the operation of Islamic REITs so that it complies with every aspect of Shari'ah principles including investment, deposit and financing decision for Islamic REITs, acquisition and disposal of real estate and rental earnings and activities. The Shari'ah committee is also required to supervise and ensure that all funds are managed and administered according to the Shari'ah principles decreed and outlined by the Securities Commission.

There are several specific aspects of Shari'ah-compliant assessment process that Securities Commission has outlined in the Guidelines for Islamic REITs. The following highlights the salient aspects that need to be scrutinised when conducting Shari'ah-compliant assessment.

1. Non-Permissible Rental Activities

Since rental constitutes the main income stream for investors, it is pertinent to ensure that this rental derived from *halal* or permissible sources. Accordingly, the Shari'ah Advisory Council of Securities Commission delineates the following rental activities that are classified as non-permissible. The list includes financial

services based on interest (*ribā*); gambling/gaming; manufacture or sale of non-*ḥalāl* products or related products; conventional insurance; entertainment activities that are non-permissible according to the Sharīʿah; manufacture or sale of tobacco-based products or related products; stockbroking or share trading in Sharīʿah non-compliant securities; and hotels and resorts. Apart from these activities, the Sharīʿah committee or advisors are allowed to use their own discretion based on *ijtihād*¹ to determine other activities that are deemed non-permissible to be included as a criterion in assessing the rental income for the Islamic REIT.

2. Rental from Tenant who Operates Mixed Activities

When there is a case of tenant who operates mixed activities i.e. one where its core activities are permitted by Sharīʿah, although there are some other activities that may contain a small extent of prohibited elements, the Sharīʿah advisors must perform compliance assessment with additional consideration. One of the most important considerations is that the rental from non-permissible activities must not exceed 20% of total turnover of the Islamic REIT (based on the latest financial year). To that effect, Sharīʿah advisors need to advise the Islamic REIT fund manager not to invest in the real estate involving non-permissible activities that clearly exceed the benchmark.

3. Method of Calculating the Ratio of Rental of Non-Permissible Activities

There are several approved methods that can be used for calculating the ratio of rental of non-permissible activities from a tenant operating mixed activities. The methods include the usage of space, hours of service and other methods deemed appropriate by the Sharīʿah advisors using their own *ijtihād*. In the case of a supermarket for instance, the rental of non-permissible activities such as selling of alcohol can be based on the ratio of area occupied for non-permissible activities to the total area occupied. For example, if the total area rented out is 10,000 square feet and the area allocated for the sale of alcoholic beverages is 1000 square feet, then the ratio of area used for non-*ḥalāl* activities is 10%. Thus, the rental from non-permissible activities is 10% of the total rental paid by the supermarket. In this case the 10% rental income is deemed to be permissible as it is still within the acceptable benchmark of 20% of total turnover of the Islamic REITs.

4. Acquisition of Real Estate

Sharīʿah-compliant assessments must be carried out by the appointed Sharīʿah advisor. It is not permitted to acquire real estates in which all tenants operate non-permissible activities, even if the percentage of rental from the said real estate is within the accepted benchmark i.e. below 20% of the total turnover of the Islamic REITs.

5. Renting Out to New Tenant

The 20% benchmark in determining the status of mixed rental income need not be applied in case of renting out to a new tenant. This is because the exact rental

receipt from non-permissible activities is still unknown. However in an obvious case whereby the new tenant involves in activities which are deemed impermissible then it is not allowed for Islamic REIT fund manager to accept such tenant. For example, a well-known casino operator who plans to rent the real estate of the Islamic REIT must not be accepted as a new tenant.

6. Instruments used in Investment, Deposit and Financing for Islamic REITs

An Islamic REIT must also ensure that all forms of investment, deposit and financing instruments comply with the Shari'ah principles. For example, in financing the acquisition of real estate, Islamic REIT fund manager must not engage in *ribā*-based instrument which would have an effect on the Islamicity of the Islamic REIT operation and transaction.

7. *Takāful* Coverage

The Guideline issued by the Securities Commission also stipulates that an Islamic REIT must use *Takāful* schemes to insure its real estate. However in case that *Takāful* schemes are unable to provide the insurance coverage, then the Islamic REIT is permitted to use conventional schemes (Securities Commission, 2005a).

8. Risk Management Issues

Islamic REIT is permitted to participate in forward sales or purchases of currency, and is encouraged to deal with Islamic financial institutions. If the Islamic REIT deals with Islamic financial institutions, then it will be bound by the concept of *wa'd* (a unilateral promise where only one party is obligated to fulfil his promise or responsibility). The party that is bound is the party that initiates the promise. However, if the Islamic REIT deals with conventional financial institutions, it is permitted to participate in the conventional forward sales or purchase of currency.

In a nutshell the preceding features of Islamic REIT as described and outlined in the Guidelines for Islamic REITs reflect fundamental differences between Islamic REIT and conventional REIT. The key difference between the two lies in how the incomes from REIT are earned and how the fund is supposed to be managed. For Islamic REIT, these two aspects need to be based on the principles of Shari'ah.

Besides the distinctive nature of Shari'ah-compliant investment which may appeal to Muslim investors, the Islamic REITs has the potential to attract investors due to their unique characteristics such as high dividend yields, low correlation with common stocks and a potential hedge against inflation (Lin & Yung, 2006).

According to Forest (1994) and Lin and Yung (2006) the high dividend yield of REITs is a major reason investors move into REIT market. The high dividend yield also relates to the higher certainty of income as the fund manager is required to distribute its income in the form of dividend in order to enjoy tax incentives (Chang, 2006). In Malaysia, REITs are required to pay out a minimum amount to

qualify for tax transparency, which in most cases is at least 90% of their income as distribution (Treasury Malaysia, 2006). This provides investors with a regular income as compared to the dividend payout of a listed company's shares equity which is at the discretion of the company. With a stable flow of income coupled with the REIT's low risk, appeal to certain types of investors, such as pension funds and retirees (Ghosh, Nag, & Sirmans, 1999; Lin & Yung, 2006). Furthermore, the ability of REITs to offer steady flow of income is attributed to its relatively stable cash flow since almost all of its revenue is generated by rentals under the terms of tenancy agreements, which are typically for specific durations.

4. CASE STUDIES OF ISLAMIC REITS IN MALAYSIA

Whilst the discussion in the preceding sections mainly aim to illuminate the understanding about the nature and characteristics of Islamic REITs operation, the subject of interest in this section sheds some light on the actual issuance of Islamic REITs in Malaysia based on two case studies namely, Al-'Aqar KPJ REIT and Al-Hadharah Bousted REIT.

Al-'Aqar KPJ REIT

Al-'Aqar KPJ REIT is claimed as the world's first Islamic REIT. It was established as a Malaysian-based unit trust on 28 June 2006 with the investment objective of owning and investing in Sharī'ah-compliant real estate. When it was launched, Al-'Aqar KPJ REIT owned and invested in six hospitals which were first acquired from KPJ Healthcare Bhd and its subsidiaries. These properties were endorsed and approved as Sharī'ah-compliant real estate by the appointed Sharī'ah committee². The properties which worth a total market value of RM481 million include Ampang Puteri Specialist Hospital Building, Damansara Specialist Hospital Building, Johor Specialist Hospital Building, Ipoh Specialist Hospital Building, Puteri Specialist Hospital Building and Selangor Medical Centre Building (Idris, 2006).

These acquired properties are then leased back to KPJ Healthcare Bhd and its subsidiaries. In other words, Al-'Aqar KPJ REIT is wholly dependant on the performance and operation of the KPJ Group for its revenue. KPJ and its subsidiary companies is a healthcare focused group and its portfolio of businesses include hospital management, healthcare technical services, hospital development and commissioning, nursing and healthcare professional continuous education, pathology services, central procurement and retail pharmacy (KPJ REIT, 2006) It is expected that being the single tenant of the properties and long term player in the healthcare industry, KPJ Group is able provide stable rental income to the Al-'Aqar KPJ REIT.

To protect the unit holder's interests, *Amānah* Raya Berhad was appointed as the trustee. As required by the Securities Commission Guidelines, the trustee shall actively monitor the administration of the fund by the management company to

ensure that the interests of unit holders are upheld at all times. The trustee will ensure that the fund is managed and administered by Damansara REIT Manager in accordance with the objective of the fund, the deed, REIT Guidelines and acceptance and efficacious business practices within the real estate investment trust industry. *Amānah* Raya is also responsible to avoid any potential conflict of interests arising from future acquisition of Shari‘ah-compliant properties especially with regards to the fact that the tenants are subsidiaries of KPJ and both the sponsor (KPJ Healthcare Bhd) and the manager (Damansara REIT Manager Sdn. Bhd.) are 71.09% owned and 100% owned subsidiary of Johor Corporation (JCorp). Figure 14.2 illustrates the structure of Al-'Aqar KPJ REIT.

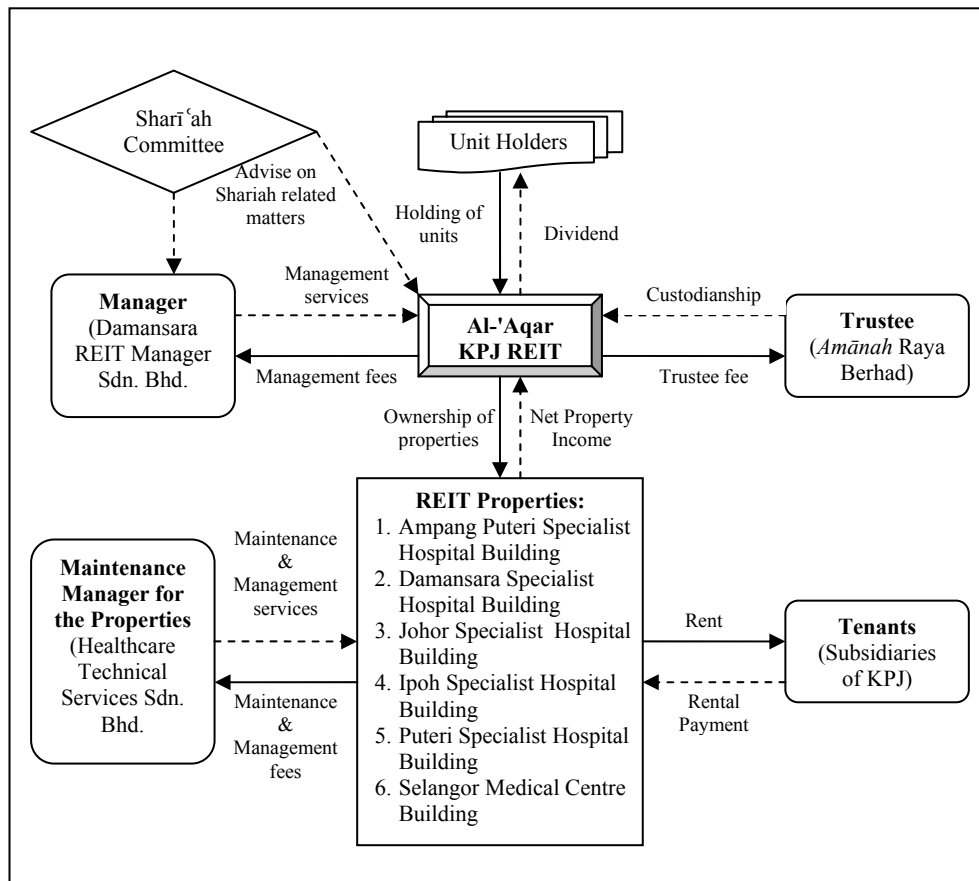


Figure 14.2 Structure of Al-'Aqar KPJ REIT

Al-Hadharah Bousted REIT

Al-Hadharah Bousted REIT is the second Islamic REIT listed on Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange). It was officially

launched on 15 January 2007. Al-Hadharah Bousted REIT is the first Islamic REIT made up of plantation assets, particularly oil palm plantation. Similar to Al-'Aqar KPJ REIT, the initial transaction involves sale and lease back mechanism based on the contracts of *al-bay'* and *al-ijārah*.

Al-Hadharah Bousted REIT acquires plantation assets from Bousted Group involving eight oil palm estates and two palm oil mills, all located within Peninsula Malaysia. Total purchase consideration for these plantation assets, which forms the basis of this Al-Hadharah Bousted REIT fund is RM472 million. To fund the purchase consideration of the plantation assets, Al-Hadharah Bousted REIT issues units (the undivided interest in Al-Hadharah Bousted REIT as constituted by the Deed) to the vendors (namely the subsidiaries of Bousted Group, which include Bousted Properties, Bousted Plantations Berhad and Bousted Heah Joo Seang Sdn. Bhd.) as well as through public offering. These assets are subsequently leased back to the subsidiaries of the Bousted Group, who then become tenants based on *Ijārah* agreement (Bousted REIT, 2007) Similar to Al-'Aqar KPJ REIT, whereby the maintenance and management of REIT properties are done by the maintenance manager, Al-Hadharah Bousted REIT appointed a plantation adviser to monitor the overall state and condition of all aspects of the plantation assets.

Consequently, fixed rental is the main source of income for Al-Hadharah Bousted REIT. Tenants pay a cumulative fixed rental of RM41.3 million per annum on a bimonthly basis for the first tenancy term of three years. The rental is reviewed at the end of every three years and the new rental is determined based on historical crude palm oil prices, prevailing and expected future crude palm oil prices, cost of production, extraction rates and yield per hectare (Bousted REIT, 2007). All the leasing matters are clearly outlined under the *Ijārah* agreement between Al-Hadharah Bousted REIT and the vendors.

In addition to the fixed rental, other sources of income for Al-Hadharah Bousted REIT include performance-based profit sharing and capital gains. The former refers to an annual profit sharing of net incremental income based on a formula pegged to crude palm oil prices and fresh fruit bunch prices. The profit will be shared on an equal basis (50:50) between the tenants and the fund. It was claimed that this profit sharing payment is the first of its kind in the REIT market and may translate into more handsome dividend yields for investors. As for the capital gain, the fund shall distribute any gains realised from the sale proceeds of selected plantation assets in form of bonus dividends (Bousted REIT, 2007). There are also fees, charges and expenses involved in the administration of the fund, including manager's fees, plantation adviser's fees and trustee's fee.

As noted earlier all the plantation assets are rented back to the vendors who are effectively the subsidiaries of Bousted Group. In other words, the entire rental income of Al-Hadharah Bousted REIT under the *Ijārah* agreement is derived from only three parties that are within the Bousted Group. Hence, there is a risk of overdependence on single tenant and related party tenants. This is particularly true

since the tenants' ability to pay rental very much dependent on their performance in the global commodity market. Fluctuations in crude palm oil and palm kernel prices coupled with volatility of foreign exchange currency rates could adversely affect the ability of the tenants to pay rental which make up a material proportion of the operating income of the fund. Figure 14.3 illustrates the structure of Al-Hadharah Bousted REIT.

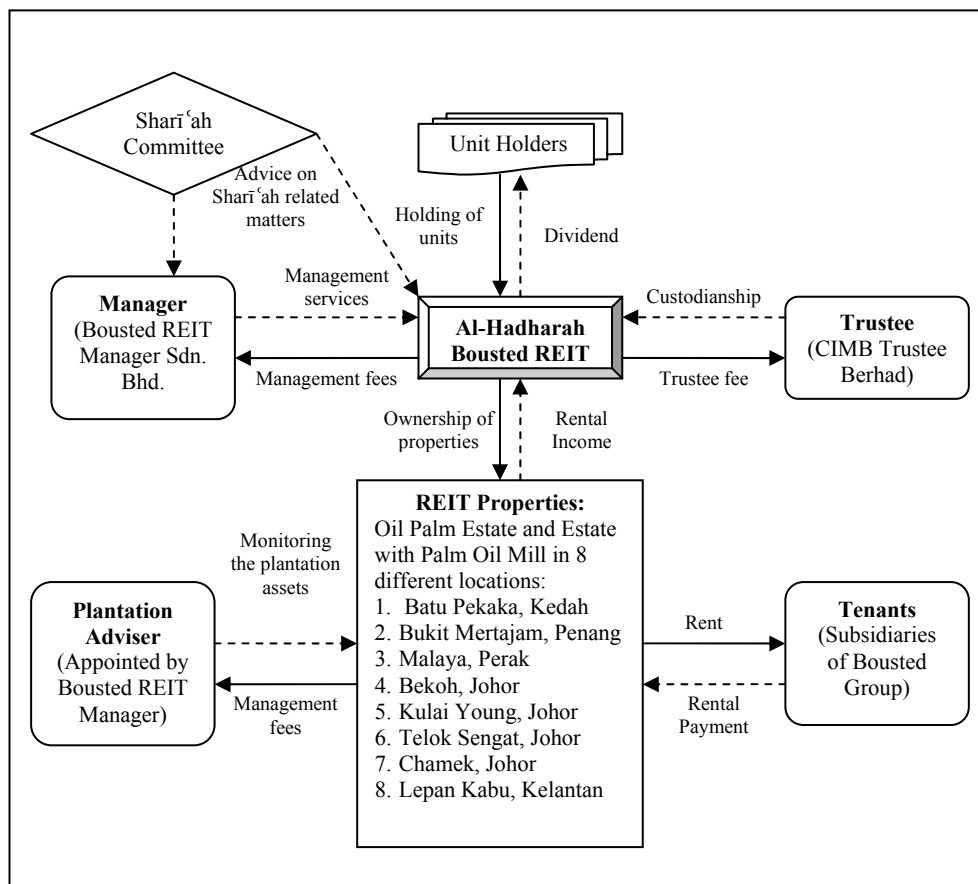


Figure 14.3 Structure of Al-Hadharah Bousted REIT

5. PROSPECT OF ISLAMIC REITS IN MALAYSIA

The future prospect of Islamic REITs in Malaysia looks very encouraging. It is envisaged that the growth of Islamic REITs in Malaysia to be further boosted following the recent tax transparency and incentives from the Malaysian government. Perhaps, as part of the Malaysian government's effort to promote Malaysia as an Islamic financial centre and capitalise on the influx of liquidity, particularly from the Middle East, various incentives were introduced via 2007

Budget proposals announced by the Prime Minister and Minister of Finance on 1 September 2006 (Treasury Malaysia, 2006). This has partly resolved the uncompetitive business environment due to high taxation regime which had discouraged foreign investors from entering the Malaysian capital market before.

Based on the 2007 Budget Proposals, the tax incentives can be generally categorised into two main areas, namely the enhancement of tax transparency system and reduction of investor's tax. Under the enhanced tax transparency system, REIT is fully exempted from paying its income tax on its taxable income if it distributes at least 90% of income to investors. In other words, the undistributed income from REITs is exempted from tax provided that the REITs distribute at least 90% of their income. On the other hand, where the 90% distribution is not complied with, the undistributed chargeable income of the REITs will be subject to income tax at the prevailing tax rates (Treasury Malaysia, 2006). This particular incentive encourages REITs manager to distribute at least 90% of income to investors thus not only providing investors more certainty of income but also ensuring higher yields from their investments in REITs.

The National Budget 2007 also provides tax incentives to entice specific investors to the Malaysia REIT market through the reduction of tax on the investors. According to the new tax proposal, dividends received by local and foreign individual investors and local unit trusts from listed REITs subject to a withholding tax of 15%, while foreign institutional investors (include a pension fund, collective investment scheme or such a person approved by the Minister of Finance) be reduced to 20% from the previous 28% for five years (Badawi, 2006; Treasury Malaysia, 2006). Undoubtedly, the tax incentives proposed in the National Budget 2007 would enhance the competitiveness of Malaysian REIT market.

In addition to various tax incentives, Islamic REITs are also expected to operate in a more transparent and well regulated environment. The issuance of two important documents by Securities Commission, namely Guidelines on REITs and Guidelines on Islamic REITs essentially provide a more transparent regulatory approach in Islamic capital market. The Guidelines delineates the roles and responsibilities of all stakeholders in the REIT structure. It clearly states the structure of the fund, restrictions, investment powers, fees and expenses, valuation requirements and procedures as well as reporting and disclosure requirements. Furthermore, the introduction of the Guidelines on Islamic REITs as guidance on Shari'ah-compliance criteria and requirement for managing Islamic REITs facilitates the development of a wider range of Islamic collective investment schemes for global Islamic funds. In a sense, the new guideline on Islamic REIT can be considered a supplement to the existing guidelines which are general rules on all aspects of investments in REIT in Malaysia. It also sets a global benchmark for the development of Islamic REITs. Undoubtedly, these two guidelines attest

sound and tight regulatory framework, which promotes transparency and predictability in regard of business strategies and financial standing.

Finally, the Islamic REITs as offered in Malaysia demonstrate high-quality assets which can generate a stable stream of cash flow backed by a steady portfolio of tenants. For example, in the case of Al-'Aqar KPJ REITs, with a portfolio of hospital buildings and 100% guaranteed occupancy rate, it may certainly appeal to investors since subscribers are to receive consistent return from stable rental income. Moreover, according to Rating Agency of Malaysia (RAM), good quality assets are more likely to command sustainable resale values through economic cycles, hence ensuring timely repayment of financial obligations through refinancing and/or disposal of assets. Assessment of asset quality according to RAM entails the type of assets involved (e.g. retail, hotel or office) as well as their location (e.g. city centre or suburb), accessibility, age and condition (Ean, 2007).

6. CONCLUSION

This paper sheds some light on the practice and mechanics of Islamic REITs as implemented in Malaysian Islamic Capital Market. The introduction of Islamic REITs is viewed as one of the most significant initiatives to broaden and deepen the product base of Islamic capital market in Malaysia. It can also help to enhance competitiveness of Malaysian Islamic capital market by attracting global Islamic investors who wish to diversify their investment portfolio which are Shari'ah compliant.

Undoubtedly, Islamic REITs, with their relatively stable returns, provide investors with a new Shari'ah-compliant investment options. As evident from the above discussion, Islamic REITs is an investment instrument not only potential in providing investors with a 'piece of mind' in terms of complying with God's law but equally important the benefits of participating in the steady rental yields of real estates and other properties. Islamic REITs typically have relatively stable cash flow since almost all of its revenue is generated by rental payments. Islamic REITs also offer the benefit of diversification arising from their holding of a portfolio of high quality real estates with different tenancy lengths and geographical locations, rather than a single real estate or building. More importantly it promotes financial inclusion by providing investors an entry into the real estate market via participation and investment in units of the Islamic REITs, which requires a smaller capital outlay relative to purchasing similar real estate on their own.

Indeed, the emergence of Islamic REITs should help to propel the expansion of Islamic capital market in Malaysia. For Malaysian Islamic REITs to be truly successful, they also have to appeal to the vast international investing community. In this regard, the various tax incentives and regulatory framework introduced by the Malaysian authorities are perceived as a move in a right direction towards realising the noble vision of becoming the world's Islamic financial and capital hub.

Notes

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¹ Ijtihad is the process of reasoning by Islamic jurists to obtain legal rulings from the sources of Shari'ah. Refer to (Mohammad Hashim Kamali, 1989a; Muhammad Hashim Kamali, 1989b).

² The Shari'ah committee members include the Mufti of Johor Dato' Haji Nooh bin Gadut, former Mufti of Wilayah Persekutuan, Dato' Hj Md Hashim Yahaya and Prof. Madya Dr. Abdul Halim bin Muhammad.

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Examining The Malaysian Sharī'ah Guidelines for Islamic REITs

*Abdulazeem Abozaid**

ABSTRACT

In November 2005 the Sharī'ah Advisory Council (SAC) of the Securities Commission in Malaysia outlined basic guidelines to facilitate the establishment of an Islamic real estate investment trust (Islamic REIT). It clarified that those guidelines were not applicable to real estate used for residential purposes. Rather, they were applicable to rental of Real Estate by Islamic REIT for business purposes. This paper is an effort to examine and review these guidelines as they, along with similar guidelines in other Muslim countries, have been deemed controversial by some Sharī'ah observers. These guidelines contain four main points: (1)-Acquiring real estate with existing tenants. (2)-Renting out real estate to a new tenant. (3)-Insurance in Islamic REITs. (4)-Forward sales or purchase of currency for risk management in Islamic REITs. For brevity purpose, this paper limits the discussion to the first two points as they are deemed to be encompassing more controversial issues than the other two.

1. INTRODUCTION

For the objective of expanding the Islamic capital Market in Malaysia, the Malaysian Security commission has recently introduced a new investment opportunity in the Islamic Real Estate Investment Trusts¹. Guidelines on the issuance of Islamic REITs have been outlined to facilitate the development of this sector and provide Sharī'ah guidance on this type of investment. However, to many Sharī'ah observers these guidelines involve some controversial issues. These controversies are the subject of our discussion. This paper provides discussion only on the first two points of the four points highlighted by those guidelines which are considered to be the first guidelines on Islamic REITs in the global Islamic sector. The reason for limiting the discussion to the first two points in these guidelines is the fact that the third as well as the fourth point tackles different issues; insurance and forward sales respectively. Although the last two are not free from controversies either, but the first two encompass more controversial issues and

have other applications in the stock market sector, which is a vital sector in the modern-day Islamic financial industry.

2. SECURITIES COMMISSION GUIDELINES FOR ISLAMIC REITS

The first two guidelines, which are our subject of study, as outlined by the Shari'ah Advisory Council of the Securities Commission in Malaysia read as follows:

"1)- Acquiring real estate with existing tenant(s).

(a) Shari'ah-compliant assessments must be carried out by the appointed Shari'ah committee/Shari'ah adviser to assess any property to be acquired by an Islamic REIT. However, in the event that the tenant(s) is found to operate non-permissible activities, the fund manager for the Islamic REIT must perform additional compliance assessments; (b) The fund manager must obtain the rental from each non-permissible activity operating at the property to be acquired. Rental from each non-permissible activity must be added to obtain the total rental from non-permissible activities.² (c) Subsequently, the total rental from non-permissible activities will be compared to the total turnover of the Islamic REIT (latest financial year) to obtain the percentage of rental from non-permissible activities. The percentage amount will be referred to the 20% benchmark as determined by the SAC for the criteria on rental from non-permissible activities; (d) In the event that the percentage exceeds the benchmark, the Shari'ah committee/Shari'ah adviser shall advise the Islamic REIT fund manager not to invest in the said real estate; and (e) However, an Islamic REIT is not permitted to own real estate, for example, a building, in which all the tenants operate non-permissible activities, even if the percentage of rental from that building to the total turnover of the Islamic REIT is still below the benchmark (20%). This is to protect the image of the Islamic REIT.

(2)- Renting out real estate to a new tenant(s):

The guideline pertaining to this issue states that "The Shari'ah committee/Shari'ah adviser must advise the Islamic REIT fund manager not to accept a new tenant(s) whose activities are fully non-permissible".³

3. EVALUATION AND EXAMINATION OF THE MALAYSIAN REITS GUIDELINES

Although these guidelines do not provide any justifications or evidences to support their conformity with the Shari'ah, we may refer to justifications and evidences given for the issue of investing in the equities of joint stock companies which occasionally deal with prohibited transactions while their main business activities are basically lawful. The common ground for these two matters is the fact that they both use benchmarks to determine the acceptable and the unacceptable

percentage of the *haram* activities that are involved in the total investments of the tenant in the Real Estate sector or the joint stock companies. In the context of Islamic REITs, it is 20% as came in the guidelines. The question that should be raised here is: what are the evidences to suggest that these benchmarks are valid and can be used in the contexts they have been used into?

Before we expose the evidences the Security Commission justified its resolutions on the basis of which and discuss them, we mention the mechanism suggested by the Security Commission for calculating the portion of rental of non-permissible activities from the total rental paid by tenants operating mixed activities as came in the guidelines. The securities commission envisages two cases: activities that involve the usage of space, such as hotels that house bars, and activities that do not involve the usage of space, such as service-based activities. With regard to the first case, calculation of the rental of non-permissible activities from a tenant(s) operating mixed activities can be based on the ratio of area occupied for non-permissible activities to the total area occupied (must be less than 20%). The percentage will be used as the basis for determining the ratio of rental of non-permissible activities to total rental paid by the tenant (again must be less than 20%). As regards the activities that do not involve the usage of space, such as service-based activities, the calculation method will be based on the *ijtihad* of the Shari'ah committee/Shari'ah adviser of the Islamic REIT.⁴

4. JUSTIFICATIONS PROVIDED FOR THE ESTABLISHMENT OF THESE BENCHMARKS

The following is a summary of the justifications provided for the establishment of these benchmarks and their discussion:

4.1. Some *Fiqh* Maxims

The presence of prohibited elements does not affect the permissible part which is large and more important. Ibn al-Subki states in *Al-Ashbah wal Nasa'ir* that "To rule as prohibited something that is a mix of the permissible and the prohibited is *ihtiyat* (precautionary) and it is not necessarily prohibited". In answer to the following maxim, which is apparently contradictory to Ibn al-Subki's statement "If there is a mix of the permissible and the prohibited, then it is ruled as prohibited", for example the mixing of slaughtered animals by Muslims and the Majusi is ruled to be totally prohibited, they said: this is because such a mixed item is prohibited in essence (*haram lighairihi*). Whereas, if the essence of such an item is not prohibited, but it is prohibited for other reasons (*haram lighairihi*), it needs to be looked at differently.⁵

To discuss this, it is true that some of our esteemed past scholars differentiated between *haram lighairihi* and *haram lithatihi*, but they never based on this that the former can be compromised. These *fuqahā'* meant by the *haram lighairihi* what is originally lawful but made unlawful due to the presence of certain conditions like

sale contract during *Jum'a* (Friday) prayer, or praying in stolen clothes or on a stolen land. It is known to all that the sale contract is originally valid and not *ḥarām*; however it is considered *ḥarām* during *Jum'a* prayer because it may lead to missing this important prayer. Similarly, *Salat* is, of course, not *ḥarām*; rather, it is *wājib* (obligatory), or *mandub* (recommended) saying the least, but if performed in stolen clothes, for example, it will be considered as *ḥarām* then.⁶

Conversely, *ribā*, gambling and trading in liquor and so on are *ḥarām lithatihi* as they are originally *ḥarām* and their prohibition is not due to the presence of something else⁷. Therefore, even if we presume that we can tolerate the *ḥarām lighairihi*, we still cannot tolerate such activities as they are genuinely *ḥarām lithatihi*. Knowing that the *ḥarām* activities in which a tenant or a company may be involved are normally of the type of *ḥarām lithatihi* such as *ribā*, gambling and trading in liquor or pork, we may conclude that such activities can never be tolerated in any case regardless of their magnitude. As for Ibn al-Subki's statement, it is explained in light of the example mentioned below.

4.2. Analogy to Some *Fiqh* Rulings

Some *fuqahā'* have ruled that a garment made of threads mixed of silk and cotton or wool can be worn by Men if the ratio of the silk thread mixed with the cotton or the wool does not exceed 50%. Thus, *ḥarām*, in principle, can be tolerated if it is lesser than the *ḥalāl* with which it is mixed.⁸

The question that anyone has the right to raise here is: If this percentage (less than 49%) is a valid benchmark why it has not been adopted in the application of companies or tenants with mixed activities of *ḥalāl* and *ḥarām*?!

Now to clarify this ruling mentioned by some jurists, we can say that the thread which consists of silk and cotton or wool threads cannot be considered as silk and cannot be called silk if the silk substance is the lesser one. So, we can say here that the nature of the new thread has departed from both silk and cotton and, consequently, ruled as *ḥalāl* for men by some jurists.

Another valid example is the jewellery which is made of gold and copper. To jurists, rulings pertaining to *ribā* do not apply to such jewellery as long as the gold is less than the copper in that jewellery, simply because it is not regarded as gold in itself if the gold substance in it is less than the other substance.⁹

Therefore, ruling that such a mixture of silk and cotton takes the same ruling of silk, or that mixture of gold and copper takes the same ruling of gold, is a ruling that is based on *ihtiyat* and *wara'* (extra precaution and piety) and not on solid foundation of Sharī'ah rulings. In this respect, some jurists, such as Ibn al-Subki, formulated this statement "To rule as prohibited something that is a mix of the permissible and the prohibited is *ihtiyat* and it is not necessarily prohibited".¹⁰

So, we may conclude that there is no contradiction in *fiqh* between a statement such as "To rule as prohibited something that is a mix of the permissible and the

prohibited is *ih̄tiyat* and it is not necessarily prohibited" and a maxim such as "If there is a mix of the permissible and the prohibited, then it is ruled as prohibited", simply because each statement has a different scope of application as explained above.

4.3. Partnering Non-Muslims is Permissible

Some past Jurists believe it is permissible for Muslim to partner non-Muslims or Muslims who are not observant about the Shari'ah rulings though, very likely, they will get involved in *ḥarām* activities such as dealing with *ribā* or trading in wine!¹¹

In answer to this argument we may say that it is true that these Jurists do not disallow the Muslim to partner a non-Muslim let alone a disobedient Muslim. However, jurists stipulate that the non-Muslim must not be allowed then to initiate a contract in the absence of the Muslim. This is to ensure that contracts concluded by the non-Muslim partner are all Shari'ah-compliant contracts.¹² In brief, the majority of jurists do not invalidate partnering non-Muslims as long as it is ensured that they abide by the Islamic law of transactions. Consequently, if the non-Muslim partner is to get involved in *ḥarām* activities, such a partnership then is null and void.

4.4. The Prophet S.A.W. Set A Benchmark

The prophet s.a.w. set a limit for what can be considered as benchmark for what is excessive. "One day, the prophet s.a.w. visited Sa'ad bin Abi Waqqas who was ill. Sa'ad expressed to the prophet s.a.w. his feelings that his illness was coming to an end and that death was near. He asked for the prophet's s.a.w. opinion on giving his property away as alms for he had only one daughter to inherit his wealth. Therefore, he wished to give as alms 2/3 of his property. However, the prophet s.a.w. stated his objection. Then Sa'ad asked whether he could give away 1/2 of his property. The prophet s.a.w. still said no. The prophet s.a.w. then said: 1/3 (of Sa'ad's property to give away as alms) is enough though it is still much. Verily, to leave your heir wealthy is better than leave your heir impoverished and dependant on other people's charity".¹³ This benchmark, the third, although it relates to the bequest of property and giving alms, it can be used as a benchmark to set the upper limit of a mixture because an amount exceeding the percentage set will be considered excessive.¹⁴

To answer to this argument, we may say that there is no indication ever in the *Ḥadīth* that one third is a valid general benchmark for what is excessive. The utmost thing the *ḥadīth* can, in this respect, indicate is that one third is more than enough in bequest. Any attempt to drive a general benchmark from this *ḥadīth* amounts to an out-of- context interpretation of the *ḥadīth*; as a result, it should be regarded as wrong.

4.5. Benchmark in Ghabn Cases

Ghabn, which means the gain that exceeds the market price, is tolerated if it is minor and not excessive (*fahish*). The *Hanafis* ruled that the upper limits for *ghabn fahish* are as follows:

- 5% for ordinary goods.
- 10% for animal used for riding.
- 20 % for fixed assets.¹⁵

Before we discuss this issue we need to clarify that, according to *Hanafis*, *ghabn* means the gain that exceeds the market price regardless of this increase being achieved through cheating or not. Any seller, of course, has the right to demand the price he wants for his commodity. Approval of the buyer to the price demanded by the seller does not render this sale contract *ḥarām*. Therefore, *ghabn* is *ḥarām* only if achieved through cheating and only then it gives the buyer certain rights over the seller.¹⁶

These benchmarks set by the *Hanafis* are meant to draw the line between the excessive *gharar* and the minor *gharar*. This means that if the *ghabn* is below this percentage, then it is not that kind of *ghabn* that may give the buyer the option to revoke the contract or claim the difference between the selling price and the market price. Therefore, these percentages as set by the *Hanafis* cannot be understood to imply that they constitute the drawing line between the *ḥalāl* and the *ḥarām*. Rather, setting these percentage means that if the *ghabn* exceeds them, then it gives the buyer the right to revoke the contract or claim the price difference.¹⁷ As for Shari'ah appraisal of *ghabn*, it is *ḥarām* regardless of its magnitude if achieved through cheating. As result, we may conclude that these percentages or benchmarks set by the *Hanafis* cannot be held to suggest a line drawn between the *ḥarām* and the *ḥalāl*. Rather, they are measurements arrived at by means of *Ijtihād* with reference to the market practices and *ʿurf* (Custom).¹⁸ Finally, it worth noting that the benchmark of '20%' adopted by the securities commission in Islamic REITs was taken from the Hanafis' benchmark of the excessive *ghabn* in fixed assets, which include, of course, the real estates.

4.6. *Umum al-Balwa, Fasad al-Zaman and ʿUrf*

If the *ḥarām* elements involve matters such as *umum al-balwa* (common plight), *fasad al-zaman* (prevalence of *ḥarām*) and *ʿurf* (custom), then we may tolerate this *ḥarām* as long as the core activity of the company or the tenant is *ḥalāl*.¹⁹

To begin with, *umum al-balwa* (common plight), this term, was mentioned by some of our esteemed past jurists in their discussions of *Tahara* and *Najasa*, which is cleanliness of body, clothes and place for the purpose of performing certain types of *Ibadah*, and they meant by it a case in which the avoidance of *najas* (dirt) is almost impossible, such as the mud in streets though mud may contain *najas*

elements like animals' urine. *Umum al-balwa* was not mentioned by jurists out of this context nor was it discussed or mentioned independently.²⁰ However, it is clear from the only few contexts in which *umum al-balwa* was mentioned that it meant disregarding some Sharī'ah rules when conformity to them is almost impossible and out of control, based on the notion of Removal of Hardship; a well-established Sharī'ah norm derived from the ayah "He has chosen you (to convey his message) and has not laid upon you in religion any hardship". [V.22:78]

Hence, we may conclude that in order for this norm to be operating in any proposed matter the latter must fulfill this condition of inevitability of the thing to be legalized on the basis of *umum al-balwa*. Knowing that investing in companies of mixed activities of *halāl* and *ḥarām* is not inevitable, and that investment is not a necessity in itself, we may then conclude that validating such kind of investment on the basis of this norm of *umum al-balwa* is wrong. It involves an out-of-context use of this norm and consequently, does not lead to the result arrived at by its users.

As for *fasad al-zaman* (prevalence of *ḥarām*), it is not an excuse for Muslims to commit the *ḥarām* on the pretext that it is prevalent so avoiding it becomes difficult. We should, rather, fight the *ḥarām* should the *ḥarām* prevail, and eradicate its causes and channels, not to surrender to it and further contribute to it!!

With regards to *urf* (custom), be it the common *urf* or the *urf* pertaining to the economic practices (*urf Iqtisādi Khas*), *urf* has never been a valid source of Sharī'ah rulings if it found to be in conflict with the established Sharī'ah rulings. It is a well-established principle of *urf* that in order for it to function as a source of law it must fulfill this condition of not to object the Sharī'ah texts or its established rulings. If the *urf* has the power to contradict the texts, then it is deemed to be a stronger source of Sharī'ah than the texts though *urf* has derived its authority from the texts!!

4.7. *Maṣlahah*

Maṣlahah (public interest) is a valid source of Sharī'ah, or Islamic law. It means that if a certain matter is deemed to be beneficial to a society by bringing *maṣlahah* to it, then it is legitimate to accept it and overlook committing the *ḥarām* that might be associated with it, because the ultimate objective of the Sharī'ah is the realization of *maṣlahah*. Consequently, we may accept investing in mixed activities since investment in principle is beneficial to the Islamic economic system, or the society as a whole.²¹

The crux of problem in the modern approach to *maṣlahah* lies in the attempt to overemphasize *maṣlahah* and treat it as a priority over textual Sharī'ah sources. In other words, if there is a conflict between textual evidences and *maṣlahah*, the latter is presumed to prevail. We feel the need to evaluate some exaggerations and misconceptions in modern application of *maṣlahah* as it has been used as pretext to validate many unlawful activities.

First, the belief that conflict between Shari‘ah text and *maṣlahah* as is inevitable is an erroneous presumption. If we believe that Shari‘ah rulings aim at realization of *maṣlahah*, then why do we assume a potential conflict is inevitable between Shari‘ah text and *maṣlahah*?

Second, even if such a conflict exists, then it is the Shari‘ah texts that should be given priority over *maṣlahah*. This is particularly true especially when we know that *maṣlahah* itself derived its authority from the Shari‘ah text and not vice versa. It is illogical if one is to give priority to a branch over its core and source of authority. Therefore there is no reason for *maṣlahah* to be in conflict or even oppose to the Shari‘ah text in any manner.²²

Third, the approach of giving priority to *maṣlahah* fails to distinguish between the definitive (*qat’i*) and the speculative (*dzanni*) texts. If the text is definitive with regards to its authenticity (*thubut*) and meaning (*dilalah*), then the ruling it produces is final and binding; i.e. there is no room for human’s perception of *maṣlahah* to add any interpretation to the text in any way they see fit.²³ While if the text is speculative with regards to its authenticity or meaning, then there may be avenues for *maṣlahah* to further interpret and give meaning to the text in a way that does not hinder its realization. This is acceptable as long as the perceived *maṣlahah* meets all its conditions: being public not private, authentic not false, definitive not probable.²⁴

Fourth, the issue of potential conflict between a definitive Shari‘ah text and the *maṣlahah* is not conceivable if we refer *maṣlahah* to the Shari‘ah point of view. However, if we are referring *maṣlahah* to human point of view then the conflict is plausible. Nevertheless, the determination of what is beneficial and what is harmful cannot be left to human reasoning alone as Al-Shatibi the pioneer of the science *Maqāṣid Al-Shari‘ah* (objectives of the Shari‘ah) says.²⁵

5. CONCLUSION

After exposing the justifications claimed for validating such benchmarks and their discussion, we may conclude that all benchmarks suggested to be adopted in REITs or stock market do not fall back on any valid Shari‘ah background, and any attempt to legalize them by drawing analogy to some benchmarks mentioned by some past jurists involves an out-of-context use of these benchmarks. The Resolution of the *Fiqh* Academy supports this result as it reads: “It is unlawful to participate in the equities of joint stock companies which occasionally deal with prohibited transactions although their main business activities are basically lawful”.

In addition to refutation of the claim about the validity of these benchmarks, there is a very crucial point that needs to be observed and taken into consideration when looking into this matter. It is the fact that by accepting dealing with tenant or companies of mixed activities, we are contributing to the commission of the *ḥarām*; promoting and facilitating it, which is something that is totally intolerable.

However, this result, in my opinion, does not mean in Islamic REITs a total rejection of dealing with tenant with mixed activities. Instead, we believe that there is still some room for accepting the existing tenants with some unlawful activities upon fulfilling of the following conditions:

- The core activity of the tenant must be permitted.
- Lack of fully lawful investment alternatives.
- The lease term of the existing tenants operating some impermissible activities must not be long, and it is the role of the Shari'ah board to decide on what constitutes a long term in each case.
- The objective of acquiring a real estate with current tenants with *haram* activities is to gradually transfer the real estate activities to become completely compliant with the Shari'ah. Or, if the acquirers of the estates with such tenants believe they can make such tenants eschew operating with unlawful activities
- Accepting dealing with tenant operating some impermissible activities must not in anyway involve facilitating or promoting of the *haram* operated by the tenant.
- Revenue obtained from tenants with unlawful activities must be disposed of by channelling it to charity.

From these conditions it can be observed that the rationale of this opinion is the eventual islamization of the activities in a given real estate. However, in order to protect the image of the Islamic REITs, we stipulated that the core activity of the tenant must be permitted and that the lease term of the existing tenants operating some impermissible activities must not be long. And since the tenant operating some impermissible activities already exists, then acquiring such estate does not basically involve facilitating of the evil, unlike accepting new tenants with unlawful activities as this involves facilitating of the commission of the *haram*. The revenue obtained from tenants with unlawful activities must be channelled to charity because it is an unlawful income.

Notes

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¹ Islamic REIT has been defined by the Securities Commission in Malaysia as a collective investment scheme in real estate, in which the tenant(s) operates permissible activities according to the Shari'ah.

2- The rental activities that are classified as non-permissible as decided by the Shari'ah Advisory Council (SAC) of the Securities Commission are the following:

- Financial services based on *ribā* (interest).
- Gambling.
- Manufacture or sale of non- *halāl* products or related products.
- Conventional insurance.
- Entertainment activities that are non-permissible according to the Shari'ah.
- Manufacture or sale of tobacco-based products or related products.
- Stock broking or share trading in Shari'ah non-compliant securities.
- Hotels and resorts.

Apart from the activities listed above, the securities commission added that Shari'ah committee/ Shari'ah adviser can apply *ijtihad* for other activities that may be deemed non-permissible to be included as a criterion in assessing the rental income for the Islamic REIT.

³-See the Securities commission guidelines for Islamic REITs in Malaysia.

⁴ - See the Securities commission guidelines for Islamic REITs in Malaysia.

⁵ - See Resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, p. 118-119-124.

⁶ - Kamali, "Principles of Islamic Jurisprudence" p.330

⁷ - Kamali, "Principles of Islamic Jurisprudence" p.330

⁸ - See Resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, p. 125.

⁹ - Ibn Abdeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)*, 4/182-241, Dar Ihiya' al-Turath al-Arabi, Beirut, 1987; Al-Dasuqi. *Hashiyah*, 3/43, Dar Ihiya' al-Kutub al-Arabiyyah; Al-Hattab. *Mawahib Al-Jalil*, 4/335, Dar al-Fikr, Beirut, 1987.

¹⁰ - For a similar maxim see: Ibn Taimiyyah, *Majmu' al-Fatawa*, 29/273

¹¹ - See Resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, pp. 124-127.

¹² - Al-Hattab. *Mawahib Al-Jalil*, 5/118-119 (Dar al-Fikr, Beirut, 1987); Al-Bahuti. *Kashaf Al-Qina'*, 3/496, (Dar Al-Fikr, Beirut, 1402 A.H).

¹³- Narrated by Al-boukhari in his *Sahih* 1/435, Ḥadīth No (1233); and by Muslim in his *Sahih* 3/1250, Ḥadīth No (1628).

¹⁴ Laldin, M.A, (2007), "*Shari'ah Approved Securities Screening Process in Malaysia*" p.148, A paper submitted to the conference on Securities Markets & Bourses held in Dunbi

6-8 March 2007; Resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, p. 126.

¹⁵ - See Resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, p. 127.

¹⁶ - Ibn Abdeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)*, 4/ 270, Dar Ihiya' al-Turath al-Arabi, Beirut, 1987.

¹⁷ - Ibn Abdeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar)*, 4/ 270, Dar Ihiya' al-Turath al-Arabi, Beirut, 1987.

¹⁸ Ibn Humam. *Fath al-Qadeer*, 6/115, Dar Ihiya' al-Turath al-Arabi, Beirut.

¹⁹ - See resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, pp. 120-121; Laldin, M.A, (2007), "*Shari'ah Approved Securities Screening Process in Malaysia*" p.148.

²⁰ - Al-Kasani. *Bada' al-Sanai'*, 5/144, Dar al-Kitab al-Arabi, Beirut, 1982; Ibn Humam. *Fath al-Qadeer*, 1/185, Dar Ihiya' al-Turath al-Arabi, Beirut.

²¹ - See resolutions of the Securities Commission Shari'ah Advisory Council, Securities Council Malaysia, p. 121.

²² - Al-Zuhaili Wahbah, *Al-Waseet fi Usul al-Fiqh*, p. 361

²³ - See: Al-Ghazali, *Al-Mustasfah*, p176; Al-Bouti, *Dhawabit Al-Maslah*, p119.

²⁴ - Al-Bouti, *Dhawabit Al-Maslah*, p119.

²⁵ His argument is supported by a number of Qur'anic verses. One of which is Qur'an 23:71. Refer to Al-'iz bin Abdelsalam, *Qua'id Al-Ahkam fi Masalih Al-Anam*, 2/161.

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PART II: MARKET DEVELOPMENT AND POLICIES

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Venture Capital Funds: A Venue for Growth of Islamic Capital Markets

*Farhan Hameed**

1. INTRODUCTION

The Islamic Capital Markets have experienced tremendous growth over the last twenty years and have become a vibrant part of the international capital markets. This growth of the Islamic financial sector and its integration with the international financial system stems from several factors including innovative financial structures which are both Shari'ah compliant and replicate financial products in the non-Islamic financial sector such as sovereign *Shukūk*, credit cards, line of credits and securitizations. But in order to be truly innovative and dynamic the Islamic capital market will have to look beyond banking, trade and debt financing.

This paper will argue that with Shari'ah constraints on *Ribā* and asymmetric risk, one of the most prominent venues for growth in Islamic capital markets is through venture capital funds. The key differences between regular financial intermediation (financing through banks or bonds) and venture capital are the sharing of risk between the investor and the firm and management mentoring. The basic argument is that with slight changes venture capital products can be easily adopted into the Islamic financial markets without requiring any intellectual gymnastics. In fact, an older form of venture capital called *commenda* thrived at the time of Catholic Church's injunctions against usury.¹ We will draw similarities between the *commenda* organization and the current VC firms arguing that in fact they are the most current form of a type of contract developed in the Islamic world.

Arguments have been made both in theoretical and empirical literature showing that equity financing and risk sharing maybe more profitable but for various reasons the debt-based financing has dominated the financial system. It has been argued that profit sharing contracts might be the most efficient way of managing uncertainty since they address the moral hazard problem. Different profit-risk sharing contracts have emerged throughout history to finance new innovations which in the modern times have taken the form of venture capital funds².

Venture capital in recent times has been closely associated with technology. The digital revolution was primarily financed by venture capitalists which resulted in such iconic firms as Apple, Microsoft and Intel. We will analyze the link between economic growth and rise of a venture capital industry. There is some evidence that VCs play an important role in bringing new technologies to the market. Further, VCs provide two ingredients which are in short supply in the SME sector, capital and professional management skills. By filling this gap VCs can provide an impetus to growth. Further, VC products are conducive for both large and small scale ventures and there is evidence (although limited) that they have a positive impact on economic growth.

Most countries have strict rules on who can invest in VC funds since these are considered highly risky and usually have high minimum deposits with long required investment periods. The paper will discuss the suitability of allowing smaller investors in Islamic VC funds and legal and structural changes which may be required. Based on global experience we will explore what governments can do to promote the VC industry and draw some lessons for Muslim countries.

The organization of the paper is as follows: The paper will start with a brief historical analysis of risk sharing venture contracts and show that in fact the modern day venture capital contracts have historical roots in types of contracts seen in the earlier Muslim world. This will be followed by a brief overview of the VC industry and the explosive growth it has experienced in the recent past. We will discuss the disciplined approach to investment selection and management mentoring which are the critical ingredients of the success of the VC industry. This approach can easily be transferred to a fund which complies with Islamic principles and can be an important engine for growth in the Islamic world. The next section will discuss how a thriving VC industry can encourage development of Islamic capital markets. This will be followed by a discussion of what government actions can foster a VC industry and achieve industrial growth. The paper will conclude with some suggestions on policy suggestions for the Muslim countries and the prospects for a thriving VC industry in the Islamic capital markets.

2. VENTURE FINANCING: A HISTORICAL PERSPECTIVE

Innovation is widely recognized as the main driver of economic development. The process of technological innovation is erratic and moves in spurts and stops rather than a smooth progression. This view of economic development as espoused by Schumpeter (1978) sees economic growth as an evolutionary process rather than a linear progression. Different technologies are tried by firms and the most efficient firms remain succeed and their practices are adopted by other firms. The innovation does not have to be a new technology in the sense of a new product but includes innovation in process (e.g. just in time manufacturing) or discovery of a new trade routes or new organizational structures.

In this view of economic development the new ideas or new products have to be put to the test and can only be eliminated by competing ideas. This evolutionary process can be expensive because it is expensive to develop and bring products to markets based on untried technologies. Similarly, launching an expedition to discover new trade routes is risky and chances of success are low but the corresponding returns are also high. The problem of managing this uncertainty has been facing humanity throughout time and has been addressed in several different ways.

Before delving into specific historical examples of profit sharing contracts in detail it is pertinent to discuss some of the arguments supporting profit sharing contracts under uncertainty. The issue of debt based financing where the risk is borne by the borrower vs. equity based risk-sharing financing has been a hotly debated topic in economics and particularly in the field of information economics. Problems such as adverse selection and moral hazard increase fragility of the banking system which are addressed through central bank supervision and requiring collateral. This can be inefficient since it excludes borrowers who may have viable projects without sufficient collateral while at the same time it may increase the banks' exposure to those firms' which have quality collateral with less viable ideas.

Similarly, in empirical literature this debate was most clearly stated by Mehra and Prescott (1985) which is now referred to as the "equity premium puzzle". This paper found that in the long-run the return on equity investment substantially outpaced real return on a safe asset such as US t-bills. This spawned a vast literature attempting to explain why investors switch to equity investments and reduce the premium through arbitrage but with limited success. Regardless, it is clear that profit and risk sharing type of contracts have higher returns compared to debt based financing.³

In at least two different historical periods the sudden technological spurts were predominantly financed through profit sharing contracts. The first well documented period was the extraordinary development in maritime trade in Medieval Italy and the second was the development of the Silicon Valley as a world centre for digital revolution. We will first show that the *commenda* organization popular in Italy in Medieval Italy was quite similar to contracts used earlier in the Muslim world. Further, there is evidence that these types of contracts continued to be used in the Ottoman Empire well into the nineteenth century. Lastly, we will draw similarities between the *commenda* organization and the current VC firms arguing that in fact they are the most current form of a type of contract developed in the Islamic world.

The medieval Islamic world developed several modes of financing which were non-interest bearing and complied with religious theory including business partnerships, credit arrangements, letters of credit and transfer of debt. One of the more commonly used business partnership practiced since the classical era was *muḍārabah* partnership. This involves two parties one of whom provides the

capital and other provides the entrepreneurial skills with an agreement to share the profits. The agent who is entrusted the capital is known as the *muḍārib*. The risk of a loss is entirely borne by the investor and the *muḍārib*'s liability is limited to his share of the profit. An important covenant of the *muḍārabah* contract is that it is limited to the time stipulated in the contract, for example it may be limited to the amount of time taken to complete a trade route. A *muḍārabah* contract was commonly used to finance trade expeditions even before the time of Prophet Muhammad (PBUH).⁴

The other classical type of contract used to finance economic ventures was *Mushārahah* (partnership). This is type of financial arrangement dates back to pre-Islamic times and was widely accepted during the Islamic times. It is a combination of the *Shirākah* (partnership) and *Muḍārabahh* contracts, "combining the act of investment and management" (Iqbal and Mirakhor (2007)). *Mushārahah* usually involves two or more partners who combine their capital, labour or both. The profit and losses are shared and all partners have similar right and liabilities. Each partners' profits should be specified in terms of percentage of total profits and not an absolute amount. Regardless of the share in profits the loss shall be borne according to their contributed capitals. If a partner has only contributed labour then they are not liable for any capital loss.

Although both the *muḍārabahh* and *mushārahah* contracts pre-date Islam, there is evidence that up until the middle of the nineteenth century, Ottoman jurists in Anatolia and Istanbul used classical Islamic principles based on teaching of medieval Muslim jurists to adjudicate cases involving these partnerships (Pamuk (2005)). This assertion has been supported by gleaning court records various Ottoman centres. With a few innovations, there is evidence that classical Islamic partnership forms not only survived but were applied, with minor exceptions, true to their original forms until the nineteenth century. It has been suggested that the continued dominance of small scale firms or partnerships was probably the most important reason for the limited changes in this area (Pamuk (2005)).

The next step in our argument is to show that types of contracts used in Medieval Italy to finance ventures (plying of trade routes) were quite similar⁵ to the pre-Islamic contracts discussed above. We have already argued that these prevalent in the Muslim world even until the 19th century so it is not out of the question that they could have been adopted by Medieval Italy. A popular form of equity financing used in medieval Italy is often reference to as the *commenda* organization or simply as *commenda*. These were particularly popular in Pisa and Venice and were used to finance risky maritime ventures⁶. These dated back to 12th century and similar *collegantia* contracts in Venice even dated back to the 11th century.

The discovery of new trade routes could only be accomplished by launching several new expeditions of which a small percentage was able to accomplish its goals. Investors and managing partners would form a *Commenda* with varying

rights to profits and liabilities. The investor would trust their funds to the managing partner who usually sailed with the ship. The managing partner could contribute solely his labour or could also contribute capita. Weber (2003) distinguished contracts based on contribution of the managing partner (agent). In a unilateral *commenda*, the agent contributed only labour and was entitled to one fourth of the profit while the investor received three fourths of the profits. The significant difference between the profit ratios were justified in order to address agency problems since the investor would not be on the ship to monitor the agent's behaviour. The active sea-going merchant would have full information on the realized profits and despite check and balances it was possible that the investor could be defrauded of his profits. In order to compensate for these risks the investor would demand a higher share of the profits.

In the bilateral *commenda* (*Societas Maris*), the managing partner would contribute one third of the capital and was entitled to half the profits. Of the 50 percent of the profits, 25 percent was for management and 25 percent as 1/3 of the remaining profit since they contributed 1/3 of the capital. . The *commendas* were usually valid for one trip and the profits were distributed once the goods were sold. While the *commendas* in Venice were contracted for a specified time which was limited to at most 2 years by 1271. Many large ventures involved multiple *commenda* contracts involving several investors who would usually receive profits based on the proportion of capital provided.

An important aspect of the *commenda* and *Societas Maris* types of contracts was the risk sharing and limited liability. Those providing the capita i.e. the investors bore all the risk and in the unilateral *commenda* the liability of the active (managing) partner was limited to the opportunity cost or any liabilities he may have acquired from a third party not covered by the *commenda* contract. These could be covered by his own resources and assets. On the other hand the liability of the investor was strictly limited to the capital invested and the investor was not liable for any debts or other losses incurred by the active trading partner. *Commenda* contracts declined in popularity during the 14th and 15th centuries. With the high risk involved in overseas trading the investors were no longer content to carry the total risk for the capital and the *commenda* evolved to increase the liability of the active partner. This was a precursor to the modern day corporation with many investors and one managing partner and evolved into managed funds.

Now we will discuss the four properties that are shared with the classical Islamic instruments, *commendas* and modern day venture capital (VC) firms. First is the limited time of validity of the contract. *Commendas* were limited to a single journey or as in Venice limited to at most 2 years. Similarly, many of the venture capital funds are raised for a limited period of time, usually 10 years. Secondly, the performance of the venture is objectively based on market outcomes, be they sales of merchandise in a *commenda* financed trade route or IPO of a VC financed firm.

The third similarity is the sharing of profits between the entrepreneur and the investor (investors). As stated above the investor(s) could receive up to 75 percent of the profits while the entrepreneur was entitled to 25 percent. In the VC firms the standard cut is usually 20 percent while some elite VCs like Kleiner Perkins can demand up to 30 percent. Finally, the limited liability of the investors as well as the entrepreneurs can be contrasted to the modern VC which are established as limited liability partnerships and the liability of the investors is limited to the funds invested.

2.1. VC Firms and their Economic Effects

Venture Capital (VC) has experienced dramatic growth since its inception in the modern form during the 1960s. The rise of modern days VC firms is widely recognized as the major force behind the technology boom of the Silicon Valley including such iconic firm as Intel, Apple and Digital Equipment Corporation. Venture capital is a type of private equity provided by professional investors to new and growing businesses. VC funds are usually subscribed by high net worth individuals and institutional investors to invest in new high growth potential firms. The funds provide capital as well management services to entrepreneurs in exchange for stake in the firm. VC investments are considered high risk since investments are in risky unproven ideas/firms but they also promise above average returns. VC firms usually invest for long term and usually exit through IPOs.

A venture capital fund is a pooled investment vehicle (often a partnership) with limited liability that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. In addition, VC participation may include managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. Firms which are new and either have limited operating history or require significant upfront investment (such as software development) usually cannot raise funds from banks or a debt issue. These firms turn to VC for capital in exchange for equity in the firm as well as executive control.

Venture capital fund executives are general partners and are the investment professionals responsible for making investment decisions. They come from varied backgrounds but many were either executives in types of firms which are financed by the funds or in several cases were founders of companies. The next important section of a VC firm are the investors themselves. The general partners are required to hold stakes in the fund but majority of the shares are generally held by other investors who are known as limited partners. The limited partners include high net-worth investors, institutional investor such as pension funds and university grants as well as pooled investment vehicles such as funds of funds.

The other positions at VC include venture partners who are responsible for seeking out deals and only receive compensation linked to particular deals. VCs

also hire entrepreneurs for limited periods who are expected to develop and pitch ideas to the host firm. Both venture partners and entrepreneurs move into management positions at portfolio firms. Many of these individuals are successful entrepreneurs in their own right and have either successfully sold their business or have moved into an advisory role at their firms leaving the day-to-day functioning of firm to professional managers.

Most VC funds have a stated life of ten years with a possibility of an extension for a few years. The first phase a fund is the investing cycle which last from 3 to 5 years and the remaining life of the fund focuses on managing the firms in the portfolio. This model was pioneered by successful funds in Silicon Valley through the 1980s to invest in technological trends broadly but only during their period of ascendance, and to cut exposure to management and marketing risks of any individual firm or its product. In such a fund, the investors have a fixed commitment to the fund that is "called down" by the VCs over time as the fund makes its investments. There are substantial penalties for a Limited Partner (or investor) that fails to participate in a capital call.

In a typical venture capital fund, the general partners receive an annual management fee equal to 2% of the committed capital to the fund and 20% of the net profits (also known as "carried interest") of the fund; a so-called "two and 20" arrangement, comparable to the compensation arrangements for many hedge funds. Strong Limited Partner interest in top-tier venture firms has led to a general trend toward terms more favourable to the venture partnership, and many groups now have carried interest of 25-30% on their funds. Because a fund may run out of capital prior to the end of its life, larger VCs usually have several overlapping funds at the same time; this lets the larger firm keep specialists in all stages of the development of firms almost constantly engaged.

By providing the capital and management advice the VC firms foster new firms and ideas and help them grow to a stage where the VC firms can exit. The popular modes of exit are either through an IPO or a private equity sale. Although the focus of VC was on the technology sector in the US, over the last decade there has been an expansion of VC industry to other sectors as well other geographical areas including China and India.

The structure described above could easily be adopted in the Islamic financial system and the oil money which is spent on private equity deals in the West could be channelled back to Muslim countries to encourage economic growth.

It is widely recognized that technology is main driver of economic growth. Following, Schumpeterian framework of analysis, venture capitalist is part of a larger selection environment that allows economic systems to change and to perform with regard to innovation and growth. An important function of Venture Capital is to act as a mechanism to support and select across variety in new technological opportunities and in transforming these into viable businesses. This

function of Venture Capital is, first of all, related to its role as a financial intermediary. However, VC literature has referred to the value adding capabilities provided by VC firms to their portfolio companies with regard to management, headhunting, marketing, networking, certification and reputation. VC firms also claim to be a critical ingredient for the rapid international expansion of promising start up companies. In addition to these ‘coaching’ functions, VCs also act as ‘scouts’ to identify promising start-up ventures (Baum, Silverman, (2004)).

Several papers have attempted to evaluate the economic impact of VCs. Since VC play a major role in bringing technology to market many papers have considered VC contribution similar to experimental development performed by large firms. Econometric results confirm our assumption that VC contributes to growth through two main channels.⁷ The first one is the introduction of new products and processes on the market. The second one is the development of an improved absorptive capacity of the knowledge generated by private and public research institutions. The social return to VC is much larger than the return to business or public R&D, probably due to a high risk premium and large potential spillovers or knowledge externalities – large firms devote the bulk of their research activities to product or process improvement which is associated with lower risks and lower expected returns.

A high VC intensity further allows to improve the economic impact of private and public R&D capital stocks. In other words, VC improves the “crystallisation” of knowledge into new products and processes. According to our estimates, VC must be considered as an additional “link” explaining variations in economic performances. Romain and van Pottlesberghe (2004) empirical results confirm Baumol’s conjecture that entrepreneurial activity may account for a significant part of the “unexplained” residual in the traditional production function. These results therefore call for innovative policy instruments that would stimulate the participation of private VC funds available in the market.

2.2. Fostering a VC Industry

So the next question is what can the governments do to promote the VC industry? The major ingredient for development of the industry already exists in many of the Islamic countries that is a large number of high net-worth investors. The task of Islamic world is to find ways to channel that money to new and growing firms. We will discuss four different areas that the government in various Muslim countries can address to foster a VC industry. These include legislative changes which are conducive to a VC industry, promotion of research and university-industry linkages, creation of public venture capital funds and finally encouraging growth of pension funds and other institutional investor who are likely investors in VC funds.

Most of the scholarly research suggest that the roots of the modern VC industry lie in the Small Business Investment Act of 1958 which led to the establishment of

Small Business Investment Companies. SBICs are private corporations licensed by the Small Business Administration (SBA) to provide professionally managed capital to risky companies. To encourage their formation, SBICs were allowed to supplement their private capital with SBA loans and were eligible for certain tax benefits. In return, SBICs were subject to certain investment restrictions, including limitations on the size of the companies in which they invested and restrictions on taking controlling interests in companies. In response to the government's active promotion of SBICs and the availability of low-cost money, 692 SBIC licenses were granted during the program's first five years. These firms managed \$464 million of private capital and included forty-seven publicly owned SBICs that raised \$350 million through public offerings.⁸

The SBIC program suffered from several defects, however. First, not all SBICs provided equity financing to new ventures. In particular, SBICs that took advantage of the leverage provided by SBA loans were themselves required to make interest payments, and thus they concentrated on providing debt financing to small businesses that had positive cash flows. Second, SBICs attracted mainly individual rather than institutional investors, especially the publicly traded SBICs, which were among the largest in the program's early years. These individual investors did not fully appreciate the risks and difficulty of private equity investing.

Despite these drawbacks SBIC program was successful in developing a group of highly skilled professional investors who could either start their own VCs or to take a leading role in other VC funds. Further, it helped jump start the VC industry in the US which eventually spread to rest of the World. It is high time that Muslim governments implement a law similar to SBIC.

In addition to the legislative changes and the availability of funds a very important ingredient for the VC industry is a continuous supply of new ideas and entrepreneur ventures. For this purpose, a number of countries have firmed their efforts for creating linkages between universities and industry. This could include creation of technology incubators as well as research grant institutions.

In addition to these efforts many government have also experimented with public venture capital funds with mixed results. The public venture funds are usually designed to promote a certain geographical area or a certain sector such as the Small and Medium Enterprises. The literature on entrepreneurship has long recognized the fact that venture capital is a major form of external financing for new firms. Despite evidence that most governments in developed countries have public venture capital programs in place, little economic analyses of these programs exist in the literature. A paper by Secrieru and Vigneault (2004) builds a model that endogenously determines the optimal amount of venture capital and managerial advice provided by the Business Development Bank. Using an occupational-choice model with informational constraints, they find that, with full information, entrepreneurs who are more or less able may be credit rationed or over invest compared with the profit-maximizing outcome. Furthermore, the

introduction of asymmetric information has no effect on the use of capital by more-able entrepreneurs. Less-able entrepreneurs, however, may be credit-rationed compared with the full-information case.

One of the main roles of venture capitalists, besides supplying capital to start-ups, is to provide managerial expertise. In this paper, the effect of managerial advice on welfare has been, in general, ambiguous. It was found that, starting with a situation in which the BDB does not provide managerial advice, a small increase in the level of advice has a negative effect on welfare; it results in an increase in the interest rate for more-able entrepreneurs that is not offset by an increase in their probability of success. Although the effect of public VC is ambiguous it may still be useful for countries to jump start the industry through public VC funds.

Finally, in order to increase the demand for VC funds it is important that governments encourage private pension and other institutional investors such as endowments. Many countries have already taken steps to establish mutual funds and privatizing pension there are many steps which can be taken to further this process.

Currently, there is very little activity of VC funds in the Islamic financial system. Addressing some of the issue listed in the paper will go some way in improving this situation. As we have shown in the paper VC funds are a modern form of the classical Islamic venture instruments and can be easily adopted in the Islamic capital markets.

Notes

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¹ Although it has been argued that the prevalence of *commenda* organization had nothing to do with that ban. (Brouwer 2005).

² The term venture capital (VC) will be defined more concretely later the paper but for the term is being used loosely to include types of private capital injections including early stage Angel investors.

³ Although it is outside the purview of this paper, the question of why debt based financing has become more prevalent compared to profit and risk sharing contracts would be an interesting line of enquiry.

⁴ See Iqbal and Mirakhor (2007) for more details.

⁵ Some authors have even argued that they were derived from the pre-Islamic contracts. See Udovitch (1970).

⁶ Although the commenda contract is interest free, the spread of this type of contract had little to do with the ban on usury that was proclaimed by the Catholic Church ((Weber

(2003) in Brouwer (2005)). The commenda organization had already become popular before the canonical prohibition of the sea loan in 1234.

⁷ See Romain and van Pottelsberghe (2004).

⁸ See Fenn et al (1995).

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Analysis of Risk Attitudes, Spirituality, and Sharī‘ah Consciousness of Current and Prospective Investors (An Empirical Survey in Malaysia)

Ronald Rulindo, * Amy Mardhatillah ** and Sutan Emir Hidayat†

ABSTRACT

Islamic finance has received huge attention from Muslim as well as non Muslim investors. However, the proportion of Islamic funds which being invested either in Islamic banks or Islamic capital market are relatively low compare to the conventional counterparts. Therefore, practitioners of Islamic finance should design and implement more creative strategy to attract investors especially Muslim which not replace their fund in Islamic investment yet. This research tries to investigate three variables namely spirituality, risk profile, and Sharī‘ah consciousness which probably influence Muslim investors in investing their money in Islamic Capital Market. This research will use primary data by distributed questionnaires to various prospective Muslim investors in Malaysia and analyze them by using Spearman Correlation. The result of this research perhaps can be one of the consideration used by Islamic fund manager in determine marketing strategy in order to attract Muslim investor funds.

1. INTRODUCTION

In recent days, investment choices have naturally become much more complex because there are many factors that should be considered before making investment decision (Filbeck et al, 2005). Because investment choices or investment decision become much more complex, it have also become more risky (Keller and Siegrist, 2006; Murphy and Sortar, 2005). Therefore, understanding how people invest and what factors influence their financial decisions is increasingly important. Furthermore, the results of these decisions will have a significant impact on many people’s lifestyles, particularly in their retirement years.

According to Wärneryd (2001) as cited in Keller and Siegrist (2006) investors do not act in accordance with rational models of investment, as assumed by the theory of efficient markets and by rational models of portfolio choice. According to Tigges et al (2000), Psychological research shows that the idea of a primarily rational “homo economicus” does not satisfy the demands of predicting human behavior. Kostolany (1997) in Tigges et al (2000) even noted that ten percent of

stock market reactions are based on facts, while the rest 90 percent are based on psychology”

Thaler (1980) in Murphy and Soutar (2005) addressed that there is an obvious link between financial investment choices and consumer behaviour. Research into consumer behaviour may prove useful in increasing our understanding of the extremely complex financial marketplace. This opinion was strengthened by Wilcox (1999) who argues that financial markets provide a rich environment to study consumer behavior (Murphy and Soutar, 2005).

According to Wood and Zaichowsky (2004) there is correlation between behavioural factors and investment decision. Through their research, they found that a behavioural finance literature review reveals five main constructs that drive investor behaviour: investment horizon, confidence, control, risk attitude, and personalization of loss. In addition, Okuyama and Francis (2006) addressed that the field of behavioural finance recognizes that the basis of an investment decision is an assessment of the trade-off between gain and loss. Ultimately, all investment decisions are binary: to act or not to act. Therefore, the implementation of this decision can produce success or error as the outcome.

Keller and Siegrist (2006) note several literatures that addressed psychological factors that appear to play an important role in individual investing decisions. Some factors that have been investigated include locus of control (McInish, 1982), affects associated with industries (MacGregor et al. 2000), the social unacceptability of firms perceived as producing risks to health, safety, and the environment (Fischhoff, Nadai, and Fischhoff, 2001), attitudes toward saving (Euwals, Eymann, and Borsch-Supan, 2004), and risk attitudes (Carducci and Wong, 1998; Morse, 1998, Tigges et al., 2000, Wärneryd, 1996, 2001).

Among those psychological factors above, risk attitude is one of the most important factors that frequently mentioned by behavioural finance literatures as the factors that probably affect the investment decision in financial market. However, since all research above was conducted in conventional capital market and no one conduct such research in Islamic capital market, it is interesting to know whether risk attitude have contribution or not in Islamic capital market.

Islamic capital market is a newly field in capital market. It has significant growth in recent years and many people and parties, Muslims and non Muslims are actively involved in this market. Since Islamic capital market underlying the principle of their operation based on Islamic principles, it is interesting to know whether the attitude of investors in this market are similar or not with those of in conventional capital market, at least in term of risk attitude.

Based on the opinion above, this research tries to explore the correlation between risk attitudes and the intention or decision to invest in Islamic capital market. This research conducted surveys to 75 prospective investors and investors that have investment Islamic capital market in Malaysia. In addition, this research

also tries to investigate the correlation between intention and decision with two "Islamic" behaviours that are spirituality and Shari'ah consciousness. Although there are no research that have been used these variable in Islamic capital market research, it is important to bring these variable into these research to capture the clear picture why people make decision to invest in capital market.

Since behavioural research can rationally explain the homogenous behaviour in stock market, investment firms can then develop targeted marketing strategies to appeal more effectively to the different segments (Wärneryd, 2001 in Keller and Siegrist, 2006). Based on this opinion, perhaps the result of this research can explain why people make decision to invest in Islamic capital market and then investment companies which are actively involve in Islamic capital market can adapt the result of this research to develop more targeted marketing strategy to attract new customers to invest in this market.

2. LITERATURE REVIEW

There are several literatures that have made their way in behavioural finance research that discuss and analyze the risk attitude of investors. As example, Jaggia and Thosar (2000) analyzed the issue of risk aversion and the investment horizon. Investment managers generally subscribe to the principle of time diversification. This implies that a larger portion of the portfolio should be devoted to risky assets as the investment horizon increases. In contrast, academics have shown that for investors with utility functions characterized by constant relative risk aversion, the optimal asset allocation strategy is independent of the investment horizon. The relative risk aversion in these studies is assumed to be constant both with respect to wealth as well as investment horizon. We suggest a utility function that explicitly captures the notion that individuals are more risk tolerant when the investment horizon is long, thereby validating the intuitively appealing time diversification argument.

Sehity (2002) addressed the issue of hindsight bias and individual risk attitude within the context of experimental asset markets. This paper investigates the robustness of hindsight bias in experimental asset markets, the time-invariance of the different experimental risk elicitation methods of certainty equivalents and binary lottery choices, and their correspondence. The results of this research that used 133 traders as the object do not support the conjecture that hindsight bias is a general phenomenon. Therefore, these findings challenged the presumption of time-stable risk preferences and of procedural invariance with respect to different experimental risk elicitation methods.

Wood and Zaichowski (2004) analyzed the attitudes and trading behaviour of stock market investors by using segmentation approach. This study identifies and characterizes segments of individual investors based on their shared investing attitudes and behaviour. This study found five main constructs that drive investor behaviour: investment horizon, confidence, control, risk attitude, and

personalization of loss. Furthermore, ninety individual investors were surveyed via questionnaire on these constructs. The result of this cluster segmentation analysis identified four main segments of individual investors: 1) risk-intolerant traders; 2) confident traders; 3) loss-averse young traders; and 4) conservative long-term investors. Each segment purchased different types of stocks, used different information sources, and had different levels of trading behaviour.

Lampenius and Zickar (2005) developed and validated a model and measure of financial risk-taking investors. This study presents a theoretical model and assessment tool that measures individual differences in risk-aversion in financial matters. Unlike other measures of financial risk-taking, this measure assumes no prior technical knowledge of finance. The assessment tool was developed using item response theory as well as classical test theory methods. The measure is tested for predictive validity through various procedures and proves to have those properties. In addition the measure is tested for construct validity using structural equation modeling and allows for the successful classification of individuals in one of four classifications: Non-Investor, Risk Managing Investor, Conservative Investor, and Speculator. We discuss potential applications of this measure.

Roszkowski and Grable (2005) analyzed gender stereotypes in advisors' clinical judgments of financial risk tolerance. A sample of 183 financial advisors and 290 advisory clients was used to determine the degree of correspondence between advisors' subjective clinical judgments about their clients' financial risk tolerance and the clients' actual financial risk tolerance. The correlation between the estimates and the actual measures was 0.41. It was further determined that advisors overestimated the risk tolerance of men and underestimated the risk tolerance of women. This distortion could not be attributed to income or wealth differences between the males and females.

Murphy and Soutar (2005) analyzed individual investor preferences by using a segmentation analysis. As the baby boomers age, individuals are being encouraged to take responsibility for their retirement income. Despite the importance of individual investment decisions, we know very little about what factors influence them. Having identified characteristics that are important to individual investors in shares using a conjoint analysis approach, this study uses cluster analysis and discriminant analysis to look for subgroups with differing attitudes and approaches to investment alternatives. Results suggest that four significant subgroups exist within the investor sample, each with different investment preferences and goals. The results have implications for providers of financial services and for those involved in educating individual investors.

Filbeck et al (2005) discussed risk aversion and personality type. The finance literature supports an increasing role for behavioural aspects of investment decision-making. Among other factors such as demographics, personality type may influence risk tolerance as well. This paper explores the relationship between personality type dimensions of the Myers-Briggs Type Indicator (MBTI) and the

moments approach to individual investor risk tolerance inherent in expected utility theory (EUT). Our study uses survey results to relate ex ante EUT tolerance for variance and skew to MBTI measures. Results indicate that personality type does explain individual ex ante EUT risk tolerance. Our results further suggest that the relationship between personality type and individual ex ante EUT risk tolerance is non-linear in form.

Keller and Siegrist (2006) analyzed money attitude typology and stock Investment. This study identifies segments of individual investors based on their money attitudes (attitude toward financial security, attitude toward stock investing, obsession with money, perceived immorality of the stock market, attitude toward gambling, interest in financial matters, attitude toward saving, frankness about finances). A cluster analysis of data from a representative mail survey conducted in Switzerland (N = 1,569) yielded four main segments of individual investors we term safe players, open books, money dummies, and risk-seekers. This typology has forecast value for behaviour: Each type differed with regard to having investment portfolios, buying and selling securities, risk tolerance for maximization of capital, response to price fluctuations, and willingness to make environmentally and socially responsible investments.

Although several researches have been made on risk attitude in financial market, there are no literatures find yet about risk attitude of investors in Islamic capital market. Perhaps, Islamic capital market is newly develop is the main reason why research on risk attitude in particular or behavioural finance in general are rarely found in this field.

There are also no previous research that discussed the Shari'ah consciousness and spirituality of investors in Islamic capital market. However, it is important to discussed this issue since Islamic capital market is a unique market that have unique characteristics that make it difference from it conventional counterparts. Therefore, bring the "Islamic behaviour" issue in Islamic capital market research especially in the field behavioural finance is important to capture the more comprehensive understanding about the behaviour of Investors and prospective investors of Islamic capital market.

3. RESEARCH METHOD

This research use empirical study as the methodology of this research by distributing questioners to investors and prospective investors of Islamic capital market in Kuala Lumpur Malaysia. The survey use convenient and snow ball sampling approach. This research successfully collected 75 respondents with various demographic backgrounds.

This research defined risk attitude as the behaviour of investors toward the risk. This research categorized risk attitude by following the investor's propensity to take risk that have been used by Haque (2007). There are five types of risk attitudes

which are, risk averse, cautious approach to risk, moderately speculative, actively speculative, and risk takers. A scoring system was designed and appropriately benchmarked across all relevant questions. However, there is one main limitation of this benchmarked question which is since it is not psychometrically measure, the accuracy of this measurement can be questioned. In contrast, this kind of benchmarked is easy to administer. Therefore, this kind of measurement is preferably especially in conducting a preliminary research in the new field such as Islamic capital market.

For spirituality measurement, this research constructs the new spirituality scale based on Emotional Spiritual Quotient (ESQ) model. This new scale has reliability 87.2% so we can use this scale to estimate the spirituality level of some body. The ESQ model proposed by Agustian (2001) and the spirituality scale that been constructed can estimate the level of spirituality based this model. ESQ model identified spirituality as universal value that owned by human that have been given by Allah and it in born with human nature. However, every body will not have equal level of spirituality because the spiritual values sometimes are not reflected in their activity and their feeling since it covered by prejudice, way of life, experience, self interest, view point, comparison, and literatures. If a person can avoid these things in making decision or in all activity of his life and let and do everything just because of Allah, this kind of person can be called as spiritual person.

Shari'ah consciousness defines as the sensitivity level of some one, especially Muslim in buy and sale of a product, as example by searching the *halal* label before buy that products. Since there is no previous research that we can find which discuss Shari'ah consciousness, this research derive its own benchmark to measure the Shari'ah consciousness level of somebody. In the end, other researchers can question the ability of this benchmark in measuring the Shari'ah consciousness level of somebody. However, this research argue that since it is the first research, at least in capital market research that discuss about Shari'ah consciousness, it is acceptable for this research to use its own benchmark. Perhaps, future research can continue this research in order to get the standardize Shari'ah consciousness measurement. This research also argues that investigating Shari'ah consciousness level of investors and prospective investors of in capital market is important. If the result of this research shows significance correlation between Shari'ah consciousness of investors and prospective investors with investment decision to invest in Islamic capital market, the Islamic investment managers can develop more targeted marketing strategy in order to capture the money of prospective investors that are not be invest in Islamic capital market yet. In addition, Shari'ah consciousness is different with spirituality. Although theoretically both variables have correlation each other, but culture and behaviour can make some one who have high level of spirituality may be not have high level of Shari'ah consciousness, and vice versa. As example, in a country that dominated by Muslims such as Indonesia, people may not so concern with the "*halal*" label of

a product since majority products that been traded in the market are *halal*. It is different from Malaysia case. Since that country also has significance number of non Muslims, there are many non *halal* products that available and easy to get in the market. Therefore, people especially Muslims in Malaysia might be more Shari'ah consciousness rather than people in Indonesia.

Beside risk attitudes, Shari'ah consciousness and spirituality, this research also ask the demographic data of respondents in order to understand the condition of respondents and to provide more elaborative suggestion toward the strategies that can be taken by Islamic investment managers or marketing managers in approaching prospective investors to invest in Islamic capital market.

4. FINDINGS

Respondents' Profile

Total respondent are 75 persons. It consists of 34 male participants and 35 female participants, two of the respondent did not disclose the information. 22.7% of respondent work in the private sectors, 16% as the government employees, 14.7% as a lecture, 16% having their own business, and only 2.7% of the respondent are the housewife. 91 % of the respondents are Muslim. The distribution ages of the respondent are spread with 26.6% of total respondent for the ages between 17-25 years old, 26-35 years old, and 36-45 years old while there are 12% of respondent's ages between 45-55 years old and 4% of respondents ages are above 55 years old. The distribution of income among respondents is also quite widespread. There are 17.3% of respondents have income between Rm.500 to Rm. 1,499, 36% have income between Rm. 1,500 to Rm. 2,499, 25.3% have income Rm. 2500 to 4,499, 4% have income between Rm. 5, 000 to 6, 999, and 4% have income more that Rm. 7000

The distribution of respondents that have investments in Islamic capital market is also spread across the employment sectors. Among 20 people who have investment in Islamic capital market, 4 people are working as government employee and in private sector, 5 people are business owner, and 3 people are from others work while none of the housewife has investment in Islamic capital market. In addition 3 respondents out of 20 respondents that have investment in Islamic capital markets are between 17-25 years old, 4 people between 25-35 years old, 7 people between 35-45 years old, 5 people are between 45 -55 years old, and one respondent are above 55 years old. Table 17.1 and 17.2 shows the distribution of demographic data and the distribution of investors that have investment in Islamic capital market.

Table 17.1 Demographic Data

Grouping Variables	Frequency	Percent
Gender (n =69)		
Male	34	45.3
Female	35	46.6
Age (n =72)		
17-25 years	20	26.6
26-35 years	20	26.6
36-45 years	20	26.6
45-55 years	9	12.0
above 55 years	3	4.0
Religion (n =70)		
Islam	68	90.6
Non Islam	2	2.6
Income (n =65)		
Rm500-Rm1,499	13	17.3
Rm1500-Rm2,499	27	36.0
Rm 2500-Rm4,999	19	25.3
Rm5000-Rm6999	3	4.0
Above Rm7000	3	4.0
Employment Sector (n =70)		
Government employee	12	16.0
Private Sector	17	22.6
Lecture	11	14.6
Own business	12	16.0
Housewife	2	2.6
Others	16	21.3

Source: Author

Table 17.2 Investment in Islamic Capital Market

Group	Yes	No
Employment sector		
Government employee	4	8
Private Sector	4	12
Lecture	4	7
Own business	5	8
Housewife		2
Others	3	13
Group		
Age		
17-25 years	3	17
26-35 years	4	16
36-45 years	7	13
45-55 years	5	4
above 55 years	1	2

Source: Author

Main Findings

Result showed, only 26.7 % of the respondents have investment in Islamic Capital Market. 48 % of the respondents always checked the *Halāl* label in other word almost half of the respondents having Shari'ah consciousness. With regard to the choice of investment 36 % of the respondents prefer to set up a new business, 29.3 % buying a new house, 20 % prefer to have fixed return saving account, and only 6.7 % of the respondents choose to invest in stock market. It is reflected that people interest to invest in stock market less preferred then others choice of investments.

However, for about 44 % of the respondents should be expected to invest in Islamic capital market. Only 10 % of the respondents said not likely at all to invest in Islamic capital market. This indicates that, people do have interest to invest in Islamic Capital Market. Barrier like lack of information with regard to the Islamic Product could be the reason of low number of Muslim who invests in Islamic Capital Market.

The finding of this research shows many interesting results. Unlike the investor behaviour in conventional capital market, risk attitudes do not have any influence to the interest of prospective investors that want to invest in Islamic capital market and to decision of investor that have invested in Islamic capital market. Therefore,

this research assumes that risk attitudes are not the main reason why people chose to invest in Islamic capital market.

Contrary to the risk attitudes, Shari'ah consciousness was found as has significance correlation to the interest of prospective investors of Islamic capital market with 27.5 % correlation and significance at 5% Alfa level. Interestingly, Shari'ah consciousness has significance negative correlation to the decision of investors that have made investments in Islamic capital market. This result is so surprising, why prospective investors consider Shari'ah consciousness as the reason why they are interested to invest in Islamic capital market but in contrast investors that have invested in Islamic capital market do not invest because of Shari'ah consciousness. Several explanations can be raise to answer this phenomenon. First, those investors see the Islamic capital market products as profitable investments and they do not so concern with the Shari'ah compliance of those investments. This result supported by the finding that there are no significance correlation between religion and interest to invest in Islamic capital market. Second, the prospective investors, especially the Muslims who interested to invest in Islamic capital market do not have channel or proper information to Islamic investment companies. Therefore, they do not execute their interest by make a decision and action to invest in Islamic capital market.

Similar to Shari'ah consciousness, spirituality was found not correlated to the reason the reason why investors invest in Islamic capital market. However, spirituality has positive correlation with the interest of prospective investors in Investing in Islamic capital market but it is not significance. Spirituality also found has significance and positive correlation (26.3%) with Shari'ah consciousness at 5% Alfa level. Since prospective investors who interest to invest in Islamic capital market have high level of Shari'ah consciousness and people who have high level of Shari'ah consciousness have high spirituality. It is good for Islamic investment companies especially the marketing manager to provide marketing strategy that can touch the community who active in developing spiritual characteristics, such as religious group discussion, mosque communities, etc. Marketing managers of Islamic investment companies also can develop marketing strategy by using Shari'ah sensitivity motto as the branding of their investments products. Islamic investment companies also should provide easy access and mass marketing in order to attract the Shari'ah consciousness investors. It is important since many prospective investors that have higher level of Shari'ah consciousness still not invest in the Islamic capital market yet.

Among the demographic variables, only gender that has positive correlation (23.3%) with the interest of prospective investors in invests in Islamic capital market with significance at 10% Alfa level. age religion, income, and employment sectors have found no correlation with the investor's interest in Islamic capital market. Therefore, marketing manager of Islamic investment companies can use

the gender approach as their marketing strategy in approaching the prospective investors to invest in Islamic capital market.

5. CONCLUSION, LIMITATIONS AND SUGGESTIONS

Risk attitudes were found has no correlation with the investment decision of investors as well as prospective investors to invest in Islamic capital market. Shari'ah consciousness was found has correlation with the interest of prospective investors to invest in Islamic capital market. However, Shari'ah consciousness is not the main reason why investors invest in Islamic capital market. Spirituality was found has correlation with the interest of prospective investor to invests in Islamic capital market but unfortunately the correlation is not significance. However, spirituality has positive and significance correlation with Shari'ah consciousness. Therefore, marketing managers of Islamic investment companies can develop more targeted customer strategy to the "spiritual community" such as religious group discussion, mosque community, etc in order to attract them to invest in Islamic capital market as well as use Shari'ah compliance sensitivity issue in branding the Islamic capital market products.

There are several limitations and suggestions of this study. First, the number of respondents who has invested in Islamic Capital Market is too small. Therefore, it is better for future research to increase the sample size and control the sample by selecting 50 % participant who already invests in Islamic capital market and another 50 % from the one who have not yet invest in Islamic capital market. In addition, since the numbers of the sample can not representing the investors and prospective investors of Islamic capital market as a whole, the results of this researches can not be generalized yet to the entire population of Islamic capital market investors. Second, the sampling method that using convenient and snow ball sampling that been used in this research cannot reflect the real condition of investors and prospective investors. Third, there are many researches that should be done to cover the limitation of this study since there are not many studies that discuss the behavioral science of Islamic investors in Islamic capital market. As example, it is important to identify again the classification of risk attitudes of Islamic investors. It is also important to analyze how Islamic value differentiates the perception of Islamic investors toward risks. In addition, future research also can explore factors that might enhance prospective Muslim investors to invest in Islamic capital market. However, it is better for future research to be more focus in analyzed these issues. As example, future research can conduct research on the influence of gender on risk attitude in Islamic capital market, or shari'ah consciousness and investment preferences in Islamic capital market.

Notes

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Developing Capital Markets in Muslim Countries: Strategies and Policies for Securities Regulation and Corporate Governance

Ali Adnan Ibrahim *

ABSTRACT

This paper examines comparative scholarly perspectives on developing regulatory framework and corporate governance regime with specific reference to the Muslim countries and the Islamic financial services industry. The paper spells out salient features of legal reform policies, governance and regulatory strategies that are likely to help these countries in not only nurturing Islamic finance internationally but also growing their indigenous capital markets.

A well developed, integrated, homogeneous Islamic securities market may provide for a regional hub for Islamic finance. Such a market, among others, will be able to compete with the international markets in attracting bulk of Islamic finance due to their established regulatory framework. In the absence of such integrated markets, only a few Muslim countries will be able to retain international participation while the bulk of capital will fly to the more developed international financial markets.

1. INTRODUCTION

The Scope

During its brief history, the growth of Islamic finance has not been a jurisdiction-specific phenomenon. It has been winning popularity in almost every significant financial market. It is equally true that Islamic finance has to undergo a long journey before achieving a true global identity. Flashing success and increasing familiarity at the global level is expected to direct this journey in the right direction. Continued intellectual efforts will continue to supplement the industry's consistent growth.

In the above backdrop, it is pertinent to raise some questions. Are there any home jurisdictions for Islamic finance? If so, how such jurisdictions could attract international participation to take Islamic finance beyond-local. If home jurisdictions fail to attract international investments, whether there are prospects of Islamic finance flying to more established markets for preserving its international

character. If the answers are in affirmative, we need to examine the market structures that can make such a difference. Thus, the regulatory and comparative corporate governance analysis becomes significantly relevant.

Some recent scholars maintained that a wholesale export of the regulatory and corporate governance structures of successful markets is essential for establishing deeper and broader markets in the Muslim countries. The proposition infused one of the most profound scholarships in the context of international financial market regulation. The critics argue against this formal convergence and highlight various informal aspects of successful markets that can only be homegrown and cannot be borrowed.¹

In view of the aforesaid convergence debate, the paper will examine the scope and nature of regulatory policies and corporate governance strategies to be adopted by the Muslim countries with reference to Islamic finance, and in general. Among others, the paper seeks to explore: Whether the policies and strategies developed and practiced in the successful international financial markets could be relevant to Islamic finance and/or to Muslim countries; Whether a wholesale export of such policies could lead to a bigger problem; and What, if any, policy filters may be applied in learning from the experiences of the established markets.

The Prospects of Islamic Capital Market Today

Unlike some of the recent capital market products and *takāful*, the mainstream Islamic finance still appears concentrated in the form of Islamic banking. Islamic banking, however, remains increasingly a phenomenon in which the some of the GCC member countries dominate. For instance, as of 2005, ninety-seven Islamic banks were operating throughout the world. Approximately fifty-eight percent of them are in the Arab world. Eighty-three percent of the total assets of the Islamic banks are in the Arab world.² Consumer financing appears to be the overwhelming trend in Islamic finance,³ which indicates increased demand from the Muslim middle class.⁴

The above does not in any way criticize the growth spectrum of Islamic finance. Instead, it is presented to highlight a point of inquiry: Whether Islamic finance is truly becoming global or is it on the right track for becoming so. Given the nascent history of Islamic finance, the industry definitely aspires to become global but it is not there yet.

In this background, it is pertinent to pose some other questions: Whether the indigenous demand-and-supply efficiencies are *per se* less significant in uplifting Islamic finance from what may be termed as concentrated in one geographic region; Whether the success of Islamic finance is in any proportion relevant to a host jurisdiction; Whether a set of regulatory framework and corporate governance regime important for the success of Islamic finance in any given jurisdiction; and Whether the strong international financial markets run a greater chance in contributing to the ongoing success of Islamic finance than any Muslim country.

Affirmative responses to the above questions would lead the analysis at a deeper level.

The Roadmap

This paper examines the scope and nature of regulatory policy and corporate governance strategies with reference to Islamic finance. In the examination, the paper seeks to explore the following scenarios: Whether success of Islamic finance is equally relevant to the regulatory policy and corporate governance strategies of the countries where it is more naturally ingrained or rooted; Whether the policies and strategies developed and practiced in the broader and deeper financial markets of the world could be relevant to Islamic finance; Whether a wholesale export of such policies could lead to a bigger problem.

In sum, the paper will evaluate the possible reform strategies that the Muslim countries, which contemplate taking serious measures in Islamic finance's growth, can develop to attract more international investor participation. After this introduction, which constitutes the first section, the rest of the paper is organized in four main sections. Section 2 of the paper discusses various aspects and relevant issues for the formation of capital market in the Muslim countries. Section 3 sets out the contemporary debate over the convergence of corporate governance in the context of Muslim countries. Section 4 outlines issues relating to the securities markets regulation in the Muslim countries. Section 5 provides the conclusions.

2. DEVELOPING CAPITAL MARKETS IN THE MUSLIM COUNTRIES

2.1. What Steps Need to be Taken?

Capital markets facilitate securities' transactions in debt and equity and thereby supply financial resources in the financial markets. With increased activity of transactions, access to cash becomes easier and the capital markets become efficient, creating enough liquidity in the market that spreads the economic and financial benefits to the market participants. More the number of the participants deeper get the capital markets, and, therefore, deeper markets generate a larger financial activity. Deep capital markets improve economic growth at micro and macro level.⁵ Or, put differently, there is simply a larger pool of available capital that enterprises can tap into to finance their activities.

Owing to divergence of issues in the debt and equity markets, the discussion below mainly refers to the equity markets.

Legal Reforms and the Capital Market Development

Recent empirical studies have shown that developing capital markets is a result of appropriate legal framework, or that "law matters." The "law matters thesis,"⁶ mainly emphasizes strong protections for the minority shareholders.

Since the capital markets contribute to the economic growth and development, poor investor protection results in smaller capital markets. Accordingly, good legal protections for investors and economic development are interlinked.⁷

Recent studies bring evidence in an effort to answer why the United States and the United Kingdom have larger equity markets than Germany in France, and found that protections by way of legal rules and their enforcement have strong effects on the size and breadth of capital markets.⁸ Good legal protection of potential financiers against possible expropriation by entrepreneurs ensures more funds, and hence expands the size of capital markets.⁹

The variables that are relevant to explain U.S. and European capital structures have been found relevant in the similar analysis for the Muslim countries, including other developing countries.¹⁰ However, development of financial and securities markets in the Muslim countries requires more specific studies that could, *inter alia*, examine the cultural practices and social norms to identify the “general structure and efficiency of legal systems” in such economies, and thereby inform the reform process for appropriate corporate law and governance. While categorizing corporate governance initiatives to economic and legal institutions, an argument suggests that a political process may change such institutions for the better.¹¹

In sum, capital markets, including those in the Muslim Countries, cannot flourish without an appropriate legal framework that reduces subjective decision making and encourages transparent and objective enforcement of laws and the related regulatory framework. Certainty as to the working and fairness of the systems will attract more participation in financial market, and will curb interest groups that benefit from its weakness. Law should also build upon the social and cultural factors that enjoy similar force or obedience, such as customary laws.

Agency Problems: Self-Dealing and Investor Protection

In general, the foundations of the market systems include compelling transparency, prohibiting insider-dealing and policing self-dealing.¹² “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”¹³ and it also “deals with the agency problem: separation of management and finance.”¹⁴ Investor protections and market development go hand in hand in the real world, and if “protections are absent, one-sided deals flourish and outside equity capital either becomes more expensive or dries up altogether.”¹⁵

To counter the agency problem, one of the arguments is that small investors cannot be attracted to the business of financing companies without legal protections against expropriation by managers and large investors.¹⁶ Greater protections for shareholders strongly predict the stock market development.¹⁷ Effective regulation of self-dealing is the fundamental element of shareholder protection¹⁸ that also results in dispersion of ownership.¹⁹

The corporate model of “separation of ownership and control”²⁰ is popular in the richest common law countries. Outside the United States, especially in countries with poor investor protection, the largest firms tend to have controlling shareholders.²¹ There may be greater reliance on debt financing rather than equity financing in such countries.²² Ownership concentration is a consequence of poor legal protection of minority shareholders.²³ However, in concentration of ownership, the protections for investors may be complementary to corporate governance.²⁴ On a related issue of redistribution of wealth in the economy, the large investors could be ineffective, even though they may effectively control the agency problem.²⁵

In countries with poor protections, the larger firms have ultimate owners, such as family, State or financial institutions.²⁶ Globally, forty-five percent of the medium-sized firms are family-owned. Bank-based ownership structure, like in Germany, is not the most common one; it is the family ownership.²⁷ But, in countries with poor investor protection, widely held firms are otherwise exceptions.²⁸ However, the family control is likely to facilitate corruption, and is more important in the most corrupt countries.²⁹

By limiting expropriation, the law raises the securities’ price in the market, and thus encourages more entrepreneurs to seek external finance. This expands the financial markets.³⁰ In countries of poor investor protections, poor shareholder protections result in lower valuations, but the higher cash-flow ownership by the controlling shareholders improves valuation.³¹

Quality of information regarding the value of company’s business and confidence against self-dealing are the preconditions for strong public securities markets.³² Honest courts and government, regulators and prosecutors are important, and should be homegrown before the market development.³³ Suggestions for long-term steps include strengthening business and law schools, training young people and developing reputation intermediaries.³⁴ The reputation intermediaries, however, are not likely to grow in anticipation of market growth; but their increasing demand will facilitate their growth in the Muslim countries.

The studies have examined anti-self-dealing measure for their relationship to financial markets development³⁵ and found that a high anti-self-dealing index was associated with valuable stock markets.³⁶

While laws against self-dealing—and their effective enforcement—are crucial for the Muslim countries (and other emerging markets), the Muslim countries (and other economies in transition) face the additional challenge of “twin agency problems” in international investments and financial globalizations. That is to say, one of the corporate insider’s discretion and, the second, of the political or state-ruler’s discretion. The central role of the twin agency problem appears to remain unaffected for fostering ownership concentration.³⁷ “[I]nvestment in corporate governance is less profitable in countries in which the agency problem of state

ruler discretion is significant because many activities that entrench corporate insiders help reduce the risk of expropriation by the state.”³⁸

Fighting agency problem is equally crucial for the Muslim Countries. Effective transparency and accountability will ensure flow of the corporate profits to the investors. Expectancy of profit and security of investment will encourage a larger number of investors to move their bank deposits to the capital markets, a trend that is direly needed in the Muslim Countries.

‘Minimum Standard of Treatment’ and Investor Protection

Axiomatically, investment disputes erode the goodwill of a host jurisdiction. Some international investors have invoked bilateral investment treaties before the International Center for the Settlement of Investment Disputes (ICSID) in cases involving capital market products where the host state, as asserted, failed to accord minimum standard treatment. Filing of such cases is unprecedented and raises unique questions of international law for the investor protection. The cases remain pending final adjudication.³⁹ However, scholars consider the minimum standard doctrine to be indeterminate and leaving the governments with vagueness as to the prohibited treatments of foreign investors.⁴⁰ Such indeterminacy is likely to breed more litigation.

In particular, if dragged into international investment litigation, the Muslim countries will find themselves in a difficult situation in trying to restore the foreign investor’s confidence, if the lose it once. Therefore, the strategy should be to include consistent and unambiguous investor protection policies.

Effective Enforcement of Laws

It has been argued that effective law enforcement by the legal institutions is more important for enterprise finance in the transition economies, including the Muslim countries, than the laws on the books.⁴¹ This argument will be accurate upon assumption that there is no room or possibility for improving the laws on the books, and effective enforcement is the only option for ensuring best results in the given scenario. However, this assumption simply does not exist in the Muslim countries. Almost competing with each other, the emerging Muslim countries are taking serious measures to improve the legal framework mainly for attracting foreign investment. In these circumstances, the Muslim countries must be reminded that effective enforcement will always be equally important. Put differently, modern legal reforms should go hand in hand with the improvements in the enforcement mechanisms.

Scholars have considered public involvement to be crucial for the development of financial markets and, therefore, the public sector has a key role to play: designing the rules that may be enforced.⁴² Arguing further, it was noted that securities law matter, as it facilitate private contracting⁴³ and that financial markets may not prosper if left to market forces alone.⁴⁴ Without taking the above

arguments in the proposed generality, the above arguments appear more relevant for the Muslim countries that are yet to ensure either basic legal protections or, if such protections exist, their effective enforcement. In the absence of substantive rights and their effective enforcement, the emerging capital markets are not likely to mark their success. Features like market discipline, private litigation, private contracting, standardized disclosure and private dispute resolution within market-friendly standards of liability have been considered relevant for stock market development.⁴⁵ In the Muslim countries, the above features would be relevant if introduced gradually and in a culturally neutral manner.

As recently confirmed, expensive implementation through a focused regulator,⁴⁶ democratic and political rights,⁴⁷ criminal sanctions,⁴⁸ and fines⁴⁹ do not matter for developing stock markets. However, the above would matter for the Muslim countries, although the studies do not specifically address the issues of Muslim countries in this respect. Developing capital markets are usually dominated by interest groups that stall the reforms that seek to circumvent their vested interests. Such groups promote insider dealings and related market abuses to the detriment of the other market participants. Proper enforcement, through legal institutions and effective regulator, criminal sanctions and fines, will safeguard against expropriation, and will help prevent destabilization caused by the market abuses. As for relevance of democratic and political rights, they will allow common understanding of corporate democracy and empower minority shareholders to assert their rights. As such, in the absence of the developed market legal and non-legal institutions, the role of the regulator, criminal sanctions and fines become more significant to help avoid market malpractices, and across the board enforcement is likely to encourage the market growth.

Effective and transparent accountability at the macro-level strengthens people's confidence on their rights, and discourages those who would benefit from the weaknesses of the system. Developing capital markets cannot grow if norms like the rule of law are missing in society. A general tendency to disregard the rule of law, which, unfortunately, is perceived to be widespread in most of the Muslim countries, shapes a culture of lawlessness that not only adversely impacts the growth of the capital markets but also the overall economic growth. The culture of lawlessness breeds expropriation in the developing capital markets. Therefore, for the Muslim countries, the legal culture of effective implementation and enforcement should receive greater attention, because no legal or regulatory measures would be fruitful in its absence.⁵⁰

2.2. Other Considerations

The Formation of Trust

Illiteracy is rampant in most of the Muslim countries, and the appreciation for the human interaction and collective engagement in civic activities is accordingly lacking. Indeed, most of such population cannot read and write, and live in a

dreadful poverty. Mobilizing them toward positive civic and infrastructural engagement would entail allocation of substantial financial resources that first of all help them meet their needs. Painfully, most of the Muslim countries lack such financial resources. Therefore, society's ability to foster social capital remains seriously impaired. For the same reasons, impairment is far greater for expanding network of social capital to foreigners.

Lack of trust in a society may result in judicial system that cannot guarantee reliable enforcement.⁵¹ As defined, "trust is a habit formed during a centuries-long history of horizontal networks of association between people, covering both commercial and civic activities."⁵² Building upon an existing argument that "trust or social capital determines the performance of the society's institution,"⁵³ some scholars have explored "the forces that encourage the formation of trust" and endorsed the argument. The scholars noted that "trust should be more essential for ensuring cooperation between strangers...than for supporting cooperation among people who interact frequently."⁵⁴

Regarding foreign investment in the Muslim countries, one of the main questions appears to be whether foreign investors would trust the local investors for participation in their ventures, and vice versa. Formation of trust, therefore, appears essential in the Muslim countries. However, it has been argued that securities laws may serve as proxy for trust.⁵⁵ But such laws can only serve the purpose if the capital markets are already popular and flourishing. In order to create such a level of growth, developing and strengthening trust within the society appears essential for the Muslim countries.

An analysis is important as to how a particular society regards people from different social origins. One social force that encourages—or discourages—social interaction stems from religion. Empirical confirmations are available that "hierarchical religion discourages horizontal ties between [the people] and hence the formation of trust."⁵⁶ The findings suggest that adherence to hierarchical religion, including Christianity, are likely to lack formation of trust within the society. However, other studies have found better enforcement and protection of creditors' right in Protestant countries. The reasons explained in this regard include that centralization arises out of people's dependence on a religious group for seeking knowledge, and hence does not encourage people to seek knowledge independently. Specific studies in regard to the Muslim countries analyzing effects of religion on the capital markets in such economies are not available. Future studies highlighting such issues will assist the Muslim countries devising future strategies for the growth and development of the capital and securities markets.

Because a majority of the Muslim countries share a history of colonization, the Muslim countries may not be able to ensure formation of trust with the foreign investors because of the historical sentiments of dislike toward the foreigners, and such sentiments may still exist at the micro-level. The scholars, while discussing issues regarding formation of trust, have not discussed this possible aspect of

inquiry. The scholars have also erred in their finding about the Muslim emerging markets.⁵⁷ Therefore, a comprehensive work examining the development of trust that is essential for the growth of capital markets is needed.

As for developing trust between the locals and foreign investors in the Muslim countries, such formation of trust is likely to occur more easily after the capital markets have started to be profitable to the locals. Profit motives will make it easier for the locals to more openly welcome the foreign investors in the capital markets. Policies of attracting foreign investment in the Muslim countries lack understanding of this aspect and rely more on developing the market through the foreign investment. Such approach is less likely to work. The locals without having the opportunity to maximize their wealth in their own capital markets are likely to resent the foreign investors, and may classify them at par with the colonial looters. Such sentiments would work against the developing strong capital markets in the Muslim countries.

Cultures and Customs⁵⁸

While understanding corporate governance across countries, culture—including religion—must be kept in view. In other words, culture matters.⁵⁹ Some scholars have found correlation between culture and development of debt and banking markets.⁶⁰ Other scholars have highlighted its relevance for developing capital markets.⁶¹

(a) Norms and Law

A notable scholar has suggested a significance and prevalence of norms in circumstances where the law remains weak or fails to provide reasonable protection. Noting a converse suggestion, it was added that the importance of norms is likely to fade away when law provides adequate remedial recourse.⁶² However, it remains to be seen whether the established social norms in the developing economies are likely to persist; notwithstanding the introduction of new rules that remain unfamiliar, unless the new rules draw upon the existing norms.⁶³ Indigenous culture can reassert itself forcefully in transition economies,⁶⁴ including the Muslim countries. The studies have discussed countries' adopting "their legal systems involuntarily (through conquest or colonization)"⁶⁵ but such studies did not examine the efficacy of such rules. These rules may well be on the books even enforced, yet it is debatable whether such rules enjoy popularity at the grass-roots level. The people in such societies may still look for a customary or religious source of law.

Evaluating drawbacks of the cultural norms, a relationship-based system of governance may be more practical for the Muslim countries, but it will inevitably result in the misallocation of capital that discourages the entrepreneurs.⁶⁶ As another drawback of a relationship-based system, it will exclude foreigners from the operating circle of the market.

(b) Customary Law

Informal constraints, social norms and formal laws could be categorized as “institutions” within the meaning ascribed thereto by the neo-institutional economics.⁶⁷ Customary law fits well in the category. Customary law may be understood as part of the conscience of a community⁶⁸ and exists even in the modern communities parallel to the statutory law.⁶⁹ More specifically, “custom become law when it is known to be law, is accepted as law and practiced as law.”⁷⁰ Adherence to the principles of Islamic finance and success of Islamic financial services reinforces the argument in favour of the persistence of the customary law in the Muslim countries.

To date, not only that such customary laws are deeply entrenched and strongly adhered to in the Muslim countries but also that their statutory and judicial recognition continues in the prevalent legal system.

The scholars on corporate governance and transition economies, however, have not discussed the role of customary law in defining corporate governance regime for the Muslim countries. Specifically, the analysis is missing as to whether corporate governance reforms are likely to conflict with existing customary law in the Muslim countries; and, if so, whether the customary laws are likely to persist. The scholarship does not shed light on whether the customary law plays a significant role in shaping corporate behaviour and ownership structure in Muslim countries. Future studies examining customary law in the context of capital market growth are likely to inform the scholarly debate highlighting the ignored aspects of the Muslim countries.

To coexist with the customary law, the modern reforms should take into account the customary law in such a way that the regulatory structure is built with due recognition of it. The process of removing any inconsistencies, if found, between the substantive rights and the customary laws, should be staggered and achieved gradually. Further discussion in this regard is also set out below.⁷¹

3. CONVERGENCE OF AND POLICIES FOR CORPORATE GOVERNANCE IN THE MUSLIM COUNTRIES⁷²

For transition economies, including the Muslim countries, there is a desire to catch up with the western standards, leading the wholesale transfer of commercial laws to the transition economies.⁷³ Convergence of this nature limits corporate evolution.⁷⁴ Reforming corporate governance is a matter of comparative institutional analysis.⁷⁵ Indiscriminate mixing of legal rules may result in a dysfunctional or unbalanced system lacking certainty. The results are likely to be worse if an ineffective rule is borrowed from any internationally recognized standards.⁷⁶ The scholars have expressed serious doubt for the success of transplanted reforms without developing “complimentary institutions”⁷⁷ or “institutions.”⁷⁸ However, some scholars recommended selective incorporation of

foreign regulation into one country's law for the possibility of offering an economical and efficient means of transforming the legal structure to attract foreign investment.⁷⁹

Although formal convergence is likely to face several obstacles, functional convergence is achievable through international securities markets, as seen when a foreign firm migrate to the U.S. equity markets.⁸⁰ As a general rule, however, the mere transplantation of laws to transition economies, including the Muslim countries, may not accomplish the goals of developing strong capital and securities markets if the government continues to maintain a major role in the economic decision-making of the private sector.⁸¹

3.1. Convergence of Corporate Governance and the Muslim Countries

Most of the Muslim countries do not have the Anglo-American dispersed ownership structure, but rather a concentrated corporate ownership structure, like those in developed civil law countries. While the securities market in the Muslim countries might develop like the Anglo-American model in the long run, as long as the current ownership structure persists, an analytical recourse to the current corporate governance regimes in France, Germany and Japan appears advisable—on account of the resembling structures of concentrated ownership. As such, scholars have suggested that the transition economies would be better served if they benefit from the corporate governance systems of Germany and Japan.⁸² To the contrary, the Muslim countries borrow heavily from the countries of common law origin.⁸³

Notwithstanding the fact that countries with common law origin were rated higher than countries of civil law origin in providing safeguards against related party transactions and for “predict[ing] stock market development,”⁸⁴ a comparative recourse to the civil law countries appears beneficial for the Muslim countries. One of the reasons is for such recourse is to be able to identify the real problem and look for any similarities in other countries. For instance, issues of corporate governance related to the concentration of ownership may be resolved with an analytical lesson from the other jurisdictions having resembling ownership structures. Choosing jurisdictions for finding a short-cut legal solution may amount to taking wrong medication for a different symptom. As noted recently, shareholder and creditor rights in the Muslim countries (or, for that matter, in the emerging markets) do not develop as a result of a country's historical association with a particular legal origin.⁸⁵ At times, the experts advising such reforms incorporate provisions from the law of a particular origin or a country.⁸⁶

However, sharp distinctions between the common law and civil law no longer exist. The countries, once having a specific legal origin, now share the traditions from their counterpart. In this way, the distinctions that once existed in history have largely diminished over the time. Put simply, the Muslim countries may either be part of commonwealth, and not common law countries, as apposed to

belonging to a group of imperialist countries, which once were known as civil law countries. A blanket denomination of civil law and common law countries does not accurately convey the meanings for the present, but would make sense if used for the ease of reference to identify the historical perspective. Therefore, substantive rights for protecting minorities and investors in general do not necessarily emanate from the legal origins, and both the concepts exist independent of each other.

A study finds the legal rules and their enforcement for investor protection to be higher in the common-law traditions.⁸⁷ Another study has found a correlation between stock market development and the countries' legal origin.⁸⁸ As discussed above, regarding the diminishing distinctions of common law versus civil law, it is unlikely that such distinctions could provide any assistance to improving our understanding of the Muslim countries. The laws in the Muslim countries are less influenced by the legal origins but are framed more on the basis of local needs and international relations.⁸⁹ A recent work has confirmed the nexus of international relation with the legal development in corporate governance.⁹⁰ Convenient access to the modern legislation internationally appears to be the current driving force in the Muslim countries. Before advancement of informational technology, such access was limited to conventional sources, and the choices were limited to the familiar legislation from the imperialist origin.

Besides irrelevance of legal origins to the Muslim countries, converging to the U.S. model of corporate governance would mean adopting the shareholders' model of maximizing the shareholders' wealth.⁹¹ However, in a concentrated corporate ownership structure, like in most of the Muslim countries, maximizing shareholders' interest would result in enrichment of fewer people and would adversely affect the market development.⁹² The shareholder's model, therefore, may not be workable for achieving "thick and deep equity markets" in the Muslim countries. As noted below in the concluding remarks, political drive to alleviate poverty coupled with the peer-pressure for corporate philanthropy, initiatives for social welfare are expected of the successful firms in countries like Pakistan. In addition, many laws require firms to contribute to the employees' provident, benevolent and workers' welfare funds in addition to subjecting the corporate earnings to *zakāt*.⁹³ Therefore, to coin a new expression, "socially responsible shareholders' model" may become the dominant corporate model for many years to come. Furthermore, in the future, it would be quite logical to expect a mandatory corporate social responsibility regime to be a part of corporate governance regime in the Muslim countries.

The likely role of a corporation in social development in the Muslim countries does not coincide with the Anglo-American model. Therefore, a strict convergence in the Muslim countries is not likely to be possible, despite strong international pressures.

Finally, as noted recently, convergence to the international corporate governance regimes may be more likely only to the extent that such regimes seek to enhance investor protection, transparency and accountability. Such objectives are equally noble to Shari'ah. On the other hand, transactional divergence (as opposed to convergence) is likely to persist for inherent differences between Shari'ah and the conventional finance in regard to a number of transactions.⁹⁴

3.2. Transplantation of Laws, or Formal Convergence

Indigenously developed legal framework that takes into consideration main concerns of investor protections, effective accountability, and transparency and ensuring effective enforcement will survive the criticism against convergence. The scholars do not approve of transplanting laws alone; they seem to suggest transplanting institutions too. This form of convergence is workable only if the emerging capital and securities markets start moving toward "functional" or "stealth" convergence. Functional adaptation will provide a hint that the markets are ready for the formal transplant of laws and institutions to the extent of functional convergence. At this juncture, the formal rules to provide back-up for the functional convergence should keep in view the social and cultural considerations, as discussed above.

Put differently, despite supply of foreign legal rules, the legal reforms in Muslim countries tend to respond to the legal change rather than leading it,⁹⁵ or a gradual policy approach.⁹⁶ Countries implementing economic reforms gradually coupled with "legal and other institutional reforms have developed more effective institutions than those that pursued a radical reform agenda."⁹⁷ Therefore, improving the law gradually and keeping in view the market development and response will be more beneficial to the Muslim countries.

Furthermore, in the Muslim countries, the market structure may have a strong connection with the legal origins. Based on a recent study,⁹⁸ the UK, Australia and Hong Kong have similar regulatory framework, which could be a result of their common law background. Other scholars found better corporate governance in the countries of common law origin.⁹⁹ However, recent establishment of Capital Market Authority of Saudi Arabia apparently ignored the legal origin question and the Capital Market Law of 2003 was designed mainly on the common law model,¹⁰⁰ or the "Flexibility Model." The success of the Saudi capital market law remains to be examined; and such an examination will enrich the debate of legal origin on the formation of corporate law and securities regulation.

4. STRATEGIES FOR REGULATION OF SECURITIES MARKETS IN MUSLIM COUNTRIES

4.1. Objectives of Financial Regulation

Objectives for financial services regulation include protection of public investor, elimination of externalities from the failure of intermediaries,

redistributive policies, equitable norms and consideration of political economy,¹⁰¹ and “elimination of financial crime and international terrorism.”¹⁰² There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions.¹⁰³

As for the emerging securities markets, a combination of market institutions and regulations ensure effective corporate governance.¹⁰⁴ Well-regulated stock exchanges will make raising finances convenient. This can lead to economic growth, without having to deal with the drawbacks associated with the foreign aid and borrowing.¹⁰⁵ In addition to the legislative and regulatory measure, the stock exchanges, as frontline regulators, may improve corporate governance practices by protecting investors and maintaining the integrity of securities market.¹⁰⁶

Issuers' Choice

In the post-globalization scenario, with lowered barriers to capital and instantaneous information flow, securities markets compete and issuers chose the market on which to list their securities,¹⁰⁷ and would be subject to one set of liability standards and enforcement remedies.¹⁰⁸ Taking advantage of this trend, issuers, particularly from transition economies (including the Muslim countries), may raise equity capital from the market of their choice.¹⁰⁹ However, the issuers from the developed markets may not find it advantageous to chose the emerging securities markets. Availability of “viable”¹¹⁰ and internationally competitive and securities markets in the Muslim countries is likely to change the trend.

Issuers opt for international listing for financial reason of raising capital at a lower cost and higher valuation for their business on account of foreign identity.¹¹¹ However, due to lower exchange rates, it appears difficult for companies in the Muslim countries to pay dividends in a currency of a higher value. For instance, the dollar amount is always going to be higher in most of the Muslim countries when it comes to payment of dividend to the shareholders in the international markets. With the expectancy of profit always likely to be lower, the issuers from most of the emerging securities markets may not have the advantage of raising financial capital at the developed markets.

In the absence of sufficient legal and regulatory infrastructure¹¹² the Muslim countries cannot offer sophisticated and internationally competitive securities law. With the lack of competitiveness of the emerging securities markets, the foreign investor from the developed economies might stay home,¹¹³ instead of choosing to list on emerging securities markets. On the other hand, the lack of international competitiveness may prompt the issuers from the emerging securities markets to opt out of their jurisdictions in favour of any developed market, making it more difficult for the emerging securities markets to develop the lacking competitiveness.

In short, it appears imperative for the Muslim countries that their legal framework, in particular the corporate laws, serve the objectives similar to its

counterpart in developed economies. Essentially, it is necessary to set out governance rules that not only recognize and implement the customary law, but also maximize the value of investment¹¹⁴ and provide minority protection.¹¹⁵ Or, put differently, blending the customary law and the substantive rights for minority and investor protection into the corporate governance regime would be beneficial for the Muslim countries. Unlike the laws that are not effectively enforced for the reasons of inconsistencies with the customary law, a regime combining the substantive rights and the customary law would be easily enforceable because ensuring compliance with such regime would be easier. In this way, a better form of corporate governance would become economical and cost-efficient not only for the Muslim countries but also for the firms subject to such regime.

Regulatory Competition

Internationalized securities markets have made it easier to trade securities around the world¹¹⁶ and listing in multiple legal regimes.¹¹⁷ With the disclosed information becoming available in multiple jurisdictions, each disclosure has a different impact in different jurisdictions, introducing the possibility for the listed entity to migrate to the lower regulatory jurisdiction,¹¹⁸ or a race to the bottom. However, regarding foreign corporations abiding by the U.S. laws when they gain access to the U.S. capital markets, the evidence suggests that the corporations opted for the higher-standard regime, or a race to the top.¹¹⁹ Thus, the migrating entities exert a downward pressure on jurisdictions concerned.¹²⁰ As found by scholars, the entities may not necessarily migrate, but rather play one jurisdiction against the other in an effort to have the most suitable conditions, known as regulatory arbitrage. Regulatory arbitrage, however, is not always successful, and the jurisdictions concerned may enhance the regulatory regime.¹²¹ Also, many of the securities markets in transition have not experienced these dynamics of internationalized markets.

For regulatory competition to occur, there must be some degree of choice available to an entity to govern its activities. Additionally, the entity must also be able to move between the eligible jurisdictional regimes without incurring excessive costs. The relevant governments should also have the inclination of changing the rules in response to the choices of selection that the entity makes.¹²² The issuer choice does not generally lead to a race to the bottom. On the contrary, it worked in the opposite direction, toward higher disclosure standards.¹²³ Evolving linkages across the securities markets, like in E.U. member countries, may reduce any need for issuer choice.¹²⁴

Regulatory Intensity and Public Benefit

In general, regulatory intensity responds to the prevailing markets practices. It is difficult to measure the most desirable regulatory intensity in a particular country due to the variety of cross-country variables. Clearly, different levels of regulatory intensity exist in different jurisdictions.¹²⁵ Increased regulatory intensity is

generally beneficial to society, but carries a risk of its being counterproductive in some cases.¹²⁶ Overregulation is also likely to make raising capital costly.¹²⁷ It is generally difficult, and complex, to measure the public benefits of financial regulation.¹²⁸ As for the Muslim countries, a bare-minimum of regulatory intensity may direct and allow development in a safe and effective manner. A basic standardization in this regard is likely to be helpful. Such standardization may include the principles and objectives proposed by international organizations.¹²⁹

Regulatory structures are influenced by various considerations that vary across jurisdictions.¹³⁰ The U.S. and the U.K. share various organizational traditions, including legal and disclosure-based securities regulation, and financial regulation in general.¹³¹ Despite this, there is a substantial divergence between the regulatory structures of both the countries,¹³² with regulatory intensity in the U.K. to be substantially lower than the U.S.¹³³

Minimum Standards: Learning From the International Organization of Securities Commissions and the Organization of Economic Cooperation and Development

The *Objectives and Principles and Securities Regulation* issued by the International Organization of Securities Commissions (IOSCO) provides a basic checklist of regulatory measures. The basic IOSCO objectives premise: investor protection; fairness, efficiency and transparency of the markets; and reduction of systemic risk.¹³⁴ IOSCO further lists thirty principles in eight different categories. Such categories relate to: regulator; self-regulation; enforcement of securities regulation; cooperation and regulation; issuers; collective investment schemes; market intermediaries; and secondary market.¹³⁵ The overarching theme of the aforesaid principles could be found in IOSCO's statement that "sound domestic markets are necessary to the strength of a developed domestic economy and that domestic securities markets are increasingly being integrated into a global market".¹³⁶

As for the Organization of Economic Cooperation and Development (OECD), the OECD is committed to economic development of its member countries. To advance its objectives, the OECD issued *Principles of Corporate Governance* in 2004. Totalling seven, the principles sets out a (nonbinding) policy within with the corporate law could optimally function for sustainable economic development. The principles are: "ensuring the basis for an effective corporate governance framework"; "the rights of shareholders and key ownership functions"; "the equitable treatment of shareholders"; "the role of stakeholders in corporate governance"; "disclosure and transparency"; and "the responsibilities of the board."¹³⁷

The Muslim countries may adopt the IOSCO's and the OECD's principles for guidance and as a minimum standard. To make such adoption smooth, the Muslim countries may also consider giving themselves deadlines for the effectiveness any

of the principles. This is, however, not to suggest that the Muslim countries should export the principles blindly but after a pragmatic and comprehensive indigenous review. As suggested below, the intra-Muslim countries dialogue, would be the best forum to discuss the aforesaid principles and gradually working to build upon them.

Regulatory Models

A recent study has found that most of the developed markets have varying, and often divergent, regulatory strategies. For instance, the survey found three different models of securities regulation: “Government-led Model,” “Flexibility Model” and “Cooperation Model”. The scholars find that France, Germany and Japan have a government-led model in which the central government has significant power over the securities market regulation. Flexibility model prevails in the UK, Australia and Hong Kong where the regulatory scheme allows the government agencies to set out a policy framework while retaining some enforcement capacity. The cooperation model, as in the US and Canada, allows a greater power to market participants with strong (overlapping) market oversight through government agencies that are well-known for their forceful enforcement.¹³⁸ This is the first study of its kind that seeks to examine the regulatory diversity of the various international markets. Hopefully, future works based on the survey will help understand the optimal regulatory strategies.

A similar study for Bahrain, Bangladesh, Egypt, Indonesia, Malaysia, Pakistan, Qatar, Saudi Arabia and UAE will provide a better insight into the regulatory structure of some of the Muslim countries. The survey findings will hopefully help strategize the consistent future policies without entangling with one-size-fits-all reforms, which have more chances to bring chaos than streamlining the market.

Regulatory and Academic Cooperation among the Muslim Countries

In addition to focusing on capital market development in accordance with the *Objectives and Principles and Securities Regulation* issued by the IOSCO, consistent and optimal financial services regulatory policies across the Muslim countries will help nurture Islamic finance at a wide scale. Such policies should emanate from an intra-regulatory dialogue of capital market regulators of the Muslim countries. A dialogue of this nature should be established initially among such Muslim countries that have made significant progress in establishing adequate market regulation and enforcement. Subsequently, the sphere of this dialogue should gradually expand to the remaining Muslim countries.

Such a dialogue has already begun between the US Securities and Exchange Commission and the European Commission. Recently, it was proposed that the dialogue should also include the industry, the business and the end-users.¹³⁹ Some scholars have added academics to the list of regulatory stakeholders.¹⁴⁰ Accordingly, such a wholesome regulatory policy-making approach will help the

Muslim countries is strengthening Islamic finance in successfully developing indigenous markets and housing Islamic finance.

4.2. Regulatory Convergence in International Markets

Unlike corporate laws, securities laws are more likely to functionally converge, or, in other words, by way of “stealth convergence.”¹⁴¹ Such convergence is generally achieved by modifications (or up-gradation) in the listing regulations by the front-line regulators. Amendments in corporate laws are a time consuming process, and is less influenced by the regulatory competition and issuers’ choice. As for convergence at the level of securities regulation, this phenomenon has some similarity in the emerging securities markets where the publicly traded firms (including the listed foreign investing vehicles) have been required by the stock exchanges to comply with the codes of corporate governance, including following both new listing rules as well as the applicable securities regulation.¹⁴² Because the functional or stealth convergence may be a result of market efficiency, the emerging securities markets may have to rely more on formal convergence in order for them to achieve efficiency. However, the form of convergence that can promise efficiency to the emerging securities markets is an issue that remains largely unanswered. As discussed above, the market response will provide a good indication whether and when to introduce any modern reforms.

Although the Muslim countries may learn from the experiences of more advanced countries, they should be careful in importing regulatory structures because of the variation in the underlying differences. Such differences could be of scale, composition and sophistication of the financial services industry, regulatory objectives, levels of enforcement intensity, and levels of lawlessness of population.¹⁴³ The discussion of regulatory convergence is simplified if it implies that the adopted legal rules would be enforced optimally. Optimal enforcement would explain if there is *de facto* regulatory convergence, in addition to *de jure* convergence.¹⁴⁴ Accordingly, the evidence of convergence would be more informative if it also includes the intensity with which a transplanted rule is being enforced.¹⁴⁵

Despite benefits of international comparisons, there are numerous constraints on the regulatory harmonization.¹⁴⁶ In general, the corporate governance regime of any country affects the form and substance of its securities regulation.¹⁴⁷ Although corporate laws are more likely to converge through harmonization, the securities laws are not.¹⁴⁸ Effective securities regulation may make up the existing deficiency in corporate laws.¹⁴⁹ However, some scholars have predicted convergence at the level of securities regulation.¹⁵⁰ The “piggybacking” strategy helps the issuer to move to a better corporate governance regime by listing its shares on a foreign market.¹⁵¹ Therefore, cross-listing may be a way to achieving international convergence toward the most desirable regimes,¹⁵² despite the fact that cross-listing may not be a quick solution to improving the corporate governance—the effective measure in this regard should come from the home

country.¹⁵³ However, cross-listing could be an effective and *interim* substitute for convergence among different Muslim countries.

Cultures and Customs in Regulatory Convergence

“[A] systematic cross-cultural theory for corporate governance is urgently needed.”¹⁵⁴ The national cultures play a significant role in the origin and development of the corporate governance systems.¹⁵⁵ The “cultural infrastructure calls on people to seek guidance for conducting their personal life in social interactions in sources other than the law.”¹⁵⁶ The foreignness of modern reforms is fundamental and the “cultural value emphases may preserve and perpetuate the imprint of ancient intellectual legacies and historical initial conditions.”¹⁵⁷ All the players in the international securities markets, including stock exchanges and issuers, understand the overriding factors of distances and cultural proximities and make their moves accordingly.¹⁵⁸ The cultures and informational distances matter even for the cross-listing of securities.¹⁵⁹ Some scholars have argued that “[r]eligion is a convenient proxy for culture [but it] fails to capture the richness of cultural differences.”¹⁶⁰ “Without considering the countries’ cultural regional affiliation, the legal family classification may yield inaccurate depictions of global pattern in corporate governance regimes.”¹⁶¹

The available literature does not distinguish between culture and the customary law and may include customary law in its generality. The absence of such distinction may be the result of reliance upon scholarly works in the general areas of social sciences. A distinction, however, exists in jurisprudence.¹⁶²

Convergence vis-à-vis Specialization

It is likely that different markets specialize in trading securities of a particular type of firms.¹⁶³ This phenomenon may be developed in the emerging securities markets (including in the Muslim countries) where firms eyeing for particular incentives invest in specialized sectors. Accordingly, given the nature of incentives in various sectors by the Muslim countries, the emerging securities markets (including in the Muslim countries) may develop specialized trading expertise in the securities of a particular sector or industry.

Future Considerations for Regulating Securities Markets in Muslim countries

A standard pattern of foreign investment in the transition economies (including in the Muslim countries) suggests that the foreign investors are more attracted to industrial and related sectors mainly for cost efficiency reasons. In doing so, the foreign investors retain majority control in the investing vehicle and avoid a resisting minority by rarely diluting the ownership interests. More rights and increased protections for the minority, as reiterated recently,¹⁶⁴ may stand inconsistent with the existing business strategy of cost efficiency. Viewing this way, an inverse demand for convergence of the corporate governance regime may partly exist in the Muslim countries. The convergence to this effect could lead to

investment flight to less stringent emerging securities markets, unlike a race to the top in the developed economies.

Continued lower standards of corporate governance appears to increase the quantum of industrial foreign investment while higher standards of corporate governance, ironically, dissuades the foreign investors from diluting their ownership interest in the emerging securities markets. However, it remains to be examined whether the convergence of corporate governance could lead to investment flight to less stringent emerging securities markets.

Muslim Countries and Ineffective International Initiatives

Reforms suggested by various international organizations¹⁶⁵ and those sponsored by the international lending agencies do not appear to be helping the expansion of the securities markets. The main reason for their lack of efficacy is the unfamiliar origin of the new rules. When a significant number of potential market participants do not understand the new rules and their intent in their common parlance, they are less likely to follow them for lack of understanding. Therefore, an examination of local customs and market practices is pertinent.

As discussed above, achieving a self-reliant market is possible through implementing and, where necessary, modernizing the indigenous customary practices. Increased local participation in the emerging securities markets will be an outcome of the market ensuring protection of investment and culturally consistent and familiar corporate governance regime. Once strengthened by the local participation, foreign investment will turn to the emerging securities markets to tap the potential profits, and not *vice versa*: The market will not be profitable merely by inviting foreign investment to the securities markets.

In the event that the foreign investment in the securities market is found less likely to strengthen the securities market, the Muslim countries will be left with only the option of mobilizing the local entrepreneur to the securities market. Although this outcome would be contrary to the expectations and national policies of various Muslim countries, but this strategy should be the starting point, rather than the fall back option for failure of foreign investment to provide a kick-off start. Foreign investment will find an emerging securities market attractive if the market is already offering profitable participation. To achieve a level of increased participation, the Muslim countries need to focus on the concerns that an ambivalent entrepreneur or local investor may have. Such concerns may adequately be addressed through, among others, modernizing the corporate and securities laws in light of the persisting cultures and customary law.

4.3 Islamic Finance Regional Securities Market and Competing International Markets: A Futuristic Perspective

As recently noted, a regional homogenous Islamic financial services securities market may help Islamic finance without the usual constrains of a conventional

exchange.¹⁶⁶ The law of one price provides another possibility for the emerging Muslim countries to have integrated arrangements.¹⁶⁷ Before achieving regionalization or integration, the Muslim countries may consider harmonization, multi-jurisdictional disclosure system and an offshore free-zone to increase their competitiveness.¹⁶⁸

Scholars have recommended regional cooperation among the emerging securities markets, focusing specifically on Latin America,¹⁶⁹ Sub-Saharan Africa¹⁷⁰ and Eastern Europe.¹⁷¹ Likewise, some of the Middle-Eastern economies¹⁷² are on their way of a regional securities market. Furthermore, to launch a world-class financial centre in the Middle East, Dubai¹⁷³ established the Dubai International Financing Centre, a free-trade zone with an independent regulatory authority to oversee the activities related to the Centre.¹⁷⁴ In sum, a culturally sensitive regulatory framework and regional cooperation will promote the success of securities market in a developing country.¹⁷⁵

Absence of regional initiatives is not likely to harm the growth of Islamic finance, but may deprive a majority of Islamic countries from offering international participation in Islamic financial services. Muslim countries with stronger markets may, however, have no incentive to regionalize the Islamic finance or otherwise working toward a regional market on account of their existing or continuing success. Integration, therefore, will work better for the Muslim countries that expect to lag behind in their capital market development.

From the increasing size of Islamic finance in the next few years, it is clear that Islamic finance is going to be a permanent feature of international finance. Markets in the Muslim countries are the most natural venues for Islamic finance. However, the international participation in Islamic finance will keep pressurizing the Islamic-finance offering Muslim countries to upgrade and optimize their corporate governance and securities regulation. In a way, the international character of Islamic finance provides an incentive to the Muslim countries to harmonize their corporate and securities regime with the internally acceptable standards.

The established international markets have an advantage over majority of the Muslim countries in developing and maintaining optimal corporate and securities regime. With the increasing popularity and demand-supply of Islamic finance, the established international markets may become the popular venue for Islamic finance. In addition to some of the Muslim countries, a well-developed, regionally integrated and homogeneous Islamic securities market may give international markets a tough competition.

5. CONCLUSIONS

Comparing the corporate evolution in the developed economies with the Muslim countries provides us a better insight to the distinct features of the Muslim

countries. Comparisons *inter se* the Muslim countries will also highlight the existing strategies and policies pursued. Identification of similarities and differences will help devise better reforms strategies for the capital market development in the Muslim countries.

The lack of homegrown regulatory measures is likely to exert pressure for wholesale transfer of laws from other markets. If not passed through a well-informed indigenous review, such transfer of laws may, to say the least, slow down the process of capital market development, in addition to creating various anomalies within the existing body of laws in the individual Muslim countries.

A non-integrated capital market development in the Muslim countries may invite a race to the bottom, which may destroy such markets' credibility for a long time. On the other hand, consistent and integrated policymaking will eventually help create a race to the top. The race to the top, as compared to the race to the bottom, is a healthy competition and causes no structural damage to any competing; notwithstanding that it may become less lucrative for some or most of the losing markets. Accordingly, suboptimal markets in the Muslim countries may develop a negative incentive for the competition.

In order for the Muslim countries to avoid the shortcomings of the race to the bottom or the race to the top, an integrated market development approach appears more advisable. Such approach may, however, does not discount the significance of taking measures by individual Muslim countries toward establishing a market with legal regime that ensures and effectively administers the internationally recognized minimum substantive protections. Not doing so will eventually cause the Islamic finance to fly to, and remain, in the more established international markets.

Notes

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¹ For an overall perspective, Paredes (2004) (quoting the works of Rafael, La Porta et al.); Katharina Pistor et al. (2000); Bernard S. Black et al. (2001); Bernard S. Black (2001); Jordan, Cally (2005); William W. Bratton & Joseph A. McCahery (1999).

² Philip Molyneux & Munawar Iqbal (2005: 153) stating that 18.56% were in South and South East Asia, nine percent Africa and 14.43% in the rest of the world; and 13.05% assets are in South and South East Asia and 3.63% in the rest of the world.

³ Hegazy, Walid (S. Nazim Ali ed., 2005: 147-148).

⁴ Many international financial institutions are increasingly focusing on Islamic finance “to tap Islamic middle class.” Warde, Ibrahim (2000: 86) listing the main international financial institutions offering Islamic financial services.

⁵ See generally, La Porta et al. (1998: 1113, 1152).

⁶ This expression was employed to describe the earlier works in the series of *The Law and Economics of Self-Dealing*. For “law matters thesis,” Paredes, Troy A. (2004) [herein after *A Systems Approach to Corporate Governance Reform*]; and for “law matters,” Coffee, Jr. (2002) [hereinafter *Racing Towards the Top?*].

⁷ La Porta et al. (1998: 1152). Although there were inconsistencies found in data gathering and coding techniques, the study remains a pioneering work. Spamann, Holger (March 2006).

⁸ La Porta et al. (1997: 1132, 1149).

⁹ La Porta et al. (1997: 1149).

¹⁰ Booth, Laurence et al. (2001).

¹¹ Shleifer, Andrei et al. (1997: 738), For further treatment of the argument, Stulz, Rene M. and Rohan Williamson (2003: 346); Roe, Mark J. (2002: 1253, 1265, 1268); Licht, Amir N. et al. (2005); and Song, Ok-Rial (2002: 187).

¹² Bratton, William W. and Joseph A. McCahery (1999: 296-97).

¹³ Shleifer, Andrei et al. (1997: 737).

¹⁴ Shleifer, Andrei et al. (1997: 773).

¹⁵ Bratton, William W. and Joseph A. McCahery (1999: 297).

¹⁶ Shleifer, Andrei et al. (1997: 769).

¹⁷ Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 34).

¹⁸ Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 35).

¹⁹ La Porta, Rafael et al. (1999: 496).

²⁰ Berle, Adolf A. and Gardiner C. Means (1933).

²¹ La Porta, Rafael et al. (1999: 511).

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- ²² La Porta, Rafael et al. (1999: 508).
- ²³ La Porta, Rafael et al. (1999: 511).
- ²⁴ Shleifer, Andrei et al. (1997: 773).
- ²⁵ Shleifer, Andrei et al. (1997: 774).
- ²⁶ La Porta, Rafael et al. (1999: 497).
- ²⁷ La Porta, Rafael et al. (1999: 496).
- ²⁸ La Porta, Rafael et al. (1999: 498).
- ²⁹ La Porta, Rafael et al. (1999: 510).
- ³⁰ La Porta, Rafael et al. (2002: 1147).
- ³¹ La Porta, Rafael et al. (2002: 1168).
- ³² Black, Bernard S. (2001: 783).
- ³³ Black, Bernard S. (2001: 848).
- ³⁴ Black, Bernard S. (2001: 848).
- ³⁵ Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 2).
- ³⁶ Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 27).
- ³⁷ Stulz, Rene M. (2005: 1633).
- ³⁸ Stulz, Rene M. (2005: 1634).
- ³⁹ <http://www.worldbank.org/icsid/>
- ⁴⁰ Porterfield, Matthew C. (2006: 113).
- ⁴¹ Pistor, Katharina et al. (2000: 328).
- ⁴² Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 37).
- ⁴³ La Porta, Rafael, et al. (2006: 28).
- ⁴⁴ La Porta, Rafael, et al. (2006: 27).
- ⁴⁵ La Porta, Rafael, et al. (2006: 28).
- ⁴⁶ La Porta, Rafael, et al. (2006: 27).
- ⁴⁷ La Porta, Rafael, et al. (2006: 25).
- ⁴⁸ La Porta, Rafael, et al. (2006: 28).
- ⁴⁹ Djankov, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer (December 2005: 37-38).
- ⁵⁰ Tabalujan, Barry S. (2002: 169-171).
- ⁵¹ Pistor, Katharina et al. (2000: 328).
- ⁵² La Porta, Rafael et al. (1997: 336).
- ⁵³ La Porta, Rafael et al. (1997: 333).
- ⁵⁴ La Porta, Rafael et al. (1997: 333).
- ⁵⁵ La Porta, Rafael, et al. (2006: 25).
- ⁵⁶ La Porta, Rafael et al. (1997: 333) (Quotation marks omitted).
- ⁵⁷ La Porta, Rafael et al. (1997: 336). The authors have noted that Muslim countries have “hierarchical religion.” Islam does not encourage hierarchical division amongst the people rather it mandates horizontal proximity. The Muslim countries’ inability to turn their social capital or trust into the industrial success does not appear to be on account of any (hierarchical or otherwise) religious adherence, but it may have other reasons, such as absence and non-development of corporate vehicle in the Islamic societies in the previous centuries. *See generally* Kuran, Timur (2006).
- ⁵⁸ For a related discussion on the subject, please also see Section 4 below.

⁵⁹ Stulz, Rene M. and Rohan Williamson (2003: 346). However, the authors have not treated Islamic law to be relevant legal system for investor protection even for the Muslim countries where Islamic law has been practiced for centuries. *See also* Roe, Mark J. (2002: 1253, 1265, 1268); Licht, Amir N. et al. (2005: 187); and Song, Ok-Rial (2002: 187).

⁶⁰ Stulz, Rene M. and Rohan Williamson (2003: 316). The study confirmed that legal origins matter for the development of the stock markets, in contrast to significance of culture for debt markets.

⁶¹ *See generally* Roe, Mark J. (2002: 1253, 1265, 1268); Licht, Amir N. et al. (2005: 187), and Song, Ok-Rial (2002: 187).

⁶² Coffee, Jr., John C. (2001: 2175-77).

⁶³ A possible argument could be based upon unfamiliarity of the modern reforms that are likely to attract resentment, particularly in countries with colonial legal history. For instance, if one argues against adherence to the rule of law in Pakistan, one reason for such social tendency could be explained that the law itself is being perceived as a colonial legacy, and hence, perceived to deserve lesser regard. The resentment toward a foreign set of rules breeds disregard or violation and, therefore, corruption may follow in most cases.

⁶⁴ Stulz, Rene M. and Rohan Williamson (2003: 346), the authors specifically note this possibility for the countries with the history of being colonized.

⁶⁵ La Porta, Rafael et al. (1998: 1126).

⁶⁶ Coffee, Jr., John C. (1999: 706).

⁶⁷ Pistor, Katharina (2000: 61).

⁶⁸ *See* Berman, Harold J. (1983: 11).

⁶⁹ Watson, Alan (2001: 91).

⁷⁰ Watson, Alan (2001: 93).

⁷¹ Toward the end of Section 3 below.

⁷² For a related discussion on the subject including regulatory convergence, please also see Section 4 below.

⁷³ Pistor, Katharina et al. (2000: 327).

⁷⁴ Coffee, Jr., John C. (1999: 646).

⁷⁵ Paredes (2004: 1155).

⁷⁶ Jordan, Cally (2005: 984).

⁷⁷ Gilson, Ronald J. (2001).

⁷⁸ *See A Systems Approach to Corporate Governance Reform, supra* note 2.

⁷⁹ Jackson, Howell E. (October 1998).

⁸⁰ Coffee, Jr. John C. (1999: 650).

⁸¹ Coffee, Jr., John C. (2001: 81).

⁸² Shleifer, Andrei et al. (1997: 738).

⁸³ *See, e.g.*, Securities and Exchange Commission of Pakistan (2002: 1), Manual of Corporate Governance. The Securities and Exchange Commission of Pakistan acknowledged that its Code of Corporate Governance “draws upon the experiences of...countries with a common law tradition” and expressly referred to reports and recommendations from the U.K. and South Africa. *See also* Beach, Joseph W. (2005), discussing the strategies adopted in drafting the Capital Markets Law of Saudi Arabia.

⁸⁴ *The Law and Economics of Self Dealing, supra* note 1, at 35-36; La Porta, Rafael, et al., *supra* note 8. However, it has also argued that the corporate governance systems of the United States, Japan, and Germany are equally good because they not only survived but

also the economies of these countries prospered. *See generally* Shleifer, Andrei et al., (1997: 771).

⁸⁵ Pistor, Katharina, (2000: 85).

⁸⁶ Pistor, Katharina, (2000: 93). In Pakistan, for instance, the adviser to the Government of Pakistan are more likely to carve out a proposed legislation from the array of similar legislation from various countries that are available online.

⁸⁷ La Porta, Rafael et al. (1998: 1151).

⁸⁸ Stulz, Rene M. and Rohan Williamson (2003: 316).

⁸⁹ For instance, the laws in Pakistan draw on Pakistan's commitment to the World Trade Organization and other international commitments, including treaties. Foreign investors and international development organizations also advise on framing legislation, and often pressurize the transition economies to pass legislation on their suggested format.

⁹⁰ Gordon, Jeffrey N. (February 2003). *See also* Gordon, Jeffrey N. and Mark J. Roe, eds. (2005: 161-209).

⁹¹ *See generally* for shareholders' model Hansmann, Henry and Reinier Kraakman (2001).

⁹² Roe, Mark J. (2001: 2064-67, 2080), arguing that in concentrated form of corporate ownership the shareholders primacy could diminish GNP by resulting into weak competition and monopolistic tendencies.

⁹³ An Islamic religious obligation to annually pay 2.5% of the income for charitable purposes. This was made applicable to corporations in Pakistan in 1980.

⁹⁴ Ibrahim, Ali Adnan (forthcoming Spring 2007).

⁹⁵ Pistor, Katharina, (2000: 60).

⁹⁶ Pistor, Katharina, (2000: 90).

⁹⁷ Pistor, Katharina, (2000: 93).

⁹⁸ Jackson, Howell E. and Stavros Gkantinis (January 2007).

⁹⁹ Please see discussion on the issue at Section 2 herein.

¹⁰⁰ Beach, Joseph W. (2005), discussing the strategies adopted in drafting the Capital Markets Law of Saudi Arabia.

¹⁰¹ Jackson, Howell E. (1999: 332-339).

¹⁰² This has been added to the list recently. *See* Jackson, Howell E. (August 2005: 6-7).

¹⁰³ Jackson, Howell E. (2001: 649).

¹⁰⁴ Black, Bernard S. et al. (2001: 546).

¹⁰⁵ Philbrick, William, C. (1994).

¹⁰⁶ Lang; Robert Todd et al. (2002: 1558), The author suggests that the stock exchanges should do this with the help of the stakeholders.

¹⁰⁷ Coffee, Jr., John C. (2002: 1759-60).

¹⁰⁸ Scott, Hal. S (2000: 71). In this regard, against the sufficient investor demand, Optimal Standardized Issuance has been recommended to reduce the cost of issuance and promote healthy competition in the primary market.

¹⁰⁹ Coffee, Jr., John C. (2002: 1759-60).

¹¹⁰ Coffee, Jr., John C. (1999: 38), Arguing, *inter alia*, that viable markets will not develop in the absence of a workable regulatory mechanism.

¹¹¹ Licht, Amir N. (2000: 54).

¹¹² Including the use of technology for more optimal arrangements at the level of primary market. *See generally* Scott, Hal. S (2000: 104).

¹¹³ Tung, Frederick (2005: 532), Arguing that such lack results in indeterminacy of the legal system.

¹¹⁴ Black, Bernard S. and Reinier Kraakman (1996: 1913). The authors have also suggested that the corporate laws for the emerging markets must be drafted afresh to work within the available infrastructure.

¹¹⁵ Coffee, Jr., John C. (1999: 39).

¹¹⁶ Licht, Amir N. (1998a: 564).

¹¹⁷ Licht, Amir N. (1998a: 566-7).

¹¹⁸ Licht, Amir N. (1998a: 567).

¹¹⁹ Jackson, Howell E. and Eric J. Pan, (2001: 655).

¹²⁰ Licht, Amir N. (1998a: 567). See also Coffee, Jr. John C. (1999: 705).

¹²¹ Licht, Amir N. (1998a: 567). Owing to the economic interdependence in the multiple listings, the statement may have to formalize their internal cooperation, probably through an institution, p. 637.

¹²² Jackson, Howell E. and Eric J. Pan, (2001: 658-9).

¹²³ Jackson, Howell E. and Eric J. Pan, (2001: 691).

¹²⁴ Jackson, Howell E. and Eric J. Pan, (2001: 691).

¹²⁵ Jackson, Howell E. (August 2005: 2-3).

¹²⁶ Jackson, Howell E. (August 2005: 3).

¹²⁷ Black, Bernard S. et al. (2001: 546). In post Sarbanes-Oxley period, various companies have unlisted themselves and lesser companies are going public due the increased costs of disclosures and auditing. An estimate of increase in costs is 4%. This could be an example of over-regulation and increased costs.

¹²⁸ Jackson, Howell E. (August 2005: 3-4, 31). However, for measuring the public benefits of financial regulation, the author suggested, for instance, examination of the banking and securities regulation, p. 32.

¹²⁹ For instance, OECD's Principles of Corporate Governance, IOSCO's Objectives and Principles of Securities Regulation.

¹³⁰ Jackson, Howell E. (August 2005: 3).

¹³¹ Jackson, Howell E. (August 2005: 2).

¹³² Jackson, Howell E. (August 2005: 2).

¹³³ Jackson, Howell E. (August 2005: 43).

¹³⁴ International Organization of Securities Commissions (May 2003: (i)).

¹³⁵ International Organization of Securities Commissions (May 2003: (i - iii)).

¹³⁶ International Organization of Securities Commissions (May 2003: (i - iii)).

¹³⁷ Organization for Economic Cooperation and Development (2004).

¹³⁸ Jackson, Howell E and Stavros Gkantinis (January 2007).

¹³⁹ Alexander, Karen et al (January 2007: 33).

¹⁴⁰ Alexander, Karen et al (January 2007: 33), noting the success of the Cambridge University Seminar of 2005 was the first milestone in which the academic community contributed to the transatlantic regulatory dialogue.

¹⁴¹ Coffee, Jr., John C. (1999: 705).

¹⁴² The Securities and Exchange Commission of Pakistan directed the stock exchanges to incorporate the Code of Corporate Governance in their listing rules. See The Code of Corporate Governance, available at:

[http://www.secp.gov.pk/news/code_corporate\(revised\).htm](http://www.secp.gov.pk/news/code_corporate(revised).htm) Introducing codes of corporate governance as part of their listing rules is also an international trend in the stock exchanges. See generally Licht, Amir N. (2001a: 707).

¹⁴³ Jackson, Howell E. (August 2005: 12-14).

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- ¹⁴⁴ Jackson, Howell E. (August 2005: 30-31).
- ¹⁴⁵ Jackson, Howell E. (August 2005: 31).
- ¹⁴⁶ Jackson, Howell E. (August 2005: 3).
- ¹⁴⁷ Licht, Amir N. (1998b: 227, 230).
- ¹⁴⁸ Licht, Amir N. (1998b: 227, 285). The author treats corporate law to be a part of private law and securities regulation to be a part of public laws. The author argues that due the public character, the securities regulation are less likely to converge.
- ¹⁴⁹ Licht, Amir N. (1998b: 227, 230).
- ¹⁵⁰ See Coffee, Jr., John C. (1999).
- ¹⁵¹ Licht, Amir N. (2001a: 679).
- ¹⁵² Licht, Amir N. (2004: 197).
- ¹⁵³ Licht, Amir N. (2003: 163).
- ¹⁵⁴ Licht, Amir N. (2001b: 203).
- ¹⁵⁵ Licht, Amir N. (2001b: 203).
- ¹⁵⁶ Licht, Amir N. (2004: 230-1).
- ¹⁵⁷ Licht, Amir N. (2004: 232).
- ¹⁵⁸ Licht, Amir N. (2003: 163).
- ¹⁵⁹ Licht, Amir N. (2004: 239).
- ¹⁶⁰ Licht, Amir N. (2005: 231). This analysis, however, does not take into consideration whether the reverse would be true, that is, religion shaping the culture and not *vice versa*.
- ¹⁶¹ Licht, Amir N. (2005: 247).
- ¹⁶² See generally Winston, Kenneth I. ed. (2001).
- ¹⁶³ John C. Coffee, Jr., John C. (1999: 652).
- ¹⁶⁴ See generally The Law and Economics of Self Dealing, *supra* note 1.
- ¹⁶⁵ Such institutions include: Asia Pacific Corporate Registers Forum (APCRF); Asian Development Bank (ADB); International Finance Corporation (IFC); International Monetary Fund (IMF); International Organization of Securities Commissions (IOSCO); Organization for Economic Co-operation and Development (OECD); South Asian Securities Regulators Forum (SASRF); United Nations Development Fund (UNDP); and World Bank. These institutions are officially designated as “stakeholders” by Securities and Exchange Commission of Pakistan at: <http://www.secp.gov.pk/InternationalOrganizationAgencies.htm> , (last visited January 14, 2006).
- ¹⁶⁶ Ibrahim, Ali Adnan (forthcoming Spring 2007).
- ¹⁶⁷ Licht, Amir N. (2001a: 687). The author argues, *inter alia*, that the law of one price curbs arbitrage profits—under-priced buying and overpriced selling.
- ¹⁶⁸ Scott, Hal S. (2000: 78, 92). Author does not consider harmonization and multi-jurisdictional disclosure system viable for international securities market—but recommends establishing offshore free-zone.
- ¹⁶⁹ Riordan, Les (1996).
- ¹⁷⁰ Bradley, Evelyn (1999). Also see for a criticism of the strategy in this regard Pouncy, Charles R. P. (2002); See, for general economic cooperative initiatives in Africa, Dickerson, Claire Moore (2005).
- ¹⁷¹ Philbrick, William C. (1994).
- ¹⁷² Mackey, Paul A. et al. (2005: 373). These countries are also committed to reforming their capital markets and continue to look for the right guideline for the reforms. For instance, the Director General of “Dubai International Finance Centre” announced the

establishment of a “Regional Institute of Corporate Governance to serve at improving the regional securities and financial markets. Dr. Omar Bin Sulaiman maintained:

Transparency and governance is critical in delivering the knowledge, capital, and skills that will enable the region to diversify its economies away from oil and gas, and to grow the wealth of its people, which will lead to political and social stability. As we raise our corporate governance levels, it will increase trust in the region's financial sector, and contribute to attracting foreign direct investment, as well as encouraging local and regional banks to provide financing to SMEs and entrepreneurs.

For complete coverage of the above announcement, see <http://www.ameinfo.com/73238.html>. (last visited January 14, 2005).

¹⁷³ Dubai is one of the 5 Emirates of the United Arab Emirates, and is regarded the most attractive for foreign investment in whole of the Middle-East. Dubai appears to stand out as successful experiment of legal transplant. This aspect required further analysis in a separate work.

¹⁷⁴ Mackey, Paul A. et al. (2005: 374).

¹⁷⁵ Gottlieb, Jason (2000: 275).

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PART III: COMPARATIVE DEVELOPMENT

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Design and Use of Innovative Islamic Capital Market Products: Experience of Pakistan and Malaysia

Huma Ayub^{*} and *Behzad S. Kawish*^{**}

ABSTRACT

Islamic capital market (ICM) is one of the components of overall capital market that triggers economic growth of a country. This paper examines the performance of ICM in Pakistan and Malaysia. More specifically try to highlight relationship between the emergence of innovative Islamic instruments and Islamic capital market growth. The research is exploratory in nature and based on the published secondary data. It focuses on the development of innovative ICM products, in the two countries, that ultimately ensure greater diversification of risk and resilience of Islamic financial system. The paper also highlights the implications of the new products in harnessing the potential of Islamic capital markets in the two countries. Thus it provides an opportunity to learn from the successes and failures.

1. INTRODUCTION

The Islamic capital market (ICM) is a component of the overall capital market which plays an important role in generating economic growth for a country. A modern and efficient capital market is the backbone of an economy. In most of the Muslim countries ICM functions as a parallel market to the conventional capital market, and plays a complementary role to the Islamic banking system in broadening and deepening the Islamic financial markets. The development of Islamic capital markets is essential for efficient resource mobilization and allocation in an Islamic economy. Islamic capital market is increasingly commanding global attention as a source of financing as well as for investment activities that adhere to Shari'ah principle. As in ICM transactions are carried out in ways that do not conflict with the religion of Islam and conscience of Muslims. Hence the activities in ICM must be free from *ribā*, gambling and *gharar*.

A flourishing global ICM has been supported by a recent statistic that the estimated world Muslim population is 1.5 Billion which is representing sizeable percentage of almost 24% of total world population of 6.3 billion. Latent Islamic funds in global financial institutions is said to be at US\$1.3 trillion while the

Islamic financial market is estimated to be US\$230 billion in size, with an annual growth rate of 12% to 15%.¹

Design and use of innovative products is the lubricant for the ICM to act more effectively as an engine of growth for Islamic financial industry. Absence of sufficient degree of financial innovation may pose a serious risk to the competitiveness of ICM in the fast changing financial market. In comparison to the conventional finance, Islamic finance literature on innovation is lagging behind. Although, scholars as well as practitioners increasingly talk about innovation and its importance but still a consolidated body of relevant literature specifically related to the design and use of innovative products of ICM that can contribute to enhance the growth for Islamic financial industry and that will ultimately generate economic activities in Muslim countries is need of an hour.

In this context, research paper aims to highlight the gap between supply and demand of ICM instruments that can be bridged through the continuous effort to design and use innovative Islamic Capital market products that indeed have ability to meet the risk and return appetite of various investors. In this regard, research presents an overview of the current ICM practices and use of innovative products in Malaysia and Pakistan and how and till what extent it help both the countries to broaden and deepen their Islamic financial markets. In the last section researcher suggests the ways for both countries to improve their ICM by learning from each other experiences of success and mistakes.

2. LITERATURE REVIEW

ICM is an integral part of capital market. The issue of development of Islamic capital market is not separated from the issue of development of capital market in general. Capital market plays a vital role in attracting savings and channelling them for productive purposes (Ali, 2005). While Islamic banking is the most developed part of the Islamic financial system, but still there is great potential for the Islamic capital market as the industry to matures and holdings of financial assets gradually transfer from the Islamic banking sector to the Islamic capital market.²

Evolution process of ICM from 1980 till 1990's shows that earlier the Islamic Financial Institutions were involved and heavily focused on trade financing and short-term instruments but with the changing market conditions in late 1990's there were many calls for the introduction of new products and the promotion of financial engineering. By the late 1990s, Islamic financial institutions had realized that the development of capital markets was essential for their survival and further growth (Iqbal et al. 2006).

No one can overlook the importance of ICM in today's environment to cater the needs of diversified investors. Islamic capital markets are now gaining the momentum to grow into a vibrant marketplace, especially for emerging market

borrowers in the regions of the Middle-East, South-East Asia, South Asia and North Africa (Iqbal et al. 2006).

2.1. Design and Use of Innovative ICM Products is Need of Hour

In current study, the word innovation denotes the effort of Islamic capital market to exploit Shari'ah-compliant new ideas and possibilities in order to meet increasing demand of investors. Absence of sufficient degree of financial innovation may pose a serious risk to the competitiveness of ICM in the fast changing financial market. A way to increase the share of Shari'ah compatible products in capital market is to develop new products that suit different kinds of users i.e. issuers and investors of varying characteristics. Experiments in development of Shari'ah compatible products for general use in the capital market reveal that product development and its market acceptance is a complex issue (Ali, 2005). A considerably large volume of literature is available on innovation in conventional financial institutions but Islamic financial Institutions still lack in this area (Noman, 2002). Noman argues that one may suppose that a very small room is left for financial innovation in the Islamic finance because of the strict condition of Shari'ah compliance. But in response to such claims, he suggested that there is enough room exist for financial innovation within the framework of current understanding of Islamic finance, which is clearly distinguished from its conventional counterpart, as 'everything is allowed except that what is forbidden'. He supported further this point by the well-known tradition of the Prophet (Peace be upon him) which allows Muslims to agree on their own terms and conditions so long as they do not contradict explicit Shari'ah rules and principles. Islamic law, in fact is flexible within its ethical and jurist framework to accommodate new financing modes and institutions (Noman, 2002).

It is therefore time to address the issue of developing innovative modes and techniques which can contribute to make ICM more efficient and more competitive. As according to task force report (2004) there is increasing worldwide demand from the investing public, international institutions and corporations for Islamic capital market products and services. This demand is driven by an increasing number of Muslim investors who are looking for products and modes of investment that are acceptable and in compliance with the Shari'ah. Bearing this consideration also in mind, Islamic Capital Market need to design innovative products in order to capture the hitherto untapped potential of Muslim savings and investments. Therefore, it is imperative for ICM to study the issue of having to remain innovative in the market.

While significant progress has been achieved in order to build a dynamic and resilient Islamic Financial industry but still the way forward is in innovation to further expand product diversity to meet the growing requirements of more sophisticated investors and issuers. Innovation will also strengthen capabilities and provide cost effective options to remains competitive. Industry players, financial institutions in particular can play an important role to promote innovation through

their research and development efforts in designing new products and services (Yakop, 2005). Development of an ICM talent pool is indispensable for sustaining the performance, competitiveness and future growth of this sector. The ICM needs a new generation of innovators, regulators, intermediaries and risk managers with the right blend of capital market knowledge and understanding of Shari'ah principles (Zinkin, 2007). In this regard development of innovative products of ICM requires constant and co-coordinated participation and involvement of all relevant stakeholders, including intermediaries, advisors, corporate and educational institutions, policy makers and investors.³

2.2. Innovative ICM Products as Engine to Growth

By looking at the supply and demand sides of ICM many things become clear with regard to the increasing role of innovative ICM products in the growth of Islamic Financial Industry. First by looking at the supply side of ICM, according to Iqbal et al (2006) the volume of Islamic investments with a preference for Shari'ah compliant instruments have grown to form a critical mass that can support a well-functioning and efficient capital market. Not only highly rated borrowers such as the Multilateral Development Banks (for example, the World Bank), but also developing country borrowers with lower credit ratings, such as Pakistan, have successfully raised a considerable volume of funds in this market. While on the demand side, he argues that countries in the developing world, especially the middle-income countries, will require a significant volume of investments in infrastructure over the next decade. ICM with its innovative instruments can support infrastructure projects in developing countries.

The most prominent development of ICM is the introduction of innovative corporate and sovereign *sukūk* structures that significantly contribute to the widening of Islamic Financial Market. As Wilson (2006) argues that Islamic securities have become increasingly popular in the last five years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through the offer of corporate *sukūk*. In 2000 there were only three *sukūk*, worth US\$336 million, issued, but in 2004 there were 64 issues worth almost US\$7 billion, and in 2005 the figure will certainly exceed US\$10 billion, with 54 issues already either fully subscribed or announced.

In her key note address⁴ BNM Governor highlights the importance and the role of innovative ICM products mainly she discuss the immense role of *sukūk* as engine to growth. She argues that the financing requirements for economic development are immense and bond market is key to meeting these funding needs for both the public and private sectors and this is particularly important for emerging market economies. Middle East and in Asia, two of the fastest growing regions in the global economy are following privatization and implementation of infrastructure projects. According to her Asia alone will be spending an estimated USD 1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD 500 billion over the same

period. The challenge is to place an intermediation system that will channel the surplus savings in both these regions into productive investments. It is in this context that the ICM, in particular the innovative *ṣukūk* market will serve as an important avenue to efficiently mobilize longer term funds to meet these funding requirements.

The pace of the development of Islamic capital market products and services is insufficient to ensure an adequate supply of products to satisfy the growing appetite for Islamic products. Especially as developing countries requires significant volume of investments in infrastructure in this regard we need innovative ICM instruments that can support infrastructure projects in such countries e.g. in Pakistan as will be discuss in the coming section. We will also discuss the experience of Malaysia in developing an efficient and resilient ICM that helps it in financing high capital expenditure projects through its design and use of innovative ICM products. Before discussing the experiences of Malaysia and Pakistan in developing innovative ICM products it is helpful to see Table 19.1 (on next page) which gives the types of capital market products that were available in the two countries by the year 2005.

2.3. Experience of Malaysia

Islamic capital market (ICM) is playing a complementary role to the Islamic banking system in creating a comprehensive Islamic financial market in Malaysia. ICM has received strong commitment, resources and facilitation from Government. Therefore it is not surprising that the Malaysian ICM has emerged as a significant area of growth. Today, it has a full complement of products, infrastructure, institutions, intermediaries and investors, contributing to the development and deepening of the entire capital market. ICM products and services are now an integral component of the Malaysian capital market, offering viable and competitive forms of financing and investment alternatives to their conventional counterparts.⁵

Shari'ah-based unit trust funds reach to the amount of 100 or 24.0% of the total of 416 approved funds in Malaysia. Of the Shari'ah-based unit trust funds, 50 were equity funds, 18 were *ṣukūk* funds, 19 were balanced funds while the remainder were money market funds, structured products, feeder funds and fixed income funds. The Net Asset Value (NAV) of Shari'ah-based unit trust funds grew at a compounded annual growth rate of 33.8% from 1997 to 2006; outstripping the industry growth rate of 15.4%. This reflected the strong latent demand for innovative Islamic investment products. While in year 2006 Shari'ah Compliant equities were 886 or 86.1% of the total listed equities on Bursa Malaysia. The market capitalization of Shari'ah-compliant equities stood at over RM548.4 billion or at more than 64.6% of total market capitalization.

Table 19.1 Types of Capital Market Products Available in Malaysia and Pakistan

Malaysia	Pakistan
Ordinary stocks	Ordinary stocks
Preferred stocks/Warrants	Preferred stocks/Warrants
	<i>Muḍārabahs</i> (or <i>Muḍārabah Ṣukūk</i>)
Futures	Single stock futures
Index Futures contracts(if underlying asset is Sharī'ah approved)	
Bonds	Bonds and Term Finance Certificates(TFC)
<i>Ijārah Ṣukūk</i>	<i>Ijārah Ṣukūk</i> (issued but not available in local market).
	Partnership <i>Ṣukūk</i> (Participation Term Certificates)
<i>Salam/Istiṣnā'</i> based <i>ṣukūk</i>	
Mutual funds(Islamic/Conventional)	Mutual Funds (Islamic/Conventional)
Discounting products	
<i>Murābahah</i> Bonds(Securitized debt)	
Use of SPV Structures to trap liabilities	Use of SPV Structures to trap liabilities

Source: Extract taken from Syed Salman Ali (2005) Kinds of Capital Market Products Available

The Malaysian capital market has experienced considerable growth. The capital market is now 2.4 times nominal GDP. Adding the equity and bond markets together, the size of the Malaysian capital market as at end-2006 was RM1.3 trillion, expanding by 17% or by RM190.1 billion.⁶ Malaysia originates over two-thirds of the world's total *ṣukūk* issued. About 70% of the value of *ṣukūk* approved by the Securities Commission was structured using the profit and loss sharing principle i.e. *Mushārahah*.⁷ In year 2006 out of 116 bond issues 64 issues were *ṣukūk* valued at RM 42.02 billion. The issuance of globally accepted *ṣukūk* has shown remarkable progress in which 27 out of 64 or 42% of *ṣukūk* were based on the profit and loss sharing (*Mushārahah*), leasing (*Ijārah*), progressive sale (*Istiṣnā'*) and profit sharing (*Muḍārabah*) principles. In year 2006, total of

Developing new and unique products and improves the existing ones paved the

way for Malaysia to lead the financial industry. Product innovation has been significant in the Islamic capital industry over the last decade in Malaysia which results in a wide array of Islamic instruments being introduced in the market. In this section we will focus on brief introduction since inception to the recent innovations of ICM products that contribute to widen and deepen ICM of country, which no doubt act as engine to growth for Malaysian economy.

The first Islamic bond, Government Investment Issue or GII was initiated by the Malaysian Government in 1983 because of the pressing need to address liquidity management for Islamic banks and *takāful* operators. The issuance of GII was based on the Islamic concept of *qardḥ ḥasan* which did not permit secondary trading but later on the underlying concept of GII was changed to *bayʿ al-ʿInah* to facilitate tradability in secondary market.

In 1993 First Islamic equity unit trust fund was established by the name of Arab Malaysian Tabung Ittikal. Following this in 1994 the very first full fledged Islamic stock broking company was launched, BIMB Securities Sdn Bhd. In 1995 Islamic Capital Market Unit was formed by Securities Commission which later evolved into a full-fledged department. Another milestone was the establishment of Shariʿah Advisory Council in 1996. Capital market master plan was launched in 2001 by the Ministry of Finance, which established Malaysia as an international centre for Islamic capital market activities.

Islamic equity financing represents a component of the overall capital market activity. In Malaysia, the initial efforts to provide a list of Shariʿah-compliant stocks were undertaken by Bank Islam Malaysia Bhd in 1983. This was later followed by the introduction of a list of Shariʿah compliant stocks in June 1997 by the Securities Commission of Malaysia. The implementation of a process to identify Shariʿah-compliant stocks facilitates the establishment of Islamic indices. The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the launching of the Dow Jones Islamic Market Index (DJIM) by Dow Jones & Company in February 1999, the Kuala Lumpur Shariʿah Index (KLSI) by Bursa Malaysia in April 1999. The first full-fledged Islamic stockbroking service was launched by BIMB Securities Sdn Bhd (a subsidiary of Bank Islam Malaysia Bhd) in 1994. A significant development has been Malaysia's increasing ability to innovate sophisticated Shariʿah-compliant stocks e.g. Single stock futures (SSF) contracts and issuance of structured warrants on foreign shares and indices and finally the reintroduction of regulated short selling (RSS) and stock borrowing and lending (SBL) which will be implemented in 2007⁸

In 2002 Malaysian Government issued the first global sovereign *ṣukūk*, raising USD 600 million. It became an international benchmark for the issuance of global *Ṣukūk*. Currently the Malaysian Government is actively promoting the Labuan International Offshore Financial Centre as a global centre for the ICM. Labuan has historically been a home for various international financial activities and has been

an offshore centre for more than a decade. First innovative Islamic residential mortgage backed securities was introduced by Cagamas MBS Berhad in Malaysia. The instrument involved the securitization of a pool of government staff housing loan valued at RM 1.6 billion. The issue was oversubscribed by 5.6 times both by local and foreign investors. Following this issue, Cagamas MBS Berhad issued the 2nd residential mortgage-backed securities under the *Mushārah* principle the securitization of the government staff home financing under the *Mushārah* structure reflected the Government's continuous and innovative effort to broaden the local ICM by introducing new asset classes. In 2005 Malayan Banking Berhad issued the first innovative Islamic subordinated debt in the world using *Al-Ijārah Thumma Al Bay'* (AITAB) financing contract for the purchase of motor vehicles.⁹

The year 2007 also witnessed another issuance of innovative ICM instrument to the tune of RM1.4 billion junior and senior *ṣukūk Istiṣnā'* by Lebuhraya Kajang-Seremban Sdn Bhd to fund the construction of a 44.3km toll highway which will connect Kajang, Semenyih and Seremban.¹⁰ Another innovative product introduced in Malaysia is Islamic cross currency swap. This is a significant development in broadening the range of Islamic capital market instruments. The Islamic cross-currency swap is an arrangement between the two parties to exchange a series of profit and/ or principal payment denominated in another currency, based on a notional principal amount over an agreed period. In order to ensure Sharī'ah compliance the arrangement uses commodity *Murābahah* transactions as the underlying transactions.¹¹

There were many innovative *ṣukūk* issuances in 2006. Among the most innovative are the RM9.1 billion PLUS Expressways Bhd's *ṣukūk Mushārah*, RM950 million Mukah Power Generation's *ṣukūk Muḍārah*, as well as the US\$750 million Khazanah Nasional Bhd's exchangeable *ṣukūk*. Khazanah's *ṣukūk* was the world's first which incorporated full convertibility features usually seen in the conventional equity-linked transactions.¹²

Above discussed series of innovations as being introduced and incorporated by ICM are highly supported by the Government with the vision to stimulate ICM in Malaysia. As the government perceive that Islamic finance can effectively function as a viable alternative market for capital seekers and providers. Continuous efforts in shape of tax incentives were in place as a comprehensive tax incentive package for Islamic securities similar to conventional securities was proposed under the Federal Budget 2004. In this context recently in the National Budget 2007, Government has proposed many incentives to accelerate the development of innovation in Islamic capital market.

After discussing the continuous effort of Malaysian ICM to design and use innovative products for broadening ICM, we may also have to look on the other side of picture as Ali (2005) mentions that ICM products in Malaysia are mainly innovative on certain contracts like BBA (*Bay' Bitamin Ajil*), *Ijārah suma bay'* based and receivables discounting *ṣukūk*. All of them have the premise of

tradability of certain kind of debt. However this is not an acceptable premise in the *fiqh* understanding of the rest of the world. Thus the scope of such debt based *ṣukūk* has become restricted to the East Asian markets. Islamic product development efforts therefore should look for more widely acceptable *fiqh* premises. As was the global *Ijārah* bonds from Malaysia that targeted to tap a wider investor base is therefore constructed on the wider acceptable contract of *Ijārah* rather than *Murābahah* or BBA concepts. This fact is also admitted by the key market players of Malaysia e.g. Aseambankers in their web site¹³ highlighted same trend of using BBA structure as a preferred choice to finance long gestation period projects such as infrastructure projects. Besides BBA, they have also mentioned another popular Islamic capital market tool i.e. *Murābahah* which caters for short to medium term requirements. They admit that these two financing structures have dominated the local scene largely because they are easily understood by issuers and investors. But with the passage of time Malaysian Islamic bond market has ventured into new innovative structures which is the result of the growing interest of catering the need of diverse segment of Muslim population mainly Middle East. They have mentioned the progress of innovative ICM instruments since 2005 as several new Islamic financial products were introduced that include residential mortgage-backed securities, commodity based financing as well as investment and equity linked products based on *Mushārahah*, *Muḍārahah* and *Ijārah*. This is also supported by the Securities Commission annual report 2006 as it states the issuance of globally accepted *ṣukūk* has shown remarkable progress in which 27 out of 64 or 42% of *ṣukūk* were based on the profit and loss sharing (*Mushārahah*), leasing (*Ijārah*), progressive sale (*Istiṣnāʿ*) and profit sharing (*Muḍārahah*) principles.

Last but not the least, the rapid pace of product innovation in ICM poses considerable challenges in building the necessary skills to the ICM of Malaysia. In this regard Malaysia has hosted many International Conferences, investors Forum, training programs, workshops and colloquium to increase the awareness especially with regard to *ṣukūk Mushārahah* and *ṣukūk Muḍārahah*. Moreover, quarterly bulletin on Malaysian ICM generate greater awareness and understanding of ICM matters domestically and internationally. To conclude, as acknowledged in the Annual report of SC that Malaysia is committed in adopting and implementing policies that strengthen the ability of Malaysia's capital market to meet the competitive challenges and to capitalize on opportunities offered by a fast-changing landscape.

2.4. Experience of Pakistan

Pakistan has made considerable progress in the development of financial markets. The financial sector now has vibrant institutional markets for money, foreign exchange and short-term government debt. Pakistan's capital and stock markets have witnessed impressive growth over the last several years. As task force consensus report has indicated that a capital market with a sound, regulatory

framework and appropriate supporting infrastructure must first be present in order to nurture and support an Islamic capital market component. This finding is significant as it postulates that Islamic capital market products and services may be introduced and developed within any existing well-structured securities market and as Pakistan's capital and stock markets have witnessed impressive growth over the last several years on account of market-friendly and investment-friendly policies pursued by the government. Hence the above postulate may leads to the prospects of ICM in Pakistan.

As the ICM consist of three components mainly Islamic Funds, Shari'ah compliant stocks and Islamic bonds. In year 2006 growth of mutual funds industry has been substantial. Net Assets under management by mutual funds grown by 39.2 percent and number of fund has increased by 9 compare with June 2005. Mutual fund assets have grown faster in the last three years and the industry is set to grow further, due to booming stock market and rising demand for funds among retail investors. The over all growth in these funds suggests that the investors confidence is increasing in these lesser risky instruments due to better performance of the market and improved monitoring by the regulator and secondly the returns on these funds has also been substantial.¹⁴

Literature on Islamic Funds and Shari'ah compliant stocks are not enough to support the contribution of ICM for the generating economic activities in Pakistan. However available literature shows that Pakistan's Islamic Mutual Funds sector is still at the nascent stage and has yet to achieve mainstream status. There is a strong need to develop innovative products to offer in the market for both corporate and individual investors. Currently Shari'ah Compliant Stocks are being offered by few players in the market e.g. Meezan Islamic Funds in Pakistan and the Pakistan International Element Islamic Fund. As far Islamic Bonds are concerned a great implementation can be witnessed in this regard in Pakistan and in this section the focus will be on the initiatives taken by private and public sectors to design and use innovative ICM products in order to avail Shari'ah compliant long term financing.

Ali (2005) mentions *Mudārabah* Companies (MCO's) as unique innovation for Islamic Financial sector in Pakistan. They evolved and increased their activities since 1984. According to him MCO sector has a great potential to direct finance to productive enterprises. However innovative, majority of MCO's were not able to perform up to the expectations in Pakistan. He has also discussed various lessons for the development of new products in Pakistan.¹⁵ Another innovative product that has been use in capital market of Pakistan is Participation Term Finance Certificates whereby an investor shares in the profits of a business for a specified time through his instrument. Sitara Chemical Industries Ltd, a public limited company, made a public issue of profit & loss sharing based on *Mushārahah* Based Term Finance Certificates (TFCs) worth Rs 360 million in 2002. Al-Zamin Leasing *Mudārabah's Shukūk* issue of Rs.250 million in December 2003 was the first ever TFC to be issued by the *Mudārabah* sector on Islamic principles. This was a

Mushārakah-based Term Finance Certificates (TFC). The very first attempt made by Government of Pakistan was in 2005, a \$600 million and five year Islamic *ṣukūk*. *Ṣukūk* got \$1.2 billion in subscriptions which made it one of the largest *ṣukūk* in demand at that time. Another major transaction in the public sector was the Wapda *ṣukūk*, the transaction was up to Rs 8 billion issues for Wapda. It had a requirement for funding part of Mangla Dam raising project. Key objective of this transaction was to catalyze the promotion of Islamic Financial Instruments and lead the way for other public entities for using ICM instruments for infrastructure projects financing. The transaction of Wapda *Ṣukūk* was seen as the first step in that direction.

Wateen Telecom issue *Ṣukūk* up to the tune of PKR1, 200 million in December 2006. Other initiative are taken by Karachi Shipyards & Eng Work to the tune of PKR 3,500 million and Pakistan International Airline to the tune of PKR 2,000 million by considering *Ṣukūk* as innovative financing option and both transaction are still in process.

Recently another infrastructure project is being financed by innovative *ṣukūk* facility as Sui Southern Gas Company opted for *ṣukūk* financing facility to the tune of PKR 2 billion on May 31st, 2007. Sui Southern Gas Company (SSGC) is Pakistan's leading integrated gas company mainly engaged in the business of transmission and distribution of natural gas. The government owns majority of the shares which is presently over 70%.¹⁶ Meezan Bank and Standard Chartered Bank are Lead Advisers and arrangers to SSGC for the *ṣukūk* issue to finance its on going major capital expenditure programs. This is another example of financing infrastructure projects through using innovative ICM products i.e. *ṣukūk* in Pakistan. Another recent example of using ICM products for infrastructure development is the PKR 2 billion *Ṣukūk* issue for the infrastructure development of industrial parks in Pakistan. Emirates Global Islamic Bank Limited (EGIBL) will act as financial advisors. EGIBL has been mandated by Pakistan's National Industrial Parks Development and Management Company (NIP) to arrange the financing under the Sharī'ah compliant mode of Islamic *ṣukūk*. A memorandum of understanding (MoU) was executed between EGIBL and NIP in this regard.¹⁷ Another initiative in this regard is taken by Pakistan's state power utility as it shows interest to issue a 10-year domestic Islamic bond, or *ṣukūk*, worth at least 8 billion rupees (\$132 million) to partly fund projects and for other needs. The issue will be backed by government guarantee and will be eligible for inclusion in the statutory liquidity reserves, or SLR, of Islamic banks as well as conventional banks having Islamic banking windows.¹⁸

An encouraging message is stated by Prime Minister of Pakistan Shaukat Aziz on the occasion of the publication of the Year Book 2006 of the *Muḍārabah* Association of Pakistan. He said that the *Muḍārabah* sector plays an integral role in economic development of Pakistan by facilitating the productive investment in accordance with the Islamic principles. He pointed out that with the increasing

interest in Islamic Banking around the world, the *Muḍārabah* sector has become an important part of Pakistan's financial sector.¹⁹

Governor State Bank of Pakistan, Dr. Shamshad Akhtar said²⁰ that the State Bank is keenly focused on the development of Islamic Financial Services, making it one of the fastest growing segments of the financial sector in Pakistan. She said that the *Muḍārabah* sector is an important component of this segment and over the years has been dedicatedly committed to providing Sharī'ah compliant financing options.

Above mentioned transactions and statement reflect healthy start of designing and using innovative ICM products but mean while it is rational to see the other side of picture that is, why ICM products are not as successful as it should be in Pakistan. In this context Ali (2005) explains the factors that contribute to the less success of ICM products in Pakistan that mainly includes the state of economy and the going interest rates in the conventional financial markets as they are important factors in the success of Islamic product innovation and its repeat issuances. He mentions the example of Islamic (participation) *Mushārah* Term Finance Certificates of Sitara Chemicals in Pakistan as it was a successful product innovation in the sense that it combined many new ideas and proved attractive to investor. However the product have not been replicated by others in the following years might be because of the possibility of decreased interest rates and banks flushed with liquidity are willing to lend on easy terms consequently big businesses who are the potential issuers of Participation Term Finance Certificates are finding banks borrowing much cheaper than to use capital market or to innovate a financial product for the market.

Although of importance of designing and use of innovative products of ICM are well understood a long time ago in Pakistan but literature shows lack of real implementation in this context.

3. FINDINGS

There is a growing awareness and demand for investing in accordance with Sharī'ah principles and the pace of development of ICM products is insufficient to ensure an adequate supply of products globally. Although Malaysian Islamic capital market is currently increasingly using innovative products and new asset classes to meet the desired needs of the investor. Malaysian ICM has evolved not only in terms of size and efficiency but more in terms of segments and the range of products offered. Current literature shows that Malaysian ICM has developed the skill of learning from the past experiences, as witnessed through the issuances of recent innovative *Ṣukūk*, mostly based on *Mushārah*, *Ijārah*, *Istiṣnā'* and *Muḍārabah* principles to gain global acceptability. Other appreciable innovations in ICM are Islamic residential mortgage back securities and Exchangeable Khazanah's *Ṣukūk*. But still there is a need to be compliant with Sharī'ah and *fiqh* in many Islamic domestic debt issues. Malaysian innovations in

the ICM is complemented by the government continuing efforts to support growth of ICM, though its pragmatic policies as just after the financial crisis government has foreseen the potential of designing and use of innovative ICM products as an alternative source of channelling funds for the productive purpose mainly for infrastructure projects. In addition to this, Continues tax incentive packages and platform for the consultation act as catalyst to the innovative process in ICM. There are certain pre requisites for the design and use of innovative ICM products i.e. regulatory framework, facilitative tax environment, continuous government support, constructive policies and infrastructure as noticed in the experience of Malaysia. Despite of the impressive achievements of ICM Malaysia, there is still room for further growth and innovation to compete globally and to tap vast opportunities available world wide.

Contrary to the introduction of the innovative ICM product like *Muḍārabah* companies in 1984, till yet less benefits are derived out. The *Muḍārabah* sector is considered to be an important component of ICM to provide Sharī'ah compliant functioning option but the pace of development specially innovations with respect to the design and use of innovative structure and instruments in this sector is legging behind. Although unique Participation Term Finance Certificate was an attractive innovation by a public limited company but it also failed to replicate itself in Pakistan. On the other hand, Islamic Bond market has witness growth in Pakistan through the innovative offering of *Ṣukūk* structures to mainly finance the infrastructure projects. Islamic Funds specially receives warm welcome from the Pakistani investors which shows increased confidence of investors as linked with the substantial returns. In a nutshell, Islamic capital market as far Islamic funds and Sharī'ah compliant stocks are concerned is still in its infancy stage and only a few individual efforts are recently recognized, when compared to Malaysian ICM which is mainly because of lack of innovation and weak support of infrastructure and resource commitment. Although organized ICM have not yet appeared in Pakistan, but the wind of innovation has hit the capital market specifically in case of Islamic bonds. Transformation in shape of innovations in *Ṣukūk* is in process. Malaysia has learnt a lot from its past experience of difficulties in gaining global acceptance of its innovative ICM products and now is on the way to qualify itself as hub for ICM activities. It is the time for Pakistan to learn from the experience of Malaysia for designing and using innovative ICM products in order to revive the slow pace of its Islamic Financial Industry.

4. CONCLUSION

Design and use of innovative Islamic Capital Market products is a critical success factor and engine to growth as witnessed through Malaysian Experience and expected to gain huge momentum in future. There is a strong commitment needed to expand and broaden ICM by focusing on this success factor to accelerate growth in Islamic Financial Industry.

Notes

- * International Islamic University Malaysia, E-mail: huma_ayub@yahoo.com
- ¹ Source: Bursa Malaysia, Islamic capital market.
- ² Source: Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions, 2004.
- ³ Islamic Capital Market Review, Securities Commission Malaysia, Annual Report 2006.
- ⁴ Source: Aziz, Zeti Akhatar (2007), Keynote Address in *Shukūk* Summit 2007 London.
- ⁵ Source: Quarterly bulletin of Malaysian Islamic capital market.
- ⁶ Ibid.
- ⁷ Source: Securities Commission Annual Report, 2006
- ⁸ Securities Commission Annual Report, 2006.
- ⁹ Source: <http://www.aseam.com.my>
- ¹⁰ Source: Quarterly bulletin of Malaysian Islamic capital market.
- ¹¹ Please see Aseambanker website for more details.
- ¹² Source: Securities Commission Annual Report ,2006.
- ¹³ <http://www.aseam.com.my>
- ¹⁴ State Bank of Pakistan Annual Report for 2005-06.
- ¹⁵ For detail discussion see (Ali , 2005).
- ¹⁶ Source: Meezan Bank web site.
- ¹⁷ Source: Quarterly Islamic Banking bulletin, July 2007.
- ¹⁸ Ibid.
- ¹⁹ Ibid.
- ²⁰ Ibid.

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Comparing The Development of Islamic Financial/Bond Markets in Malaysia and Indonesia

*Ascarya** and *Diana Yumanita**

ABSTRACT

Islamic finance has been growing very rapidly all over the world, not only in banking, but also in Islamic bonds, especially Şukūk. Malaysia and Indonesia are two countries that develop Islamic bond market in different ways. Malaysia has been developing Islamic finance, including Şukūk, very seriously since 1983 with strong government commitment and top down approach comprehensively and pragmatically. Currently Malaysia has become the leading Islamic financial centre with 84% share of global Şukūk market. Indonesia started the development of Islamic finance in 1992 with less government commitment and bottom up approach. The market share is still low, but it has stronger fundamental base. To accelerate the development, the government should give more commitment and supports, all legal frameworks should be put in place, while government Islamic instruments should be issued as soon as possible, and the development of human resources, society education and socialization should be the next priority.

1. INTRODUCTION

1.1. Background

Islamic finance started to re-emerge in modern sense since the establishment of Islamic Development Bank in 1975. Since then, Islamic finance has been growing very rapidly almost in every part of the world in the form of direct and indirect Islamic financial markets. As a direct financial market, Islamic capital market consists of Islamic equity market and Islamic bond market. Islamic bonds are becoming increasingly popular, since the structure of Islamic bonds provide an avenue for Islamic investors to invest in Shari'ah compliant investments. Therefore, Islamic bonds guarantee access to a larger investor base, as well as provide potential lower pricing to issuers. Moreover, one type of Islamic investment instruments in the Islamic bond market that growing in popularity is *Şukūk*. *Şukūks* are certificates of Islamic investment which comply with the Islamic Law (Shari'ah). AAOIFI (Accounting and Auditing Organization for Islamic

Financial Institutions) defines *Ṣukūks* as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct of *Ijārah* or services (in the ownership of) the assets of particular projects or special investment activity. Hence, *Ṣukūk* is neither share nor bond as far as the standard concerned.

Ṣukūk market provides investment opportunities to a broad range of investors including public pension fund managers, reserve managers, central banks, as well as *Awqāf* managers. Moreover, *Ṣukūk* introduce a new asset class for investment diversification and fill the gap of Shari'ah compatible tradable instruments. Some key benefits of investing in *Ṣukūk*, among others: 1) *Ṣukūk* are priced competitively in line with conventional bonds; 2) *Ṣukūk* can be an excellent alternative financial instruments for ethical funds, since *Ṣukūk* is Shari'ah compliant; 3) *Ṣukūk* can be used for liquidity instruments, since *Ṣukūk* is tradable in secondary market; 4) *Ṣukūk* is potential for trading at premium, since *Ṣukūk* is highly demanded; 5) *Ṣukūk* is independently rated by rating agencies; and 6) *Ṣukūk* is listed in international exchanges.

Ṣukūk can be used as an alternative financing, not only for countries who can issue sovereign international *Ṣukūks*, but also for regional governments and corporations that can issue sovereign and corporate *Ṣukūks* to finance their projects and expansions to capture Islamic wealth looking for Islamic investments. Some advantages of *Ṣukūk* as an alternative financing, among others: 1) *Ṣukūk* has a wide array of Islamic concept to cater different needs of financing; 2) *Ṣukūk* can be an alternative source of long term and *ribā* free financing; 3) *Ṣukūk* could be cheaper as a source of financing, since fine pricing is achievable due to high demand on Shari'ah compliant and ethical investment instruments, as well as larger pool of investors; and 4) *Ṣukūk* provides mechanism for financing through mobilization of Islamic dormant assets.

Malaysia is among the earliest countries that developed Islamic finance gradually and comprehensively since 1983, including Islamic banking, Islamic capital market, and Islamic insurance or *Takāful* (1984). Malaysia introduced first Islamic bonds in the 1990s and now has become the largest *Ṣukūk* market in the world, tapping 84% share (Aseambankers, 2006). Currently, *Ṣukūk* market (ex-Malaysia) is dominated by foreign issuer. As December 2005, there are 333 issues of rated Islamic corporate bonds worth RM148 billion (US\$39 billion) to finance infrastructures and utilities (53%), property/real estate (21%), and Industrial products (8%). Moreover, the preferred Islamic structures are *Bay' Bithaman Ājil* or BBA (52%) and *Murābahah* (26%), while *Mudārabah* (0%) is the most unpopular.

Demand for domestic Islamic debt instruments in Malaysia, which accounted for 7% of total bonds raised in 1999, grew to 25% in 2000 and subsequently to 76% in 2005, primarily due to investor awareness of alternative funding sources. The proportion of Islamic bonds in Malaysia is no fewer than 45% and is continue

to grow, since Islamic debt instruments in Malaysia is growing exponentially. The significant growth of Islamic bond over the years is due to: 1) high demand of Islamic securities; 2) relatively more cost effective for corporate issuers; and 3) increasing depth and breath of Islamic money market. Malaysia has developed a comprehensive capital market plan to nurture the development of domestic Islamic capital market.

Meanwhile, Indonesia has just started the development of Islamic banking in 1992, *Takāful* in 1994, and Islamic capital market in 2003. The rapid growth of Islamic banking in Indonesia shows that market confidence in Islamic finance has been significantly improved. Islamic modes of financing based on profit and lost sharing (*Muḍārabah* and *Mushārahah*), sale (*Murābahah*, *Salam*, and *Istiṣnāʿ*), and lease (*Ijārah*) are becoming more and more popular and preferable than interest based financing. Indosat was the first corporation issuing *Ṣukūk* with *Muḍārabah* structure in 2002. Even though sovereign *Ṣukūk* has not been issued yet by the government of Indonesia, there are several corporations that are already issued corporate *Ṣukūks*, such as, Indosat, Matahari, and National Electricity Company (PLN). Meanwhile, National Oil Company (Pertamina) and others are studying the possibility of *Ṣukūk* as their alternative corporate financing. Moreover, *Ṣukūk* to finance infrastructures, such as toll roads, are being studied by PT. Jasa Marga. By July of 2007, there are 20 Islamic bonds outstanding totalling Rp3.2 trillion (US\$355.6 million) or approximately only 2.3% of total bonds issued nationally. Moreover, the preferred Islamic structures are *Ijārah* (72%) and *Muḍārabah* (28%).

The issuance of sovereign *Ṣukūk* is very important for several reasons: 1) to raise fund Islamically; 2) to provide opportunities for Islamic investment in secondary market; 3) to meet the liquidity requirement of Islamic financial institutions and investors; and 4) to create Islamic paper's benchmark for sovereign risk rating. The potential *Ṣukūk* market in Indonesia is said to be around US\$500 million to US\$1 billion. *Ṣukūk* has advantages over other interest based financing as a source of financing. *Ṣukūk* could be cheaper, *Ṣukūk* has several different structures to suit the needs of the regional government or corporation, and *Ṣukūk* is of course Shari'ah compliance.

Based on the above backgrounds, there seems to be a big potential, especially for emerging and developing countries with large Muslim population, to develop Islamic bond market and its instruments as an alternative financing and investing mode. Therefore, there should be a study on the development of Islamic bond markets that reviews the various experiences of countries in developing this market and its instruments with all the nitty-gritty, comparative analysis with its conventional counterpart, and policy issues and implications for regulators and other stakeholders.

1.2. Objectives

The objectives of this study is to discuss the experiences and lessons from Malaysia and Indonesia which have or are in the process of developing domestic Islamic bond markets, specifically:

- 1) To provide an overview of the current state of Islamic bond markets globally and in the two selected countries, including size, liquidity, and instruments.
- 2) To analyze, comparatively, the development strategy of Islamic bond markets in Malaysia and Indonesia.
- 3) To consider policy issues from a central bank and market development perspectives.

1.3. Data and Methodology

The quantitative data needed for this study will be collected from secondary data of several publications of Bank Indonesia, Biro Pusat Statistik, International Financial Institutions, and other related sources, whereas the qualitative data will be obtained from some qualitative surveys. Moreover, this study will apply qualitative approach. Descriptive study will be done through literature studies from text books, journals, papers, and other publications. Moreover, discussions with prominent scholars and practitioners will be conducted through focus group discussions and in-depth interviews.

2. GLOBAL ISLAMIC BOND MARKET DEVELOPMENTS

2.1. A Global View of Islamic Finance

Islamic finance is an ethical and equitable mode of finance which derives its principles from the Qur'ān (the holy book) and the *Sunnah* (the traditions of the prophet Muhammad s.a.w.), which prohibits *ribā* (interest), *gharar* (uncertainty, excessive risk, or speculation), and *maysir* (unclear transaction). Even though interest is prohibited, it does not mean that capital is costless in an Islamic financial system. Islam recognizes capital as a factor of production, but it does not allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest, so that any predetermined payment over and above the amount of principal is prohibited. In Islamic finance, the investor must share in the profits or losses arising out of the enterprise or commercial activity for which the capital was provided. Islamic finance is fundamentally based on assets transactions and contracts. Investments should only support practices or products that are not forbidden or discouraged by Islam.

Islamic funds in global financial institutions is said to be at US\$1.3 trillion operated by over 300 Islamic financial institutions in more than 75 countries worldwide, sprawling from London, New York and Zurich to the Middle East, Africa and Asia. Meanwhile, the Islamic financial market is estimated to be

US\$400 billion in size, with an annual growth rate of 12%-15%. Moreover, there are more than 100 Islamic funds worldwide managing assets in excess of US\$5.0 billion, with estimated annual growth for Islamic capital market of 15%-20%.

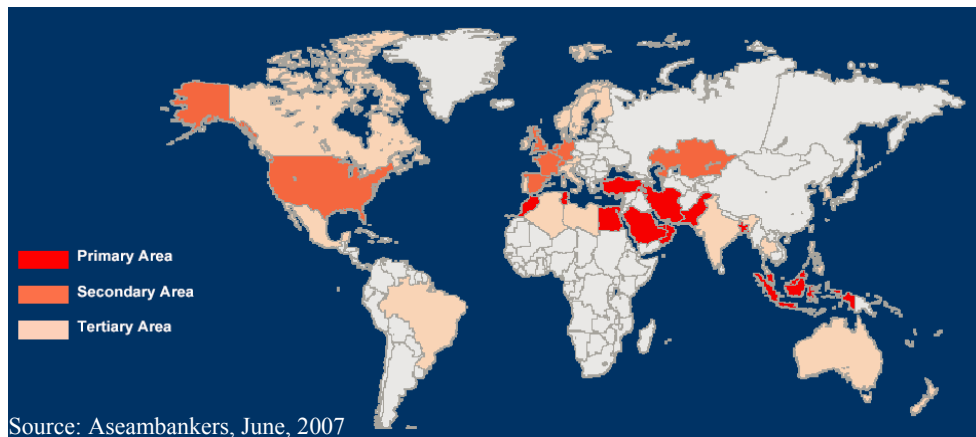


Figure 20.1 The Map of Global Islamic Finance

According to IIFM data (September, 2006), countries with the most advance Islamic finance are Malaysia, Kuwait, Saudi Arabia, United Arab Emirates (UAE), Kingdom of Bahrain, and Qatar. They are already at the level of business innovation and continuous market expansion. The next countries that try to catch up the first group include Brunei, Indonesia, South Africa, Morocco, Turkey, and Pakistan. They are at the level of competitor matching and market expansion to reach the critical mass. Other countries that already started the development of Islamic finance include Syria, Lebanon, Germany, USA, and Singapore. While others, like China, India, Hong Kong, and Australia, are still wait and see.

Even though Islamic finance is expanding rapidly, the size of the market is still relatively small. As an illustration, out of US\$11 billion revenue of Investment Banking operations in Gulf Cooperation Council (GCC) countries and Malaysia, the Islamic share is estimated to be only 10% - 20%. Nevertheless, the market potential is huge, since currently there are 1.5 billion Muslims in the world, where by 2020, as Muslim religion is the fastest growing religion, they will become 2.5 billion or equal to 30% of world population with the fastest growing wealth. It is expected that Islamic banks will account for 40%-50% of total savings of Muslim population worldwide in 8-10 years. Standard & Poors estimated that potential market for Islamic financial services to be over US\$4 trillion. Moreover, it is estimated that GCC surplus will continue for the next 4-5 years, mainly due to oil demand and price, with increasing trend of going public and multi-million US\$ infrastructure projects.

2.2. Demands for Islamic Financial Instruments

The primary demand for Islamic financial instruments has traditionally come from the Middle East, where the majority of Islamic institutions and Islamic assets are, with healthy distribution into OIC countries. The issuance of globally accepted *Ṣukūk* has shown remarkable progress as world wide investors are more mature and sophisticated. Total investable wealth in the MENA (Middle East and North Africa) is in excess of US\$2.3 trillion, of which over US\$1.5 trillion are from the GCC countries.

Other than that, there is also an increasing demand from conventional investors. Recently, more and more European and Asian mutual funds, pension managers, financial institutions, and central banks are holding *Ṣukūks* as part of their diversification strategy. As an example, more than half of the investors of the US\$300 million Malayan Banking Berhad (MBB) *Ṣukūk* came from Asia and Europe. From the conventional multilateral institutions, the International Finance Corporation (IFC) and the International Bank for Reconstruction and Development (IBRD) have issued their first ever Islamic *Ṣukūk* issuances in Malaysia in December 2004 and April 2005, respectively. Both issuances totalled US\$332 million, where all of which were over subscribed. Portion of these papers was purchased by non resident investors, indicating foreign interest in the Ringgit denominated instruments. Moreover, the US\$800 million *Ṣukūk* from Abu Dhabi Investment Bank that closed in December 2006 has over 40% of the investors came from Europe.

As an illustration, the recent US\$300 million MBB *Ṣukūk* of Malaysia was over subscribed by more than seven times by international Islamic and conventional investors from Asia (61%), Middle East (15%), and Europe (24%). This transaction achieved a number of pricing benchmarks, namely: 1) the tightest pricing ever achieved on a US\$ issue from Malaysia to-date; 2) the second tightest pricing ever for a US\$ sub-debt bank issue from Asia (ex-Japan); and 3) the tightest pricing ever for a US\$ *Ṣukūk* globally (excluding supranational issuers).

The high demand of *Ṣukūk* is not surprising, since there are many benefits of investing in *Ṣukūk*, namely: 1) *Ṣukūk* is priced competitively normally lower than conventional bonds; 2) *Ṣukūk* is Sharī'ah-compliant investment instruments that can serve as alternative financial instruments for ethical funds; 3) *Ṣukūk* is tradable in the secondary market that can be used for liquidity management; 4) *Ṣukūk* is highly demanded on the buy side, so that there is a big potential for trading at premium; 5) *Ṣukūk* is independently rated by rating agencies; and 6) *Ṣukūk* can be listed on international exchange, such as Labuan, Dubai, Singapore, and Luxembourg. Moreover, *Ṣukūk* also has advantages over other interest based financing as a source of financing. *Ṣukūk* could be cheaper, *Ṣukūk* has several different structures to suit the needs of the regional government or corporation, and *Ṣukūk* is of course Sharī'ah compliance.

2.3. Global *Ṣukūk* Market

The market for *Ṣukūk* is now maturing and increasing in momentum in the wake of interest from issuers and investors. *Ṣukūk* market provides investment opportunities to a broad range of investors including public pension fund managers, reserve managers, central banks and *Awqāf* managers. Moreover, *Ṣukūk* introduce a new asset class for investment diversification and fill the gap in Shari'ah compatible tradable instruments

Recently, there has been a rapid growth of multi billion dollar market in sovereign and corporate *Ṣukūks*, especially due to a shift to Shari'ah compliance investments and new petro-dollar wealth. The market for *Ṣukūk* is now maturing and increasing in momentum in the wake of interest from issuers as well as investors. Up to September 2006, global *Ṣukūk* issuance has reached US\$18 billion, and estimated to reach US\$50 billion at the end of 2008 (read Figure 20.2).

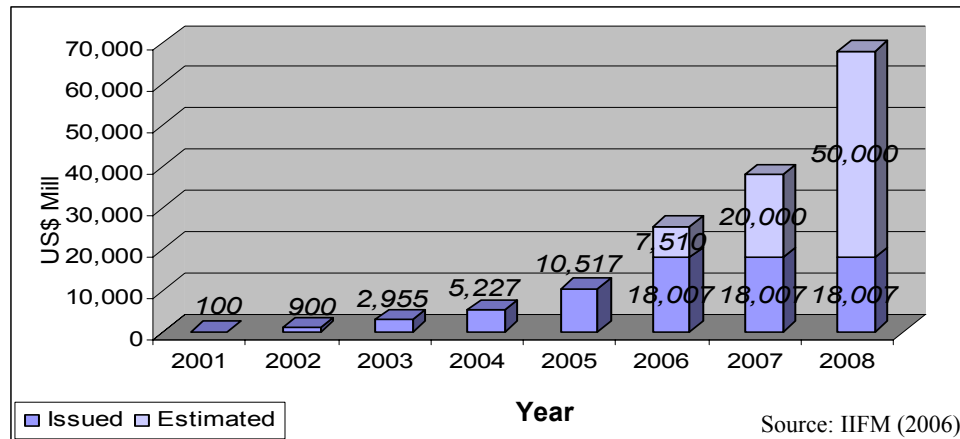


Figure 20.2 Global *Ṣukūk* Issued and Estimated

Several countries have issued global *Ṣukūks* since 2001, such as, Bahrain, Kuwait, UAE, Malaysia, Germany, US, UK, Qatar, Pakistan, as well as Islamic Development Bank or IDB (read Figure 20.3). Malaysia and UAE possess the most advanced *Ṣukūk* markets in the world, while Indonesia is still in the early stage of development with a few corporate *Ṣukūks* and no sovereign *Ṣukūk* yet.

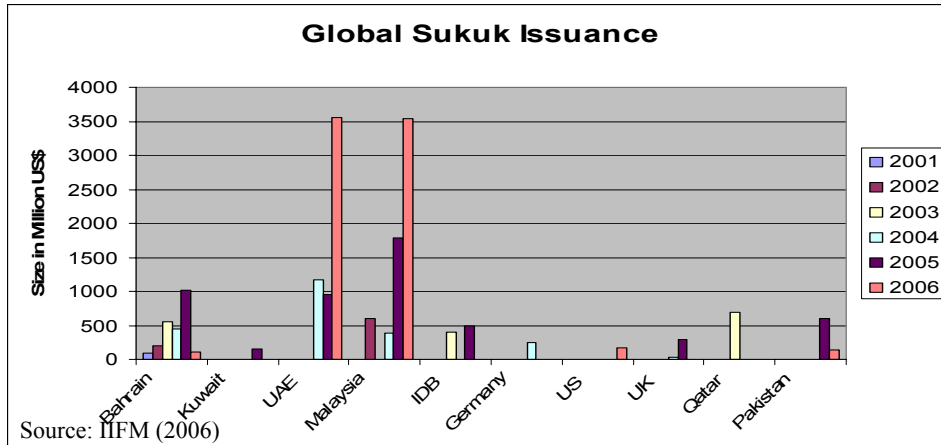


Figure 20.3 Global *Şukūk* Issuance by Country

Malaysia is the pioneer of *Şukūk* with the world first issuance of corporate *Şukūk* (Shell MDS) in 1990, first global corporate *Şukūk* (Guthrie) in 2001, and first sovereign *Şukūk* (Malaysia Global Inc.). Currently, Malaysia holds 84% share of global *Şukūk* market (local currency and dollar *Şukūks*). UAE is the next advanced *Şukūk* market. In 2003, *Şukūk* was non existent in UAE, but in 2007, UAE has emerged at second spot together with Bahrain with 4% share each (read Figure 20.4).

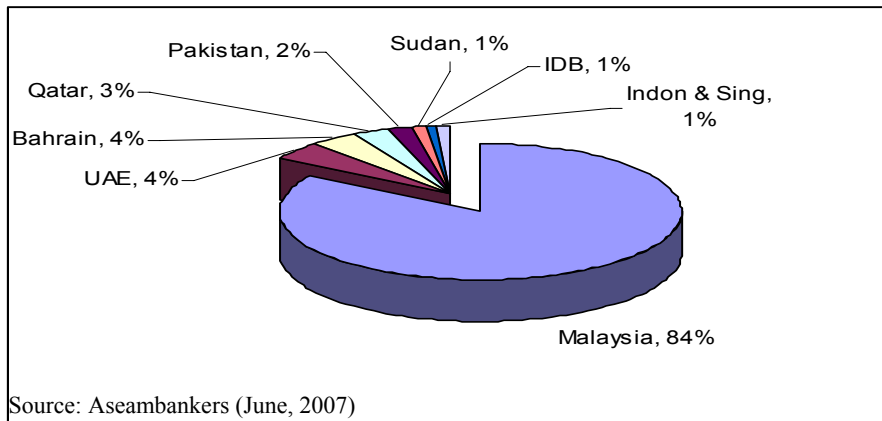


Figure 20.4 Global *Şukūk* Market Share by Country

The biggest activity in sovereign *Şukūk* issuance remains in GCC and Malaysia, with UAE holds the biggest market share of 45%, followed by Bahrain (17%), Saudi Arabia (7%), and Malaysia (6%). Currently, the number of sovereign *Şukūk*

has reached 76 with total amount of US\$24.2 billion (LMC, June 2007). Nevertheless, the world trend is moving towards the issuance of corporate *Şukūk*.

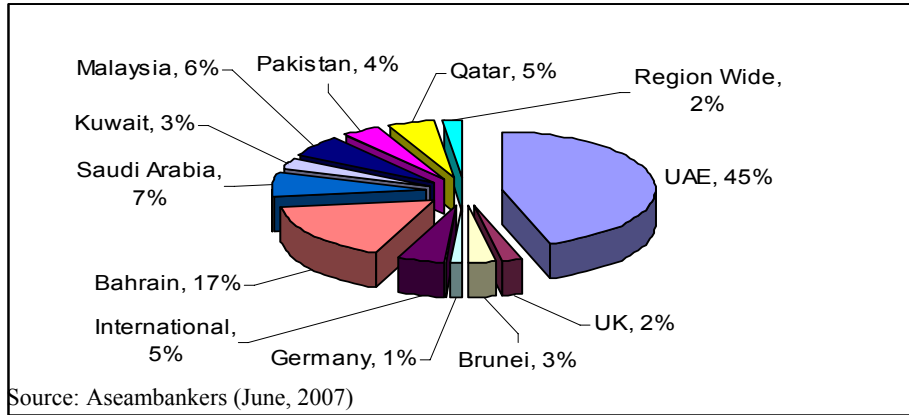


Figure 20.5 Global Sovereign *Şukūk* Market Share by Country

The biggest sovereign *Şukūk* is US\$3,520 million Nakheel *Şukūk* from UAE, issued in November 2006. The biggest 20 sovereign *Şukūk* can be read in Table 20.1.

Table 20.1 Largest Sovereign *Şukūk*

No	Issuer	Country	US\$ mil	Issue Date	Tenor
1	Nakheel <i>Şukūk</i>	UAE	3,520	Nov-06	3 years
2	PCFC <i>Şukūk</i>	UAE	3,500	Jan-06	2 years
3	Al Dar Properties	UAE	2,350	Jan-07	5 years
4	Dubai Civil Aviation	UAE	1,000	Nov-04	5 years
5	SABIC <i>Şukūk</i>	Saudi Arabia	800	Jul-06	5 years
6	ADIB <i>Şukūk</i>	UAE	800	Dec-06	5 years
7	Qatar Global <i>Şukūk</i>	Qatar	700	Oct-03	7 years
8	Malaysian Global <i>Şukūk</i>	Malaysia	600	Jul-02	5 years
9	Pakistan International <i>Şukūk</i>	Pakistan	600	Jan-05	5 years
10	DAAR International <i>Şukūk</i>	Saudi Arabia	600	Jan-07	3 years
11	Emirates Airline <i>Şukūk</i>	UAE	550	Jun-05	7 years
12	IDB Trust Services	International	500	Aug-03	5 years
13	Islamic Development Bank	International	500	Jun-05	5 years
14	Aabar <i>Şukūk</i>	UAE	460	Jun-06	4 years

No	Issuer	Country	US\$ mil	Issue Date	Tenor
15	Solidarity Trust Services	Region Wide	400	Aug-03	5 years
16	Sharjah Electricity & Water Auth.	UAE	350	Jan-07	9 years
17	Sarawak Corp <i>Şukūk</i>	Malaysia	350	Dec-04	5 years
18	Malayan Banking – MBB <i>Şukūk</i>	Malaysia	300	Apr-07	10 years
19	Qatar Real Estate Investment	Qatar	270	Aug-06	10 years
20	BMA International <i>Şukūk</i>	K. of Bahrain	250	Jun-04	5 years

Source: LMC and Bloomberg (June, 2007)

2.4. Global *Şukūk* Structure Development

Even though AAOIFI has issued standards for 14 different types of investment *Şukūk* (namely: 1) *Istişnā'* *Şukūk*; 2) *Murābahah* *Şukūk*; 3) *Mushārahah* *Şukūk*; 4) *Muḍārahah* *Şukūk*; 5) *Wakālah* *Şukūk*; 6) *Muzārā'ah* *Şukūk*; 7) *Musāqah* *Şukūk*; 8) *Mughārasah* *Şukūk*; 9) *Salam* *Şukūk*; 10) *Şukūk* of existing services; 11) *Şukūk* of future services; 12) *Şukūk* of existing owned assets; 13) *Şukūk* of existing leased assets; and 14) *Şukūk* of future assets on lease contract), the most common *Şukūk* principles include *Ijārah*, *Murābahah*, *Istişnā'*, *Mushārahah* and *Muḍārahah*. *Mushārahah* is the most used structure in terms of amount issued, while *Ijārah* is the most used structure in terms of number of issuance, due to familiarity of the principle. Currently in the Middle East, *Ijārah* *Şukūk* has been the preferred principle, but institutions are now started utilizing different techniques such as the *Mushārahah*, *Muḍārahah*, and *Istişnā'* *Şukūks*.

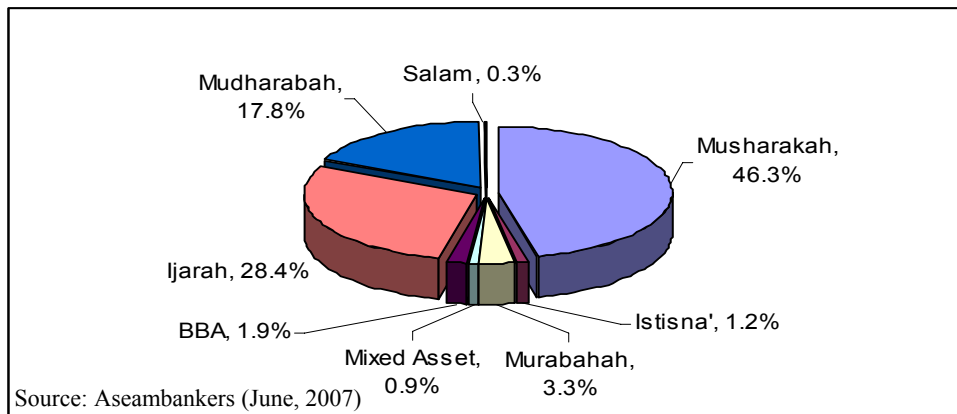


Figure 20.6 Composition Structure of Global *Şukūk*

The structure of *Şukūk* in global market follows international standards from AAOIFI. Guthrie *Şukūk* was the first global *Şukūk* issued in 2001 with *Ijārah* structure. Since then, *Ijārah* has become the preferred structure for global *Şukūk*. *Murābahah* structure was used by Arcapita in 2003. In 2005, Dubai Port Authority issued global *Şukūk* with *Mushārahah* structure, which later has become the most popular structure for large amount *Şukūks*, including convertible *Mushārahah*, like PCFC *Şukūk*. Moreover, *Mudārahah* structure has also gaining popularity in 2006 as it can also be used as convertible *Mudārahah*. Currently, 46.3% global *Şukūk* are structured in *Mushārahah*, 28.4% are structured in *Ijārah*, and 17.5% are structured in *Mudārahah*. Another *Şukūk* structure beginning to be used is *Al-Istismār* (IDB, 2003), *Al-Intifā* (Munshaat Al-Bahrain, 2006) and Hybrid (Tabreed, 2006) *Şukūks*.

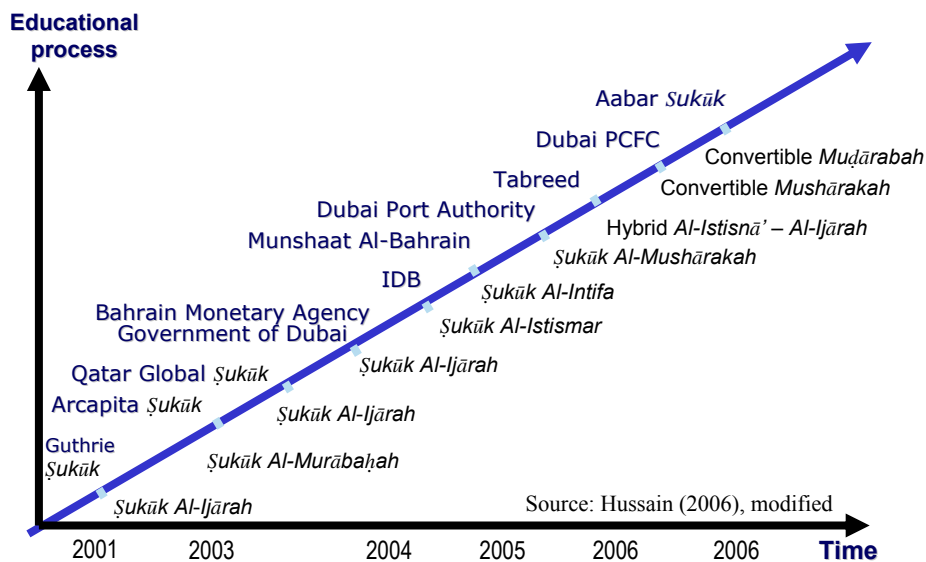


Figure 20.7 Development of Global *Şukūk* Structure

3. MALAYSIAN ISLAMIC FINANCIAL MARKET

Malaysia is a country with various ethnic groups and religions consists of 58% Muslims, 24% Christians, 8% Hindus, and 10% others. Nevertheless, the state religion is Islam. Therefore, the government of Malaysia has the obligation to accommodate the development of Islamic system. Based on this premise, Malaysia started the implementation of dual economic system and the development of Islamic financial and banking systems since 1983.

Historically, Islamic financial institution has been in existence since the establishment of the Pilgrimage fund board in 1969. The Islamic financial system in Malaysia has evolved as a viable and competitive component of the overall financial system. The strategy adopted by Malaysia has been to develop a comprehensive Islamic financial system that operates in parallel with the

conventional system. Emphasis was given to the development of a comprehensive financial infrastructure that includes the Islamic banking industry, *Takāful* operators and Islamic financial markets (Islamic money and capital markets). The intra-dependency of these key structural components creates a comprehensive enabling environment for the financial system to effectively play its role as an efficient conduit to mobilize resources and provide financing to economic sector.

Malaysia started the establishment of one Islamic bank (Bank Islamic Malaysia Berhad, 1983) to spearhead the introduction of Islamic banking products and services and followed by the establishment of *Takāful* operator (Syarikat *Takāful* Malaysia Berhad), 1984. To provide a strong support to Islamic banking system and *Takāful* industry, the Islamic money market was established in 1994. Today, Islamic financial system in Malaysia has emerged as important components that contribute to the growth and development of Malaysian economy with the creation diversity of players encompasses the domestic as well as the foreign banking players. The Islamic banking system is currently represented by 32 Islamic banking institutions, comprising of 12 Islamic banks (including three foreign Islamic banks, i.e., Al-Rajhi, Kuwait Finance House, and Asian Finance Bank) and 7 Islamic banking scheme banks (Islamic windows) offering comprehensive and wide range of Islamic financial products and services. The *Takāful* industry is currently represented by 9 *Takāful* operators. Currently, Islamic financial institutions and markets in Malaysia also represented by Islamic unit trusts, Islamic equity market, Islamic bond market, and Islamic money market.

3.1. Characteristics of Islamic Finance in Malaysia

There are several characteristics that reflect the Islamic financial system of a country, among others: 1) financial and banking system; 2) Muslim characteristics; 3) Islamic financial institutions regulations; and 4) National Sharī'ah Advisory Council; and 5) Islamic financial system development strategy.

a. Financial and Banking Systems

Malaysia is a country that adopted dual financial and banking system since 1983 when the government passed several legislations on Islamic finance, such as the Islamic Banking Act and the Government Investment Act in 1983, *Takāful* Act in 1984. Subsequently, the government established first Islamic bank (Bank Islam Malaysia Berhad or BIMB) in 1983, first *Takāful* company (Syarikat *Takāful* Malaysia Berhad) in 1984, and issued first Islamic government securities (Government Investment Issues) in 1983. Since then, Islamic financial institutions operated side by side with conventional financial institutions to provide Islamic financial products and services to the community.

b. Muslim Characteristics

The majority of Muslims in Malaysia adhere to Syafī'i *madzhab* (school of thought). Even though Malaysian Muslims and Indonesian Muslims have similar *madzhab*, the implementation of Sharī'ah principles in Islamic finance could be different, depended on the understanding of their scholars. For example, the NSAC Malaysia views that cashflow is similar to debt, while debt is similar to property. Since debt is similar to property, it can be traded at any price. For instance \$1000 debt can be exchanged for \$800 cash (discounting), or vice versa. This principle will affect on the contracts (*'aqd*) that can be used to structure Islamic financial instruments. Therefore, *Bay' Al-Inah* (sale and buyback) and *Bay' Al-Dayn* (debt trading with discount) are permissible in Malaysia.

c. Regulations of Islamic Financial Institutions

Islamic banking in Malaysia is regulated under different regulation, depended on the type of the institution. Full fledged Islamic banks are regulated under Islamic Banking Act of 1983, while Islamic windows of conventional banks are regulated under conventional banking act. These two different regulations, make full fledged Islamic banks can operate more flexibly than Islamic windows in adopting Sharī'ah principles. However, the Islamic banking Act of 1983 (and *Takāful* Act of 1986) does not constitute an Islamic law as defined by the Federal Constitution. Although they are based on Islamic principles, these law falls under the jurisdiction of the civil courts. Disputes are presided by civil court judges who may not be familiar with Islamic jurisprudence or *uṣūl fiqh* and the Islamic law of contracts or *fiqh muamalat* (Rosly, 2005). Therefore, Islamic Bank Act embraces some Sharī'ah values but not enough to overrun existing banking laws to reflect genuine Islamic conception of contracts. For example, current practices in Malaysia do not allow a direct sale between the bank and the supplier. This is because a bank, whether Islamic or otherwise, can only provide financing facilities. They are not allowed to purchase and sell assets to earn money. In this way, banks cannot buy houses from the vendors/suppliers. They only provide financing, i.e. make loans, to make profit.

d. National Sharī'ah Advisory Council

The highest Sharī'ah authority on Islamic finance in Malaysia is National Sharī'ah Advisory Council (NSAC), established on May 1997 within the BNM, to streamline and harmonize the Sharī'ah interpretations among Islamic financial institutions, including Islamic banking business, *Takāful* business, Islamic financial business, Islamic development financial business, or any other business which is based on Sharī'ah principles. NSAC is supervised and regulated by Bank Negara Malaysia.

The existence of NSAC within the BNM will improve the responsiveness and the effectiveness of decision making and fatwa regarding Sharī'ah problems faced by Islamic financial institutions. However, NSAC independence becomes limited,

since NSAC is not an independent institution, but it is under the board of director of BNM.

3.2. Strategy to Develop Islamic Finance in Malaysia

Malaysia adopted pragmatic and gradual development approaches to develop a comprehensive Islamic financial system, with the long-term objective to create an Islamic financial system operating on a parallel basis with the conventional financial system. To qualify as a viable system, Islamic financial system requires a large numbers of players, a wide range of instruments, transparent market, efficient settlement system, efficient principle dealership, robust regulatory framework, various types of financial institutions, and other supporting infrastructures.

Malaysia starts with the first stage to create enabling environment by setting up various infrastructures, especially legal framework. The next stage is to increase the size and create the market for Islamic financial institutions for fair competition. The third stage is to create harmonization and convergence with international Islamic financial markets, so that Malaysian Islamic financial institutions can compete in international arena.

The first stage of development is started with the enactment of Islamic Banking Act (IBA) on July 1983 for Islamic banking institutions to exist side-by-side with the conventional banks and allows BNM to supervise and regulate Islamic banks. The IBA facilitated the establishment of Bank Islam Malaysia Berhad (BIMB) that started its operation on July 1983 with total asset of RM369.8 million. In 1983, the Government Investment Act was also enacted at the same time to empower the Government of Malaysia to issue Government Investment Issues (GII), which is the government securities issued based on Sharī'ah principles. As the GII is regarded as liquid assets, the Islamic banks could invest in the GII to meet the prescribed liquidity requirements as well as to invest their surplus funds. Thereafter, the *Takāful* Act (TA) was enacted in 1984 that paved the establishment of Syarikat *Takāful* Malaysia. This act governs the conduct of *Takāful* business. The establishment of *Takāful* was inspired by the demand for Sharī'ah compliant alternative to conventional insurance, as well as to complement the operation of the Islamic bank. In terms of Sharī'ah infrastructure, the IBA and the TA requires the Islamic Bank *Takāful* operator to establish Sharī'ah advisory council to ensure their operation satisfy with Sharī'ah requirements.

The second stage of development is started on March 1993 with the introduction of Islamic banking scheme or Islamic windows that allows conventional banks to offer Islamic banking products. The benefit of Islamic windows structure, among others, are: 1) the ability to disseminate Islamic banking on nationwide basis with immediate increase in number of ready players and within shortest period; and 2) optimizing available resources that achieved cost effectiveness and promote synergies to undertake Islamic banking business. Another important thing is that the Islamic windows structure is in compliant with Sharī'ah requirements. Under

the Islamic banking scheme, the conventional banks are allowed to offer Islamic banking products and services using their existing infrastructure, including staff and branches. This scheme was launched on a pilot basis involving 3 banks and 54 financial institutions, and has essentially created more players in the Islamic financial system.

On January 1994, Islamic Inter-bank Money Market (IIMM) was established as a short-term intermediary to provide a ready source of short-term investment outlets based on Shari'ah principles. IIMM will be able to link Islamic financial institutions through Islamic money market instruments, which also mark the development of Islamic financial instruments. Thereafter, Islamic capital market was established in 1996 to accelerate the development of Islamic securities. In order to streamline and harmonize the Shari'ah interpretations among Islamic financial institutions, the National Shari'ah Advisory Council (NSAC) was established on May 1997, under BNM, as the highest Shari'ah authority on Islamic financial businesses in Malaysia. In this second stage, the second Islamic bank (Bank Muamalat Malaysia Berhad or BMMB) was opened. Moreover, three *takāful* operators were also opened for operation, namely, *Takāful* National Sdn. Berhad, Maybank *Takāful* Berhad, and *Takāful* Ikhlas Sdn. Berhad.

The third stage of development is started with the launching of the Financial Sector Master plan (FSMP) in 2000. The 10-year master plan represents the blueprint that provides the strategic direction for the development of the Islamic financial system. The overall objective of the FSMP is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of Malaysian financial sector while meeting the economic needs of the nation. One of achievement would be Malaysia as regional Islamic financial centre in 2010. The overall recommendation are designed to focus on 3 main areas, namely: 1) Strengthening operational and Institutional infrastructure; 2) Financial infrastructure development targeted to promote healthy competitive culture; and 3) Prepared banking sector for progressive liberalization of financial industry. To facilitate FSMP, especially the development of Malaysia as Islamic financial centre, the strategy of Islamic windows was reviewed in 2004 and encouraged them to transform into Islamic subsidiary. In the same year, Islamic banking and *Takāful* sectors were liberalized allowing foreign players to participate in the growing domestic and regional markets.

With this development strategy, Malaysia is strengthening its position as an international Islamic financial hub - a centre of origination, issuance and trading of Islamic capital market and treasury instruments, Islamic fund and wealth management, international currency Islamic financial services, and *Takāful* and re-*Takāful* businesses. Malaysia is the first country to develop an Islamic money market (in 1994) and pioneered the issuance of Islamic bonds. Malaysia issued the world's first global corporate Islamic bond (Guthrie – worth US\$150 million in

2001) followed by the world's first global sovereign *Shukūk* (Malaysia Sovereign - worth US\$600 million in 2002). Another achievement is that 86% of listed equities in Malaysia are deemed Sharī'ah compliant stocks and 36% of all Sharī'ah listed equity funds in the world are listed on Bursa Malaysia. Presently, there are about 89 Islamic unit trust funds in Malaysia.

To achieve the goal as international Islamic financial hub, in August 2006, Malaysia International Islamic Financial Centre (MIFC) was launched with the role as a Mecca for investors and fund-seekers to conduct transactions in foreign currency. They free to come and issue *Shukūk*, undertake to raise Islamic syndicated facilities or partake in many other financial opportunities using the MIFC infrastructure and intermediaries. Moreover, to help Islamic financial institutions to manage short-term liquidity in Malaysia's Islamic inter-bank money market, BNM announced the Commodity *Murābahah* Programme on March 2007, a new Islamic monetary instrument backed by crude palm oil contracts applying the concept of *Murābahah* or *Tawarruq*. The Islamic financial system development stages in Malaysia can be read in Figure 20.8.

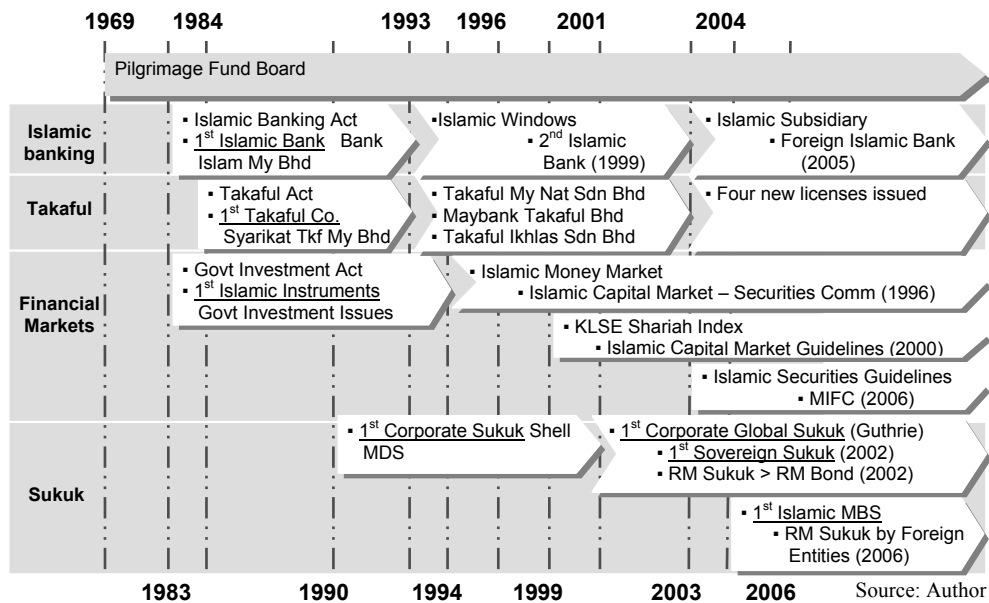


Figure 20.8 Development Stage of Islamic Financial System in Malaysia

3.3. Islamic Bond Market in Malaysia

Malaysia is among the earliest countries that developed Islamic finance gradually and comprehensively since 1983, including Islamic banking, Islamic capital market, and Islamic insurance or *Takāful* (1984). Malaysia introduced first Islamic bonds or *Shukūk* in the 1990s, first global corporate *Shukūk*, the *First Global Shukūk Inc* (Guthrie *Shukūk*) in 2001, and first global sovereign *Shukūk*, the Malaysian

Government *Ṣukūk* (*Malaysia Global Inc*) in 2002. Today, Malaysia has become the largest *Ṣukūk* market in the world, tapping 84% share (Aseambankers, 2006).

Currently, *Ṣukūk* market (ex-Malaysia) is dominated by foreign issuer. As December 2005, there are 333 issues of rated Islamic corporate bonds worth RM148 billion (US\$39 billion) to finance infrastructures and utilities (53%), property/real estate (21%), and Industrial products (8%). Moreover, the preferred Islamic structures are *Bay' Bithaman Ājil* or BBA (52%) and *Murābahah* (26%), while *Muḍārabah* (0%) is the least popular.

Demand for domestic Islamic debt instruments in Malaysia, which accounted for 7% of total bonds raised in 1999, grew to 25% in 2000 and subsequently to 76% in 2005, primarily due to investor awareness of alternative funding sources. The proportion of Islamic bonds in Malaysia is no fewer than 45% and is continue to grow, since Islamic debt instruments in Malaysia is growing exponentially.

The significant growth of Islamic bond over the years is due to: 1) high demand of Islamic securities; 2) relatively more cost effective for corporate issuers; and 3) increasing depth and breadth of Islamic money market. Malaysia has developed a comprehensive capital market plan to nurture the development of domestic Islamic capital market.

3.3.1. Size and liquidity

In terms of outstanding Islamic bonds as of May 2007, total Islamic bonds (corporate and government), has reached 32% of total market or RM164 billion (US\$47 billion). Islamic bonds are gradually taking up more shares from time to time from just 9% in 2000. The majority of outstanding Islamic bonds are from corporate sector which accounted for 68% or RM111.5 billion.

Table 20.2 Outstanding Bonds in Malaysia

Securities (RM mil)	2005		2006		May-07	
	Conv	Islamic	Conv	Islamic	Conv	Islamic
Asset Backed Securities	10,895	3,150	10,509	3,160	11,558	5,568
ABS (Commercial Papers)	-	-	-	-	-	-
ABS (MTN)	174	104	125	54	131	54
Bonds	61,727	62,560	61,725	64,926	57,649	64,382
Medium Term Notes	7,335	16,749	10,894	26,963	13,731	36,253
Commercial Papers	3,381	4,359	3,883	5,890	3,742	5,245
Loan Notes	1,094	-	1,146	-	1,146	-
Loan Stocks	11,337	-	11,611	-	11,503	-
TOTAL CORPORATE ISSUES	95,943	86,922	99,893	100,993	99,460	111,502
Bank Negara Bills/Negotiable Notes	10,000	7,000	9,500	7,600	-	-
Bank Negara Monetary Notes	-	-	4,000	2,000	40,500	14,600
Cagamas Bonds	20,927	-	14,475	-	11,970	-
Cagamas Notes	-	-	780	-	2,780	-
Danaharta Bonds	-	-	-	-	-	-
Danamodal Bonds	-	-	-	-	-	-
Khazanah Bonds	1,000	10,000	1,000	7,370	-	6,350
Government Investment Issues	-	10,100	-	19,600	-	23,100
Islamic Cagamas Paper	-	3,430	-	6,130	-	5,835
<i>Şukūk</i> BNM <i>Ijarah</i>	-	-	-	400	-	400
Malaysian Government Securities	166,050	-	173,800	-	184,500	-
MGS Callable	-	-	500	-	1,000	-
Malaysian T Bills	2,320	2,000	2,320	2,000	2,320	2,000
TOTAL SOVEREIGN ISSUES	200,297	32,530	206,375	45,100	243,070	52,285
Total Debt Securities	296,240	119,452	306,268	146,093	342,530	163,787
AGGREGATE		415,692		452,361		506,317

Source: BNM

The majority of corporate Islamic bonds issued in the infrastructure/utilities sector at the amount of RM51 billion (US\$16 billion), or 51% share. The infrastructure projects usually require high funding with long gestation period, including highway, toll roads, LRT, and ports. These projects are also commonly associated with the GLCs, such as Syarikat Prasarana Negara, Khazanah, and so on. The next most *Şukūk* issuance is in property/real estate sector which accounted for 14% share or RM18 billion (US\$5.1 billion).

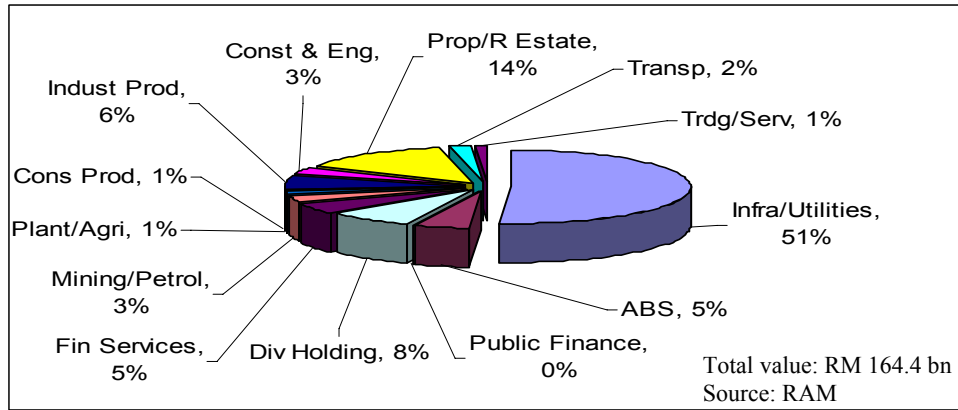


Figure 20.9 Corporate *Şukūk* by Sector in Malaysia

In terms of *Şukūk* structure, the majority of Islamic bonds issued are based on the contract of sale, the main contract of exchange in Islamic finance. Out of RM164 billion of Islamic bonds rated to date, 40% or RM66 billion are in the form of BBA (*Bay' Bithaman Ājil*) contract, 25% or RM41 billion are in the form of *Murābahah*, and 17% or RM28 billion are in the form of *Mushārahah*. *Istişnā'* (9%) and *Ijarah* (3%) are two other less popular structures. Moreover, *Muḍārahah* structure accounted for only 1%. Although BBA contracts forms the bulk, partnership-based contracts (especially *Mushārahah*) is getting more popular. It is expected that this trend will continue in the future, in line with the Malaysia's Government initiative to encourage more partnership based *Şukūks* which are globally Shari'ah compliance. A number of incentives have also been introduced to encourage more partnership based *Şukūks*.

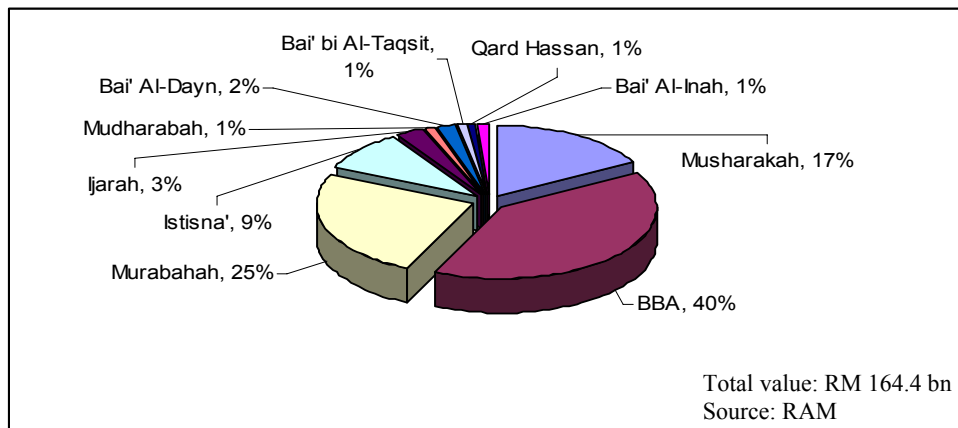


Figure 20.10 Corporate *Şukūk* by Structure in Malaysia

In terms of pricing, coupon or profit rate of Islamic bonds are slightly lower than conventional bonds. Figure 20.11 shows the coupon/profit rate comparison between conventional Malaysia Government Securities (MGS) and Islamic Malaysian Government Investment Issues (GII).

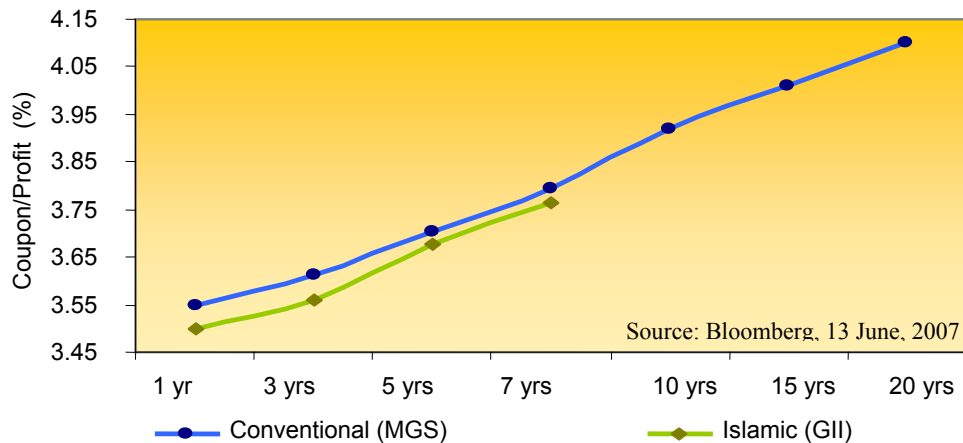


Figure 20.11 Coupon/Profit Rate Conventional vs. Islamic Bonds

3.3.2. Instruments

Instruments in Malaysia Islamic bond market can be grouped into four categories, namely: 1) Islamic fixed income securities; 2) *Şukūk Ijārah*, *Mushārahah*, and *Mudārahah*; 3) Islamic asset-backed securities; and 4) Islamic bond funds. However, since Islamic bonds are identical to *Şukūks*, the instrument differentiation is showed from their structures. In Malaysia, *Şukūk* structures develops in phases, namely: 1) first phase: BBA bond and *Şukūk Al-Ijārah*; 2) second phase: *Şukūk Al-Istismār* and *Şukūk Al-Mushārahah*; 3) third phase: Hybrid structures and Islamic convertible *Şukūk*.

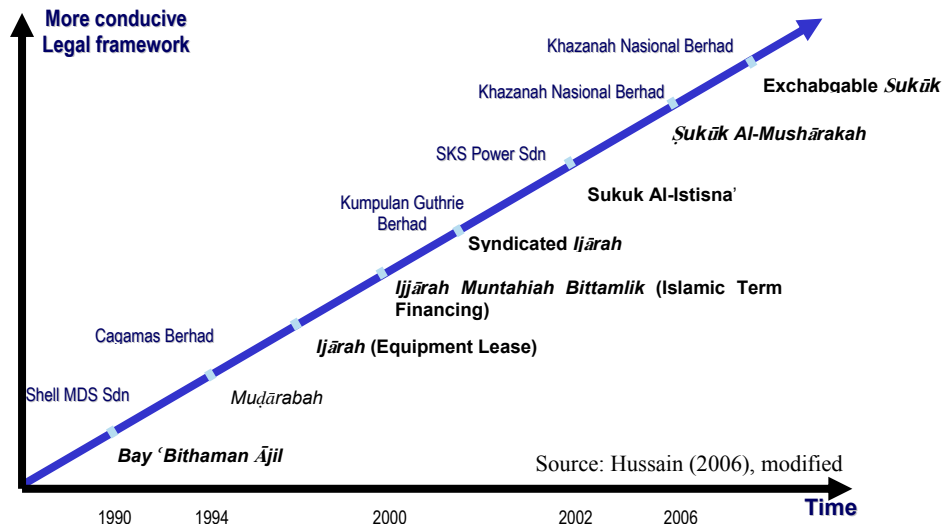


Figure 20.12 Development of *Ṣukūk* Structure

4. INDONESIAN ISLAMIC FINANCIAL MARKET

Indonesia is the biggest archipelago country in the world that has various ethnic groups, languages, and religions with 240 million people. Even though Indonesia is not officially a Muslim country, it is a country with the largest Muslim population of 88%. Others include Christian 5%, Catholic 3%, Hindu 2%, Buddhist 1%, and others 1%. The more advance financial and banking systems and the more improved welfare of the society, especially Muslims, the more people need financial products and services which accordance to the Sharī'ah principles they believe in.

4.1. Characteristics of Islamic Finance in Indonesia

The characteristics of Islamic financial system in Indonesia can be viewed from various aspects, among others: 1) financial and banking system; 2) Muslim characteristics; 3) Islamic financial institutions regulations; and 4) National Sharī'ah Advisory Council; and 5) Islamic financial system development approach.

a. Financial and Banking Systems

Indonesia is a country that adopt economic capitalist system. Since Banking Act No. 7 of 1992 was introduced, Indonesia started to introduce dual banking system, because banks can operate under profit and loss sharing principles (i.e., Islamic principles). The first Islamic bank was established at the same year, while the first Islamic insurance, or *Takāful*, was established in 1994.

Since the new Banking Act No. 10 of 1998, the implementation of dual banking system or dual financial system was becoming more on track and more and more

Islamic financial institutions were established and operated side by side with conventional financial institutions. As what happened in Malaysia, Islamic financial institutions in Indonesia have developed to be alternative financial institutions for those who need financial products and services that comply to Shari'ah principles. They have also developed to be direct competitors to conventional financial institutions.

b. Muslim Characteristics

Like in Malaysia, the majority of Muslims in Indonesia adhere to the Syafi'i *madzhab* (school of thought). However, Indonesian scholars seem to be more prudent in implementing Shari'ah principles into Islamic finance. They tend to have similar views to Middle East scholars. Therefore, Islamic contracts (*'aqd*) applied to structure Islamic financial transactions are those that have been approved by the majority (*jumhur*) of scholars. With this prudential principle, controversial contracts are not being used in application.

In the case of debt, Indonesian scholars have similar views to Middle East scholars, that debt is similar to money, and different from property, so that debt cannot be traded at any price unless at the same price. In this case, therefore, Indonesian scholars have similar stand to Sudanese scholars, that *Bay' Al-Inah* (sale and buyback) and *Bay' Al-Dayn* (debt trading with discount) are not permissible and not comply to Shari'ah principles. Consequently these contracts should not be used in structuring transactions.

c. Regulations of Islamic Financial Institutions

Islamic banks in Indonesia, whether full fledged, full branch or rural bank, are regulated under Banking Act No. 10 of 1998, where they can operate fully in compliance to the Shari'ah principles, so that they can apply funding contracts, like *Wadi'ah* demand deposit and *Mud'arabah* saving and time deposits, and financing contracts, like debt financing (*Murabahah*, *Ijarah*, *Istisna'* and *Salam*) and equity financing (*Mud'arabah* and *Musharakah*), as well as other Shari'ah compliance products and services. Therefore, Islamic banks in Indonesia can operate as universal banking that can offer consumer banking, investment banking, merchant banking, leasing company, investment agent, as well as an institution of *zakah*, *infāq* and *ṣadaqah*.

The guidelines to issue corporate Islamic bonds have been simplified by regulation No.IX.A.13 and No.IX.A.14 of 2006, while regulations on other financial institutions, like *Takāful* Act, Government Islamic Bond Act, Islamic Bank Act, have been drafted and waiting to be approved by the Congress.

d. National Shari'ah Advisory Council

The highest Shari'ah authority on Islamic finance in Indonesia is National Shari'ah Board or Dewan Syariah Nasional – Majelis 'Ulamā' Indonesia (DSN-MUI), which is an independent body in issuing Shari'ah opinions or *fatwās* on any

Shari'ah matters of *ibādah* and *muāmalah*, including Islamic economics, finance, and banking.

The main task of DSN-MUI in Islamic finance and banking is generally similar to those of NSAC in Malaysia that is the only authority to provide Shari'ah opinions to related institutions, like Bank Indonesia, Ministry of Finance, and other government and private institutions dealing with Islamic finance and banking. DSN-MUI also coordinates, analyzes and evaluates Shari'ah issues and aspects of new scheme, products or services proposed by Islamic financial institutions.

The position of DSN-MUI outside the central bank organization makes this Shari'ah authority more independence, credible, and acceptance nationally in issuing *fatwās* on Shari'ah matters of Islamic financial institutions. However, since DSN-MUI is a general body responsible for all Shari'ah matters, the responsiveness to solve the problems in economics, finance and banking issues becomes relatively lower than specialized Shari'ah Islamic finance and banking authority, like NSAC in Malaysia, and therefore is lagging in meeting the demand of the market.

4.2. Strategy to Develop Islamic Finance in Indonesia

After the success of the Islamic financial institution pilot projects of *Baitut Tamwīl-Salman* in Bandung and *Koperasi Ridho Gusti* in Jakarta, based on the urgency of the society that need Islamic banking products and services, the first Islamic bank was established in 1992 and the government introduced dual banking system. Following the establishment of Islamic bank, Islamic insurance or *Takāful* was established in 1994. The government commitment to develop Islamic financial system started to take shape since 1998, where Islamic banking was given the opportunity to expand and develop widely by allowing conventional banks to open Islamic branch, separate from the parent bank, to offer full Islamic products and services.

The following year, Bank Indonesia was given the responsibility to regulate, supervise, and develop Islamic banking in Indonesia with the renewed Central Bank Act of 1998. Since then, Bank Indonesia set up a master plan or blue print to develop Islamic bank in Indonesia based on four strategies, namely: market driven, fair treatment, gradual and sustainable development, and compliance to Shari'ah principles. Market driven strategy is applied to make the development of Islamic banking and finance grow strong from the bottom up without any artificial and temporary support from the government. Fair treatment strategy is taken to make Islamic banking and finance able to survive and adapt to the existing environment. Gradual and sustainable approach will enable Islamic banking and finance to develop inline with their condition and readiness without enforcement to build strong and viable system. Compliance to Shari'ah principles are designed to ensure that all products and services offered by Islamic banking and finance are always Shari'ah compliance and accepted nationally and internationally.

With these strategies, Islamic banking in Indonesia has developed to be one of the most Sharī'ah compliance systems in a country with dual financial system. The development of Islamic banking has a great impact in the development of other sectors based on Sharī'ah principles, such as, *Takāful*, Islamic capital market, Islamic bond, Islamic unit trust, Islamic education, Islamic voluntary sectors, legal frameworks, etc.

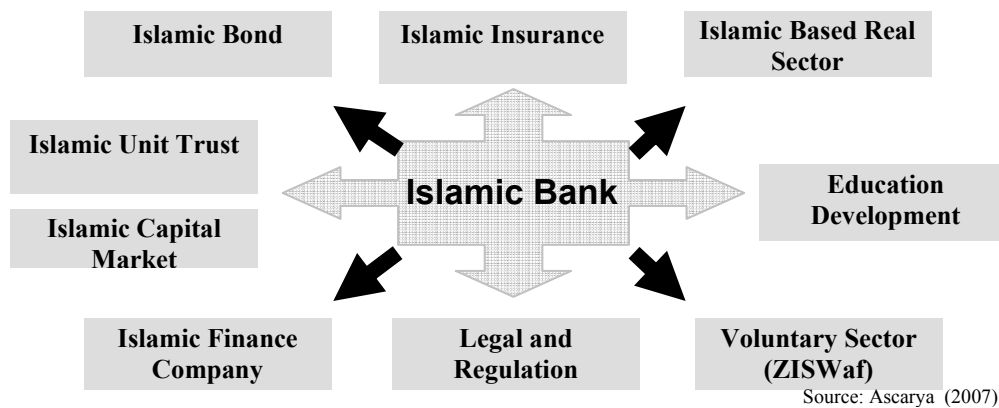


Figure 20.13 The Impact of Islamic Banking Development to Other Sectors

The blue print of Islamic banking development comprises of four stages. The first stage (2002-2004) is to set up foundation for development, the second stage (2005-2009) is to strengthen industry structure, the third step (2010-2012) is to meet international standard of service and quality, and the fourth stage (2013-2015) is toward the integration of Islamic financial institutions. In current second stage, bank Indonesia has set up the objective to reach 5% market share by the end of 2008. To accommodate the new market share objective, in early 2006, Bank Indonesia launched Office Channelling allowing Islamic banks to open counter of Islamic services in its parent conventional bank offices.

In *Takāful* industry, the first *Takāful* operator was established in 1994. *Takāful* branches of conventional insurance companies were allowed to operate since 2002, and the first Islamic re-insurance was established in 2004. Currently there are more than 30 *Takāful* operators offering variety of Islamic insurance products.

The development in the financial market started with the introduction of Islamic Money Market and Islamic money market instrument (Inter-bank *Muḍārabah* Investment certificate or IMA certificate) in 2000, followed by the introduction of Jakarta Islamic Index (JII) in the stock market. Islamic Capital Market was then introduced in 2003, followed by Capital Market Master Plan in 2005 that include master plan for Islamic capital market.

Meanwhile, the development of Islamic bond or *Ṣukūk* started with the first issuance of corporate *Ṣukūk* by Indosat in 2002 using *Mudārabah* structure. Since then, 18 *Ṣukūks* have been issued and 4 more to come. The guidelines to issue corporate Islamic bonds or *Ṣukūk* have been simplified by regulation No.IX.A.13 and No.IX.A.14 of 2006, while regulations on other financial institutions, like *Takāful* Act, Government Islamic Bond Act, Islamic Bank Act, have been drafted and waiting to be approved by the Congress.

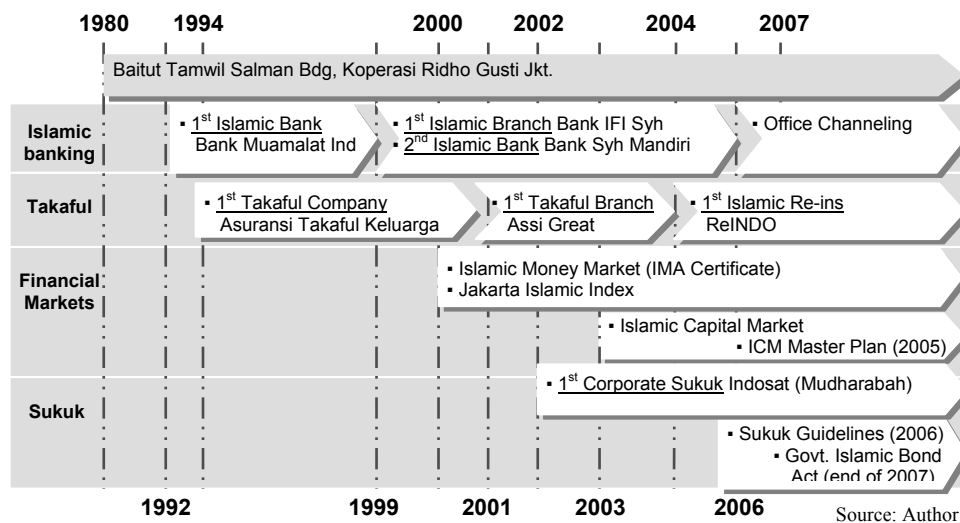


Figure 20.14 Development Stage of Islamic Financial System in Indonesia

4.3. Islamic Bond Market in Indonesia

As showed in Figure 20.8, the development of Islamic bond or *Ṣukūk* in Indonesia just started in 2002 when the first corporate *Ṣukūk* was issued by Indosat, structured in *Mudārabah*, at the amount of Rp175 billion. The issuance of *Ṣukūk* usually parallel to the issuance of conventional bond of that corporation, so that the price of *Ṣukūk* could be benchmarked to its conventional counterpart, since sovereign *Ṣukūk* is not available yet.

The growth of corporate *Ṣukūk* in Indonesia has usually been initiated by underwriter, rather than by the corporate issuers, since *Ṣukūk* is not yet familiar for them and they were not fully understand the advantages and disadvantages of issuing *Ṣukūk*. There are several benefits of issuing *Ṣukūk*, among others, are 1) to tap wider investor based, especially those who concern with Sharī'ah compliance investment; 2) to diversify the portfolio of their source of fund; 3) High demand and low supply; and 4) Similar or lower price to conventional bond. Meanwhile the drawbacks of issuing *Ṣukūk*, among others, are: 1) more complicated to structure requiring underlying asset; 2) tax and legal uncertainty, since there is no explicit regulation that ensure similar tax treatment to conventional bond; and 3) no official benchmark, since government *Ṣukūk* has not been issued, yet.

4.3.1. Size and liquidity

Until the end of July 2007, there are 25 corporate *Şukūks* issued with capitalization value of Rp3.6 trillion. The market size has increased more than 4 times from only Rp790 billion in 2003. Moreover, the average size of each *Şukūk* issued has been increased, from Rp102 billion in 2003 to Rp162 billion in 2007. However, the share of Islamic bond is only 5% of the total bonds issued in capital market.

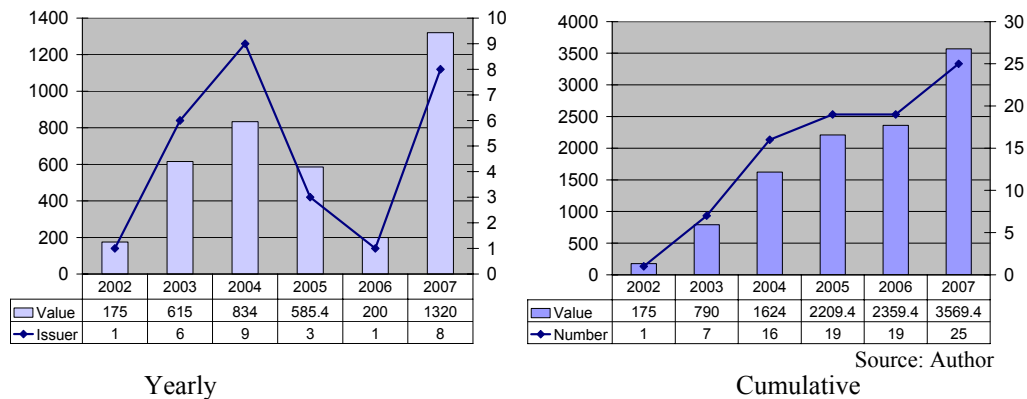
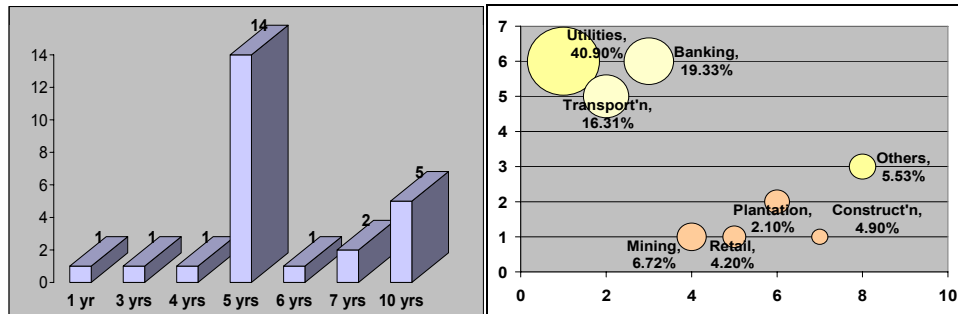


Figure 20.15 The Value and Number of *Şukūk* Issued

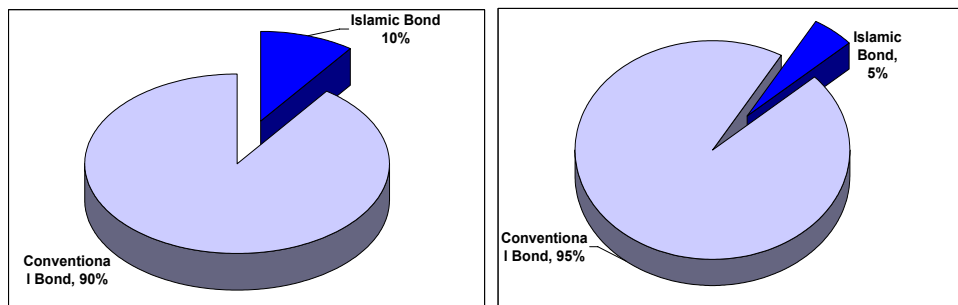
In terms of maturity, most *Şukūks* (14) have 5 year maturity. Recently, longer maturity up to 10 year is becoming more popular, since the main investors of *Şukūk* include *Takāful* operators and Pension Funds that need long investment instruments. Moreover, in terms of sector, *Şukūk* mostly issued in utilities (telecommunication and electricity), followed by banking and transportation sectors.



Source: Author

Figure 20.16 The Maturity and Sectors of Şukūk Issued

The share of Şukūk in the bond market has reached 5% in terms of value, and 10% in terms of number issued. This share is significantly higher than the share of Islamic banking (1.7%). Figure 20.17 also shows that the average issued size of Şukūk is lower than that of conventional bond. The low market share of Şukūk can be attributed to uncertain tax and legal frameworks, as well as official price benchmark. It is expected that once the government Şukūk is issued, the corporate Şukūk issuance will increase, subsequently.



Source: Author

Figure 20.17 The Share of Şukūk in Number and Value

The lists of Şukūk issued in Indonesia can be read in Table 20.3 for Şukūk structured in *Muđārabah* and Table 20.4 for Şukūk structured in *Ijārah*.

Table 20.3 Şukūk Muḍārabah in Indonesia

No	Date	Issuer	Sector	Tenor	Rating	Value	Return
1	11-02	Indosat	Telecom	5	AA+	175	15.75
2	05-03	Berlian Laju Tanker	Transportation	5	A-	60	14.75
3	07-03	Bank Bukopin	Banking	5	BBB+	45	13.75
4	07-03	Bank Muamalat Ind	Banking	7	BBB-	200	17.00
	09-03	Ciliandra Perkasa *	Wood Indst	5	BBB	60	17.70
5	10-03	Bank Syariah Mandiri	Banking	5	BBB	200	13.00
	12-03	PP (MTN I)	Construction	3	BBB+	50	13.75
	03-04	PP (MTN II)	Construction	3	BBB+	50	13.125
6	03-04	PTPN VII	Plantation	5	BBB+	75	13.875
7	01-07	PP (MTN III)	Construction	1		50	
8	01-07	BSM I (subnotes)	Banking	10		150	
9.	02-07	BSM II (subnotes)	Banking	10		65	
10	04-07	BSM III (subnotes)	Banking	10		30	
11	07-07	Adhi Karya	Construction	5	A-	125	
		TOTAL <i>Muḍārabah</i>	33%			1175	

Source: Bursa Efek Surabaya (July, 2007); Value in billion Rp; Left Rating by Pefindo and Right Rating by Moodys; Return in % equivalent; * Fully bought back on March 2007.

Table 20.4 *Ṣukūk Ijārah* in Indonesia

No	Date	Issuer	Sector	Tenor	Rating	Value	Return
1	05-04	Matahari Putra Prima	Retail	5	A+	150	13.80
2	06-04	Sona Topas Tourism	Tourism	5	A1	52	14.50
3	07-04	Citra Sari Makmur	Telecom	5	A3	100	14.25
4	10-04	Arpeni Pratama (MTN)	Transportation	3	A	100	14.00
5	11-04	INDORENT/CSM	Transportation	4	Baa2	100	13.25
6	12-04	Berlina	Plastic Indst	5	Baa3	85	13.75
7	12-04	Humpuss Intermoda	Transportation	5	A1	122	14.00
8	04-05	Apexindo	Mining	5	A-	240	12.50
9	06-05	Indosat I	Telecom	6	AA+	285	12.00
10	07-05	Ricky Putra Globalindo	Textile & Gmt	5	Baa1	60.4	12.25
11	06-06	PLN I	Energy	10	A	200	13.60
12	05-07	Indosat II	Telecom	7	AA+	400	10.20
13	07-07	Berlian Laju Tanker	Transportation	5	AA-	200	10.30
14.	07-07	PLN II	Energy	10	A1	300	10.40
TOTAL <i>Ijārah</i>			67%			2394.4	

Source: Bursa Efek Surabaya (July, 2007); Value in billion Rp; Left Rating by Pefindo and Right Rating by Moodys; Return in % equivalent.

In terms of liquidity in secondary market, *Ṣukūks* are not frequently traded. The investors usually prefer buy and hold strategy, since *Ṣukūks* are relatively rare instruments in the market, so that they are hard to find when needed. Moreover, demand for *Ṣukūk* is still significantly higher than its supply. The lack of liquidity in the secondary market is also due to the profile of *Ṣukūk's* main investors that include Islamic banks, Pension Funds and *Takāful* operators. Most of them are long-term investors that try to match their funding structures.

4.3.2. Instruments

Instruments in Indonesia Islamic bond or *Ṣukūk* market can be differentiated from their structures. In Indonesia, *Ṣukūks* are structured either in *Muḍārabah* or

Ijārah. The first *Ṣukūk* was issued in *Muḍārabah* structure, since this is believed to be the most Sharī'ah compliance structure. *Ijārah* structured *Ṣukūk* was first introduced in 2004, when investors started to prefer more fixed return, rather than variable return. Since then, almost every new *Ṣukūk* issuance is structured in *Ijārah*. Currently, *Ṣukūk Muḍārabah* accounted for 33% (11 out of 25), while *Ṣukūk Ijārah* accounted for 67% (14 out of 25). This trend is in line with the trend in conventional bond market where fixed rate bonds are more popular than variable rate bonds.

5. POLICY ISSUES

Malaysia has successfully developed Islamic financial system since 1983 adopting pragmatic, comprehensive, and top down approaches with strong government commitment and support. Today, Islamic financial system in Malaysia has emerged as an important component that contributes to the growth and development of Malaysian economy with the creation diversity of players encompasses the domestic as well as the foreign players. The Islamic financial system is currently represented by 32 Islamic banking institutions, 9 *Takāful* operators, Islamic money market, Islamic unit trusts, Islamic equity market, and Islamic bond market with more than 333 *Ṣukūks* issued. Islamic financial system offers comprehensive and wide range of Islamic financial products and services, not only for Muslims, but also for everybody who feels that Islamic finance is more beneficial than conventional finance.

There are still some issues left that need to be reviewed and solved, among others:

1. Some Sharī'ah contracts adopted, like *Bay' Al-Inah*, *Bay' Al-Dayn*, and *Bay' Bithaman Ājil*, are not acceptable by most scholars outside Malaysia. This has made some Malaysian Islamic financial products based on these contracts could not accepted in International Islamic financial markets. The government should gradually move away from the use of these debatable contracts and start adopting contracts that accepted and meet international standards.
2. The very minimal use of profit and loss sharing (PLS) contracts will pose some problems in the future, since market return of PLS will become the new benchmark and policy rate replacing conventional interest rate benchmark, when the share of Islamic finance becomes significant enough to lead the financial market. There should be government Islamic instrument using PLS contract, while Islamic financial institutions should increase the use of PLS contracts in their products.
3. The development trend of Islamic finance towards the duplication of its conventional counterpart will make Islamic finance as a subset of conventional finance. Islamic finance is an alternative to conventional

finance that able to fill the gaps and drawbacks of conventional finance to achieve the equitable welfare of the society. Therefore, the long term objective of Islamic finance development should be directed towards this end.

Meanwhile, Indonesia has also successfully developed Islamic financial system since 1998 adopting gradual, sustainable, Shari'ah compliance and bottom up approaches with less government commitment and support. Although, in terms of size and share, Islamic finance in Indonesia is still relatively small, it has a stronger development base, due to the support and involvement of the society in the bottom up development. Islamic finance in Indonesia has been globally awarded as one of the most Shari'ah compliance system. The Islamic financial system is represented by 24 Islamic banks, 30 *Takāful* operators, Islamic finance companies, Islamic money market, Islamic unit trusts, Islamic equity market, and Islamic bond market with 25 *Shukūks* issued, offering various Islamic financial products and services.

Nevertheless, there are some big issues faced that hinder faster pace development and direction, among others:

1. The development of Islamic finance has received minimal commitment and supports from the government in all levels, so that the goals and objectives are not clearly stated and followed by the stakeholders. What the government does is just follow where the market goes without any clear mission, vision, and strategies to follow. Therefore, the government should give more commitment and support, especially in the strategic levels, to accelerate and give direction to the development of Islamic financial system.
2. The legal frameworks of Islamic finance are still lacking, so that market players are still reluctant and choose to wait and see until they are sure on the government stands. This uncertainty makes the development of Islamic finance, especially Islamic bond, has slowed down, missing the opportunity to invite excess liquidity from petro-dollar for the country's dire need of investment. The draft laws that still in the waiting lists of the Congress should be given priority to be published.
3. Islamic finance in Indonesia still does not have government Islamic instruments needed as a policy instruments and benchmarks for corporate and private Islamic finances. Islamic financial institutions still benchmark their pricing to their conventional counterparts. Islamic banks benchmark to conventional banks, Islamic bonds benchmark to conventional bonds, and so on. These conditions make Islamic finances are vulnerable to the fluctuation of interest rates, which should be avoided. Therefore, the issuance of government Islamic instruments, like government *Shukūk*, government Islamic Treasury Bills and central bank Islamic instruments should be the next priority.

4. The rapid development of Islamic finance in Indonesia leaves the development of human resources in the field of Islamic finance behind. Most players in Islamic finance come from their counterparts in conventional world. Islamic bankers come from conventional bankers, Islamic fund managers come from conventional fund managers, and so on. These conditions make the players in Islamic finance still behave like players in conventional finance. Therefore, the development of human resource should be also put as a priority. Government should take the lead and initiatives in the policy and strategy to develop knowledgeable and competent human resources in Islamic finance. Moreover, society education and socialization are also very important to improve their awareness and participation in Islamic finance.

Notes

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Role of Islamic Financial Institutions in Enriching the Structure and Menu of Financial Instruments for Capital Markets

*Muhammad Iqbal Anjum**

1. PROLOGUE

The dawn of 21st has been accompanied by the crystallization of a progressive trend of the fast growing and globalizing Islamic capital markets. In this context, it is important to note that the spectacularly progressing national and international Islamic financial institutions (e.g., Islamic universal banks, Islamic commercial banks, Islamic mutual funds, and Islamic insurance companies etc.) constitute the centre of the fast globalizing contemporary International Islamic capital markets. The recent early years of the 21st century, which have been witnessing impressively growing roles of the contemporary Islamic financial institutions in enriching the structure and menu of financial instruments of the fast globalizing Islamic capital markets in the 21st century, merit careful empirical attention, study and analysis from the point of view of improving both the structure of the Islamic capital markets in the context of their various classifications (e.g., primary versus secondary markets, organized versus over-the-counter markets, equity markets etc.) and the Islamic design as well as the efficient use of Islamic financial instruments for financing development-oriented long term investments. Therefore, this paper presents an objective study on the subject along the aforementioned lines in the light of the realities of the contemporary Islamic capital market, identifies the related dilemmas, and offers feasible policy recommendations for accelerating the roles of the Islamic financial institutions for enhancing the processes of development and integration of the capital markets of the Islamic countries in the coming decades of the 21st century.

2. ISLAMIC FINANCIAL INSTITUTIONS AND THE FAST GLOBALIZING ISLAMIC CAPITAL MARKETS

At the very outset of 21st century, Islamic banks and other non-bank Islamic financial institutions have evolved into a global industry which conducts business amounting to multi-billion dollars. Currently, at least 20 countries (Bangladesh, Bahrain, Canada, Egypt, Indonesia, Iran, Jordan, Kuwait, Luxembourg, Malaysia,

Pakistan, Qatar, Saudi Arabia, Singapore, South Africa, Sri Lanka, Sudan, UAE, UK, and USA) are offering either one type or several types of Islamic capital products. This spectacular global growth of the Islamic banking and finance industry has instituted and accelerated the dynamics of the processes of establishment and globalizations of the Islamic financial markets which include the Islamic money markets and the Islamic capital markets.

In the background of the 1999 Agreement of the representatives from the Islamic Development Bank (IDB), Labaun Off-shore Financial Services Authority (LOFSA) of Malaysia and Bahrain Monetary Agency for cooperating in accomplishing the tasks of establishing International Islamic Financial Market (IIFM) and instituting the mechanism and code of conduct of IIFM, a memorandum of understanding was signed by representatives of Indonesia, Ministry of Finance of Brunei Darussalam and Bank of Sudan in 2000. Ultimately in November 2001, the implementation of IIFM Establishment Charter was signed by the aforementioned founders of IIFM and the structure of organization of the IIFM was formed by the then simultaneously established institutional network of Board of Directors, Secretariat, Market and Product Development Committee (MPDC) and Shari'ah Supervisory Committee (SSC). The founders of the IIFM automatically became the members of its Board of Directors. A representative of Bank Indonesia became a member of both IIFM's Executive Committee and IIFM's Islamic Supervisory Council. At present the secretariat of IIFM is situated in Manama, Bahrain which is a hub of Islamic financial institutions.

Because of the fast increasing number of the internationally operating Islamic financial institutions, several Islamic countries have not only realized a developed Islamic money market but also they have successfully cooperated and established institutions such as Accounting and Auditing Organization for Islamic and Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) for setting a standard code of conduct for the IIFM including the international Islamic capital market. The fast crystallizing global character of Islamic capital market is premised in the fact that the central banks of Bahrain, Iran Kuwait, Malaysia, Pakistan, Saudi Arabia, and Sudan joined the IDB, AAOIFI and the International Monetary Fund (IMF) to establish IFSB and its headquarters at Kuala Lumpur on the 3rd of November 2004 with its objectives of harmonizing the regulation and supervision of Islamic banking as well as setting the guidelines for realizing the best practices of Islamic banking operations.

IIFM has instituted the following seven step process of endorsement of the issuance of the Islamic Financial Instruments (IFIs) by IIFM:

- i. The company, which intends to issue IFIs for trading in IIFM, must appoint an Authorized Financial Institution (AFI) as the arranger.

- ii. Arranger presents the relevant documents for endorsement by IIFM Board, which can determine a fee for the endorsement of IFI, and for approval from the concerned institutions of IIFM.
- iii. IIFM endorses the IFI which is according to the Shari'ah principles and is fulfilling the criteria set forth by the concerned committee.
- iv. The endorsed IFI is announced on the Information Page of IIFM along with the information about the AFI and the details of its products.
- v. IFIs are rated by the rating agency determined by the IIFM board.
- vi. The arranger issues the endorsed IFI.
- vii. The issuer has an option of registering its IFI either at the international financial exchange [(e.g., Labuan International Financial Exchange (LFX)] or at Bahrain Stock Exchange.

In the trading framework of IIFM, AFI's can trade IFIs with AFIs or non-AFIs. For realizing the disciplined Islamic financial market growth, IIFM necessarily requires the market participants to comply with the international provisions adopted by the IIFM Board.

Within the above framework, according to Bank Indonesia's Report on Islamic Banking Development 2004, IIFM has endorsed IFIs in the form of *ṣukūk* issued by Bahrain, IDB, Indonesia, Malaysia and Qatar. More specifically, the Government of Malaysia issued Malaysia global *Ṣukūk*, based on the concept of *al-ijārah al-muntaha bi tamlik*, with a value of the issue amounting to US\$ 600 million in 2002. Similarly, the Government of Qatar issued *ṣukūk*, based on the concept of *al-ijārah al-muntaha bi tamlik*, with a value of the issue amounting to US\$ 700 million. The Government of Bahrain issued 10 *ṣukūk-ul-ijārah* having a combined value of the issue amounting to US\$ 1.13 billion by the end of 2004.

As a whole, so far, there have been issued at least 18 sovereign *Ijārah*-based *ṣukūk* amounting to US\$5.65 billion (Ali, 2005, 22). According to Ali, these sovereign *ṣukūk* have been issued by Bahrain, Dubai, Malaysia, Pakistan, Qatar and German Saxony-Anhalt state. Almost all of these Sovereign *ṣukūk* have been over-subscribed. He documents the fact that there is not observed any secondary market of Sovereign *ṣukūk* because of the existence of a general trend that the buyers of these sovereign *ṣukūk* hold *ṣukūk* till their maturity. According to him, in addition to the sovereign *Ṣukūk*, there have been issued at least 11 corporate *ijārah*-based *ṣukūk*¹, amounting to US\$1.0601 billion, by the corporate sector and by the government sector institutions. These corporate *ijārah*-based *ṣukūk* have also been oversubscribed. In addition to *ṣukūk* being the 2nd key product of the Islamic capital market, the equity is the 1st key product of the Islamic capital market. On 31st March 2007, the universe of Shari'ah compliant stocks consisted of 1942 stocks and the market capitalization of Global DJIMI amounted to USD10.65 trillion (Ali, 2005, 22). The 3rd proposed key product of the Islamic Capital Market

is Islamic Depository Receipts as an instrument of expanding the Islamic capital markets (Ali, 2005, 16).

In deed, in addition to the fundamental role of the Islamic financial institutions as the central constituent of the International Islamic Capital Markets, there are also inherent structural inter-linkages between the growth of the Islamic banking/non-bank financial institutions and the growth of the Islamic financial markets which are implied by the fact that the imperatives of the accomplishing interest-free *halāl* (i.e., the Islamically valid and allowed) financial transactions have been driving and incentivizing the Islamic financial institutions to offer banking services such as deposit and loans as well as additional wide range of non-core banking financial services such as fund management/capital market operations/ securitization/leasing/housing finance (Akhtar, 2007, 1). Consequently, with the fast growth of the Islamic financial institutions, the degree of integration among the several segments of the Islamic finance has been fast enhanced². Thus, according to Akhtar, the Islamic banks and non-bank financial institutions either end up directly having large exposure in the Islamic capital markets or indirectly by acquiring subsidiaries which transact in the Islamic capital markets. In this scenario depicted by her, the Islamic financial institutions assume the structure, characteristics, functions and institutional role of developmental Islamic universal banking which is capable of exploiting progressive money-real economy linkages.

While the Islamic financial institutions are constituents as well as the developers of the Islamic capital market, their own further growth is contingent upon the development of the Islamic financial market including both the Islamic money market for providing additional liquidity support as well as additional investment opportunities and the Islamic capital market through development of *takāful* as the constituent and promoter of the secondary Islamic bond/capital markets through its critical role as a major buyer of the Islamic financial Instruments (Akhtar, 2007, 2).

3. DIVERSE DEVELOPMENTAL ROLE OF THE ISLAMIC BANKS AND OTHER IFIS IN THE CONTEXT OF ISLAMIC CAPITAL MARKETS

Islamic Financial Institutions (e.g., Islamic investment banks etc.) have practically assumed the role of a financial innovator and have introduced a great number of financial inventions and innovations in the arena of expanding the scope and horizons of Islamic money market and Islamic capital markets. This point of view is sufficiently evidenced by an immensely large set of actually used as well as perceived Islamic financial instruments having direct and indirect linkages with real economy.

Islamic banks and other Islamic financial institutions, which are cooperative competitors of the Islamic stock market, are the potential engine of growth of real economy through the effective operationalization of linkages between money and real sectors of the economy. Islamic banks mobilize deposits on a profit/loss

sharing basis in the framework of *muḍārabah* or *mushārah* and their *muḍārabah/mushārah* contracts transform their deposits into a fund management product. In this context, fund management refers to the management of Islamic mutual funds and *muḍārabahs*. In this background it is an imperative for the Islamic banks to acquire their assets on profit/loss sharing basis as well by moving away from the fixed return products such as *murābahah* and *ijārah*. A positive response in the direction of this imperative inevitably pushes the Islamic banks into the arena of Islamic universal banking (i.e., Islamic interest-free multipurpose banking) which requires the Islamic banks to manage the portfolio profitability by investing across sectors in the Islamic principles-based businesses like the equity and *ṣukūk* in the Islamic capital market and in the trade contracts such as *murābahah*, *mushārah*, *ijārah* and *takāful*. In this scenario, development of *takāful* and re-*takāful* is of vital importance for providing Islamic insurance coverage to Islamic banking products. Thus, the Islamic financial institutions must swiftly promote their inter-linkages and mutual integration for developing themselves, the Islamic capital markets and the Islamic real economy.

Practically, some Islamic financial institutions have been playing at least some role in the context of providing finance to the needy Muslim countries/Islamic financial institutions/Muslim minorities throughout the Whole World. In this context, it is important to note that the Islamic countries and the Islamic financial institutions have played a stabilizing role in the financial crises of the late 1990s experienced in Malaysia and Indonesia as well as the most serious financial crises of Pakistan's history (e.g., the Islamic Development Jeddah helped Bank Muamalat in getting rid of its losses, Tabung Haji contributed positively to the stability of Malaysian real economy in the financial crisis years of 1997-98 by earning a significantly high profit of US\$152 million in 1998. Similarly, Muslim countries/IDB and certain financial Institutions helped Pakistan overcome the most severe post-nuclear tests financial crises of her history which emanated from the cancellation of "Enhanced Structural Adjustment Facility loan by the IMF under American political influence. For example, Kuwait extended \$250 million balance of payment support to Pakistan for a period of two years (at a 4% annual rate of return which is unfortunately un-Islamic return), IDB enhanced its credit limit from \$150 million to \$400 million in addition to providing credit lines to Malaysia for importing rice from Pakistan and for exporting pal oil, and al-Faisal Investment committed itself to provide \$50 million to Pakistan through Pakistan State Oil. Consequently, Pakistan's economy felt great financial relief. These facts highlight the urgency of the task of fast developing the Islamic international capital markets.

The aforementioned positive role of the Islamic financial institutions needs to be radically enhanced because the nature and structure of the contemporary international finance is such that the Muslim countries are unable to attract the requisite capital from the capitalist developed countries and their financial institutions as well as the foreign direct investment without sacrificing their financial interests in ideological, strategic, political, economic and socio-cultural

contexts. For example, the supply of the international capital from the capitalist countries and their financial institutions is based on the interest which is forbidden in Islam and is mother of all factors which make the complete debt-servicing impossible for the developing countries. Moreover, the international financial institutions dictate the use of their lent capital according to imposed terms and conditions, which are based on their vested interests, thereby causing not only the loss of the recipient Muslim developing countries' political and economic sovereignty along with the loss of their economic efficiency especially in the case of the dictated misallocation of resources resulting from the so-called structural adjustment program. As a result, Muslim developing countries become politically, economically, strategically vulnerable because of the expected financial outflow in the form of back payment of the principal amount along with the compounded interest.

In the above scenario, the Muslim developing countries, which are trying to develop themselves through reliance on the inflow of the development finance from the capitalist financial set-up, are getting increasingly overwhelmed by the additional complex problems of underdevelopment such as everlasting and ever-increasing debt-servicing, the corresponding chronic budget deficits, accelerated inflation, and depression. In this situation, the possibility of the demand-matching inflow of capital from the capitalist international capital markets seems to be quite limited due to the reluctance of non-Muslim capitalist of the non-Islamic countries to supply their capital on interest-free basis as well as on the profit-sharing basis. Similarly the capital surplus Muslim individuals, Islamic financial institutions and the Islamic countries will be unable to find better Islamic outlets for their surplus outside the framework of the Islamic international capital markets. In this scenario, the massive capital supply is expected to match the tremendous demand for capital in such ways that satisfy all the Islamic investment conditions within the framework of the Islamic international capital markets. Moreover, the relative swift and stable international capital flows, through the Islamic financial institutions having direct productive links with real sectors, are expected to radically improve employment, output, and income levels of workers as well as capital owners. From the point of view of maximizing the efficiency and social welfare along the Islamic lines, the market-intermediated Islamic capital inflows (i.e., based on *mushārahah/muḍārabah*/ foreign direct investment originating from the Islamic countries merit to be promoted through the role of Islamic financial institutions and markets.

Some practical insights about the diverse real roles of some existing Islamic financial institutions are presented as following:

3.1. Role of Islamic Development Bank as a Pan-Islamic Development Finance Institution

The Islamic Development Bank (IDB) is a pan-Islamic development finance institution instituted, at its headquarters in Jeddah in 1975, with 25% of its total

authorized capital contributed by Saudi Government and the remaining by the other Islamic countries, for promoting socioeconomic development in its 55 member Islamic countries (i.e., members of the Organization of Islamic Conference) as well as Muslim communities of the non-member countries both individually and jointly according to the principles of Shari'ah. IDB is authorized to accept deposits, raise funds in any other Islamically valid way, participate in equity capital, grant interest-free loans for productive projects and enterprises, set up trust funds, institute special funds for specific purposes as well as provide financial assistance to member countries and Muslim communities of the non-member countries in other possible Islamic forms for ensuring their social and economic development.

In addition, IDB is responsible for assisting its member countries in the context of promoting their foreign trade in capital goods in particular, providing technical assistance as well as training facilities to the member countries and their personnel involved in the development activities, and accomplishing research for bringing the economic, financial, and banking activities of the economic agents of the member countries in conformity with Shari'ah.

Islamic Dinar, being equivalent to one Special Drawing Right of the International Monetary Fund, is accounting unit of the IDB. IDB's ordinary financial resources, amounting to Islamic Dinars 3.5 billion at the end of 1420H, consisted of member countries' subscriptions in the form of paid up capital, reserves, and retained profits. It is important to note that at the end of 1320H, IDB's financial resources consisted of its authorized capital amounting to Islamic Dinars 6 billion, its subscribed capital amounting to Islamic Dinars 4.1 billion, and its paid-up capital amounting to Islamic Dinars 2.5 billion. IDB, in order to support its ordinary financial resources on interest-free basis by avoiding borrowing from the conventional banks, has instituted interest-free schemes and instruments such as the IDB Unit Investment Fund (UIF³), the Export Financing Scheme (EFS⁴) which was previously known as Long-Term Trade Financing, and the Islamic Bank's Portfolio (IBP⁵).

On the basis of Shari'ah-compliant modes (i.e., interest-free loans, equity participation, leasing, instalments sale, profit-sharing and contract of manufacture called *istiṣnā'*), the IDB finances the development projects of its member countries, provides finances to its member countries in the form of technical assistance, promotes trade among its member countries by instituting Import Trade Financing Operations, EFS, and IBP for investment and development, provides financial assistance and grants to Muslim communities of the non-member countries, and provides assistance from the *waqf* (i.e., Endowment) Fund in case of natural disasters.

Over the period 1976-2000 (1396H-1420H), the IDB disbursed 95% of the overall amount approved for the financing of the technical assistance as well as projects by using the Islamic modes of financing. In this background, a soft interest-free type of financing (i.e., interest-free type of loan which requires the

borrower to pay only for the actual administrative cost of the loan) constituted 33.4% of the IDB's total financing, leasing constituted 27.4% of the IDB's total financing, and instalments sale constituted 22.6% of the IDB's total financing. During the period 1395H-1420H, the total sum approved for the operations financed by the IDB amounted to Islamic Dinars 16.5 billion.

3.2. Role of Abu Dhabi Islamic Bank as UAE's Universal Islamic Bank

Abu Dhabi Islamic Bank (ADIB) was established in 1997 as a public joint stock company. It launched its commercial operations with a paid-up capital of one billion Dirhams divided into hundred million shares, with every share having a value of 10 Dirhams, in accordance with the Islamic Sharī'ah principles. ADIB's shares are quoted on the Abu Dhabi Securities Market.

While the founders of ADIB (i.e., members of the ruling family, Abu Dhabi Investment Authority, and the prominent national of the UAE) hold 39% of its equity, 61% of its equity is held by nearly 100,000 shareholders.

The mission of the ADIB is to become the premier universal Islamic financial institution operating according to the principles of Sharī'ah by sharply focusing on customer needs, offering innovative financial products and services, motivating as well as rewarding ADIB's employees, employing state-of-the-art service delivery systems, and, thereby, maximizing returns for investors and shareholder of the ADIB. For accomplishing the aforementioned mission, ADIB aims at developing a corporate culture for providing its clientele with quality, cost-effective and Sharī'ah-compliant financial services. ADIB's corporate culture having the core corporate values of realizing the Islamic ideals, practicing rules of Sharī'ah in all activities of ADIB's, focusing on 100% customer satisfaction, practicing the merit in the process of promotions of ADIB's employees, emphasizing creativity and the modern technology, and rewarding shareholders with competitive returns on their investment in ADIB.

ADIB offers the facilities of current account, chequebooks, electronic account, savings account, unrestricted recurring investment account, 24 hour telephone banking, ATM card, remittances, demand draft, execution of standing instructions, safe deposit lockers, *murābahah*-based car financing/goods financing/furniture financing/farm financing, and Sharī'ah compliant open-ended mutual fund 'Al-Hilal Fund⁶' with ADIB as the Fund Manager.

3.3. Role of Bank Muamalat as an Indonesian Islamic Commercial Bank

According to the Article 3 of the PT Bank Muamalat (BM) Indonesia's latest Articles of Association, BM is an Islamic commercial bank. The establishment of BM Indonesia, accomplished in 1991, was endorsed by the Indonesian Council of 'Ulamā' and the Indonesian Government. BM is supervised by its own Sharī'ah Supervisory Board. On the date of signing of the articles of association, Bank

Muamalat (BM) received Rp. 84 billion pledge for the purchase of the BM's shares.

BM commenced its operations in May 1992 and it also received the license to operate as a foreign exchange bank on October 27, 1994. This development strengthened BM's position as a leading Indonesian Islamic bank having a growing array of products and services.

Until the end of the year 2002, BM dominated the Islamic banking market in Indonesia by having total assets of Rp.2.14 trillion, stockholder's equity of Rp. 165.30 billion and net profit of Rp.23.17 billion for the year 2002. An glimpse of growing confidence in BM is implied by the BM's success in increasing its paid-in-capital through a rights issue which raised fresh funds amounting to Rp.104 billions from the bank's shareholders in 2002. Growing confidence in BM is reflected by the fact that BM experienced the growth in its *muḍārabah* Time Deposits of 67% as well as growth *muḍārabah* Savings Funds by 29.9%.

In the year 2002, BM served more than 296,000 customers through a net work of 70 branch offices and service outlets in 18 cities and 13 provinces with the help of 744 highly trained personnel. BM offers funding products, financing products and banking services.

BM's funding products include *Ummat* Savings (i.e., an investment account with unrestricted withdrawals from any BM branch or ATM facility), *Arafah* Savings (i.e., a saving plan for setting aside funds for Hajj), *fulinves* Deposit (i.e., a time deposit account for individual account holders with attractive revenue sharing package), *wadī'ah* Current Account (i.e., a third party demand deposit or current account that can be withdrawn at any time and the account holders are entitled to a bonus payment from the bank on the basis of bank's earnings), *Mumalat* Pension Fund (i.e., It involves a reasonably affordable monthly payment of Rp.20,000 by individuals who are in the age bracket ranging 18 year to 60 years), *wasī'ah ummat* program (i.e., a life insurance of a certain amount and premium).

BM's financing products include *murābahah*, *istiṣnā'*, *salam*, *ijārah muntahia bittamleek*, *muḍārabah*, *muḍārabah muqayyadah*, *mushārahah*, *qard*, *rahn*, *wakālah*, and *hawālah*. BM's banking services include ATM, Phone Banking (i.e., a 24-hour information service through telephone about products and services etc.), Payment Points (i.e., a service for BM's customers and non-customers to pay their telephone bills and Alms), money changer for the Saudi Riyal at *hajj* embarkation (i.e., a money changer outlet for *hajj* pilgrims), *zakāh*, *infāq*, and *ṣadaqah* (ZIS) Payment, Payroll (i.e., BM helps manage the payroll administration of a company or institution), *Sharī'ah* consistent service of Letter of Credit, Online Tax Service (i.e., online tax payment service through BM which is linked to the Directorate of Taxation for providing a reliable and convenient way for the public to pay their taxes), and other services (e.g., transfer, collection, standing instruction, bank draft, bank reference, tax payment etc.).

BM is also continuing to develop service alliance with third parties for improving its banking services. It is also applying principles of good corporate governance (i.e., principles of transparency, responsibility, fairness, and accountability). Moreover, BM has also been placing a strong emphasis on social responsibility and community care by promoting awareness and understanding about the Shari'ah economic system and about its practice, by sponsoring programs of charity, sports, culture, public education and health, and by instituting the activities of Baitul Mal Muamlat (BMM) which not only collects and distribute ZIS but also accomplishes micro financing with the support of international relief funds (e.g., Islamic Development Fund).

During the period 2001-2002, BM's amount of third party funding registered 43.6% increase from Rp.1.2 trillion to Rp.1.7 trillion. The largest constituent of BM's third party funding is *muḍārabah* Time Deposit which contributed 62.77% of the BM's total third party funds. During the period 2001-2002, BM's amount of *muḍārabah* Time Deposits registered an increase of 67%.

During the period 2001-2002, BM's amount of financing registered 46.1% increase from Rp.1.2 trillion to Rp.1.7 trillion. The most important distinctive feature of BM's financing is the fact that more than 29.8% of its financing is in the form of profit sharing financing schemes.

BM operates on the principle of prudent banking according to which it does not provide more 40% its total financing to any single financing type, industry, sector or financing tenor. Consequently in 2002, working capital financing constituted 49.8% of BM's total financing, investment financing constituted 34% of BM's total financing, and consumer financing constituted 15.3% of BM's total financing thereby reflecting the focus of BM on productive economic activities in place of consumptive activities. It is important to that financing to the business services sector constituted 29.2% of BM's total financing, financing to the construction and transport sectors constituted 23.4% of BM's total financing, financing to manufacturing and trading sectors constituted 11.7% of BM's total financing, and aggregate financing to other industrial sectors such as mining, oil, gas electricity, plantation, public services etc, being individually too small to mention, constituted 34.6% of BM's total financing. In 2002, financing for tenor of less than 1 year constituted 14.4% of BM's total financing, financing for tenor of 1-3 years constituted 36.5% of BM's total financing, financing for 3-5 years constituted 30.9% of BM's total financing, and financing for more than 5 years (i.e., long term financing which is generally provided for land development, plantations, housing, shopping malls and property development ventures) constituted 18.2% of BM's total financing.

In the period 2001-2002, BM's portfolio of SME financing increased by 82.2% from Rp.315 billion to Rp.574 billion. This fact reflects BM's concern for promoting the welfare of people in SME sector. In the period 2001-2002, BM's profit before tax increased from Rp.33.5 billion to Rp.62.7 billion and BM's net

income (i.e., BM's income after taking into account corporate taxes) decreased from Rp.43.3 billion to Rp.23.2 billion.

BM's financial transition from 1998 to 2002 reflects an increase in value of its total assets from Rp.479.1 billion to Rp.2138.74 billion, an increase in its total financing facilities from Rp.462.1 billion to Rp.1770.44 billion, an increase in its total third party funds from Rp. 391.90 billion to Rp.1719.11 billion, an increase in its total paid-up-capital from Rp.138.4 billion to Rp.165.30, an increase in its total equity from Rp. 39.30 billion to Rp.174.32 billion, a decrease in LDR⁷ from 107.15 % to 84.20%, increase in number of its shares from 101 million to 165.30 million, an increase in its earning per share from Rp.-624 to Rp.140, an increase in its ROA⁸ from -23.94% to 1.85%, an increase in its ROE⁹ from -271.94% to 15.52%, and an increase in its CAR¹⁰ from 6.75% to 9.64%.

3.4. Role of Amanah Mutual Funds as an American Islamic Mutual Fund¹¹

Amanah Mutual Funds, which were established in the mid-1980s, claim to offer the services of financial intermediation and investment in accordance with the Islamic principles¹² to the American Muslims who have few options for *halāl* investment within the interest-based American financial system. Amanah Mutual Funds try to accomplish the long-term equity investments for the sake of protecting their investments against inflation.

Now Amanah Mutual Funds have two funds namely the Amana Growth Fund aiming at the long-term growth of the capital by favouring the companies which are expected to register growth in their earning as well as in their stock prices and Amanah Income Fund aiming at the current income as well as at the preservation of the capital by investing solely in those dividend-paying common stocks which are expected to have the most stable stock prices. During the period of past 5 years, Amanah Growth Fund generated a total return of -3.5% over the past five years and the Amanah Income Fund generated a total return of 19%. Since the time of launching Amanah Mutual Funds' marketing campaign in 2001, the assets of Amanah Mutual Funds have more than doubled. On 15th of April 2005, Amanah Income Fund's price became \$ 21.19 by registering a positive change amounting to \$0.33 and Amanah Growth Fund's price became \$14.31 by registering a change amounting to \$0.20. Dividend (i.e., QID recorded on 12/31/2004) in case of Amanah Income Funds was \$0.122. On 31st of December 2004, after-tax returns on distribution for Amanah Income Funds amounted to 20.53% in case of investments for one year, 2.72% in case of the investment for five years, and 8.1% in case of investments for ten years. On 31st of December 2004, after-tax returns on distribution for Amanah Growth Funds amounted to 23.04% in case of investments for one year, -2.22% in case of the investment for five years, and 13.06% in case of investments for ten years.

3.5. Role of Tabung Haji as a Malaysian Islamic Saving Bank

Tabung Haji is one of the pioneering and successful Islamic banking institution in Malaysia. Tabung Haji signifies the culmination of Professor Ungku Aziz's innovative and progressive theoretical model of Islamic saving bank initially into an incorporated Pilgrims Saving Corporation on 30th September 1962 and later into Lembaga Usurun Dan Tabung Haji (i.e., The Pilgrims Management and Fund Board) in 1969 as a result of official merger of the Pilgrims Saving Corporation. Tabung Haji is progressive in character on account of its progressive Islamic approach of eliminating socioeconomic hardships of the prospective Malaysian pilgrims who saved mainly for financing their Islamic Pilgrimage (i.e., *hajj*) by placing their paltry savings for long periods of time in either pillows, under mattresses, in cupboards, in earthen jars buried underground or in the form of purchased land and livestock with the intention of selling them later at uncertain prices for meeting *hajj* expenses purely on the Islamic grounds of protecting their savings from being contamination with interest in case of depositing their savings in the then existing interest-based banking institutions. During and after this long uneconomic and painful exercise of savings, both the prospective pilgrims and the financially constrained poor economy of Malaysia suffered from impoverishing microeconomic and macroeconomic implications of the leakages of investable financial resources, the resulting lack of capital formation, and the development of underdevelopment. In this background Tabung Haji assumed the role of an Islamic development finance institution, whose banking program is integrated with Malaysian vision of becoming an industrialized and developed country in the year 2020, for relieving the aforementioned hardships of the Malaysian Muslim masses as well as of their country with complete official patronage, with its perfectly socialized Islamic banking agenda, and with its massive popularity by the grace of Allah (*subhanu hu wa taa'ala*).

In the background of the aforementioned facts, the core activities of Tabung Haji are *hajj*¹³ as well as fund management in modern, innovative and efficient ways due to which Tabung Haji has already earned Islamic Development Bank Prize in Islamic Banking in 1990, IT management award in 1992, and Prime Minister Quality Award for Public Sector in 1995 along with earning distinctions of becoming Certified Ms ISO 9002 for *hajj* operation in 1997, representing Malaysia in ICQCC in Colombo (Sri Lanka), and becoming Certified Ms ISO 9002 in 1998. Tabung Haji's years of experience, good computerized infrastructure, well-planned operations of worth greater than US\$53 million, good intergovernmental relations, and economies of scale enabled it to offer the high quality services at the lowest per person cost of Hajj (i.e., US \$ 2,300) as compared to that in Malaysia's neighbouring countries (i.e., US\$ 5,300 in case of Singapore and US \$3,200) in Indonesia.

It is important to note that Tabung Haji has increased its market share in terms of the number of depositors from 23 % (i.e., 2.7 million depositors out of a

Malaysian Muslim population of 11.9 million) in 1995 to 27% (i.e., 3.4 million depositors out of a Malaysian Muslim population of 12.8 million in 1995) thereby implying that its depositors are growing at an annual growth rate of 8.1% in contrast to the 2.5 % annual growth rate of Malaysian Muslim population. By the year 2000, in addition to the aforementioned enviable record of achievements in the context of *hajj* management, Tabung Haji has evolved into a corporate body having more than 100 branches, almost 4 million depositors, and deposits amounting to US\$ 1.8 billion. During the next ten years, Tabung Haji is targeting 50% of Malaysian Muslim population to become its depositors and Tabung Haji is expected to achieve this target keeping in view the significantly higher growth rate of its depositors as compared to the growth rate of Malaysian Muslim population.

In 1998, despite the impact of South-East Asian Crises experienced by Tabung Haji in the form of decline in its annual asset growth rate from 37% in 1996 to 30 % in 1997 and to 19% in 1998 in contrast to the comparable conventional counterparts of Tabung Haji which experienced a decline in their annual asset growth from 36% in 1996 to -12 % in 1997 and to -3% in 1998, Tabung Haji's assets amounted to more than US \$ 1.8 billion. Consequently, Tabung Haji's share of industry's assets increased from 5% in 1996 to 10% in 1998. Tabung Haji's has been actively investing in capital market, commercial as well as industrial enterprises, housing development, and plantations thereby promoting the cause of development in the aforementioned areas and in the Malaysian economy as a whole. For instance in 1998, Tabung Haji's investment in equity amounting to RM3.5 billion constituted 58% of its portfolio, its investment in money market amounting to RM 1.8 billion constituted 31% of its portfolio and its investment in property amounting to RM0.7 billion constituted 11% of its portfolio.

In general, the profitability of Tabung Haji has also been impressively growing over the years with the exception of years of crisis (i.e., 1997) in which the growth in profits of Tabung Haji became a bit lower than the profit growth in the pre-crisis years. However, Tabung Haji earned significantly high profit amounting to US\$152 million in 1998. Since 1996 (i.e., just 3 years after its inception), when Tabung Haji was able to pay a 3 % bonus to its depositors, Tabung Haji has been continuously practicing its policy of paying competitive bonus (i.e., dividend) to its depositors in case of earning its profits and its bonus has been well above the market rates due to its success in earning healthy profits in all years since 1996. Even after the payment of *zakāh* at a rate of 2.5% on the behalf of its depositors, Tabung Haji's rate of bonus has been ranging from 4% to 9.5% and it has been remarkably high in Malaysian economy which has an inflation rate around 2%.

3.6. Role of Offshore Islamic Banking Units

The set of Offshore Islamic Banking Units (*OIBUs*) includes five Non-Saudi Islamic banks (e.g., Faisal Islamic Bank of Bahrain), domiciled in Bahrain and Kuwait, which have been operating in Saudi Arabia outside the direct authority of Saudi Arabian Monetary Agency (SAMA). However, Saudi Arabian Monetary

Agency (SAMA) has indirect influence on an OBU through its money/foreign exchange activities (e.g., Riyal Deposits in *OBU* are subject to Saudi Arabian Monetary Agency's control through its power to adjust the legal reserve requirements and the exchange rate adjustments between Riyal and US \$).

Faisal Islamic Bank of Bahrain, which joined the rank of *OIBU*, has no lender of last resort facility. These banks are competing with Saudi commercial banks for deposits and are participating in the investment activity by taking advantage of Foreign Capital Investment Law. These banks are allowed to invest in projects that may not be funded by the Saudi specialized credit institutions. While the licensed *OIBUs* are authorized to freely involve themselves in transactions with non-residents, they (i.e., *OIBUs*) are not normally authorized to transact with residents. In the background of the distinction made between accounts held by residents and non-residents, *OIBUs* are not normally authorized to hold resident accounts.

4. CONSTITUENTS OF THE INTERNATIONAL ISLAMIC CAPITAL MARKET

In the light of the already presented contents of this paper, the set of constituents of the International Islamic capital markets includes the following institutions:

- a) State banks of certain Islamic countries¹⁴
- b) IDB
- c) The set¹⁵ of Islamic banks and non-bank Islamic Financial Institutions
- d) Islamic Mutual Funds¹⁶
- e) Offshore Islamic Banking Units
- f) National/Multinational Corporations¹⁷
- g) Governments of the Islamic countries, states/provinces and emirates¹⁸
- h) Islamic segments of stock exchanges¹⁹
- i) Islamic over-the-counter markets
- j) Securities and Exchange Commissions of Islamic Countries (e.g., Pakistan)

5. OVERVIEW OF THE EVOLUTION OF ISLAMIC CAPITAL MARKETS IN INDONESIA, MALAYSIA AND PAKISTAN

a) Overview of Evolution of Indonesian Islamic Capital Market

In Indonesia, according to Law No.8/1995 pertaining to the capital market, Islamic mutual fund is working as a Sharī'ah-consistent instrument used for collection of funds from public and their investment in the portfolio of stocks by an investment manager. The growth of the Islamic mutual fund is greatly influenced by the availability of portfolio instruments for placing the Islamic mutual funds which is indeed still quite limited. It is important to note that the Islamic mutual funds do not invest their funds in the bonds of the companies which have either un-Islamic products or un-Islamic management practices. Activities of Islamic mutual funds involve the Indonesian Capital Market Supervisory Board and Bank Indonesia for supervision and regulation. According to the article 6 point m of the Banking-related Law No. 10/1998, the Islamic bank can offer financing or perform other activities in consistence with Sharī'ah principles in relation to its mutual fund, can act as investor and buyer of mutual fund product/sponsor of bank at the mutual fund company/bank custodian/investment manager/sales agent. Thus, Bank Indonesia has provided great flexibility to the Islamic banks in the context of their Islamic mutual fund investment.

The Islamic mutual fund is considered to be having low risk when it invests in the shares of the ten highest ranked companies in the ranking based on Jakarta Islamic Index. In this background, the implied permission for the Islamic banks to get involved in the share investment is expected to cause the exposure of the Islamic banks to risks to be of higher degree than that of the conventional bank. Thus, the investor/customer of the Islamic bank placing funds in the unrestricted account of the bank faces excessive risk if the Islamic bank places an excessive large amount of the pooled funds in the Islamic mutual fund products.

In Indonesia's Islamic bond-cum-capital market, the Islamic bonds have been growing in size and significance since their introduction at the end of 2002. In contrast to the Indonesia's first issued *mudārabah* contract-based, all other bonds have been based on the concept of *ijārah*. Since the middle of 2003 the issued Islamic bonds have maturities in the range of 5 to 10 years with their cumulative nominal value ranging from Rp.50 to Rp200 billion.

So far, there have been issued 12 Islamic bonds by a set of industries including telecommunications, shipping, estate, property, trade, and banking. The issuers, with the exception of the Islamic banks, generally issue the Islamic bonds along with conventional bonds having a nominal value of the issue greater than that of the Islamic bonds. Three prominent Indonesian Islamic banks namely, Bank Muamalat, Bank Syariah Mandiri and Bank Buopin Syariah have issued Islamic bonds based on *mudārabah* contract. All the issued Islamic bonds were fully subscribed and they are held being by their holders till the time of their maturity.

Consequently, there does not exist any secondary market for the Islamic bonds in Indonesia. Increase in the popularity of the Islamic insurance and reinsurance products is reflected by the following facts:

- There exist three full-fledged Shari'ah insurance companies.
- Six conventional insurance companies have instituted 16 branches offering Islamic insurance products
- One conventional reinsurance company has instituted one unit offering Islamic re-assurance.

b) Overview of Evolution of Malaysian Islamic Capital Market

At the outset, it is important to note that Malaysian financial markets in general and the Malaysian Islamic money markets in particular are regarded as the one of the most structured and modern Islamic markets in the world.

Malaysian Islamic money market involve the trading of Islamic papers, the *muḍārabah* inter-bank investment, the Islamic clearing and settlement system for SPI (i.e., Islamic Banking Scheme) commercial banks, SPI merchant banks, approved SPI finance companies and SPI discount houses. The set of financial instruments of the Islamic money market includes the government investment issues, Islamic accepted bills, green bankers acceptances, Islamic Debt Securities (IDSs) in the form of Islamic bonds and Islamic commercial papers and Islamic negotiable instruments.

A multinational company issued *bay' bithaman ājil*-based IDSs, amounting to US\$ 32.9 million, for a distillation plant in 1990. Afterwards, IDSs became increasingly popular in the form of the medium term Islamic bonds and the short-term Islamic commercial papers based on the applications of the Islamic concepts of *muḍārabah*, *ijārah*, *qarḍ ḥassan*. Malaysian Islamic equity market, consisting of stock exchange/Islamic unit trusts/property trust companies/stock-broking firms/Shari'ah-approved counters/Islamic Equity Benchmark Index (constructed from the list-of Shari'ah approved counters issued by Securities Commission) introduced by Kuala Lumpur Stock Exchange (KLSE) for tracking Shari'ah-compliant stocks in KLSE, involves the stock-broking activities and services which are rendered by one exclusively Islamic stock-broking firm and three conventional stock-broking firms.

Malaysian Islamic capital market includes a primary securities market, in which the new Islamic government papers and Islamic corporate securities are issued to the public and institutions, and a secondary market in which the already existing Islamic commercial papers, Islamic corporate securities, equities and unit trusts are traded.

In 1970s, funds raised in the capital market came from only Government securities in the public sector and from the ordinary shares in the private sector. In

the 1990, funds raised included Islamic notes. In 1990s, the government continued with its programs to deepen and widen the capital market and the issue of bonds on Islamic rules made history. In this period venture capital companies were more active in the financing of the expansion and start up of companies primarily in the electrical, electronic and non-metallic mineral industries.

The Islamic banks in general and the Islamic commercial banks in particular constitute the centre of the International Islamic capital markets because of the following facts:

- They provide an efficient world-wide international payments mechanism which lowers transaction costs and thereby enlarges the gains from trade in goods and services as well as the gains from trade of assets²⁰ (e.g., shares of stocks) between residents of different countries
- They undertake the broadest possible range of financial activities.

It is important to note that the Islamic banks liabilities consist of deposits of different types and maturities and their assets consist of interest-free loans as well as shares of stocks. Moreover, the Islamic banks can underwrite issues of Islamic corporate stocks for a fee. Like any other international banks, the international Islamic banks can pursue abroad even those Islamic banking activities which are not allowed²¹ by either the central banks or the immature economic conditions of their home countries. It is important to note that the banking activities of especially the commercial banks have been globalizing since 1990s in the sense that they have branched out from their countries of origin into the foreign countries wherein their several foreign offices accomplish their foreign banking business, which is termed as offshore banking, through establishment of any of the following three institutions abroad:

- Agency office, which does not accept deposits, responsible for lending and transferring funds
- Subsidiary bank, controlled by the foreign owner, subject to the same regulations that regulate the local banks of the country in which it is established
- Foreign branch, carrying out the same banking business as accomplished by the local banks abroad and, which gets regulated by the home and local regulations and takes the advantage of the international regulatory differences.

It is important to mention that the rapid growth of offshore banking has been accompanied by the growth in offshore currency trading partially due to the growth of international trade and partially due to ever-growing multinational nature of corporate activities.

Nonbank Islamic financial institutions (e.g., insurance companies, pension funds, and mutual funds), which have already diversified their portfolios by moving into foreign assets, are another important set of constituents of the Islamic international capital markets. Islamic countries' government agencies and central banks, which accomplish foreign exchange interventions are also the constituent of the Islamic international capital markets.

c) Overview of Evolution of Pakistani Islamic Capital Market

Pakistan has also been experiencing the establishment and development of the Islamic capital market as a direct manifestation of the fact that Pakistan's Islamic banking and financial industry has been fast globalizing. There have been functioning indigenous Islamic banks such as Meezan Bank Limited (Pakistan's Islamic bank initially incorporated as an Islamic investment bank in 1997 and then licensed as the first Islamic commercial bank in 2002). Foreign Islamic banks such as Dubai Islamic Bank of the United Arab Emirates (UAE) and Emirates Global Islamic Bank Limited²², which is backed by the investors from the UAE and Saudi Arabia, were recently instituted in Pakistan. They have fast branched out in Pakistan. The former is having several branches in major cities of Pakistan and the later has been successful in establishing at least 6 branches in Pakistan. In Pakistan, there are 6 full-fledged Islamic Banks in Pakistan with a network of 108 branches and there are almost 58 stand alone Islamic branches of conventional banks which are accomplishing Islamic banking and are experiencing phenomenal growth according to the records documented in April 2007. In the light of the aforementioned records, the Islamic banking sector constitutes 3.3% of the present total banking assets in Pakistan.

Keeping in view the equity-based nature of Islamic banking as well as actual lack of Shari'ah compliant financial instruments in Pakistan, State Bank of Pakistan has permitted a higher level of exposure of the Islamic banks (i.e., 35% direct and 10% future of their equity) in the capital markets in contrast to conventional banks (i.e., 20% direct and 10% future of their equity). Moreover, State Bank of Pakistan has relaxed the statutory reserve requirement for the Islamic banks by reducing it from the banking industry norm of 18% to 8%.

In Pakistan, Islamic banks have been allowed by the Government of Pakistan to set up asset management companies, brokerage firms and *takāful* business in the framework of the parent-subsidiary/affiliate model. While Islamic banks are being regulated by the State Bank of Pakistan, the other non-bank Islamic financial institutions (e.g., *muḍārabahs*, Islamic mutual funds, *takāful* companies etc.) and securities' operations are under the regulatory oversight of the Securities and Exchange Commission of Pakistan. It is important to note that State Bank of Pakistan the Securities and Exchange Commission of Pakistan are following quite different approaches toward Shari'ah compliance in the Islamic financial institutions which are regulated by them.

In addition to their involvement in investment banking activities (e.g., loan syndication and structured finance, Pakistani Islamic banks have been offering not only *murābahah*-based trade financing but also the equity and quasi equity products (e.g., *mushārahah* and diminishing *mushārahah*). State Bank of Pakistan has allowed the Islamic banks to practice parent-subsidiary/affiliate model according to which the Islamic banks are instituting asset management companies, brokerage firms, and *takāful* businesses. Some conventional banks (e.g., National Bank of Pakistan, Habib Bank Limited, Habib Metropolitan Bank etc.) have established subsidiaries as well as floated *muḍārabahs*. However, Islamic banks have yet not floated a *muḍārabah* in Pakistan.

On 22nd July 2007, investors of the Middle East accomplished negotiations for the purchase of certain Pakistani Islamic banks. Now, direct investment in Pakistan's Islamic banking industry has exceeded Rs20 billion till September 2007.

Several Islamic mutual funds (e.g., Pakistan's largest Islamic fund namely Meezan Islamic Fund, UTP-Islamic Fund and the United Composite Islamic Fund) and *takāful* (e.g., Pak-Kuwait *takāful* Limited which initiated its operations in December 2005 as the first Shari'ah compliant insurance company) have been instituted in Pakistan. This phenomenon of fast globalization of Pakistan's Islamic banking sector, which is a direct result of the ever increasing liquidity in the Middle East due to the booming oil prices would, has been leading the growth in Islamic banking and the Islamic capital markets to realize new heights. Along with the rapid growth in the Islamic banking and financial industry, corporate interest in Islamic banking has also been growing in Pakistan. Recently, Meezan Bank Limited has acted as co-lead manager in the 2nd Rs8 billion *ṣukūk al ijārah* issue of Water and Power Development Authority (WAPDA) as well as acted as joint lead manager in the Rs2 billion *ṣukūk al mushārahah* issue of Sui Southern Gas Company. Moreover, Emirates Global Islamic Bank has been mandated by National Industrial Parks Development & Management Company (NIP) to act as financial advisor/lead arranger for Rs.2 billion *ṣukūk*. This money would be used by a subsidiary of Pakistan Industrial Development Corporation, NIP for the development of a world-class park in Korangi, Karachi. Dubai Islamic Bank has been involved in the process wherein two *ṣukūk* worth Rs.1.725 billion were issued by Sitara Chemicals for the financing expansion of the existing chemical plant and for the setting up of in-house power generating facilities. Dubai Islamic Bank also acted as financial advisor/lead arranger in the Rs4.2 billion *ṣukūk* issue of Karachi Shipyard & Engineering Works (KSEW) which will use the money for upgrading the shipyard facilities.

Dubai Islamic Bank Pakistan was appointed by Orient Petroleum Institutional Inc. as the financial advisor/lead arranger for a \$35 million syndicated *Mushārahah* facility. In addition to the aforementioned facts reflecting signs of the globalization of the Islamic capital market of Pakistan, another aspect of the fast globalized Islamic capital market of Pakistan is the fact that the 47%, 31% and 22% of the

sovereign *ṣukūk* (of 5 years tenor) having an issue size of US\$600 issued by the Government of Pakistan's Pakistan International *ṣukūk* Company Limited in January were subscribed in the Middle East, Asia, and Europe respectively.

6. MENU OF ISLAMIC FINANCIAL INSTRUMENTS

In order to comprehend and appreciate the points of distinctions of the menu of Islamic financial instruments, it is important to first know that the menu²³ of financial instruments traded in the conventional international capital markets which consists of both the equity and debt instruments, includes shares of stocks, stock options, currency options, bonds denominated in different currencies, and deposits denominated in different currencies. It is important to note that in contrast to equity instruments such as a share of stock²⁴ with its payoff varying according to circumstances, bonds and bank deposits are debt instruments. While facing different national price levels and exchange rates, individuals and countries tend to choose to apportion their portfolios between equity and debt instruments in such a way that enables them to realize the desired consumption and investment levels.

Keeping in view the Islamic permissibility of the debt arising from the postponement of either the price or the delivery of the commodity, Al-Jarhi (2004) has stated that the Islamic finance can be optimal only through a combination of debt, which is not marketable, and equity. Therefore, the menu of instruments of Islamic capital markets may also include both the Islamic debt and equity instruments which are being listed in the following two menus of the Islamic financial instrument:

a) Menu of Conceptual Islamic Financial Instruments

i) Menu of Possible Forms of Investment *ṣukūk* Introduced by AAOIFI

- Certificates of ownership of leased assets (*ijārah ṣukūk*)
- Certificates of ownership of usufruct
- Certificates of ownership of usufruct of existing assets
- Certificates of ownership of usufruct of the described future assets
- Certificates of ownership of usufruct of services of the specified party
- Certificates of ownership of usufruct of the described future services
- *salam* certificates
- *istiṣnā'* certificates
- *murābahah* certificates
- *mushārakah* certificates (Participation certificates, *muḍārabah* certificates, Investment Agency *ṣukūk*)

- *muzāraʿah* certificates
 - *musāqah* certificates
 - *muqāraḍah* certificates (agricultural certificates and seed planting certificates)
- ii) M.N.Siddiqi (1969) proposed for the Government of the Islamic countries to issue the following Islamic Financial Instruments:
- Government *Muḍārabah* Shares
 - Government Partnership Shares
- iii) Al-Jarhi (1981) proposes the following Islamic financial instruments to be issued:
- Central Deposit Certificates (CDCs)
 - Central Lending Certificates (CLCs)
 - Specific Investment Certificates (SICs)
 - General Investment Certificates (GICs)
 - Profit-Sharing Certificates (PSCs)
 - Leasing Certificates (LCs)
- iv) Ansari (1983) proposes for the Islamic state to get *qarḍ ḥasan* by issuing:
- State Certificates.
- v) Chapra (1996) proposes to issue the following Islamic financial instrument:
- equity-based instruments (e.g., stocks) of the public sector companies for open market operations.
- vi) Blueprint of Islamic Financial System of the International Institute of Islamic Economics (1999) proposes to issue the following Islamic financial instruments:
- Transferable *ijārah* Warrants
 - Asset *ijārah* Securities
 - Asset *ijārah* Securities involving a financial intermediary
 - Asset *ijārah* Securities issued by the government itself
 - Transferable *ijārah* Warrants with a finance-lease-transfer arrangement
 - Transferable *ijārah* Warrants with a build-lease-transfer arrangement.
 - General *mushārah* Certificates

- Decreasing-Participation/Redeemable *mushārah* Certificates
- Special *mushārah* Certificates against Existing Public Sector Undertakings
- vii) Waqar Masood Khan (Khan (2002) proposes to issue the following securities:
 - Profit Loss Sharing securities for open market operations.
- viii) Abulhasan M.Sadeq (2005) proposes for the Waqf institutions to issue the following financial instruments:
 - *Waqf* Certificates
 - *Waqf Qard* Certificates

b) Menu of Actual Islamic Financial Instruments

- Islamic government papers²⁵
- Islamic Debt Securities (Malaysian medium term Islamic bonds and short-term Islamic Commercial Papers issued by a multinational company)
- Islamic Notes (Issued in Malaysia)
- Investment Deposit Certificates (Issued by Kuwait Finance House and Sudani Islamic Banks)
- *Muqārah* (i.e., *muqārah*) Bonds (Issued by Jordan's Ministry of Endowments, Islamic Affairs and Sanctities)
- Islamic Transactions Certificates (Issued by Bank Misr of Egypt)
- IDB Investment Certificates (Issued by Islamic Development Bank, Jeddah)
- Islamic Bank's Portfolio (IBP²⁶)
- Participation Term Certificates (Issued by Pakistani banks and financial Institutions)
- *Mushārah* Term Finance Certificates (Issued by the Sitarah Group of Pakistan)
- Investment Council Unit Certificates (Issued by Investment Council in Bangladesh)
- *Qard Hasan* Certificates (Issued by the Malaysian Government)
- *Waqf* Unit Trust issued by Johar State of Malaysia

- Corporate *ijārah*-based *ṣukūk* issued by IDB
- Corporate *ijārah*-based *ṣukūk* issued by Bahrain Financial Harbour
- Corporate *ijārah*-based *ṣukūk* issued by Durarat Al Bahrain
- Corporate *Ijārah*-based *Ṣukūk* issued by Ample Zone Berhad in Malaysia
- Corporate *ijārah*-based *ṣukūk* issued by the First Islamic Bank
- Corporate *ijārah*-based *ṣukūk* issued by Tajeer (Saudia)
- Corporate *ijārah*-based *ṣukūk* issued by Emar in UAE
- Corporate *ijārah*-based *ṣukūk* issued by Ingress *Ṣukūk* k Barhad in Malaysia
- Corporate *ijārah*-based *ṣukūk* issued by Carvan 1 Limited in UK
- Corporate *ijārah*-based *ṣukūk* issued by Tabreed in UAE
- Sovereign *ijārah*-based *ṣukūk* (e.g., Malaysia's Global *ijārah ṣukūk*)
- Sovereign *ṣukūk* of Government of Bahrain
- Sovereign *ṣukūk* of Pakistan International *Ṣukūk* Company Ltd.
- Sarawak Corporate *ṣukūk*
- Dubai Global *ṣukūk*
- Dubai Civil Aviation *ṣukūk*
- Sovereign *ṣukūk* of Government of Qatar
- Sovereign *ṣukūk* of Government of Saxony-Anhalt State
- IDB Unit Investment Fund
- Amana Growth Fund of Amanah Mutual Funds
- Amana Income Fund of Amanah Mutual Funds
- Al-Hilal Fund instituted by Abu Dhabi Islamic Bank
- Islamic Corporate Securities (e.g., corporate *ijārah*-based *ṣukūk*)
- Islamic Unit Trusts
- *Ṣukūk al mushārah*
- *Qarḍ ḥasan* Certificates (issued by Malaysian Government)
- *Ṣukūk-ul-ijārah al-muntaha bi tamlik*

7. SOME DILEMMAS, POLICY RECOMMENDATIONS AND THE EPILOGUE

In the background of the fact that the most important asset of the Islamic financial institutions, which form the fundamental constituent of the Islamic financial markets, is the confidence of the public in them based on their positive reputation. Therefore, the greatest problem of the Islamic financial institutions is the reputational risk faced by them due to their different Shari'ah compliance practices which result into the misconception of the public regarding their Shari'ah compliance. For solving this problem, it is recommended that there must be instituted a strictly uniform scheme of Shari'ah compliance and that the Islamic financial institutions should function along the lines of the model of Islamic Consensus-Based Banks (Anjum, 2007, 212-214/220-222). Similarly, the quite different approaches to Shari'ah compliance in the different Islamic financial institutions regulated by the two different regulators (i.e., the central bank and the Securities and Exchange Commission) tend to expose the Islamic financial institutions to even greater reputational risk. For solving this serious problem, it is recommended for the aforementioned regulators to completely cooperate among themselves and institute a uniform approach to Shari'ah compliance in all the Islamic financial institutions of their country. Effective implementation of these policy recommendations will revitalizes both the Islamic financial institutions as well as the Islamic capital markets.

The already mentioned significantly increased exposure of the Islamic banks in the capital market exposes them to the phenomenon of volatility in the associated business. Moreover, the conglomerations arising either from the practice of Islamic universal banking or from the practice of parent-subsidiary model expose them to the problems of contagion risks, high group exposures, and conflict of interest (Akhtar, 2007, 2). For solving these problems, it is highly recommended for the Islamic banks to erect firewalls as well as by monitoring their own risk profiles, by efficiently managing their risks (Akhtar, 2007, 3), and by functioning along the lines of corporate governance-based Islamic banking model. In this context it is also recommended that supervisors of the Islamic banks effectively institute a special preventive-cum-curative supervisory regime for the Islamic banks and other Islamic financial institutions.

There is a serious institutional problem of shortage of both *Takāfuls* and *Re-Takāful*. Of course, existing *Takāfuls* are small in number and size relative to the potential size of their target market and *Takāful* insurers are themselves facing the problem of shortage of the of Islamic Reinsurance and *Re-Takāful*. Therefore it is recommended for the Governments of the Islamic countries to encourage and promote *Takāfuls* and *Re-Takāfuls* by providing appropriate incentives.

It is indeed an unwarranted serious dilemma that almost all Muslim countries and their central banks have been simultaneously practicing mutually contradictory/inconsistent interest-based conventional banking and the interest-free

Islamic banking despite the fact that the practice of the dual banking effectively constrains and hinders the movement of Islamic banking to realize its full-fledged development as well as its ideals. For ensuring the realization of the greatest blessings of the equitable interest-free Islamic financial system, it is sincerely recommended for all the Muslim countries to immediately switch over from the dual banking system to a purely Islamic banking and financial system.

Even in this age of financial globalization, the occurrence of a high frequency cross border trade in assets on a large scale is missing among all the contemporary 57 Islamic countries. This is partially due to the fact that international Islamic capital markets are narrow, fragmented and segmented either due to nationalistic considerations and policies (e.g., monetary and fiscal policies) or due to huge informational bottlenecks. This negative scenario is due to the persistence of restrictions on international capital flows in several Islamic countries other than Bahrain, Malaysia, Pakistan, and Sudan which have completely removed restrictions on international capital flows as well as due to the general absence of cross-listing of Islamic financial instrument among most of the Islamic countries other than Malaysia, Sudan and the member countries of Gulf Cooperation Council. Therefore, it is strongly recommended for the Government of the Islamic countries and the IDB to effectively promote pan-Islamic considerations and policy regimes, remove information bottlenecks, introduce a system of Islamic depository receipts, and institute as well as promote free capital flows as well as the cross-listing of Islamic financial instruments among themselves for ensuring the Islamization and globalization of Islamic capital markets and economies. In the context of the global dissemination of the requisite financial information, especially the OIC and IDB should join together to institute an efficient Pan-Islamic Information Bank.

One of the most challenging issues faced by the International Islamic Capital Markets is to ensure a systematically efficient change in the ownership of Islamic securities at the Islamic stock exchange. But in general, Islamic capital markets lack secondary markets for the Islamic financial instruments. It is recommended for the creation and enlargement of the secondary markets that appropriate steps should be taken by the Governments and the Islamic financial institution to direct their Islamic financial instruments to the small investors who will be generally interested in trading their Islamic instruments in secondary markets, to institute a trend of realizing liquidity as well as safety of principal value of the Islamic financial instruments through marketability, promote cooperative competition, integrate investment opportunities, popularize Islamic securities as collateral, and introduce comprehensive Islam financial reforms in the existing stock exchanges of the Islamic countries.

With the exception of Malaysia and some other Islamic countries, Islamic financial markets and especially the Islamic capital markets are either too under-developed or almost non-existent. Therefore, it is recommended that effective

strategies for simultaneously instituting and promoting an efficient network of both the organized exchanges as well as the over-the-counter markets should be designed as well as executed from the point of view of developing secondary markets in the Islamic countries. In this context, it is also being recommended for the Islamic countries to ensure universal access to the most economical, the most modern, and swiftest communication networks (e.g., internet facilities) at the massive scale within their national boundaries as well as among themselves.

The already presented discourses lead to the epilogue that the fast globalization of Islamic capital markets within a very short span of approximately three decades is a great pioneering accomplishment on the part of numerous Islamic financial institutions which, being a central constituent of the Islamic financial markets, have actually assumed a leading role in diversifying and enriching the structure and menu of the fast globalizing Islamic money markets as well as Islamic capital markets in the 21st century. Especially, the credit for this great accomplishment goes to the Islamic Development Bank Jeddah, Labaun Off-shore Financial Authority of Malaysia, Bahrain Monetary Agency, the Islamic Financial Services Board, AAOIFI, IMF, and the Governments as well as the Central Banks of Bahrain, Iran, Kuwait, Malaysia, Pakistan, Saudi Arabia and Sudan in the context of systematically instituting an International Islamic Financial Market including the International Islamic Capital Market as well as setting guidelines/standards for best practices of Islamic banking operations and procedures for the endorsement of issuance of the Islamic financial instruments. In this background, the phenomena of dramatic growth in both the global Islamic financial industry and Islamic capital market can be described as a pleasant outcome of the “From Top To The Bottom” multi-governmental institutional approach/strategy of systematically conceiving, instituting, regulating, and developing the institutions of global Islamic financial markets for Islamically channelling the financial fuel to accelerate the engines of growth of the real economies of the Islamic countries.

Overviews of the dynamic and highly innovative diverse roles of Malaysian/Pakistani/Indonesian Islamic financial institutions in developing themselves, their Islamic financial instruments, the Islamic financial markets of their respective countries, and the real sectors of their countries point to the bright prospects of the growth of the Islamic financial industry, the international Islamic capital markets and the economies of the Islamic countries. To realize this progressive scenario, the Islamic countries’ governments and their agencies must assume a pro-active role of providing at least a level-playing field to their Islamic financial institutions relative to the conventional financial institutions. This step of great strategic importance will effectively reinforce the roles of Islamic financial institutions as financial innovators-cum-fund providers as well as entrepreneur in revolutionizing the progress of the Islamic capital markets for developing the Islamic countries.

At least in this modern age of globalization, which signifies especially the integration of economies and markets of all countries on the globe, if the contemporary Islamic countries fail to mutually integrate their economies, monetary/fiscal regimes, labour markets, goods markets, money markets, stock markets, and the overall capital markets in the framework of the Islamic common market²⁷, then when will the Islamic countries realize the true globalization of their economies and capital markets? In this context, success of the Gulf Cooperation Council²⁸ in practically establishing the principle of free mobility of labour and capital in its jurisdiction is symbolic of the sliver lining in the clouds existing on the vast horizons of the contemporary Islamic world.

Notes

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¹ These include IDB *ṣukūk*, Ample Zone (Malaysia) *ṣukūk* and Ingress (Malaysia) *ṣukūk*.

² e.g., Because of not having the same investment avenues as those available to the conventional banks, Islamic banks tend to be strongly integrated with the Islamic capital markets (Akhtar, 2007, 1).

³ UIF is credit fund instituted, in 1410H, for pooling the savings of the Islamic countries' institutional and individual investors from the point of view of contributing funds for the economic development of the IDB's member countries. The amount of the initial issue of the Fund units was US\$ 100 million and it was raised to US\$325 million in 1996. Only, the Islamic banks, financial institutions, pension funds, charitable organizations and similar institution can invest in the UIF. IDB, as a market maker, offers the redemption facility through which the trading of units has been accomplished. UIF was listed on the Bahrain Stock Exchange in 1997 for meeting the liquidity requirements of the holders of units.

⁴EFS finances the non-conventional commodity exports of any IDB's member country to any other IDB's member country. EFS has its own membership (i.e., 23 countries in 1420H) as well as capital (i.e., EFS's subscribed capital was equal to Islamic Dinars 315.5 million and its paid-up capital was equal to Islamic Dinars 133 million. The IDB's share in the EFS, which was paid from its ordinary financial resources, amounted to Islamic Dinars 150 million. Since the date of inception of EFS (i.e., 1408H) to the end of 1420H, total volume of the approved EFS-based operations amounted to Islamic Dinars 405 million.

⁵ IDB (i.e., *mudārib*) established the IBP, with cooperation of the Islamic banks in 1407, as an independent income fund for investment and development which mainly targets the customers in the private sector of the IDB's member countries and aims at preserving its capital value and distributing its steady income among its participants/shareholders (i.e., 20 Islamic banks including the IDB at the end of 1420H). IBP has a fixed paid-up capital amounting to US\$ 100 million and a variable capital amounting to US\$ 280 million.

Moreover, IBP has access to a fund of US\$ 250 million instituted by the IDB as a specific deposit. IBP includes real asset along with cash and debts in order to ensure the consistence of the portfolio with the rules of Shari'ah which govern the circulation of shares. The initial issue certificates of ownership are subject to circulation or assignment only among the Islamic banks. Since the date of establishment of IBP to the end of 1420H, the total volume of the approved operations of the IBP amounted to US\$ 2519 million.

⁶ The units of the Fund can be subscribed to weekly as well as redeemed monthly.

⁷ LDR refers to Loan to Deposit Ratio.

⁸ ROA refers to Rate of Return on Assets.

⁹ ROE refers to Rate of Return on Equity.

¹⁰ CAR refers to Capital Adequacy Ratio

¹¹ Mutual funds, as an example of a securities-based assets-to-liabilities scheme, are financial intermediaries. Mutual funds do receive a commission or a fee for providing the service of pooling savings of several investors and channeling them directly into assets having an infinite variety of securities including treasury bonds, stocks, and international bonds/equities. In the framework of mutual funds, every investor has an account reflecting instantaneously and simultaneously the value of his holdings as well as the net "liability" of the mutual funds (i.e., the financial intermediary) toward the investor after subtracting the corresponding commission. Now, there has been observed a global shift toward a mutual fund system. Mutual funds, after being successful in accumulating assets having a value of more than \$ 4 trillion, are set to overtake the system of traditional banking system as the preferred system of financial intermediation for saving in the future due to the flexibility, transparency, and investors' control over their finances offered by the mutual fund accounts to the individual investors. The mutual funds system, within which the financial intermediary assumes the role of competing for attracting investors just like a retailer, results into a reduced role for the government because of the possibility that the mutual funds can be conveniently globalized (e.g., the mutual funds interested in selling global equity funds can easily draw on its existing funds from different regions of the globe.). Thus, a U.S. equity fund, a Latin American Fund instituted at New York, an Euro fund instituted at London, and an Asian fund instituted at Hong Kong may join to create a new fund called 'Global Equity Fund' which contains all the aforementioned funds. In a system of mutual funds, individual investors become more involved in monitoring the performance of their investments and, simultaneously, the mutual funds become more responsive to the demands of investors.

¹² Amanah Mutual Funds claim to follow the Islamic principles which require the investors to avoid interest-based investments as well as the investments in businesses of liquor, pornography, gambling, and banks. In this background, Amanah Mutual Funds claim to avoid investment in bonds and the other fixed-income securities.

¹³ Tabung Haji's *hajj* management program provides its already acknowledged world's best and most economical services to prospective Malaysian Hajis which cover all aspects of *hajj* including registration, issuance of passports and visas, medical examination and healthcare, comprehensive Hajj guidance through media as well as training programs, *hajj* operations including the supply of air travel/transportation for Hajj/food/residence/medical facilities for 25 000 pilgrims, and the banking services during *hajj*.

¹⁴ e.g., Bank Negara Malaysia (BNM), Bank Indonesia, State Bank of Pakistan etc.

¹⁵ The set of Islamic banks and non-bank Islamic Financial Institutions includes full-fledged Islamic banks/financial institutions, conventional financial institutions with Islamic

windows and full-fledged Islamic branches, and conventional financial institutions with Islamic windows. Among the leading Islamic financial institutions are some public and private banking/investment/insurance (*takāful*) institutions of certain Islamic countries, IDB, Offshore Islamic Banking Units, some corporations as well as multinational companies, the Organization of the Islamic Conference (OIC), and even the Islamic branches of some conventional banks. For example Citi Islamic Bank, which is a branch of American Citi Bank, is symbolic of the fast globalization of the Islamic banking as well as of the process of evolution of the interface between Islamic banking and conventional banking especially in Bahrain and Malaysia in several areas (e.g., current account, housing finance, use of *mushārah* and *murābahah* by some conventional banks for import and export financing etc.). A prominent example of a globalized private Islamic bank is Baraka Islamic Bank which was incorporated and licensed to operate from Bahrain as an Offshore bank on the 21st February 1984. Now this bank is a leading Islamic bank operating in Bahrain and covering Saudi Arabia, UAE, other GCC countries and Pakistan. Al-Baraka, as a part of Saudi Arabian Dallah Al-Baraka Group (founded in 1969) having interests in over 300 companies across 44 countries, is striving to be a premier regional Islamic bank. It has realized a large base of customers. Moreover, the Islamic unit trusts are specialized financial intermediaries in the Islamic capital market which provide the small investors with an opportunity to pool their resources in a diversified portfolio of securities managed and selected by the qualified portfolio managers. After the success of the Tabung Ittikal as the first Arab-Malaysian Unit Trust in 1993, there existed 13 Islamic Unit Trusts having a total fund size of US\$0.9 billion at the end of May 1999. It is important to note that Malaysia took lead in issuing first Global *ijārah sukūk* with an international rating.

¹⁶Islamic mutual funds are the Islamic counter part of the Mutual funds. Islamic mutual funds have been functioning in several Islamic countries (e.g., Indonesia, Pakistan, and UAE) and non-Islamic countries (e.g., USA). Islamic mutual fund is regarded as having low risk level when it is not involved in the share investment. National Unit Trust used to be an example of state-owned quasi-Islamic mutual fund of Pakistan.

¹⁷ i.e., Companies.

¹⁸ e.g., Government of Dubai is the owner of the 30% of the shares of Dubai Islamic Bank of UAE.

¹⁹ e.g., Bahrain Stock Exchange.

²⁰ Asset trades, which are sometimes ridiculously described as unproductive “speculation,” actually lead to gains from trade which make consumers of all countries better off.

²¹ It is important to note that the regulatory asymmetry has been spurring the growth of international banking for the last thirty years.

²² Emirates Global Islamic Bank Limited commenced operations in Pakistan in February 2007,

²³ Foreign real estate purchases and the direct acquirement of foreign factories lead to the realization of a more diversified menu.

²⁴ A share of stock is a claim to profits of a firm.

²⁵ Islamic government papers are the Government Investment Issues (GIIs) introduced in 1983 as liquid assets on the basis of the Malaysian Government Investment Act 1983 which permitted the issuance of the Islamic principles-based non-interest bearing government papers to public. In this background, SPI banks buy GIIs for meeting their liquidity requirements and for parking their temporary idle funds. It is important to note that the total outstanding GIIs amounted to US\$ 0.5 billion at the end of May 1999.

²⁶ IDB (i.e., *mudārib*) established the IBP, with cooperation of the Islamic banks in 1407, as an independent income fund for investment and development which mainly targets the customers in the private sector of the IDB's member countries and aims at preserving its capital value and distributing its steady income among its participants/shareholders (i.e., 20 Islamic banks including the IDB at the end of 1420H). IBP has a fixed paid-up capital amounting to US\$ 100 million and a variable capital amounting to US\$ 280 million. Moreover, IBP has access to a fund of US\$ 250 million instituted by the IDB as a specific deposit. IBP includes real asset along with cash and debts in order to ensure the consistence of the portfolio with the rules of Shari'ah which govern the circulation of shares. The initial issue certificates of ownership are subject to circulation or assignment only among the Islamic banks. Since the date of establishment of IBP to the end of 1420H, the total volume of the approved operations of the IBP amounted to US\$ 2519 million.

²⁷ It is important to note that the OIC-countries have already agreed upon the comprehensive resolution No.33/25-E on the Islamic Common Market in the 25th session of the Islamic Conference of Foreign Ministers held at Qatar on 15-17 March 1998.

²⁸ Gulf Cooperation Council (GCC), established in 1981, is a progressive regional economic and strategic organization consisting of Saudi Arabia, Kuwait, Bahrain, Qatar, Oman and the UAE.. GCC coordinates the economic and defense policies of its member countries.

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TRANSLITERATION TABLE

Arabic Consonants

Initial, unexpressed medial and final:

ء ʾ	د d	ض ḍ	ك k
ب b	ذ dh	ط ṭ	ل l
ت t	ر r	ظ ḏ	م m
ث th	ز z	ع ʿ	ن n
ج j	س s	غ gh	ه h
ح ḥ	ش sh	ف f	و w
خ kh	ص ṣ	ق q	ي y

Vowels, diphthongs, etc.

Short:	اَ a	ي i	و u
Long:	آ ā	إ ī	ؤ ū
Diphthongs:	أ aw		
	أ ay		

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GLOSSARY OF ARABIC TERMS

‘ <i>Āmil</i>	Agent who acts to perform a task.
‘ <i>Aqd</i>	Contract.
‘ <i>Arbūn</i>	Earnest money. (Also see <i>Bay‘ al- ‘Arbūn</i>)
‘ <i>Ibādah</i>	Worship.
‘ <i>Ibādāt</i>	Duties of man due to God.
‘ <i>Illah</i>	Reason/characteristic behind a Shari‘ah ruling such that if a particular reason/characteristic is found in other instances, the same ruling will apply.
‘ <i>Ulamā’</i>	Scholars.
‘ <i>Urf</i>	Established usage, custom. ‘ <i>urf</i> is one of the sources of Islamic law as long as it does not contradict the basic sources, i.e. the Qur’ān and <i>sunnah</i> .
<i>Aḥādīth</i>	Plural of <i>ḥadīth</i> . (For meaning, see below).
<i>Aḥkāṁ</i>	Plural of <i>ḥukm</i> . (For meaning, see below).
<i>Ajeer</i>	Lessee or worker on wages.
<i>Al-ghurm bil ghunm</i>	One is entitled to a gain only if one agrees to bear the responsibility for the loss. As an example, if someone gives finance to someone else, he is entitled to a share in profit resulting from the use of that finance only if he is also prepared to bear the loss if that happens to be the result.
<i>Al-kharāj bil ḍamān</i>	It states the principle of Islamic jurisprudence that entitlement to return or yield (<i>al-kharāj</i>) is for the one who bears the liability (<i>ḍamān</i>) for something, say asset, and one who does not bear the liability has no claim to the yield.
<i>Amānah</i>	Trust.
‘ <i>Āyah</i>	A verse of Qur’ān.
‘ <i>Bay‘</i>	Stands for sale. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like <i>murābaḥah</i> , <i>istiṣnā‘</i> , and <i>salam</i> .

<i>Bay^ʿ al- ʿArbūn</i>	ʿArbūn Sale. A sale in which someone buys an item by agreeing on a price and paying a portion of it in advance (earnest money) to the seller on the condition that if the transaction is completed the advance will be adjusted in the price and if the bargain is cancelled the seller will not return the advance.
<i>Bay^ʿ al-ʿAyān</i>	Sale of tangible objects such as goods (as against sale of services or rights).
<i>Bay^ʿ al-ʿīnah</i>	Selling of something to someone at a given price (usually on credit) and then buying it back from him at the same time at a different price (usually lower but cash). This kind of sale and buy-back is prohibited because it effectively means exchanging a given amount of money with a different amount of money, which amounts to <i>ribā</i> . It can be used as a subterfuge for <i>ribā</i> dealings.
<i>Bay^ʿ al-Dayn</i>	Sale of debt. According to a large majority of <i>fuqahāʾ</i> , debt cannot be sold for money except at its face value but can be sold for goods and services.
<i>Bay^ʿ al- Muḍāf</i>	A sales contract in which delivery of both the commodity and the payment is deferred e.g., forward sales in modern times. Such contracts are not permitted by the Shariʿah.
<i>Bay^ʿ al-Salaḥ</i>	An alternative term for <i>bay^ʿ al-salam</i> .
<i>Bay^ʿ al- Salam</i>	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
<i>Bay^ʿ al-ṣifāh</i>	Sale based on detailed description of the object of sale.
<i>Bay^ʿ Bi Thaman al- ʿājil</i>	Another term used for <i>bay^ʿ muʿajjal</i> . For meaning see below
<i>Bay^ʿ Muʿajjal</i>	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.
<i>Buyū^ʿ</i>	Plural of <i>bay^ʿ</i> . Sales.
<i>Ḍamān</i>	Guarantee, security.
<i>Ḍarar</i>	Damage, harm, injury.
<i>Ḍarūrah</i>	Necessity. (Usually used for the ‘Doctrine of Necessity’, whereby something otherwise prohibited becomes temporarily permissible).

<i>Ḍarūrah</i>	Necessity. (Usually used for the ‘Doctrine of Necessity’, whereby something otherwise prohibited becomes temporarily permissible).
<i>Dhimmah</i>	Liability, responsibility.
<i>Fasād</i>	Mischief, Trouble-making, corruption.
<i>Fāsīd</i>	Void transaction.
<i>Fatāwā</i>	Plural of <i>fatwā</i> . Religious verdicts by <i>fuqahā’</i> .
<i>Fiqh</i>	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, <i>fiqh</i> covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of <i>fiqh</i> is based primarily on interpretations of the Qur’ān and the <i>sunnah</i> and secondarily on <i>ijmā’</i> (consensus) and <i>ijtihad</i> (individual judgement). While the Qur’ān and the <i>sunnah</i> are immutable, <i>fiqhī</i> verdicts may change due to changing circumstances.
<i>Fiqhī</i>	Relating to <i>fiqh</i> (See Above)
<i>Fuqahā’</i>	Plural of <i>faqīh</i> meaning jurist, who gives rulings on various juristic issues in the light of the Qur’ān and the <i>sunnah</i> .
<i>Ghabn</i>	Loss suffered due to unfair difference between the price charged and the market value of an object of transaction.
<i>Gharar</i>	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
<i>Ḥadīth</i>	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
<i>Hajah</i>	Requirement (A need which is between absolute necessity and comfort).
<i>Ḥalāl</i>	Things or activities permitted by the Sharī‘ah.
<i>Ḥanafī</i>	A school of Islamic jurisprudence named after Imam Abū Ḥanīfa.

Ḥanbalī	A school of Islamic jurisprudence named after Imam Ahmed bin Ḥanbal
Ḥaqq	Right.
Ḥaqq	Right.
Ḥaqq al-irtifāq	<i>Lit:</i> The right of utilization or easement. <i>Tech:</i> The right to derive benefits gratis from the immovable property of someone else. The right has been recognized by the Sharī‘ah in the spirit of generosity that members of a community should display toward each other.
Ḥarām	Things or activities prohibited by the Sharī‘ah.
Ḥawālah	Literally, it means transfer. Technically, it refers to an arrangement whereby a debtor transfers the responsibility of payment of a debt to a third party who owes the former a debt. It is also used for cheque or draft.
Ḥibah	Gift.
Ḥikmah	Wisdom.
Ḥukm (Plural <i>aḥkām</i>).	Sharī‘ah ruling having general applicability.
<i>Ijārah</i>	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
<i>Ijārah muntahiyyah bil-tamlīk</i>	Lease ending in ownership.
<i>Ijmā‘</i>	A consensus (of <i>fuqahā’</i>). <i>Ijmā‘</i> is one of the sources of Islamic law.
<i>Ijtihād</i>	In technical terms, it refers to the endeavour of a jurist to derive a rule or reach a judgement based on evidence found in the Islamic sources of law, predominantly, the Qur’ān and the <i>sunnah</i> .
<i>Infāq</i>	Spending. In the literature of Islamic economics, it usually refers to spending in the way of Allah.
<i>Iqta</i>	Gift from the State, of Allah's property to whoever is able to manage it.
<i>Isrāf</i>	Extravagance, excessiveness (especially in expenditure).

<i>Istiṣnāʿ</i> (Used as a short form for <i>bayʿ al-istiṣnāʿ</i>)	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against <i>salam</i> , in <i>istiṣnāʿ</i> the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
<i>Jahl</i>	Ignorance, lack of knowledge. In contracts, it refers to lack of information with respect to the subject of the contract or the terms and conditions of the contract.
<i>Jamhūr</i>	meaning majority. For example, majority of jurists
<i>Juʿālah</i>	Performing a given task against a prescribed fee in a given period.
<i>Kafālah</i>	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.
<i>Khiyār Al-Sharṭ</i>	The option to rescind a sales contract based on some conditions. One of the parties to a sales contract may stipulate certain conditions, which if not met, would grant a right to the stipulating party an option to rescind the contract.
<i>Mabiʿ</i>	Object of sale.
<i>Māl</i>	Asset. Property.
Mālikī	A school of Islamic jurisprudence named after Imam Mālik
<i>Manfaʿah</i>	Usufruct. Benefit flowing from a durable commodity/asset.
<i>Maqāṣid al-Sharīʿah</i>	Basic objectives of the Sharīʿah. These are protection of faith, life, progeny, property and reason.
<i>Maṣlaḥah</i> (Plural <i>Maṣāliḥ</i>)	Literally, it means benefit. Technically, it refers to any action taken to protect any one of the five basic objectives of the Sharīʿah i.e., protection of faith, life, progeny, property and reason.
<i>Maysir</i>	Literally, it refers to an ancient Arabian game of chance with arrows used for stakes of slaughtered animals. Technically, gambling or any game of chance.
<i>Milkiyyah</i>	Ownership.
<i>Muʿāmalāt</i>	Relationships/contracts among human beings as against <i>ʿibādāt</i> which define relationship between God and His creatures.

<i>Muḍārabah</i>	A contract between two parties, capital owner(s) or financiers (called <i>rabb al-māl</i>) and an investment manager (called <i>muḍārib</i>). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
<i>Muḍārib</i>	An investment manager in a <i>muḍārabah</i> contract.
<i>Murābahah</i>	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. <i>Murābahah</i> is also referred to as <i>bay' mu'ajjal</i> .
<i>Mushārahah</i>	Partnership. A <i>mushārahah</i> contract is similar to a <i>muḍārabah</i> contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
<i>Muzārahah</i>	A contract whereby one party agrees to till the land owned by the other party in consideration for an agreed share in the produce of the land.
<i>Qabḍ</i>	Possession.
<i>Qarḍ or Qarḍ Al-Ḥasan</i>	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
<i>Qimār</i>	Gambling.
<i>Qiyās</i>	Derivation and application of a rule/law on the analogy of another rule/law if the basis (<i>'illah</i>) of the two is the same. It is one of the secondary sources of Islamic law.
Qur'ān (Also Written As Al-Qur'ān)	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). The Qur'ān lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
<i>Rabb Al-Māl</i>	Capital owner (financier) in a <i>muḍārabah</i> contract.

<i>Ribā</i>	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of <i>fuqahā'</i> to be equivalent to <i>ribā</i> .
<i>Ribā al-Faḍl</i>	<i>Ribā</i> pertaining to trade contracts. It refers to exchange of different quantities (but different qualities) of the same commodity. Such exchange in particular commodities defined in Sharī'ah is not allowed. Different schools of <i>fiqh</i> apply this prohibition to different commodities.
<i>Ribā Al-Nasā'</i>	<i>Ribā</i> pertaining to loan contracts.
<i>Ṣadaqah</i>	An act of charity.
<i>Salaf</i>	The short form of <i>bay' al-salaf</i> .
<i>Salam</i>	The short form of <i>bay' al salam</i> .
<i>Ṣarf</i>	Currency exchange.
Shāf'ī	A school of Islamic jurisprudence named after Imam Shāf'ī
Sharī'ah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'ān and the <i>sunnah</i> and embodies all aspects of the Islamic faith, including beliefs and practices.
<i>Shirākah</i>	Partnership. Technically, it is equivalent to <i>mushārah</i>
<i>Shuf'ah</i>	Right of pre-emption.
<i>Ṣuk</i>	Certificate or financial paper representing an asset.
<i>Ṣukūk</i>	Plural of <i>Ṣuk</i> .

<i>Ṣukūk al-ijārah</i>	A negotiable financial instrument issued on the basis of an asset to be leased. The investors provide funds to a lessor (say an Islamic bank). The lessor acquires an asset (either existing or to be created in future) and leases it out if it is not already leased out. The <i>ṣukūk al-ijārah</i> are issued by the lessor in favour of the investors, who become owners of the leased asset in proportion to their investment. These <i>ṣukūk</i> entitle the holders to collect rental payments from the lessee directly. These <i>ṣukūk</i> can also be made tradable in the stock exchange.
<i>Ṣukūk al-salam</i>	A negotiable instrument issued on the basis of a <i>salam</i> contract. A <i>salam</i> sale creates an in-kind debt payable on a future date. <i>Ṣukūk al-salam</i> represent common shares in that debt. Trading <i>salam</i> debt for money is controversial among Islamic scholars.
<i>Sunnah</i>	The <i>sunnah</i> is the second most important source of the Islamic faith after the Qur'ān and refers to the Prophet's (peace be upon him) example as indicated by his practice of the faith. The only way to know the <i>sunnah</i> is through the collection of <i>aḥādīth</i> , which consist of reports about the sayings, deeds and endorsements of the Prophet (peace be upon him).
<i>Sūrah</i>	A chapter of Al-Qur'ān.
<i>Takāful</i>	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone among the group, the loss is met from the collected funds.
<i>Tamwīl</i>	Financing.
<i>Tandīd</i>	Liquidation.
<i>Tawarruq</i>	Combination of <i>murābahah</i> and spot sale of the same commodity to same or related parties resulting in spot cash for deferred payment of a higher amount.
<i>Ummah</i>	The nation of Muslims.
<i>Uṣūl</i>	Principles, Basics.
<i>Wa'd</i>	Promise.
<i>Wadī'ah</i>	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.

<i>Wakālah</i>	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
<i>Waqf</i>	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the <i>waqf</i> .
<i>Zakāh</i>	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.
<i>Zānni</i>	Based on conjecture.
<i>Zūlm</i>	Injustice, Encroaching upon the rights of anyone else.

ABOUT THE BOOK

Islamic capital markets are among the important and growing segments of Islamic finance. These markets are experiencing inflow of innovative financial products and receiving increased investor attention. At the same time various countries and regions competing to position themselves as financial centres are gradually amending and strengthening their regulatory framework. These developments are opening new avenues for Islamic financial markets and posing new challenges.

The articles collected in this book analyze these opportunities and challenges by addressing the following three pertinent issues:

- What needs to be done to keep the innovative products, such as *sukuk*, stock indexes and similar other tradable financial products, Shari[ah]-compliant and economically useful in broadening the risk-return choices;
- How the regulatory framework for Islamic capital markets is impacting on the operations of these markets;
- How such markets compare in their level of development across various regions.

This book provides a rich food for thought and an agenda for action to researchers and policy makers.

ABOUT THE EDITOR

Salman Syed Ali is with Islamic Research and Training Institute (IRTI), Islamic Development Bank. Prior to joining IRTI he was on the faculty of International Islamic University Islamabad. His research interests are in the areas of Islamic economics & finance and game theory.

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