



الملتقى الدولي حول:

مقومات تحقيق التنمية المستدامة في الاقتصاد الإسلامي

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Islamic Financial Markets: Achievements, prospects, and challenges

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Abstract

Islamic financial services industry, including Islamic financial markets (IFMs), has been growing exponentially with an annual growth rate estimated between 10 and 15%, and has a presence in more than 75 countries. It is based upon the principles of Islamic finance (IF) such as the prohibition of *riba* (interest), *gharar* (excessive uncertainty), and adherence to profit-and-loss sharing, ethical investments, and asset backing. This paper, therefore, aims to review the evolution of the IFMs in different parts of the world. It mainly focuses on the challenges and the issues surrounding the IFMs and Islamic financial products and services. Four major issues are specifically highlighted and discussed, namely the issue of the evolution of the Islamic finance industry, basic principles of IF, IFMs (structures and products), focusing on the International Islamic Financial Market (IIFM), and the challenges the whole industry faces. Finally, a special attention is given to the Malaysian case since Malaysia is undoubtedly the pioneer of the Islamic capital markets and Islamic financial engineering.

Keywords: Islamic Financial Market, Islamic financial products and services, IIFM, Islamic financial services industry, principles of Islamic finance.

ملخص

نمت صناعة الخدمات المالية الإسلامية، بما في ذلك الأسواق المالية، بوتيرة متسارعة. إذ تراوح معدل نموها بين 15 و 20 % وأصبحت متاحة في أكثر من 75 بلدا. فهي تركز على المبادئ الإسلامية مثل تحريم الربا والغرر وغيره وتشجيع مبادئ اقتسام الربح والخسارة، الاستثمارات القيمة، وربط الاستثمارات المالية بأصول مادية. تهدف هذه الورقة إلى دراسة الأسواق المالية الإسلامية والتحديات التي تواجهها وكذا المنتجات والخدمات المالية. في هذا الإطار تم تحليل أربعة مسائل هي: تطور الصناعة المالية الإسلامية، مبادئ المالية

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الإسلامية، الأسواق المالية الإسلامية مع التركيز على السوق المالية الإسلامية العالمية، والتحديات التي تواجهها الصناعة المالية الإسلامية. كما أعطيت أهمية خاصة للسوق المالية الماليزية على اعتبار أن ماليزيا هي قاطرة أسواق رأس المال الإسلامية والهندسة المالية الإسلامية.

1- Introduction

Islamic financial services industry, comprising Islamic banking activities (commercial and investment banking), Islamic insurance (*takaful*), different Islamic capital markets, and non-bank financial institutions², is less than half a century old. The first *shariah*-compliant financial institution was Mit Ghamr Savings Project launched in Egypt in 1963. Mit Ghamr was a co-operative organization in which the depositors also had the right to take out small loans (Chong and Liu, 2009, p. 125). The same year saw the establishment of Tabung Haji in Malaysia (The Muslim Pilgrims Savings Corporation), which is still in business, profitably investing money being saved to the cost of the pilgrimage to the Holy Sites in Saudi Arabia. During the same decade many other countries, such as the Philippines, Pakistan, India, and Soudan established Islamic financial institutions in one form or another. The 1970's also saw the emerging of the main players of the Islamic banking and investment industries, such as Dubai Islamic Bank (1975), Kuwait Finance House (1977), Faisal Islamic Bank of Egypt (1977), Faisal Islamic Bank of Soudan (1977), Jordan Islamic Bank for Finance and Investment (1978), Bahrain Islamic Bank, and *shariah* Investment Company in Geneva (1980) and so on³.

Then after, Islamic finance (IF) has been developing at a remarkable pace in number (over 400 institutions worldwide), size (\$ 750 billion in assets), and in growth rate (10% -15% per annum). Islamic financial instruments are available in over 75 countries (Asian Devpt Bank, 2009, p. 1), in the five continents, although most Islamic financial institutions (IFIs) are concentrated in the Middle East and Southeast Asia, but spreading to other developed and developing markets. Moreover, demand for Islamic finance products present growth trends could see as much as \$24 billion in savings per year flowing to Islamic savings products from households by 2020, (Sproule et al., 2007, p. 1).

IF, as we shall see in more detail later, is governed by the precepts of the *shariah* which bans interest (*riba*) and speculation, and stipulates that income must be derived as profits from shared business risk rather than guaranteed return. It also bans the financing or participation in any business which is not *shariah*-compliant activity. The prohibited (sinful) activities are: alcohol, gambling, pork-related products, tobacco, firearms, conventional financial services, conventional insurance products, pornography and adult entertainment, and all other activities that violate *shariah* principles.

² - Sproule et al., consider that Islamic finance has four distinct areas: insurance, capital markets, wealth management, and retail banking, (Sproule et al., 2007, p. 3).

³ - Some writers recognize that "The Arabs from the Ottoman Empire had strong trade relations with the Spanish, and established financial systems without interest which worked on a profit-and-loss-sharing basis. These instruments catered for the financing of trade and other enterprises, (Schoon, N., 2008, p. 10).

IF has gained momentum in terms of market share during the last couple of decades, particularly in the area of *sukuk* and securitization. Islamic financial modes, mainly profit-and-loss sharing (PLS), have potential for development since they provide funds which can be used for short, medium and long-term project and other forms of financing. Nowadays, IF is not restricted to Islamic countries, but is spreading all over the world, from Japan and other countries of Asia, to Australia, Africa, USA, and continental Europe. Consequently, The German State of Saxony-Anhalt became the first non-Muslim issuer to tap the global Islamic debt market in 2004, successfully raising some 100 million Euros (US \$ 123 m), via a *Sukuk* issue (*ijarah* based issue). Among the subscribers were investors from US, UK, Saudi Arabia, Bahrain, Malaysia, Japan, Hong Kong and Germany (El-Qorchi, 2005, p. 47; Alvi, p. 9). The operation was also the first step towards the globalization of IF.

Thus, contemporary IF is becoming a rapidly growing subsector of international financial markets, and an increasingly popular area of financial innovation in those markets.

The role of Islamic financial system is quite similar to the conventional one, particularly in transferring funds from savings-surplus economic agents to savings-deficit ones. So it is an intermediary between savers and investors, and provides the economy with necessary funds through an array of financial products and services. However, this system is, in essence, ethical system, which does not violate Islamic principles, such as the prohibition of *riba* and *gharar*. Therefore, IFIs including Islamic funds and Islamic “Windows⁴” and subsidiaries must diversify their operations, especially, medium and- long-term products and services so they can compete with strong well established conventional institutions in a rapidly changing field on one side, and in a global competitive environment on the other.

The remaining of the paper is organized as follows: the next section (section 2) briefly reviews the literature. The third section traces the evolution of the Islamic finance industry, particularly since the early 1970’s. The fourth section explains the fundamental principles of Islamic finance, which includes prohibitions and obligations. The fifth section, which is the main part of the paper, provides a coherent discussion of the Islamic financial markets, focusing mainly on financial products and services, and financial market infrastructures. It also presents the Malaysian case as a pioneering experience in Islamic financial markets. The last section concludes the paper on the challenges lying ahead and provides an outlook of future development in Islamic financial markets and makes some recommendations.

2- Literature review

⁴ - **Islamic Windows.** Islamic finance *windows* are Islamic units set up by conventional banks and international financial institutions in order to provide banking services based on *shariah* principles. These units are often required to maintain separate Islamic operations and, therefore, appoint *Shariah* advisers. It is a cost efficient way for conventional banks to enter the Islamic market.

- **Islamic subsidiaries.** Western institutions may establish Islamic subsidiaries or branches (instead of *windows*), if they want to offer a wider range of *Shariah*-compliant banking products. This is the case of conventional banks with a considerable number of customers.

A sizeable body of research has examined the topic of Islamic finance in general and Islamic financial markets in particular on both theoretical as well as practical sides. This literature can be classified into three groups. The first group involves theoretical work which focuses on the fundamental principles of Islamic finance and a detail description of its historical aspects (Iqbal, Z., 1997; Alzamel, A.Y., 2002; Islamic Capital Market Task Force of the IOSCO, 2004; Tariq, A.A., 2004; Obaidullah, 2005; Jobst, A.A., 2007; Sproule et al., 2007; Moshirian, F., 2008; Alvi, I.A., 2009; Ilias, S., 2009; Chong & Liu, 2009; Siddiqi, M.N., 2001). In addition to prohibitions such as *riba*, *gharar*, and other unethical practices, they encourage to invest in profit-and-loss-sharing and asset-backing alternative forms of investment. The second group of literature explains the similarities and differences between Islamic and conventional financial markets (Wilson, 2005; El-Qorchi, 2005; Siebens, 2007; El-Hawary, 2007; Ranzini, 2007; Zaidi, 2007; Khan and Bash, 2008; Schmith, 2008; Ayub, M.; Ilias, S., 2009; Hakim, S.). It also analyses financial products and services that comply with *shariah* concentrating on *sukuk*, as well as Islamic financial market infrastructures. The last group of literature deals with the practical side of the theme, i.e. the Islamic financial market and product innovations, focusing on the leading experience of Malaysia and the achievements they have there with *sukuk* (Singh, R.A., Yusof, Z.A., 2002; Rohmatunnisa, D., 2004; Obaidullah, 2005; Bursa Malaysia, 2005; Ebrahim and Rahman, 2005; Wan Azmi, W.N., 2007; Aziz, 2007; Kuo, M., 2008; PNB Paribas, 2008; Parker, 2009; Mirakhor, A.). Researchers also try to investigate the challenges Islamic financial markets still face.

3- Evolution of Islamic finance industry

Islamic finance refers to financial transactions which are in accordance with principles of Islam or *shariah*. Modern Islamic finance has existed since 1960's, as we have already mentioned, driven primarily by (Sproule et al., 2007, p. 5; Hodgkin, 2007, p. 1; & Ranzini, 2007, p. 11.):

- the 1.6 billion of Muslims (including 13 million European Muslims, 10 million North American Muslims and many millions of developed world Muslims), as well as an important number of non-Muslim customers all over the world who seek diversification in Islamic financial products and services;
- western financial institutions offer Islamic products and services through Islamic *windows* and subsidiaries; IF outside the Islamic world;
- *shariah*-compliant banking technology contributes to reduce the number of unbanked in Muslim world, develop new products (product innovation), encourage more efficient operations, and improve prudential supervision and regulation;
- an increasing demand for Shariah-compliant financial products in many parts of the world. This demand has been further boosted by high oil prices;
- huge liquidity in the hands of individuals and sovereign funds in Muslim countries.

The development of the Islamic financial services industry has gone through many stages. It grows in institutions, products, and areas.

Table 1. Evolution of Islamic financial services industry

1970's	1980's	1990's	2000's
<p>Institutions: - Commercial Islamic banks</p>	<p>Institutions: -Commercial Islamic banks - <i>Takaful</i> -Islamic investment companies</p>	<p>Institutions: -Commercial Islamic banks - <i>Takaful</i> -Islamic investment companies - Asset management companies - Brokers/Dealers</p>	<p>Institutions: - Commercial Islamic banks - <i>Takaful</i> -Islamic investment companies -Islamic investment banks - Asset management companies - E-commerce - Brokers/Dealers</p>
<p>Products: - Commercial Islamic banks products</p>	<p>Products: - Commercial Islamic banks products - <i>Takaful</i> - Project finance and syndications</p>	<p>Products: - Commercial Islamic banks products - <i>Takaful</i> - Mutual Funds/ Unit Trusts - Islamic bonds(<i>sukuk</i>) - <i>shariah</i>-compliant stocks - Islamic stock broking - Project finance and syndications - <i>Ijarah</i></p>	<p>Products: - Commercial Islamic banks products - <i>Takaful</i> - Mutual Funds/ Unit Trusts - Islamic bonds (<i>sukuk</i>) - <i>shariah</i>-compliant stocks - Islamic stock broking - Project finance and syndications - <i>Ijarah</i> - structured alternative assets - liquidity management tools</p>
<p>Area: - Gulf/ middle East</p>	<p>Area: - Gulf/ middle East - Asia Pacific</p>	<p>Area: - Gulf/ middle East - Asia Pacific</p>	<p>Area: - Gulf/ middle East - Asia Pacific - Europe/ Americas</p>

					- Global Offshore Market
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Source: Islamic Capital Market Task Force of the IOSCO, 2004, p. 16; & Alvi. I.,A.

The previous Report shows that the IF started with a few institutions and products centered in the Middle East. However, during the last four or five decades it becomes a real industry comprising hundreds of institutions (though banking is the most developed part of the Islamic financial system), offering a large spectrum of products and services all over the world. This has led to larger cross border flows in relation to investment and trading of international Islamic instruments.

Historically, and more precisely, the IMF and UN consider that IF has undergone through 3 stages, (IMF, in: Sproule et al., 2007, pp. 2-8):

- Stage I: capture of market share (1990-2006). This stage is characterized by high demand for financial products and services and practices which are allowable under Shariah law, by rich individuals and sovereign wealth funds (from oil revenues) in Muslim countries.
- Stage II: Expanding into the European mass market (2007-2012). This step is characterized by providing attractive and cost-effective set of products and a comprehensive distribution network to the mass market Muslims living in Europe.
- Stage III: Growth of Islamic economies (2013-2020). This phase is characterized by the emergence of Islamic emerging markets which represents the most important medium to longer term prospects. It is also characterized by an increasing sophistication of Islamic financial instruments, which attracts more savers and placements in *shariah*-compliant products and services⁵.

4- Basic tenets of Islamic finance

IF is based on *shariah*, an Arabic word that is often translated into “Islamic law”. *Shariah* governs all aspects of life of Muslim societies, including day-to-day living, social policy, economics, banking, business law, economic relationships, and politics. It originates from the rules dictated by the Holy Quran and sayings and actions or explanations (*Sunnah*) rendered by the Prophet Mohamed (*pbuh*). Generally, it aims at realizing justice, fairness, honesty, equitability (protection of the weaker party), productivity, and avoidance of hoarding, tort, short selling, margin trading, *riba*, *gharar*, and *maysir* in all financial transactions⁶. In a nutshell, the guiding principles

⁵ - Ward, I., (2008), also describes the evolution of IF in 3 stages, but in different periods:

First stage: National experiments (1975-1991);

Second stage: Globalization (1991-2001);

Third stage: After September 11 (2001- Present).

⁶ - Shefrin and Startman indentify seven classes of fairness relevant to a financial system: freedom from coercion, freedom from misrepresentation, right to equal information, right to equal processing power, freedom from impulse, right to trade at efficient prices, and right to equal bargaining power, (Shefrin and Statman in: Obaidullah, 2005, pp. 8-10).

(prohibitions and recommendations) of an Islamic financial system can be summarized as follows⁷:

4-1- Prohibition of *riba*

The term “*riba*” has the literal meaning of “an excess” and is defined as “any unjustifiable high increase of capital” which accrues to the owner whether in loans or sales without providing equivalent value to the other party. More precisely, *riba* can also be thought of as the rate of interest as widely practiced in modern conventional financial industry. Thus, one of the most important features of IF is the rejection of exchanging of money for more money in the future. According to *shariah*, the mode of finance encouraged is the earning of profits through, for instance, profit-and-loss sharing or *Qardh Hassan* formulas, but forbids strongly the charging of fixed-returns and any other positive predetermined rate tied to the maturity and the actual amount of the principal (i.e. interest or usury⁸).

However, IF offers an alternative financial paradigm. For instance, in a real estate, *shariah*-compliant financing takes the form of leasing, as opposed to loans. Instead of borrowing money, the bank obtains the property and leases it to the *shariah*-compliant investor, who pays rent instead of interest (*riba*).

4-2- Prohibition of *gharar*

Gharar is defined as all activities that contain excessive uncertainty, hazard, excessive ambiguity, and deception surrounding a commodity, its price, quantity, time of payment, time or place of delivery, making a transaction invalid. It is also defined to knowingly expose one’s property to jeopardy or the sale of a probable item whose existence or characteristics are not certain. However, and because it is quite impossible to eliminate *gharar* from the market, some small amount of it is a common phenomenon in any economy. Examples of *gharar* are:

- conventional insurance, because the amount of compensation is uncertain and depends on specific events in the future,
- advising an investor to buy shares in a company that is the subject of a takeover bid, on the grounds that the share price is likely to increase,
- modern derivatives and conventional risk management instruments,
- the sale of a sick animal or an object without examining it.

To sum up, *gharar* is a broad concept (broader than *riba*) forbidden by Islamic jurisprudence (*fiqh*), since there is always someone who bargains in order to profit from another person’s uncertainty, or lack of knowledge (*jahl*), and conditions of risk are not clearly understood by all parties to a financial transaction.

4-3- Prohibition of *maysir*

⁷ - More details about fundamentals of Islamic finance are provided in :

- Jobst, A.A., 2007;
- Tariq, A.A., 2004, pp. 9-18;
- Islamic Capital Market Task Force, 2004;
- Alzamel, A.Y., 2002.
- Iqbal, Z., 1997, p. 43

⁸ - Obaidullah, (2005), distinguishes between different kinds of *riba*: *riba al-fadhl*, *riba anasiah*, ..etc..

Maysir or *Quimar* is gambling, betting and wagering, mainly in games of chance, which usually takes place away from ordinary productive economic activities. *Maysir* is also characterized by a deliberate risk taking which leads to a profit of one party at the detriment of another (total loss). *Shariah* prohibits *maysir* activities since they divert the players from productive activities and make them seeking wealth without any effort as well as related activities, such as investing or financing gambling. A common and worldwide practiced *maysir* is the games of chance in casinos and entertainment centers.

4-4- Prohibition of other practices and unethical investments and products

There are some other prohibited elements under *shariah* such as *Ihtikar*, *Najesh*, *Ghobn*, and other immoral activities. These are elaborated below, (Ilias, 2009, p. 1; Siddiqi, ; Islamic Capital Market Task Force, 2004; Bodie, et al., 2003, p. 939; Corrado, Jordan, 2002, p. 939):

- *Ihtikar*. Hoarding, withholding supplies of essential goods and services with a view to raising prices, or attempting to influence prices through creating artificial shortage of supply;
- *short selling*. A short sale (short position) is a sale in which the seller does not actually, at the time of the execution of the sale, own the securities that are sold, with the intent of purchasing them back later at a lower price. An investor with a short position benefits from price decreases, while an investor with a long position (who owns the securities) benefits from price increases.
- *margin trading*. Purchasing stocks on margin means the investor pays part of the purchase price in cash and borrows the rest from a broker, leveraging the transaction and putting up the stocks for collateral. The broker, in turn, borrows money from banks at the call money rate to finance this purchase, and charges its client that rate plus a service charge for the loan.
- *Najesh or tanajush*. Raising prices by manipulating false bids or bidding up the price without an intention to take delivery. Thus *najesh* refers to a conspiracy between a seller and a buyer showing that the buyer is willing to purchase the goods at a higher price, resulting in the seller obtaining a huge profit.
- *Ghobn*. Fraud and deception or difference between the price at which a transaction is executed and the fair price (after the evaluation of experts);
- *Bay al-mudhtar*. The exploitation of need, e.g. by charging an exorbitant high price;etc.

4-5- Asset backing

Islamic finance is an asset-backed finance; i.e. each financial transaction must be tied to a “tangible identifiable underlying” asset. Thus most Islamic financial products are based on the concept of asset backing (collateralized against real assets). An example of this is the securitization process which must be backed with tangible assets.

4-6- Sanctity of contracts

Iqbal and other Islamic scholars confirm that Islam upholds obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

4-7- Profit sharing, risk sharing and other *shariah*-compliant principles

Probably the most important fundamentals and alternative products, which form the foundation of modern Islamic financial services, are the profit-and-loss sharing principle, or PLS (*Musharakah*), profit-sharing (*Mudharabah*), cost-plus sale (*Murabahah*), leasing (*Ijarah*), deferred delivery sale or advance purchase (*Salem*), manufacture-sale facility or purchase order (*Istisna*). There are also many other *shariah*-compliant products and services of less importance of different nature, such as letter of credit (*Wakalah*), letter of guarantee (*Kafalah*), and so forth. So parties involved in a financial transaction share both the associated risks and profits. Returns are permitted so long as the business risks are shared by the capital provider and the entrepreneur. Therefore, suppliers of funds become investors instead of creditors.

Finally, the ideal of modern IF is social and economic development and aims at strengthening the linkage between the real and financial sectors of the economy. Thus, money in a *Shariah*-compliant environment must go through the real productive sector before it comes back to investors as money.

5- Islamic financial markets

Islamic financial markets (IFMs), the same as their conventional counterparts, are organized markets where securities and *shariah*-compliant financial products are bought and sold under fixed rules, and usually governed by some kind of regulating bodies. Those securities and products must not, of course, violate *shariah* principles described earlier such as prohibition of *riba*, *gharar*, speculation, short selling, margin trading, and futures,.. etc. Thus, a business firm neither seeks interest-based loans nor offers interest-yielding debt securities. Financial intermediaries, brokers, dealers and other licensed financial agents play also a key role in arranging security transactions among investors, i.e., bringing buyers and sellers together and facilitating the execution of their orders and, thereby, helping individual savers diversify portfolios in return for payment of a brokerage fee or commission.

IFMs, as opposed to money market⁹, are utilized to raise long-term capital, usually for more than one year, by floating private and public *shariah*-compliant financial instruments. An IFM also consists of two major types of markets (compartments): primary market and secondary market.

Primary market. In the primary market, or new-issue market, shares and other financial products are first sold to investors, so it is the market in which corporations and governments raise capital. If a company sells a new issue, this would be a primary market transaction, and thereby, receives the proceeds from the sale. Financial products are sold only once in the primary market.

Secondary market is the market in which existing outstanding, as opposed to newly issued instruments (already bought from the primary market), are traded among investors. Stock exchanges, such as the New York Stock Exchange and London SE are examples of secondary markets. The major function of this market is to provide permanent liquidity to those instruments.

⁹ - Money markets are the markets for short-term, highly liquid, low risk debt securities. "Short-term" generally means one year or less.

Thus, even there is a great resemblance between conventional and Islamic financial markets, the issue of *shariah* compliance of activities, products and services offered to *shariah* compliant investors remains a significant challenge, especially in such a rapid and changing financial environment.

5-1- Islamic financial products and services

There is a considerable number of Islamic financial products and services designed to meet the growing demand and needs of those who seek to invest in accordance with *shariah* principles. Certainly, *shariah* compliance is the key distinguishing feature of the Islamic financial products and services. These include *shariah*-compliant stocks, *sukuk* or Islamic bonds, Islamic investment funds and Islamic risk management products. As we shall see through this subsection most Islamic financial instruments are collateralized against a real asset, i.e., they give rise to some form of an asset-backed financial mechanism. Therefore, the defining characteristic of those instruments is that they are asset backed, which implies that when they are traded the investors are buying and selling the rights to an underlying real asset, usually a piece of real estate or a movable asset such as equipment or vehicles. In this Paper the discussion will only focus on the first three instruments.

- **Common stocks** or *shariah*-compliant stocks are certificates of equal value that represent ownership. In this case equity holders are the owners of the firms that issue the stocks and are responsible for concluding their affairs. Thus *shariah*-compliant stocks represent a form of equity partnership and participation in their capital and management, and, therefore, pose no problem in issuing and trading them in an Islamic financial market. Issuance and trading of common stocks are permitted in *shariah*, unless the concerned companies operate in a non-*shariah*-compliant activities, such as alcohol, gambling, conventional financial services, and other prohibited activities mentioned earlier.

In addition to the activities criteria, *shariah* scholars use financial ratios in classifying *shariah* stocks. The main financial ratios applied are, (Islamic Capital Market Task Force, 2004, p. 30):

- . debt-to-equity ratio,
- . cash and interest bearing securities-to-equity ratio,
- . cash-to-asset ratio.

There are also some other ways for criteria in classifying those stocks, such as the purification (cleansing) of dividends carried out by the individual investor himself.

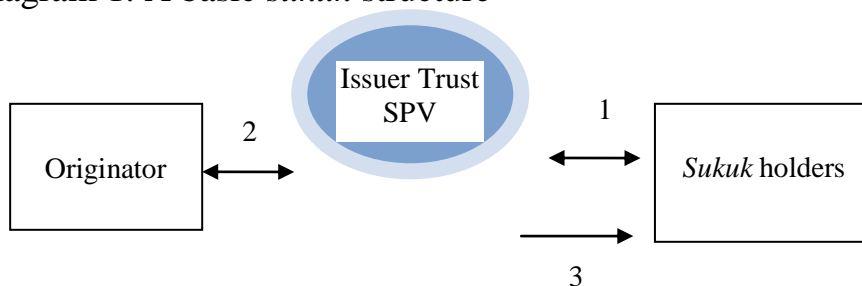
It is worth noting that the identification of a considerable number of stocks that comply with *shariah* principles, in a particular market, facilitates the establishment of Islamic financial market indices.

- ***Sukuk*** or Islamic bonds. *Sukuk* is the plural form of the Arabic word *Sak*, which is a written document (financial certificate) that represents ownership (reflects participation rights) of underlying assets. AAOIFI defines *sukuk* as: “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 activity, (AAOIFI, in : Alvi, I.A., et al, 2009, p. 5)”.

Islamic scholars have designed and constructed bonds that are analogous to conventional bonds, but which follow *shariah* principles and are linked to the performance of a real asset. Investors who place their capital in *sukuk* are referred to as *sukuk* holders. There are seven categories of Islamic bonds (*sukuk*), according to the model of financing and trades which structure the bond. These are: *Mudharabah sukuk*, *Musharakah sukuk*, *Murabahah sukuk*, *Istisna sukuk*, *Ijarah sukuk*, *Salam sukuk*, and *Hybrid sukuk*, (Rohmatunnisa, 2004, pp. 6,7).

Over the past decade, *sukuk* have evolved to become a viable form of financial market based on Islamic structured finance¹⁰. The global *sukuk* issuance in 2007 was US \$31.308 billion, 94.96 times greater than the *sukuk* issuance in 2000 (\$336 million only), (Rohmatunnisa, 2004, p. 22). It is widely recognized that *sukuk* play an immense role in financing and economic development.

Diagram 1. A basic *sukuk* structure



1- Issuer trust (Special Purpose Vehicle) issues certificates (*sukuk*) *sukuk* holders pay purchase price in cash.

2- Cash is applied by the SPV to acquire from the originator cash generating assets (on behalf of the *sukuk* holders).

3- Issuer trust applies cash from its assets to pay *sukuk* holders principle plus a return.

Siddiqi (2008), considers that *sukuk* have great potential for promoting risk sharing, thereby increasing savings mobilization and investment, spurring growth leading enhanced welfare. Therefore, he suggests exploring possible ways of keeping *sukuk* away from being debt instruments based on risk shifting that increase inequality and cause instability, thereby decreasing welfare.

a- *Mudharabah sukuk*

¹⁰ - Structured finance encompasses all advanced private and public financial arrangements that serve to efficiently refinance and hedge any profitable economic activity beyond the scope of conventional forms of on-balance sheet securities (debt, bonds, and equity) at lower capital cost and agency costs from market impediments on liquidity. In particular, most structured investments (i) combine traditional asset classes with contingent claims, such as risk transfer derivatives and/ or derivative claims on commodities, currencies or receivables from other reference assets, or (ii) replicate traditional asset classes through synthetication or new financial instruments. Following the tremendous expansion of Islamic investment products, structured products are the most recent asset class to have been added to the product range. (Jobst, 2007, p. 3; BNP Paribas, 2008, p. 3).

Mudharabah sukuk or *muqaradhadh sukuk* are nominative certificates that represent projects or activities managed on the basis of *mudharabah* principles. *Sukuk* holders as *rab-al mal* and the manager or the entrepreneur as *mudharib*, share profits according to pre-determined ratios agreed earlier (variable income securities). In the case of losses, the losses are borne by the provider of the funds only, i.e., the *sukuk* holders. Furthermore, it is not permissible for the issuer to guarantee the capital of the *mudharabah*, since the *shariah* principle is “no reward without risk or effort”.

In this context, the contract of *mudharabah* (either restricted or unrestricted) is used to create a Special Purpose Vehicle (SPV), entity/ manager, to play a well-defined role in acquiring certain assets (using the funds collected from the subscribers) and issuing certificates against those assets. The underlying assets acquired by the SPV/ manager need to be, of course, *shariah* compliant. Since *mudharabah sukuk* represent real investment partnerships and common ownership and are asset-backed instruments, they are tradable and negotiable in secondary markets, but without control and management rights. i.e., *mudharabah sukuk* holders cannot attend or vote at the annual general meeting.

On the other side, the key features of *mudharabah sukuk* are provided by the Resolution of the Islamic Academy of the Organization of the Islamic Conference ,OIC, (Ayub, without date). They were first issued in Pakistan in early 1980’s by domestic companies under some conditions and registered limited success reflecting the weakness of the companies involved and poor performance of Pakistan’s economy in general, (Wilson, 2005).

b- *Musharakah sukuk*

These are similar to *mudharabah sukuk*, but the rights of *musharakah sukuk* holders are better defined compared to those of equity investors and *mudharabah sukuk* holders. However, *musharakah sukuk* holders, unlike *mudharabah sukuk* holders have control and management rights and are owners of a specific property in common.

Technically, *musharakah sukuk* are securities of equal value issued for mobilizing funds, by an SPV for instance, to be used on the basis of partnership for financing and establishing new projects. They are tradable in the securities market. Moreover, The structure of *musharakah sukuk* requires both parties to provide financing and share in profits according to a stipulated ratio and share losses in proportion to the size of their investment. The holders will gain from any increase or loose from any decrease in the underlying asset prices. There are many forms of *musharakah sukuk* such as permanent *musharakah sukuk*, temporary *musharakah sukuk*, voting shares, redeemable *musharakah sukuk* (term finance *sukuk*), ... etc.

An excellent example of *musharakah sukuk* is the 5-years Term Finance Certificates (TFCs) issued by Sitara Chemical Industries, a public limited company in Pakistan in June 2002, (Ayub, without date, p. 352).

c- *Murabahah sukuk*

Are certificates of equal value issued for the purpose of financing the purchase of commodities or assets on a cost-plus financing basis, widely used for Islamic short-term financing. Thus, a company seeks advice from an investment bank regarding the

issuance of sukuk and the SPV is created for the purpose. Then the SPV issues the securities, collects funds, pays the commodities (or assets) from a third party, and take delivery of them. The company purchases the commodities (or assets) from the SPV and the payments are passed on by the SPV to investors (*murabahah sukuk* holders) in installments after deducting *wakalah* fee for the SPV. Since the profit rate (the yield) on these instruments is predetermined and have a maturity like any other debt instrument, they cannot be traded in secondary markets at a negotiated price and hence, are not liquid.

d- *Istisna sukuk*

Are securities that carry equal value and are issued with the aim of mobilizing funds and using them to finance construction (manufacturing) of major industrial projects such as buildings, power plants, ships and aircrafts, .. etc. Full ownership of the constructed item is transferred to the purchaser against deferred sale price that normally covers not only the manufacturing cost but also profits. The payable deferred price can be documented in the form of *sukuk* (certificates of indebtedness) known as *istisna sukuk*, (Ayub, without date, p. 354).

Debt, as we have mentioned earlier, cannot be sold in Islamic jurisprudence, and therefore, *istisna sukuk* holders cannot trade their securities in a secondary market. However, they can be transferred to a third party at any price other than their face value, (i.e., cannot be sold except at par value and not at a negotiated price).

e- *Ijarah sukuk*

Are the types of certificates based on leasing as the underlying transaction. They represent ownership of an equal share in the usufruct of an asset that is well defined and tied to an *Ijarah* contract, (Rohmatunnisa, p. 31).

Ijarah sukuk are also a leasing structure coupled with a right available to the lessee to purchase the asset at the end of the lease period (finance lease). The rental payment (called *ujrah*) generated by the leasing activity is the return payable to *sukuk* holders and the rental rates on those *sukuk* can be fixed or floating depending on the agreement. Accordingly, fixed rate *ijarah* or floating *ijarah* certificates are issued. The *ijarah* instrument is not evidence of debt, but of a prorate ownership of the assets that are on *ijarah*. Therefore, those *sukuk* can be freely traded at the secondary market and prices are determined by market forces. *Ijarah sukuk* offer a high degree of flexibility in rental payments, issuance management, and marketability. This means that securitization of *ijarah* contracts is a key factor in solving liquidity management problems and financing the public needs in developing countries, (Ayub, without date, p. 352).

f- *Salam sukuk*

Are certificates of equal value issued for the purpose of mobilizing funds. *Salam* is a contract in which advance payment of price (by issuing certificates) is made for goods to be delivered later on.

Thus, the purchase price is in cash (on the spot), but the supply of the goods is deferred. It is not permissible to sell the goods concerned before receiving them, and they become debt. The funds paid can also be in the form of certificates representing the debt, and hence creating *salam sukuk*. In general *salam sukuk* represent a kind of forward contract which is forbidden in *shariah* unless there are strict conditions attached to *gharar*.

For *salam sukuk* the attraction is that they are purchasing the commodities at a discount, the difference between this and the eventual selling price representing their return, (Wilson, 2005, p. 7). These certificates are also non-tradable although the items to be delivered on *salam* basis are owned by the certificate holders.

h- Hybrid *sukuk*

Hybrid *sukuk* combine two or more forms of Islamic financing in their structure such as *istisna* and *ijarah, murabahah* and *ijarah*, etc.

- **Islamic investment funds (IIF)**. IIF are funds managed in accordance with *shariah* principles. The most common category of those funds are Islamic equity funds (IEFs), which invest in *shariah*-compliant stocks¹¹. IEFs market is one of the fastest growing segments in the Islamic financial industry. Prior to 1995, there were approximately 10 equity funds on the market. Since 1996, the number of equity funds has doubled every year to over 120 funds estimated at US \$ 20 bn in 2007, and is growing by 12-15 % per annum (Grewal, 2008, p. 12).

5-2- Islamic financial market infrastructure: The case of the IIFM

The International Islamic financial market (IIFM) is an international infrastructure non-profit organization, established in Bahrain in November 2001, and began its operations on April 1, 2002. Its major aims are (Islamic Capital Market Task Force, 2004; Alvi, I.A; & IIFM Brochure-English):

- the establishment, development, and promotion of an international financial and money market based on *shariah* rules and principles;
- facilitating the establishment of a cooperative framework among the Islamic banks and other financial institutions worldwide to encourage product development and trading of *shariah*-compliant instruments in the secondary market,
- enhancing cross-border acceptance (listing, trading and liquidity management) of Islamic financial products by providing independent *shariah* advice and guidelines for the issuance of new Islamic instruments;
- encouraging self-regulation, best practice procedures, standardization of financial contracts leading to product innovation, market recommendations and infrastructure development,
- promoting the emergence and integration of Islamic financial market into mainstream global financial markets,
- research and development (R&D), and specialized events and forums to disseminate information (transparency) and create awareness of Islamic capital and short-term financial market,

¹¹ - There are other categories of Islamic funds, such as realty and property funds, investment and mudharabah funds, commodity funds, Ijarah funds, and hedge funds (e.g. Alfanar US Equity Hedge Fund).

- acting as the focal point for the harmonization of *shariah* interpretations in the global financial market and bridge the gap between different *shariah* interpretations,
- developing some challenging issues such as Islamic hedging, secondary market documentation and products... etc.

IIFM was founded with the collective effort of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan, Pakistan, and the Islamic Development Bank (IDB) based in Saudi Arabia, as an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic capital and money market.

IIFM benefits to the Islamic financial services industry

Market body: IIFM forms a link between Islamic financial market participants and regulatory bodies on the Islamic capital and money market segment of the industry;

Wider shariah acceptance through access to other neutral *shariah* boards;

Self-regulation. Members will benefit from recommendations, guidelines, and best practices on primary and secondary market issues;

Uniformity and standardization. The production of unified documentation frameworks and product development creates cost reduction for all Islamic financial institutions (IFIs) together with important transactional security;

Knowledge sharing. IIFM promotes active participation of both Islamic and Islamic ally-interested institutions, and industry professionals, for the exchange of knowledge and expertise on a global basis through IIFM's specialized forums and workshops on Islamic capital and money market.

Systems (infrastructure) development. IIFM advises on the integrity and compliance of a variety of Islamic financial infrastructures.

Liquidity Management Centres

As Islamic financial transactions increasingly become global in nature, there are concerns over the sufficiency of supply of appropriate instruments to address the global liquidity management needs of IFIs. Therefore, early in 2002, Dubai Islamic Bank, Bahrain Islamic Bank, and Kuwait Finance House signed an agreement to establish the Bahrain-based Liquidity Management Centre (LMC) with a paid up capital of \$15 m. The LMC is a market maker for Islamic secondary market instruments, and thereby, a segment of the IIFM. LMC seeks to (Alvi, I.A):

- develop an active secondary market for trading *shariah*-compliant financial instruments, especially short-term ones;
- facilitate the creation of an Islamic interbank money market that would enable IFIs to manage their liquidity effectively;
- facilitate the pooling of assets acquired from governments, financial institutions and corporations. This asset pool will be securitized through the issuance of tradable instruments or *sukuk* for Islamic financial services institutions to invest their surplus liquidity, (Islamic Capital Market Task Force, 2004, p. 42).

By October 2010, Malaysia also established its own LMC, which is called the International Islamic Liquidity Management Corporation, IILM. Its primary objective, as stated by the IFSB, is to issue *shariah*-compliant financial instruments (including short-term ones), in order to facilitate more efficient and effective liquidity

management solutions for institutions offering Islamic financial services, as well as to facilitate greater investment flows of *shariah*-compliant instruments across borders, (IFSB, 2010).

Islamic financial infrastructure bodies

There are several international Islamic institutions which back the IIFM and other markets. Those bodies are:

AAOIFI

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) acts as a body advising on standards to be followed by Islamic institutions worldwide. The philosophy behind this is that Islamic financial products and services differ from conventional ones. This creates a challenge for IFIs to produce a “true and fair” view of those IFIs. The need to develop accounting standards that adequately and appropriately reflect the nature of Islamic financial transactions was viewed as an important step to enhance the reliability, consistency and clarity of financial reporting by IFIs which would also enhance investor confidence in Islamic finance. AAOIFI also contributes to:

- prepare and develop accounting, auditing, governance and ethical standards relating to the activities of IFIs, taking into account international standards and practices and the need to comply with *shariah* principles (issuance of *shariah* standards and rules);
- take part in efforts to achieve harmonization between different *shariah* supervisory boards of IFIs in different jurisdictions (issuance of *shariah* standards);
- persuade regulatory authorities to adopt its standards.

IFSB

The Islamic Financial Services Boards (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. Central banks from Bahrain, Malaysia, Sudan, Jordan, Indonesia, Kuwait, Iran and Saudi Arabia worked collectively with the International Monetary Fund (IMF), the Islamic Development Bank (IDB) and AAOIFI to establish the IFSB. The IFSB was officially launched in November 2002 and is based in Malaysia.

The IFSB has already started to develop two prudential standards for the Islamic financial services industry, namely capital adequacy and risk management standards. These standards address the identification, classification, measurement and reporting of the risks for Islamic financial institutions. The IFSB is also concerned to develop standards on corporate governance, transparency and market discipline, (Islamic Capital Market Task Force, 2004, p. 44).

IIRA

The International Islamic Rating Agency (IIRA) was established by the IDB in Bahrain in October 2002. Its objective is to rate, evaluate and provide independent assessments and opinions on Islamic financial institutions and instruments. It also assesses the *shariah* compliance aspects of IFIs and products and services.

5-3- IFMs and financial crises

Global financial markets have been witnessing a series of unprecedented financial meltdowns, especially since 1987. In this context, Ilias (2009) recognizes that “Internationally, Islamic banks appear to be more resilient to the global economic turndown and international financial crises than conventional banks. They tend to avoid the speculative investments, such as derivatives, that many analysts believe led to the financial crisis affecting conventional banks. Other specialists and experts of the Islamic Finance Intelligence Service of the Swiss bank HSBC noticed during 2007 crisis that there was a “strong *sukuk* market in spite of that Summer’s credit crisis, (Hodgkinson, 2007, p. 2). This is due mainly to the fundamental Islamic principles that stipulate that each financial transaction must be tied to a “tangible” asset (a comparative advantage of Islamic investments), and “selling what one does not have” is forbidden in *shariah* law. More specifically, Islamic financial instruments (asset-backed) are less risky than their conventional counterparts, and therefore, Islamic financial markets are generally more stable.

5-4- A leading experience in IFMs: Malaysia’s achievements

Malaysia has been recognized as the pioneer of Islamic finance. It is clearly the leader in terms of volume as well as value; and also the world’s largest *sukuk* market and surpasses other Muslim countries in terms of infrastructure and government support. Key milestones making Malaysia a leading country in Islamic Capital market are, (Bursa Malaysia, 2005; IIFM, database):

- the establishment of the first Islamic equity unit trust fund, Arab Malaysian Tabung Ittikal (1993),
- the first full-pledged Islamic stockbroking company, BIMB securities Sdn Bhd (1994);
- the Securities Commission formed an Islamic Capital Market Unit, which later evolved into a full-pledged department (1995). The *Shariah* Advisory Council (SAC) was later established (1996),
- the Minister of Finance launched the Capital Market Masterplan, establishing Malaysia as an international centre for Islamic Capital activities (2001);
- the first ever issuance of global corporate *sukuk* (The Guthrie Sukuk) in 2001, which created a paradigm shift in the international Islamic financial market,
- the introduction of the first global sovereign *sukuk*, the Malaysian Government *Sukuk*, which more than twice oversubscribed (2002);
- implementation of a comprehensive tax incentive package for Islamic securities (2004);
- the introduction of the first hybrid *sukuk* in the world for the amount of US \$ 2.5 bn (2007);
- the issuance of the largest-ever *sukuk* in the world for the amount of US \$ 4.8 bn (2007);
- the liberalization of the financial market, foreign exchange controls, and financial services industry;
- the Malaysian Government is actively promoting the Labuan International Offshore Financial Centre as a global Centre for IFM,

Emergence of a global *sukuk* market

As mentioned earlier, Malaysia is the world's largest *sukuk* (Islamic bonds) market. The Malaysian domestic market is US \$ 68 bn in size, a large 67 % of the total global domestic *sukuk* market and in excess of 50 % of the entire global *sukuk* market. As against this, the Gulf Council Countries (GCC) domestic *sukuk* market is only US \$ 16 bn, miniscule compared to Malaysia and half of its own international counterpart, which is about US \$ 29 bn in size as of 30th June 2009, (Alvi, I.A.).

The total *sukuk* issued as at 5th August 2009 amounted to US \$ 133 bn. The types issued can be grouped into three main types: sale-based *sukuk* (comprising of *BBA*, *Murabahah*, *Salam*, *Istisna*), lease-based *sukuk* (*Ijarah*), and equity-based *sukuk* (*Musharakah*, *Mudharabah*, and *Wakalah*), (Dusuki, A.W., 2009, p. 10).

Table 2. Regional break-up of the Domestic *Sukuk* Market (selected countries)

Country	Volume (US \$ m)	No of issues	% of tot. value
Asia			
Malaysia	67872	792	66.8 %
Indonesia	1923	48	1.9
GCC	7665	10	7.5
S/Arabia	7151	10	7.0
UAE	167	1	0.2
US & Africa	12614	20	12.4
US Sudan			

Source: IIFM *Sukuk* issuance database, in: Alvi, I.A., A Comprehensive Study, p. 10.

The Malaysian *sukuk* market has made a significant progress due to multinational corporations operating there, legal and *Shariah* framework available, the supporting financial infrastructure including the settlement and bond information system. Perhaps more importantly, the percentage of outstanding *sukuk* to total outstanding corporate bonds in the Malaysian Market increased from 57 % in 2008 to 58.2 % at the end of July 2009, (Aziz, 2007, p. 3; Parker, 2010).

Financial innovation in Malaysia

There has been significant innovation in Islamic financial products and services. This has been especially evident in *sukuk* products (greater diversity and maturity). Currently, at Bursa Malaysia, there are 5 listed instruments that are deemed Islamic with a total market capitalization of US \$ 2 bn. Those instruments are, (Bursa Malaysia, 2005, pp. 9, 13-15):

- Serial Islamic Lease *Sukuk* by First Global *Sukuk* Inc.,
- *Sukuk* Al-Ijarah Trust Certificates by Malaysian Global *Sukuk* Inc.,
- *Sukuk* Trust Certificates by Qatar Global *Sukuk* QSC,
- *Sukuk* Trust Certificates by BMA International *Sukuk* Company,

- *Sukuk* Trust Certificates by Sarawak Corporate *Sukuk* Inc.

Moreover, Bursa Malaysia's *shariah* market contains 816 stocks. These stocks represent the components of Bursa Malaysia's *shariah* index¹², amounting to 82.5 % of the total listed companies or 64 % of the market capitalization, (Bursa Malaysia, 2005, pp. 9).

Other controversial financial innovations are practiced in Malaysian Islamic financial market (Diversity and sophistication of Islamic instruments). Some of those instruments, (which may provide depth and breadth to the Islamic Market), are, (Dusuki, Abozaid, 2008, p. 66; Bin Ibrahim, M., 2005, p. 5):

- short selling, legalized in 2006,
- forward contract, as a tool to hedge currency exposure,
- Malaysia Islamic Treasury Bills,
- Bank Negara Negotiable Notes,
- Islamic Acceptance Bills,
- Negotiable Islamic Depository Certificates,
- options and other derivatives.

On the other hand, Malaysia is amongst a few Islamic countries that are developing the process of Islamic securitization (called *Sukukisation* or *Taskik*). *Sukukisation* is carried out by the issuance of tradable *sukuk* in the form of asset-backed securities (e.g. *mudharabah* for a project or on an *ijarah* contract). Both issuers and investors (*sukukholders*) tend to ensure that the concerned assets are Islamically acceptable. *Sukukisation* plays nearly the same role as conventional securitization: i.e. it provides another alternative of financing sources, allows to monetize illiquid assets and contracts, and ensures a risk management tool.

Finally, Securities Commission of Malaysia, and in order to enable the market to operate and function efficiently and effectively, established the *Shariah* Advisory Council (SAC) in 1996. It aims primarily to:

- advice the Securities Commission on *shariah*-related matters,
- provide *shariah* guidance on ICM transactions and activities, aimed at standardizing and harmonizing applications.

6- Challenges facing the Islamic financial markets

While much has been achieved, much remain to be done to arrive at an efficient and competitive Islamic financial market. Therefore, there still exist many challenges and initiatives to be addressed.

The most important of those fundamental challenges that need to be overcome by the Islamic financial institutions and bodies are:

- the establishment of an active and efficient **secondary market** for trading *shariah*-compliant financial products. Hence any Islamic primary market depends heavily on the development of a sustainable and robust secondary market in terms of breadth and depth. A well structured and well regulated secondary market contributes enormously in boosting liquidity of those products and instruments; and thereby offers maximum

¹² - The Shariah Index was launched in April 1999 to meet various demands from local and foreign investors who seek to invest in securities which are consistent with the Islamic principles.

flexibility in terms of valuation, negotiability, pricing and risk management. An Islamic secondary market is expected to attract global investors, increase confidence, and play a significant role in the development of the financial market as a whole.

As far as intermediation is concerned, Islamic banking and financial services operate within the same institutional and regulatory framework as that of conventional ones, except that their activities and products are structured in accordance with *shariah* principles. Developing a strong and competitive environment for intermediation services and market makers are two challenges to the Islamic financial industry, which also needs to adopt appropriate risk management tools;

- the creation of **Islamic securities**. The process may take two forms- through (i) direct structuring of securities and (ii) a process of asset securities, (Obaidallah, 2005, p. 159). Thus a key challenge for the industry is to develop a wider array of cost effective *shariah*- compliant instruments to enhance liquidity and product innovation and creativity. The innovated products should be genuinely superior to the conventional ones in terms of value, quality, cost-competitiveness and ease-of-use. Another controversial challenge facing modern Islamic financial markets is the financial derivative products or derivatives, where most of them are not *shariah*-compliant instruments, and therefore, are not permissible in Islamic financial markets due to excessive uncertainty or high *gharar*. Derivatives, of course, are risk management instruments widely used in conventional markets;

- the **regulatory and supervisory framework**. Regulation as a public good, a robust regulatory and legal framework supportive of an Islamic financial system, which co-exists with the conventional one, has not been well developed. Work of varying degrees and nature has been done in countries like Bahrain, Malaysia, Saudi Arabia, Kuwait, UAE, Iran, Sudan, Pakistan, Bangladesh, Indonesia, Brunei, Britain and USA, (Ayub, p. 348). It generally provides the essential foundations for the functioning of a modern capital market, and which ensures that an investor of an Islamic product receives the same legal and regulatory protection as would be available for a conventional product.

IFIs face additional difficulties operating in non-Islamic countries owing to the absence of a solid regulatory body that operates in accordance with Islamic principles. For those IFIs fully following risk-sharing principles “one can envisage minimal regulation. It would emphasize less capital requirements, more transparency and disclosure, more screening of management, more licensing of business lines, and equivalent supervision in comparison with regulation applying to conventional banking, (El-Hawary et al., 2007, p. 791)”. Although there is a limited availability of hedging instruments and constraints on liquidity management, the development of a regulatory and supervisory framework that would address these issues (international regulatory standards) would further enhance the integration of Islamic markets in international financial markets. Regulators, therefore, can extend their influence (regulatory environment) beyond ensuring financial stability by fostering an environment receptive to *shariah*-compliant products.

Financial markets and institutions seeking to offer *shariah*-compliant products and services typically have *shariah* supervisory board, such as the IFSB in Malaysia (or at minimum a *shariah* counselor). In this sense, the functions of the regulatory authority of the Islamic capital market are fairly similar to those regulating conventional capital market, (Wan Azmi, 2007, p. 6).

- **Shariah compliance.** Compliance is an agreed upon rules set by *shariah* scholars who have developed a reputation for correctly interpreting whether the description of the financial instruments, transactions and contracts meets with the *shariah* law. Jobst (2007) notes that “Islamic jurisprudence is not definite and still lacks of homogeneous interpretation and uniform recognition...”. Clear examples of disagreement (or rigid interpretation at least), between *shariah* boards, which could change investor interest and affect liquidity, are the issuance and trading of different kinds of *sukuk* as *shariah* compliant instruments, arbitrage activities, product innovation and so on. The creation of some organizations such as AAOIFI and other *shariah* supervisory boards and advisory bodies, is to help reaching standardization and convergence between individual scholars in the interpretations of *shariah* compliance;

- **investor education.** Consumers lack knowledge and understanding about *shariah*-compliant products and services, given the fact that those products and services are still comparatively new and have more restrictive investment criteria. Therefore, providers in the Islamic financial industry need to work harder to create awareness and educate people on Islamic principles and products, with *shariah* compliance appearing to add a further level of complexity. They also should provide detailed information about the benefits and risks (including liquidity risk) of *shariah* compliant products and services and how they compare with traditional ones. In relation to this, dissemination of guides and brochures on Islamic products and markets, to issuers and investors, would enhance public confidence and facilitate the understanding of the whole industry.

As instruments and transactions continue to become more complex and the needs of market participants grow in a global changing financial environment (demand for higher standards of services including investor protection), markets will require a new generation of practitioners and experts who understand how the modern Islamic legal system, western common law, and international finance integrally function in a global economic system, (Kuo, M., 2008, p. 4). *Shariah* scholars, regulators, supervisors and board members should, however, be sufficiently trained not only in *shariah* matters, but in modern financial techniques and practices as well. Moreover, international and professional qualifications and standards (development of human capital) in Islamic finance could harmonize the application and global integration (greater cross-border transactions) of the Islamic financial industry;

- developed **database.** Islamic finance is a relatively new concept, especially for non-Muslim investors and academics. Therefore, a key challenge for the industry is to improve the process of data collection in relation to Islamic financial markets. The establishment of a diversified and up-to-date database, accessible to the large public, mainly, researchers, students and investors, is a vital goal for the development of

Islamic financial markets. Information, which becomes more and more available, will certainly help in reaching that objective;

- **other challenges** facing Islamic financial industry. Although, Islamic financial markets have survived obstacles, mainly during periods of financial crises, they continue to face many other challenges. One of them is risk management problem due to increasing integration and liberalization. Moreover, risk management is made more difficult because of the limited number of risk management tools in use. For example, it is difficult to use hedging instruments such as derivatives as they are generally forbidden in Islamic financial markets. A second key challenge is the development of monetary markets and designing Islamic instruments for monetary policy and liquidity management and market deepening. Finally, Wan Azmi (200) adds that “high transaction costs is still regarded as an issue and this stems from the differences in the regulatory and listing requirements, (Wan Azmi, W.N., 2007, p. 11)”.

7- Conclusion

Despite the fact that several successful attempts have been made so far in Malaysia, Bahrain, Qatar and other Muslim countries, to address the weaknesses of Islamic financial markets (IFMs), much need to be done for an efficient, liquid, deep, wide, transparent, and well regulated and supervised markets. From the product and services side, and for further growth in IFMs and Islamic finance industry in general, there is a strong need for financial innovation and sophistication, especially equity-based, long-term, risk management and hedging instruments, and sukukization (Islamic securitization). The lessons learnt from the Malaysian experience shows that Islamic finance (IF) is global and open to any innovations (structure and product richness) that comply with Islamic principles, has become increasingly attractive to Muslims and non-Muslims alike. In line with this, IF should make use of its main comparative advantage, i.e., it closely links between real economic activities that create value and financial activities that facilitate them, and therefore, becomes less vulnerable to speculation. This would enhance domestic as well as foreign demand for shariah-compliant, cost-effective products.

From the infrastructures side, development of institutional infrastructure, such as secondary markets and supporting institutions, accounting standards and regulatory and supervisory bodies, is a key element in the development of the IFMs and create a sound competitive environment for the industry and sustain their efficiency and growth in a globalised world. There are also some factors that require more work such as consumer understanding of the significantly expanding industry, homogeneity of interpretation of *shariah* principles and its application, transparency and disclosure standards, efficient intermediation and market making, Islamic market indexes, and market information technology (IT).

A final key priority in moving IMFs forward is to carry out an intensive, deep and fresh research in all aspects of Islamic finance industry in general and financial markets in particular. Specific attention should be paid to removing obstacles, providing resources, and establishing specialized Islamic research institutions.

Appendix 1. Islamic financial contracts

The most important investment vehicles or basic forms of Islamic financing methods are:

- ***Mudharabah*** (profit-sharing). It is a major *shariah* principle for investment activities and a form of partnership under which one party provides the entire capital needed to finance a project and another the labour, expertise and management. It offers the owner of capital, the financier, (referred to as *Rab al-mal*), the opportunity to invest his money in a *shariah*-compliant investment (with agreed business objectives), without becoming personally involved in management of the project. The investment is exclusively run by the second party of the project, i.e., the entrepreneur or the borrower (referred to as *Mudharib*), who has ideas and expertise (more skilled person), to use the funds in productive activities. Profits are distributed according to a mutually preagreed rate between the two parties (*Rab al-mal* and *Mudharib*). In case of loss, it is considered as a loss of capital and, therefore, shall be borne solely by the owner of capital (an Islamic bank for instance), unless it has occurred due to misconduct or negligence from the entrepreneur. The loss borne by the latter as the working partner (the investment manager), is that he goes unrewarded for his efforts and bears the brunt of the opportunity cost of time and labour. However, the liability of the owner of capital, the bank for instance, is limited to its investment in the project, because it does not participate in management and decision-making. An example of *Mudharabah* contract when applied to farming, is called *Muzaraah* or sharecropping.

It is important to note that *Mudharabah* model has evolved as a form of financing. In this context it appears the two-tier *Mudharabah* or the double *Mudharabah* concept. In this model the first tier, the owner of capital, is created when a depositor (*Rab al-mal*) places his capital with an Islamic bank, which acts or takes up the role of the entrepreneur (*Mudharib*). The bank in turn invests the capital (as *Rab al-mal*) with another borrower or entrepreneur (as *Mudharib*) by means of a double or second tier *Mudharabah*. In brief, by practicing this model of *Mudharabah*, an Islamic financial institution is acting as an intermediary between savers and entrepreneurs.

On the other hand, *Mudharabah* is of two kinds: restricted and unrestricted. In a restricted *Mudharabah* (*Muquayadah*), the owner of the capital specifies the type of project where the capital is invested. However, in an unrestricted *Mudharabah* (*Ghayr Muquayadah*), the owner of capital does not specify that and, therefore, the manager can choose any project he thinks it is the best.

- ***Musharakah*** (profit-and-loss sharing). A partnership arrangement similar to a classical joint venture agreement, in which two parties or more jointly provide capital

either in form of cash or in kind, in varying degrees, for the purpose of financing a *shariah* –compliant project. It is also a type of an equity participation contract under which all partners agree to supply capital and participate in management of a project in proportion to their investment, but not necessarily required (obliged) to do so. Technically, the *Musharakah* model involves the customer placing capital with an Islamic financial institution and both parties sharing the risks (losses) and rewards (returns). Therefore, any profit that is generated by the venture is distributed (shared) between the partners on a ratio that is pre-agreed in the contract. However, losses are distributed (borne) among the partners strictly on the basis of the ratio of the capital provided (equity participation). This is the basis for most deposit accounts in Islamic financial institutions (IFIs). Traditionally, this form of partnership has been used for financing fixed assets and working capital for medium- and long-term periods. *Musharakah* also involves unlimited liability of the partners since both of them participate in management and decision-making.

Shariah scholars and practitioners have developed the *Musharakah* model further by introducing two forms as a recent innovation: permanent and diminishing *Musharakah*. Permanent *Musharakah* (*Daimah*) is a partnership that continues to exist for the whole life of the investment project. However, in a diminishing or declining *Musharakah* (*Mutanakisah*) the provider of capital gets each year a pre-agreed ratio of profits and a partial return of capital (a rental payment and a periodic buy-out of part of ownership). This reduces the equity share of that provider (and increases, of course, liquidity in its investments), and increases the equity share of the investor over time, finally resulting in the complete ownership of the business project, and the contract is eventually terminated. Hence declining *Musharakah* is a temporary form of partnership. An important example of the sectors that witnessed greater use of diminishing *Musharakah* is the housing sector.

- ***Murabahah*** (Trade with make up or cost-plus sale). It is one of the most widely used instruments for short-term financing, based upon the traditional notion of purchase finance, i.e., obtaining credit without paying interest. *Murabahah* contracts are contracts for the deferred sale (purchase and resale) of goods at cost plus an agreed profit make-up. That is, the financial institution purchases the goods desired on behalf of its customer from a supplier and resells them to the same customer on a deferred basis, adding an agreed profit margin. i.e., the resale price is based on original cost (higher price). The customer then pays the sale price in cash or over installments as specified in the agreement between both parties. The cost and profit margin are made known by all parties involved and the seller must declare that before the conclusion of the transaction. The margin is a reward to the seller for his expertise in bargaining, better knowledge of the market conditions etc., and to cover transaction costs, and leave a decent profit (a profit that is made on the exchange of money for goods and not money for money, which is not permitted in *shariah*). This contract is typically used in working capital and trade financing so that around 60-70 % of Islamic financial transactions are cost-plus sales. The reason is that the risk bearing period for the FI is shorter than other financing techniques.

- ***Istisna'*** (debt instrument). It is a forward contract which provides predelivery (project) finance for future assets and long term projects, such as manufactured goods, aircrafts, ships and boats, construction of houses, plants, building of bridges, roads and highways, and other infrastructure projects. So it is based on the concept of commissioned or contract manufacturing, whereby a party (the seller) undertakes to develop or produce a specific good or commodity with clear specifications for future delivery or deferred sale. Usually, the price is paid to the manufacturer in advance with the possibility of payment in installments over the term of the lending agreement. In rare cases the price also can be deferred.

In an *istisna'* arrangement the seller may be different from the manufacturer. This allows Islamic financial institutions to engage in *istisna'* activities as intermediaries by assigning the process of manufacturing to a third party under a parallel *istisna'* technique.

-***Ijarah*** (leasing or hire-purchase). It is a popular facility and financing technique similar to conventional operating and finance leases. It implies that the Islamic bank as the owner or lessor (*muajir*) hires (leases out) a physical equipment or asset to its client, the entrepreneur, or lessee (*musta'jir*) at an agreed rental fee payable in installments according to an agreed schedule and predetermined lease period; i.e., over the term of the temporary use of the asset (*ijarah* period). The ownership of the equipment remains in the hands of the lessor (the financier) for the duration of the transaction. He bears all the risks associated with the ownership of the equipment, whereas the lessee bears the costs from the use of it. If the type of lease is a financing lease (*ijarah wa iktina'*), the payment must also include a portion of the agreed resale price along with profit, which allows the lessee (the borrower) to gradually acquire total ownership of the asset. This is the case where the entrepreneur is committed to purchase the equipment at the end of the rental period (the lease agreement includes an obligation on the client to buy the equipment from the bank at the end of the lease term). *Ijarah* is increasingly used in aircrafts, vehicles, machinery, equipments, and building finance.

- ***Salam or Bay al-Salam*** (deferred delivery sale) is one of the most prominent examples of cost-plus,-credit sales, where the object of the contract is deferred. Under this form of contract the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract or on the spot market. *Salam* is designed as a financing mechanism for small farmers (e.g., paying now for wheat or tea that is yet to be grown) and traders in need for short-term funds. It is necessary that the quality of the goods intended to be purchased is fully specified leaving no ambiguity leading to dispute.

- ***Jualah*** (service charge). A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.

- ***Urboon***. It is a small fraction of money given to a seller by the buyer as first part payment of the price of goods and services within a deal to be concluded in the future. It is also considered as an earnest money paid in advance to show that the

buyer agrees to the contract of sale and intends to honor it; and the seller, too, by accepting the earnest, determines his agreement to be bound by the contract. *Urboon* will be forfeited (lost) and kept by the seller if the transaction is cancelled, i.e., if the buyer withdraw from the deal.

Some scholars consider that conventional call options are similar to *urboon* in the sense that the buyer has the right, but not obliged, to execute the contract and the seller can keep the premium (*urboon*), if the buyer fails to perform his part.

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Contents

Islamic Financial Markets: Achievements, prospects, and challenges

- 1- Introduction
- 2- Literature review
- 3- Evolution of Islamic finance industry
- 4- Basic tenets of Islamic finance
 - 4-1- Prohibition of *riba*
 - 4-2- Prohibition of *gharar*
 - 4-3- Prohibition of *maysir*
 - 4-4- Prohibition of other practices and unethical investments and products
 - 4-5- Asset backing
 - 4-6- Sanctity of contracts
 - 4-7- Profit sharing, risk sharing and other *shariah*-compliant principles
- 5- Islamic financial markets
 - 5-1- Islamic financial products and services

- Common stocks
- *Sukuk*
- Islamic investment funds
- 5-2- Islamic financial market infrastructure: the case of the IIFM
 - IIFM benefits to the Islamic financial services industry
 - Liquidity Management Centres
 - Islamic financial infrastructure bodies
- 5-3- IFMs and financial crises
- 5-4- A leading experience in IFMs: Malaysia's achievements
 - Emergence of a global sukuk market
 - Financial innovation in Malaysia
- 6- Challenges facing the Islamic financial markets
- 7- Conclusion
- Appendix 1.
- References
- Contents