ISLAMIC COMMERCIAL LAW REPORT 2017

An Annual Publication Assessing the Key Issues and Global Trends in Islamic Capital Markets

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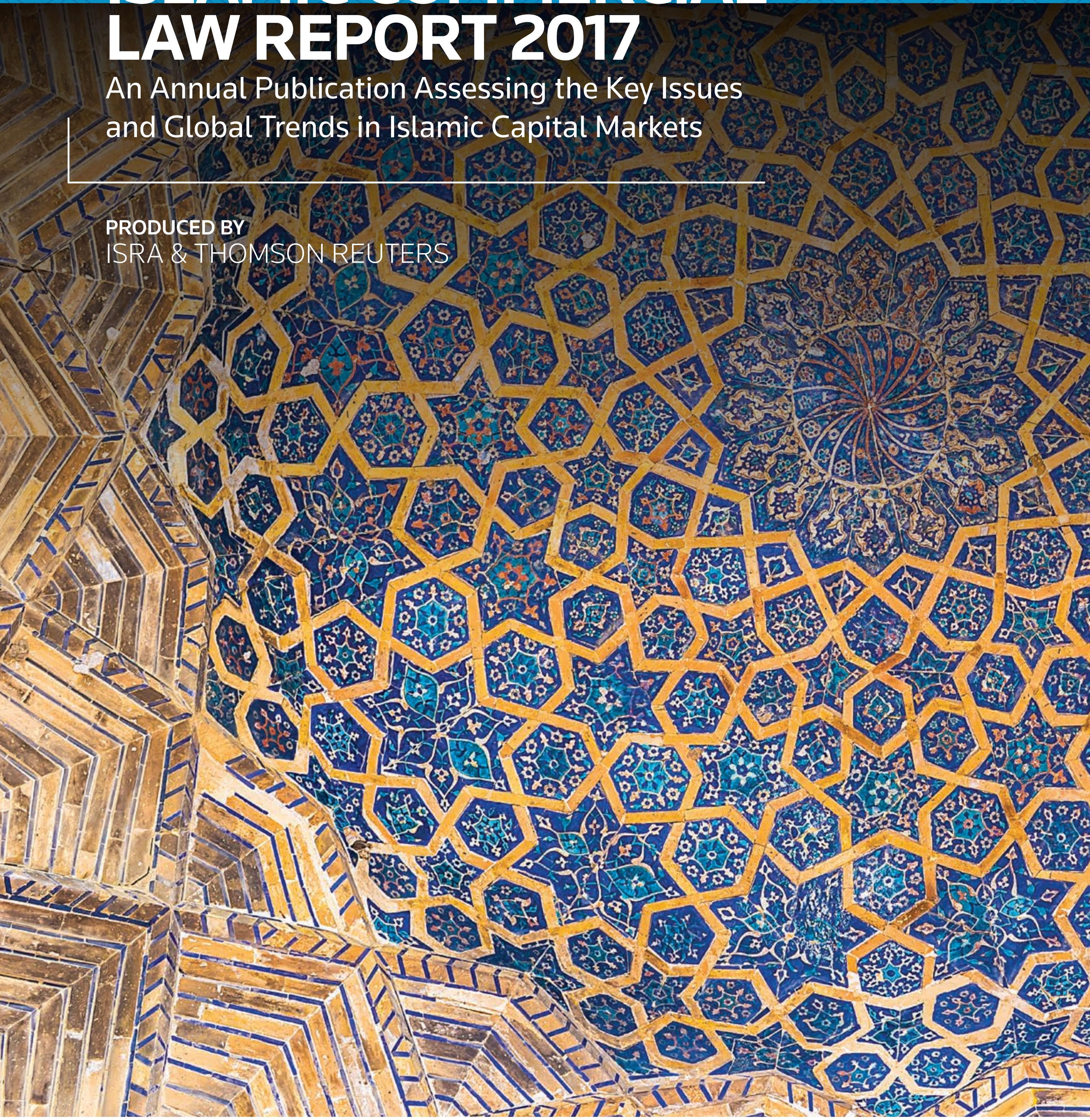

ISRA الأكاديمية العالمية للبحوث الشرعية
International Shari'ah Research Academy for Islamic Finance

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Contents

Inside view of the Ben Youssef Madrasa in Marrakesh, Morocco. Christian Mueller / Shutterstock.com

In the Name of God, the Most Merciful, the Most Beneficent.

Foreword

For more than 40 years, governments, banks and businesses in the Muslim world have strived to formalize and expand the use of Shariah in their financial dealings, both to provide services that satisfy the demands and preferences of their citizens and consumers, and to make finance better serve the real economy, as intended in the principles of Shariah. The first step in this process has been the establishment of Islamic banking industry on a country-by-country basis. In several regions, this sector has seen great success, capturing up to 25% of banking market shares as is the case for Malaysia.

However, it became apparent that banks alone cannot accommodate the increasing demand for funding at the scale at which Islamic finance now operates. therefore, the establishment of national and global capital markets became crucial to provide essential networks for funding private initiatives and public projects and underpin economic growth more broadly. They even became one of the main sources of funding for banks. Yet after the establishment of these fledging Islamic capital markets a gap remains between the public, finance professionals, and Islamic legal scholars, on how does the Shariah work in contemporary capital markets? How can Islamic finance balance the authenticity of Shariah opinions with the competitiveness and complexity of the contemporary marketplace? How best to position Islamic capital market in the global arena?

It gives the International Shari'ah Research Academy for Islamic Finance (ISRA) and Thomson Reuters great pleasure to present their second annual Islamic Commercial Law Report, which aims to answer these questions in a format engaging both experts on the Shariah and finance alike. As the sukuk market enters a dynamic phase of rebuilding, and Shariah-compliant equity investing and asset management spreads, we have chosen to narrow our focus this year on the Islamic legal debates related specifically to the capital markets, and a wide range of innovations currently being developed to provide authentic and functional solutions to the needs of Islamic finance users.

Perhaps the most significant sub-theme of the report, beyond connecting the academic and business worlds, is opening a channel for dialogue between professionals in different countries in the Islamic finance industry. Many of our authors have raised proposals to improve cross-border investing and harmonize Shariah opinions and frameworks for contracts and governance, which will bring collective benefits for the industry everywhere.

We would like to take this opportunity to acknowledge the contributions of our authors, both from ISRA and Thomson Reuters, and from a wide range of universities, research houses, regulators, corporations and financial institutions. The breadth and depth of this report would not have been possible to achieve without their expertise.

Our intention is, rather than settling matters, that this report will stimulate conversations between the disparate sectors of the Islamic finance industry working in the capital markets. Only through the cross-fertilization of opinions will we be able to develop stronger and more widely accepted solutions to building a stable and equitable financial and economic system.

Prof. Dr. Mohamad Akram Laldin
Executive Director
International Shari'ah Research
Academy for Islamic Finance

Mustafa Adil
Head of Islamic Finance
Thomson Reuters

The Islamic Capital Market: An Outlook

Shariah-compliant banking has become an established feature of the financial landscape in 60 countries. Millions of individuals and corporations have turned to Islamic banking both to satisfy their religious and ethical principles and to find innovative participatory saving and borrowing products with fair prices and strong returns.

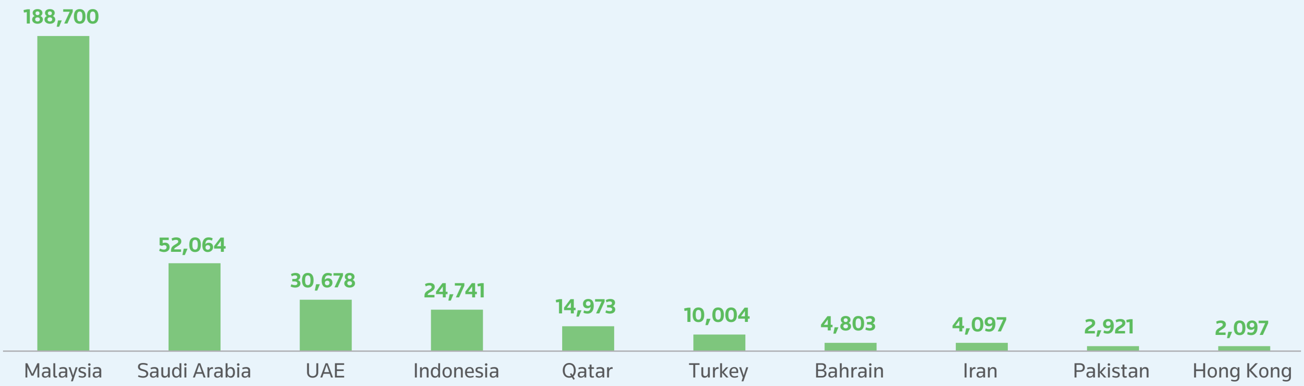
Fewer people, however, understand the role of the Shariah in the interbank and capital markets, which makes Islamic banking possible. Providing banking services that eliminate *riba* (interest) necessitates a financial infrastructure that provides banks with funding solutions that also avoid interest. Islamic financing instruments such as sukuk have grown exponentially over the past twenty years to provide such a solution, and to give corporations and governments a popular new avenue to fund large-scale projects that recycles capital into the real economy. With this trend, Islamic asset management has also moved to providing Shariah-compliant services for equity investing.

In ISRA and Thomson Reuters' second annual report on Islamic commercial law, we examine the fundamental concepts, innovation and ongoing debates in the global Islamic capital markets. The report brings together research and commentary from a group of Shariah and legal scholars, market analysts and Islamic finance professionals that ranges from theoretical issues, abstract concerns and long-term proposals to brand-new initiatives and everyday practices.

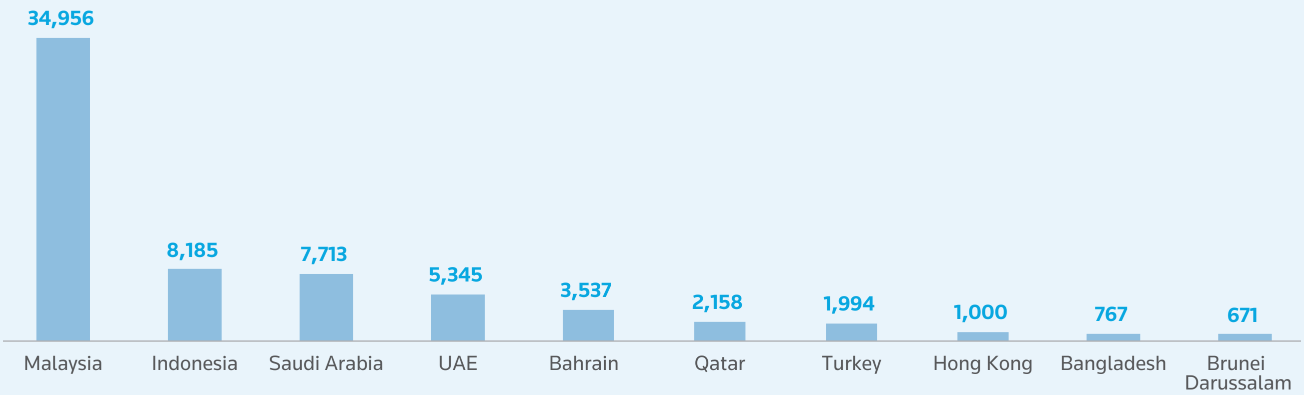
Among the topics covered are engineering Shariah-compliant instruments with a range of risk profiles, standardization and harmonization of Shariah practices between different national regulatory codes, improving tax and disclosure rules to make Islamic capital markets competitive with the conventional finance system and to encourage charitable initiatives, and contemporary best practices in governance, product design, client relations, and marketing. We hope the report will provide stakeholders in Islamic finance as well as those interested in learning more on the topic with a comprehensive and educational resource.

SUKUK OVERVIEW AS OF 2015

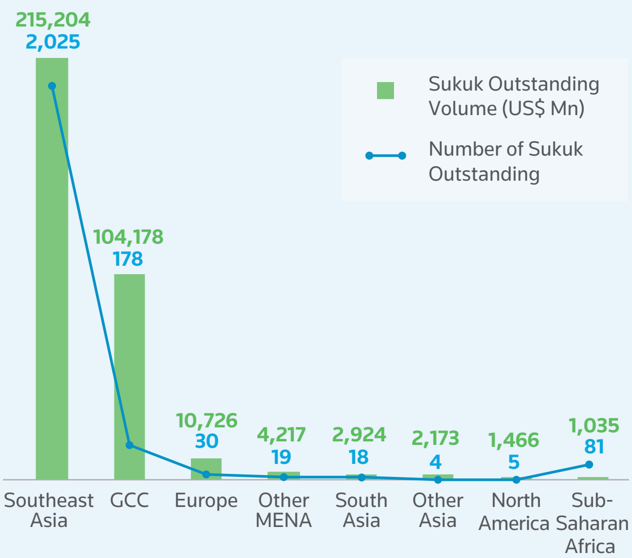
TOP 10 COUNTRIES IN SUKUK VOLUME OUTSTANDING (US$ MN, FYE 2015)



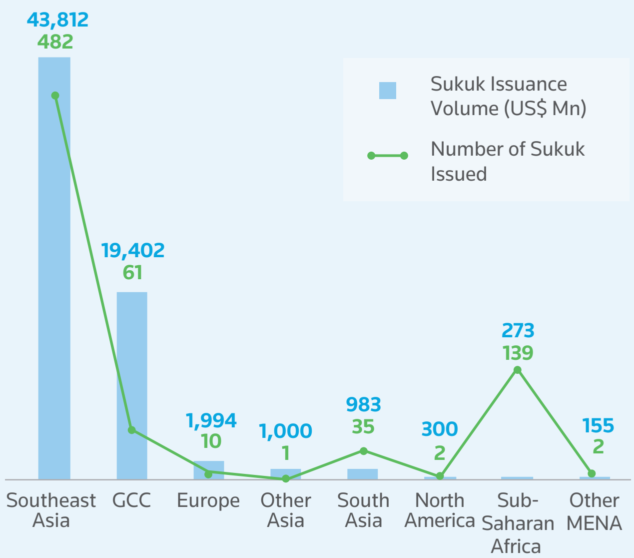
TOP 10 COUNTRIES IN SUKUK VOLUME ISSUED (US$ MN, FYE 2015)



SUKUK VOLUME AND NUMBER OF SUKUK OUTSTANDING BY REGION (FYE 2015)

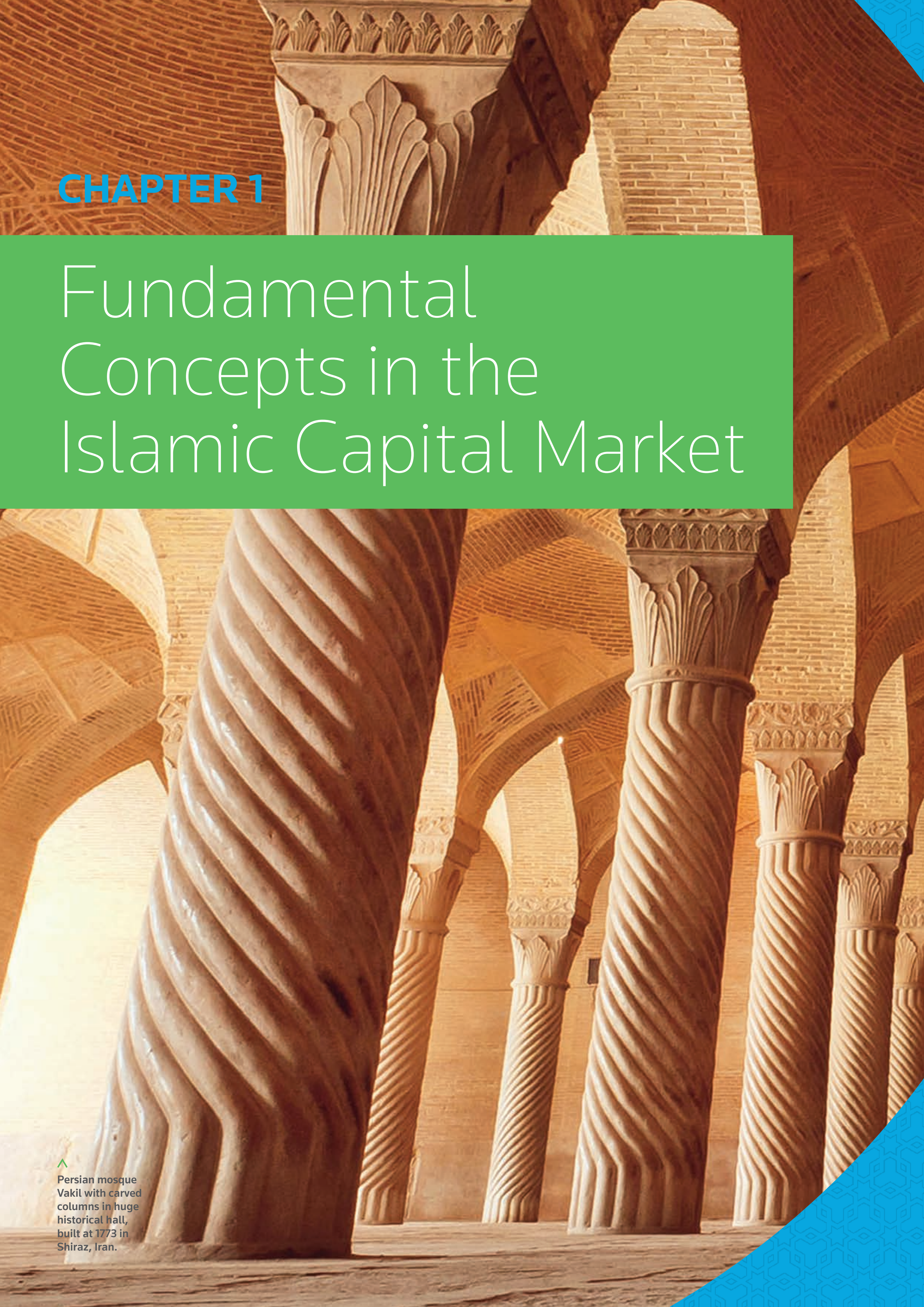


SUKUK VOLUME AND NUMBER OF SUKUK ISSUED BY REGION (FYE 2015)



CHAPTER 1

Fundamental Concepts in the Islamic Capital Market



Persian mosque Vakil with carved columns in huge historical hall, built at 1773 in Shiraz, Iran.

SUMMARY

In the past half century, the world's capital markets have become increasingly intertwined, as the liberalization of trade and investment regulations have freed the movement of capital. These markets underpin the development of national economies in general, and provide liquidity and investment capital to financial institutions in particular. However, liberalization and globalization by their nature have led to the systemic spread of leverage and speculation, even in developing economies that have less experience with and tolerance for these phenomena on a mass scale. Meanwhile, the adoption of information technology has permitted the development of ever more sophisticated debt derivatives. The result has been the endemic volatility of the world financial system, typified by the 2008 financial crisis.

In these conditions, the Shariah provides attractive alternatives to conventional, debt-based capital markets strategies and products, on the personal, corporate, national and international scales alike. While Islamic banking originated the contemporary practice of Islamic finance, the large-scale Shariah investment instruments of sukuk were not far behind, to provide the Islamic interbank market with better liquidity, and to fund large projects in countries with Islamic finance industries. Islamic asset management has ensued, to offer investors with a range of solutions in sukuk and equity that provide them with risk profiles to fit their needs.

The articles in this chapter outline the principles and affiliated terminology of Shariah-compliant investing and capital markets structures and transactions. At their core, many should be familiar to anyone aware of socially oriented and ethical investing strategies. The *maqasid al-Shariah* or "higher objectives" of Shariah are a set of principles that jurists have developed to frame their goals in judging the Shariah compliance of practices and products. Key among them is that Islamic finance activity should encourage *maslaha*, or the wellbeing of people and society. While this means fair and ethical dealing between individuals, on the scale of society, Islamic law seeks to promote economic development by helping wealth circulate in the productive economy.

Although it is not nearly the only feature of Islamic finance, perhaps the best known rule that seeks to achieve these greater aims is the prohibition on *riba*, meaning money or time-value being traded for a price, best known today as interest. For this reason, Islamic capital instruments such as sukuk are linked to an underlying asset or proven receivables that produce profits. Shariah also prohibits *gharar* (excessive uncertainty) and *maysir* (gambling), which seeks to prevents individuals from taking advantage of each other and societies from becoming crippled by speculation.

In the context of the capital markets, these prohibitions have led Shariah scholars and finance experts to seek further concepts in Islamic law that could produce sophisticated alternatives to prohibited derivatives and debt instruments. These include *wa'd* (promise), which can be applied to hedging instruments such as FX forwards, options and profit rate swaps, *hamish al-jiddyah* (security deposit) which acts as hedging or insurance on business contracts, and *qabd* (possession), which is constantly being reinterpreted to include virtual forms of ownership.

HIGHER OBJECTIVES *(MAQASID AL-SHARIAH)* IN THE ISLAMIC CAPITAL MARKET

Prof. Dr. Mohamad Akram Laldin and Dr. Hafas Furqani

INTRODUCTION

The Islamic capital market (ICM), like its conventional counterpart, is an important component of the overall Islamic financial system. It facilitates the transfer of investible funds from economic agents with financial surpluses to those requiring funds.

In its operations, the Islamic capital market follows the principles of Shariah, and it aims to realize the higher objectives of Shariah (known as *maqasid al-Shariah*). The term *maqsid* (pl. *maqasid*) refers to a purpose, objective, principle, intent, goal and end. *Maqasid al-Shariah*, hence, are the objectives and purposes of Shariah as a system of life (i.e. its rules, injunctions, and guidelines). *Maqasid al-Shariah* as a concept essentially reflects the broad and comprehensive understanding of Shariah and its relation to the economic and financial domains.

In the context of the ICM, *maqasid al-Shariah* refer to the overall goals and meanings that the Shariah aims to achieve from its principles and rulings related to financial activities and transactions.

MAQASID AL-SHARIAH

The theoreticians on *maqasid al-Shariah* have made various classifications and categorizations to make the concept viable at the practical level, with general, specific and partial *maqasid* that are relevant to ICM practices.[1]

In general, Shariah as a system of life has been revealed primarily to protect human wellbeing (termed *maslahah*; pl. *masalih*). *Maslahah* (wellbeing) is one of the general objectives (*al-maqasid al-'ammah*) that Shariah aims to realize, which embraces all dimensions of human life in the individual and community spheres, the micro- and macro-scale dimensions, as well as religious (*al-din*) and worldly (*al-dunya*) matters.

In its application, *maslahah* is divided into three main categories that signify their priority: The essentials (*daruriyyah*), the complementary (*hajiyyah*) and the embellishments (*tahsiniyyah*).

Imam al-Ghazali has identified five dimensions to be protected in order to achieve maslahah in human life, namely, the protection of religion (*hifz al-din*), life (*hifz al-nafs*), intellect (*hifz al- 'aql*), posterity (*hifz al-nasl*) and wealth (*hifz al-mal*).

Shariah also has specific goals (*maqasid al-khassah*) in every certain aspects or domains of human life. In the domain of the ICM, the goal is framed in terms of the protection of wealth (*hifz al-mal*).[2]

This approach is justified, as the purpose of the ICM is basically to allocate resources from the surplus sector (capital providers) to the deficit sector (capital users) so that wealth is smoothly circulated and human welfare is realized.

Some of specific objectives of the ICM can be identified as follows:

The objective of wealth circulation and development *(rawaj al-amwal wa tanmiyatuha wa istithmaruha)*

Shariah views business and financial activities positively as mechanisms to circulate wealth among all sections of society (Qur'an, 59:7).

> *"Strong documentation, good corporate governance practices, and the disclosure of the market capitalization of a listed company, of the Shariah screening status of listed companies, and of all rules for listing, trading, depositing and settlement... all help to realize the objective of fair and transparent dealings in Islamic capital markets."*

Wealth should be invested in productive activities and funds should not be wasted or left idle (Qur'an, 9:34).

The ICM, in particular, operates in line with Islam's objective of wealth circulation and development. ICM allows for a greater access to capital, enabling companies to expand their businesses, creating more wealth in the form of cash, real estate or physical products and services. Various products in ICM are structured and issued to fund projects such as factories and infrastructure that contribute to economic development and human wellbeing (*maslahah*).

The objective of fair and transparent financial dealings *(al-wuduh)*

Shariah aims to facilitate the realization of *maslahah* and the removal of hardship in financial transactions by guaranteeing freedom of contract within an atmosphere of fairness, equity, justice and high morality. Any contract stipulated and agreed by both parties should be respected and enforced (Qur'an, 5:1).

Shariah aims at ensuring equal and fair business transactions. It protects parties against exploitation, fraud, misrepresentation, explicit or implicit harm and injustice to one of the contracting par-

MAQASID AL-SHARIAH OF *HIFZ AL-MAL* THROUGH SCREENING METHODOLOGIES IN ICM

One application of *maqasid al-Shariah* is in providing the protection of property (*hifz al-mal*) though effective regulation, and transparent and efficient governance in ICM. This can be achieved, for example, by issuing Shariah screening methodology to ensure that shares are classified as Shariah compliant and investment is in accordance with Shariah.

Shariah screening methodology is used by the relevant parties to ensure that the shares comply with Shariah requirements in the following manner:

1. Issuers will refer to the Shariah screening methodology prior to initial public offering exercises, in order to ensure that they comply with certain benchmarks. Upon the listing of their companies, their shares will be identified as Shariah compliant shares.

2. Investors will refer to the Shariah screening methodology as a measure to assess whether the applicable shares comply with the criteria, to ensure that they invest in Shariah-compliant shares.

3. Intermediaries such as fund managers will refer to the Shariah screening methodology prior to investing funds under their management, to ensure that the applicable shares in which they plan to invest comply with the benchmarks as set out in the screening methodology and are considered Shariah-compliant shares.

Source: "Application of Maqasid al-Shariah in ICM Product". Malaysian ICM Bulletin, January–June 2014, Vol. 9, No. 1, p. 12-13.

ties or to the public at large, or an imbalance between their reciprocal rights and obligations in business transactions.

The application of Shariah in ICM practices should therefore be made in a transparent, fair and clear manner and avoid injury, harm or difficulties to either individuals or the public at large.

Strong documentation, good corporate governance practices, and the disclosure of the market capitalization of a listed company, of the Shariah screening status of listed companies, and of all rules for listing, trading, depositing and settlement, for example, all help to realize the objective of fair and transparent dealings in ICM.

The objective of justice in micro- and macro-scale dimensions *(al-'adalah)*

The objective of justice underlies the substantive and regulative rules of the Shariah, the formation of the community, and the behavior of individuals who participate in ICM.[3]

Islam puts in place measures to "level the playing field" among the parties to a contract. In Islamic capital market transactions, equality in rights and obligations is required in products such as equity-based sukuk and unit trusts as a contract cannot become effective without the mutual consent (*taradi*) of the contracting parties. Likewise, unfair dealings or unjustified actions that lead to economic injustice or exploitation, such as bribery (*rishwah*), fraud or deception (*ghish*), cheating (*tadlis*), uncertainty and lack of clarity (*gharar*) or usury (*riba*) through unfair and unjust transactions are condemned.[4]

In this regard, Kamali (2008: 22) observes that justice and fairness are the hallmark values in commercial contracts.[5] If a contract proves to be an instrument of injustice, it must be set aside, and justice, which is the goal and *maqsad* of the Lawgiver, must be given priority over considerations of conformity to an untenable contract.

CONCLUSION

In the attempt to achieve the Islamic objectives of the ICM, financial innovations should essentially be put in that *maqasidic* framework. It is not only about finding suitable contracts to modify the conventional products, but also to design the appropriate products, processes and mechanisms to achieve the noble goals as envisaged in the *maqasid al-Shariah*.

Efforts should be directed towards producing financial instruments in the ICM that are consistent with and serve these higher objectives. In the area of issuance of sukuk in particular, and other ICM products, it is pertinent for the scholars and regulators who approve these products to go beyond the legalistic approach to the *maqasidic* approach. As such, if a particular product will harm the environment such a product should be disallowed, as it will affect the wellbeing of human society as a whole. Similarly, any product that leads to an increase in overall debt in a nation, which might have adverse effect to future generations, must be stopped. To sum up, the *maslahah* (benefit) and *mafsadah* (evil) effect of any product should be assessed before it is approved by Islamic scholars and regulators.

Maqasid al-Shariah should therefore be observed by all participants in the ICM in their corporate objectives, policies, and practices to ensure both the financial and ethical quality of financial products supplied to the public.

NOTES:

1 Auda, Jasser. (2008). Maqasid Al-Shariah as Philosophy of Islamic Law: A Systems Approach. London: IIIT, p. 5.

2 Attia, Gamal Eldin. (2007). Towards Realization of the Higher Intents of Islamic Law. London: IIIT, p. 98.

3 Iqbal, Zamir and Mirakhor, Abbas. (2007). An Introduction to Islamic Finance. Singapore: John Wiley & Sons Asia Pte Ltd.

4 Laldin, Mohamad Akram and Furqani, Hafas. (2013). Developing Islamic finance in the framework of *maqasid al-Shariah*: Understanding the ends (maqasid) and the means (wasa'il). International Journal of Islamic and Middle Eastern Finance and Management, 6 (4), 278-289.

5 Kamali, Mohammad Hashim. (2008). Maqasid al-Shariah Made Simple. London: IIIT, p. 22.

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MAJOR PROHIBITIONS IN THE ISLAMIC CAPITAL MARKET

Assoc. Prof. Dr. Said Bouheraoua

INTRODUCTION

The establishment of permissibility (*ibahah*) as a basic principle in Islamic law of transactions is an important reflection of the fundamental approach to Islamic transactions; that is, to promote creativity and nurture innovation. The small spectrum of prohibitions prescribed by Shariah is not an end in itself, it is rather intended to ensure the adherence of this innovation and creativity to the ultimate objective of the Shariah, which is to serve the interests (*jalb al-masalih*) of all human beings and save them from harm (*daf' al-mafasid*). This fundamental approach applies to all Islamic transactions, including Islamic capital market transactions. This short article highlights some major prohibitions related to the Islamic capital market: namely, interest (*riba*), excessive uncertainty (*gharar*), gambling (*qimar* and *maysir*) and manipulation (*tala'ub*).

FIRST MAJOR PROHIBITION: INTEREST (*RIBA*)

Riba is the first major prohibition in Islamic law. It has been defined as "an illegitimate increment in counter-value imposed on one of the contracting parties in an exchange contract" (*al-Ghunaymi*, n.d.: 2/37), and "an [unjustified] increment in borrowing or lending money, paid above the amount of a loan, as a condition imposed by the lender or voluntarily by the borrower due to a time element."[1]

Riba is explicitly prohibited in the verse of Quran that says, "Allah has permitted exchange and prohibited *riba*" (Surah al-Baqarah: 275). It is also prohibited in other verses and in many *hadiths* of the Prophet (may the peace of Allah be upon Him). The reason behind the prohibition of *riba* is the injustice caused as a consequence of imposing and fixing an ex-ante interest or return on a loan independent of the ex-post outcome or risk, making repayment independent of outcomes. It is also prohibited because it establishes unethical concepts and values in society, such as exploitation and fostering a rentier class, "parasites" enjoying money above their capital without sharing in risks or involving themselves in real economic activity. In fact, the reverse is also true, as borrowers unjustly limit the return to capital by pre-agreeing on a capped fixed amount, not allowing the capital provider to share fully in the risks and profits.

Since no Islamic financial institution will infringe the prohibition of *riba*, as this would be in explicit breach of Shariah, what some have practiced are stratagems (*hiyah*) to work around this prohibition. The Islamic Repo contract, as practiced in the Islamic capital market, which applies the organized *'inah* (a stipulation of repurchase in the contract), is one example of what was described by some scholars as stratagem (*hiyah*) to avoid *riba*. This is because the repurchase is stipulated in the contract, making the end result of the transaction similar to *riba*, that is, exchanging cash money with an additional payment on deferred basis. The bilateral promise (*muwa'dah*) and two promises (*wa'dayn*) are other exhibitions of such possible stratagem (*hiyah*) over *riba*. Although some Islamic capital market and regulatory bodies have done their best to make Islamic repo, *muwa'dah* and *wa'dayn* Shariah compliant, controversy still remains over these instruments, and further research is needed to qualify the transactions as Shariah compliant.

> *Riba is also prohibited because it establishes unethical concepts and values in society, such as exploitation and fostering a rentier class, "parasites" enjoying money above their capital without sharing in risks or involving themselves in real economic activity.*

SECOND MAJOR PROHIBITION: EXCESSIVE UNCERTAINTY *(GHARAR)*

Gharar is the second major prohibited element in the Islamic capital market. It is defined as "something whose acquisition is uncertain and/or its true nature and quantity are unknown."[2] The prohibition of *gharar* can be deduced from the *hadith* reported by Ibn ʿUmar (RA): "The Messenger of Allah forbade sales that involve uncertainty (*gharar*)." (Sahih Muslim, 5/3).

Gharar implies uncertainty and deceit, which lead to disputes and cause injustice to one of the contracting parties. The ʿ*illah* (effective cause) for the prohibition on *gharar* is ignorance (*jahalah*) in either the nature of the subject matter or its future existence. It is prohibited because it leads to disputes and hatred. It goes against the objectives (*maqasid*) of Shariah in Islamic finance and threatens the stability of the transaction and the outcome of a contract. In contemporary conventional capital market practices, *gharar* is present in financial derivatives. Other relevant contracts that are rendered invalid because of *gharar* include forwards and futures. Futures involve *gharar* since the object of the sale does not exist at the time the trade is executed. The netting price to be paid in the future is unknown because it is determined by factors of supply and demand via the trading floor or online marketplace. Additionally, the nature of the contract is to exchange risks, not commodities. Efforts by some regulatory supporting bodies have been made to make some derivatives Shariah compliant. However, controversy over these derivatives remains.

THIRD MAJOR PROHIBITION: GAMBLING *(QIMAR/MAYSIR)*

Most Muslim jurists use *qimar* and *maysir* interchangeably to denote any activities that involve betting, whereby the winner will take the entire bet and the loser will lose his bet.[3] However, some of them consider *maysir* a type of *qimar* practiced in the pre-Islamic era where a game may involve money, but it may also only be played for fun. Imam Malik says, "*maysir* is of two types: *maysir* of [excessive] amusement (*lahw*) (activity amusement that lead to enmity and dispute and prevent from performing obligations such as prayers, *dhikr* and other obligations) and *maysir* of gambling (*qimar*)" (al-Mawsu'a al-Fiqhiyyah, 41/377). Ibn Taymiyyah concurred with this view.

Qimar and *maysir* (gambling) refer to unavoidable uncertainty and involve taking risk that is created in the contract itself. That is, the risk in gambling is intended by itself (*maqsudun lithatih*) and not created through trade. It includes games of chance operating on the basis of speculation. Nevertheless, the Shariah does not prohibit general types of speculation. It prohibits speculation that is based on exchanging risk, which makes a deal a zero-sum game, whereby one party gains and the other loses.

Gambling is present in capital market financial derivatives, because the objective of the futures market is not the exchange of goods that may or may not exist, but rather "a risk transfer mechanism whereby those exposed to risk shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator."[4] The argument over issues of selling "what is not with you" (*la tabi' ma laysa 'andak*), selling prior to taking possession (*qabdh*) or selling of debts (*bay' al kali' bil kali'*), are marginal compared to the core objective of future markets such as the London Metal Exchange (LME), which is to exchange risks of commodity price movements and paying the deference at the time of maturity of contract. Exchanging physical commodities is very rare today—the producer of a commodity and its buyer either have already entered into contractual relationship or just want to mitigate the risk by paying a margin. As stated above, conflicting views from Shariah scholars have been raised whether derivative contracts, including futures, count as gambling. Some regulatory bodies have tried to make them Shariah compliant by making some changes in their structures, however further efforts are needed to establish the compliance of these instruments to Shariah.

FOURTH MAJOR PROHIBITION: MANIPULATION *(TALA'UB)*

Some contemporary Muslim jurists equate manipulation with hoarding, while others equate it with *najsh* (artificial price hiking) and others with *tadlis* (concealment of a defect). However, a close examination of the meaning of manipulation and its end results indicates clearly that it is associated with all types of deception. Therefore, *ihtikar* (hoarding), *najsh* (artificial price hiking), *tadlis* (concealment of a defect) and other types of tricks that lead to deception and injustice are considered elements or techniques of manipulation and are thus prohibited in Shariah, based on numerous *hadiths*. This is because manipulation in the conventional sphere is not much different in definition and legal consequences from what is prohibited by Shariah.

Manipulation is considered a crime in conventional jurisdictions, and whoever engages in manipulation is subject to various civil and criminal sanctions.

PROHIBITED DEVICES OF MANIPULATION IN SHARIAH: *IHTIKAR, NAJSH AND TADLIS*

Ihtikar (Hoarding)

Ihtikar literally means hiding goods to cause an increase in price. Technically, *ihtikar* means purchasing essential commodities and hiding them from the market to cause an increase in price because of the artificial dearth of supply in the market.

The Shariah prohibits hoarding and considers it a market manipulative practice that involves the creation of artificial shortages in the supply of a specific needed commodity. Hoarding large quantities intending to profit at the expense of retailers and consumers has the negative impact of harming the poor at the subsistence level.

Prophet Muhammad (SAW) has prohibited hoarding on several occasions. The Prophet (SAW) said: "no one practices hoarding (*ihtikar*) except the sinner," (Sahih Muslim), and "whoever practiced the hoarding of necessities of life with the intention to create artificial increases thereby (profiteering) is a sinner." (Musnad Ahmad Ibn Hanbal)

Najsh (Artificial Price Hiking)

Najsh literally means "concealment," a practice hunters used to chase game for the sole purpose of ensnaring it. Technically, Imam Al-Shafiʿi defined *bayʿ al-najsh* as "the sale wherein a person bids up the price of a commodity with no intention of buying it, only to induce others to buy it for more than they would have otherwise" (*Al-Mawsuʿah al-Fiqhiyyah*). This trick is forbidden by the *hadith*: on the authority of 'Abdullah ibn 'Umar (RA), "The Prophet (SAW) forbade *al-najsh*" (al-Bukhari and Muslim).

Thus, jurists condemned the behavior of both the seller as well as the fake buyer who drums up the price of goods. Muslim jurists agree that the person who practices *najsh* is committing a sin.

Tadlis (Concealment of a Defect)

Tadlis means concealing, deceiving, or hiding. Technically, *tadlis* is an act of intentional concealment of goods' defects in a sale transaction and is thus prohibited by the Shariah. The evidence of prohibition is based on a *hadith* of the Prophet (SAW): "Do not forcefully keep the milk in the udders of camels and sheep, and if one buys it thus, then he has the option after milking it, he may keep it or return it together with a container of dates as compensation for the milk" (al-Bukhari)

CONCLUSION

In sum, the major prohibitions in Shariah discussed above should not be seen as mere restrictions, but rather as guarantees of ethical and value-added market practices that aim to ensure fairness, justice, transparency and disclosure. These are practices that help all players by establishing a level playing field with no interference in supply and demand that could force the price of a commodity or security to an artificial level.

NOTES:

1 Abdel-Rahman Yousri (2015).

2 Muʿjam ISRA, 2010: 131.

3 Al-Sullami, 2008: 303.

4 Lockhart, 1995.

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CONCEPTS EMPLOYED IN THE ISLAMIC CAPITAL MARKET: AN OVERVIEW

Assoc. Prof. Dr. Younes Soualhi

The Islamic capital market has employed a number of Shariah concepts to structure products deemed innovative and robust. In order to meet the objective of fund allocation from surplus units to deficit units, Shariah scholars have had to deploy their legal acumen by using a wide array of Shariah concepts, demonstrating the dynamism of Shariah in the modern financial world. This short article will highlight some concepts that are widely used in Islamic capital markets, namely *wa'd, qabd, hamish al-jidiyyah, 'urf tijari* and *musharakah*. We shall explain the essence of these concepts and their applications, which attract both support and criticism from industry players and Shariah scholars.

WA'D (UNDERTAKING)

Wa'd is an Arabic term that means promise. In classical Islamic jurisprudence, *wa'd* was discussed as an act that applies to all situations including financial dealings. Although the majority of Muslim scholars do not consider *wa'd* legally binding, they unanimously recommend its fulfillment in this world, as the promisor would be responsible for its breach on the day of reckoning.

The inclusion of *wa'd* in contemporary Islamic finance has triggered heated debates among scholars over whether it is binding in Islamic financial transactions. Renowned Shariah authorities such as the Islamic Fiqh Academy of OIC (IFA-OIC) and AAOIFI ruled that *wa'd* is legally binding, hence enforceable in a court of Law. This stand relies on the Maliki school of jurisprudence, which maintains *wa'd* is binding when the promisee incurs financial losses as a result of the promisor's breach of *wa'd*.

Wa'd is mainly used in sukuk and Islamic derivatives. In leased-based sukuk such as *ijarah*, *wa'd* is embedded to secure the sale of the asset by the SPV to the obligor at maturity or at the dissolution event. While sale undertaking (SU) and purchase undertaking (PU) are deemed by some Shariah scholars as permissible, the IFA-OIC, in its 20th conference held in Oran, Algeria on 13–18 September 2012, deemed such a structure tantamount to a sale and buyback transaction (*'inah*). Further, *wa'd* is also applied in Islamic hedging instruments such as FX forwards, options and Islamic profit rate swaps. In order to avoid the deferment of both value and counter value in a hedging instrument such as an Islamic FX Forward, the agreement to effectuate the exercise price should be based on *wa'd* and not on offering an acceptance without any exchange of value and counter value. Standards-setting bodies such as the International Islamic Financial market (IIFM) has adopted *wa'd* as an underlying concept in the *Tahawwut* Master agreement meant to provide Islamic hedging solutions to the financial market.

HAMISH AL-JIDDIYYAH (SECURITY DEPOSIT)

Hamish al-jiddiyyah is yet another concept related to the Islamic capital market. It is often associated with *wa'd* in several Islamic finance transactions such as *murabahah*. *Hamish al-jiddiyyah* is a fixed amount of money paid by the promisor to the promisee as an assurance by the former to the latter to buy or lease an asset in the future. If the promisor breaches his *wa'd* to purchase or lease the asset from the promisee, the latter is allowed to be compensated from *hamish al-jiddiyyah* to cover the actual loss only, but not the opportunity loss. Considered not to be a part of the price, *hamish al-jiddiyyah* plays a vital role in guaranteeing commitments in financial dealings. It should be noted that *hamish al-jiddiyyah* is different from *'urbun* (earnest money). The former is demanded upfront to honor a binding promise before the contract is concluded, while the latter is taken upfront as part of the price after the contract is duly concluded. In Islamic capital market, *hamish al-jiddiyyah* can be applied in Islamic hedging instruments, especially an Islamic call option. On the other hand, regulators such as Bank Negara Malaysia (BNM) and some central banks who have adopted AAOIFI standards have provided guidelines on the usage of *hamish al-jiddiyyah* as an assurance given by one of the contracting parties to the other, be it in Islamic banking or in the Islamic capital market.

QABD (POSSESSION)

Possession, in general, refers to the acquisition of an asset either physically or constructively. The former denotes a physical transfer of the asset from the seller to the buyer, while the former entails a symbolic transfer of the asset by way of *tamkin* (enabling the buyer to take possession) and *takahliyah* (removing hindrances that may prevent the buyer from taking possession). In the Islamic capital market, possession refers to the acquisition of Shariah-compliant securities, either physically or constructively.

Certain issues have risen as to whether all securities are fully possessed by traders before selling them in the capital market. A good example is short selling, where shares are sold without being possessed by the seller (naked short selling). Polemics over the Shariah compliance of short selling have centered on the existence of *gharar* in regulated short selling. While most Middle Eastern scholars would not subscribe to short selling (be it covered or naked), the Malaysian regulators have ruled out any *gharar* in short selling as long as the shares are guaranteed delivery by virtue of the stiff regulations in place. This is bolstered by a resolution of (SAC) of Securities Commission Malaysia in its 69th meeting on 18 April 2006. The resolution validates regulated short selling (RSS) as long as the traded shares are Shariah compliant.

'URF TIJARI (COMMERCIAL CUSTOM)

In principle, *'urf tijari* refers to the commercial ways and techniques that traders are familiar with. Most of customary business practices are local in nature. There are, however, regional and international customary practices dictated by international standards or conventions. Markets have dictated how business is conducted in terms of production, distribution and consumption. It has also decided on the modes of payments and delivery of assets. *'Urf* is equally used to determine the nature of defects that can be warranted by a seller as well as identifying new asset classes tradable in the market. Further, the documentation style within the respective legal and regulatory framework is a good example of the enforceability of contracts, which are drafted according to the customary legal framework of a particular country.

An obvious issue is the actual date of the transfer of shares and their payment in Islamic capital market. Normally, payment is made on the trading date plus one day or a number of days (T+n) where *n* is the number of days following the trading day (T). Muslim scholars have deliberated the issue of deferment in the Islamic capital market, and they have ruled that (T+n) has become a customary issue because of the technical constraints on a full exchange of the value and the counter value (share and price) on the trading date. Hence, it is permissible to adopt the (T+n) arrangement.

MUSHARAKAH (PARTNERSHIP)

One of the most important concepts used in the structuring of Islamic capital market transactions is *musharakah*. Traders in shares are basically partners in the capital of the corporation or the venture, sharing the profit and loss of the corporation proportionally. In the Islamic equities market, this principle is already established when trading ordinary shares, Islamic indices, i-ETFs or i-REITs at market value. Venture capital, hedge funds and private equity are treated on the same principles of *musharakah*. Therefore, it is not permitted to guarantee dividends of those products, as this is tantamount to a capital and profit guarantee, which is not permissible in *musharakah* transactions. Furthermore, preference shares are unanimously prohibited, except when ordinary shareholders forgo their rights of dividends in favor of the preference shareholders via *tanazul* (foregoing one's right). The latter concept, however, is not accepted by the majority of Muslim scholars, as it defeats the objective of *musharakah*, i.e. profit and loss sharing.

CONCLUSION

The Islamic capital market has proved capable of assimilating many Shariah concepts deemed both classical and appropriate for implementation in modern finance. These concepts can be used to develop new products for capital access, the expansion of businesses or the acquisition of a competitive market share. They can be used to provide solutions to investors who are looking at the Islamic capital market as an avenue for direct investments with diversified Islamic assets. However, these Shariah concepts are not free from challenges—namely, issues of harmonization with the legal framework of capital markets, differences of opinions on how to apply them, and how best they can really boost the performance of the Islamic capital market in emerging economies. Indeed, the task is daunting, when investors view the Islamic capital market as an ethical investment platform that contributes positively to national economies without compromising the precepts of Shariah.

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The West Bay City skyline as viewed from The Grand Mosque, Doha, Qatar. Sophie James / Shutterstock.com

CHAPTER 2

Trends and Product Development in the Islamic Capital Market

Kuala Lumpur Cityscape with twin tower and mosque, Malaysia.

SUMMARY

The principal product in the Islamic capital markets is sukuk. Supported by sovereign and corporate issuers primarily in the GCC and Southeast Asia, an average of nearly $100 billion in sukuk has been issued per year this decade. While sukuk are usually structured as fixed-income instruments, and are therefore commonly perceived as a Shariah-compliant replacement for bonds, sukuk offer a large variety of structures that produce many options for financing a company or project, as well as options for investors. The Islamic finance industry has thus turned to efforts to more precisely measure and serve those investors by embarking on public opinion surveys and by more closely regulating and enhancing stockbroking services.

The sukuk market has moved from a period of growth to a period of transformation. Although it has declined since a peak of US$ 137 billion in 2012, the total annual value of global sukuk issuance has remained above $50 billion since 2010. As Malaysia dominates the market of issuances, the principal reason for this decline was Bank Negara Malaysia's recent decision to stop making short-term issuances. However, new entrants continue to broaden the universe of sukuk creators, including sovereign issuers such as the UK and South Africa and corporations Goldman Sachs and Bank of Tokyo-Mitsubishi. As the number of sukuk traders remains limited for the most part to a handful of large institutions that hold the instruments until maturity, the sukuk secondary market still suffers from restricted liquidity.

As a result of the relative decline in Malaysia's dominance, the window has opened for a shift in the structuring in available and new sukuk. Since Malaysia is the only jurisdiction to permit the trading of debt-based structures, as GCC countries take a larger section of the market and demand higher Shariah standard from Malaysia itself, demand has shifted toward lease, agency and profit-and-loss-based structures. Within asset-based sukuk, the preferred structuring method has shifted from an *ijarah* (lease) structure to a *wakalah* (agency) structure, which permits a larger group of businesses to tap the sukuk markets.

Islamic finance professionals are closely tracking the growing preference of investors for sukuk and Islamic asset management. New studies have revealed that investors' personal religious beliefs and their decision to use Islamic finance products are not as tightly linked as previously thought, which could affect future decisions from structuring to marketing. One particular method of attracting new investors is through the improvement of their intermediaries — stockbrokers. In Malaysia, the regulator has put a strong emphasis on monitoring the Shariah advisory and governance of its financial intermediaries, and on ensuring they educate their clients properly about Islamic finance, with an aim to enhance financial literacy across the board.

SUKUK HISTORICAL DEVELOPMENT AND OUTLOOK

Redha Al Ansari

Sukuk is widely acknowledged as the poster child of the Islamic finance industry. Its universal appeal for all types of corporate issuers, the strong captive demand base from Islamic financial institutions and high-profile issuances of non-Muslim sovereigns have catapulted sukuk into the big leagues of finance, becoming globally visible, despite its very modest and niche size in absolute issuance terms.

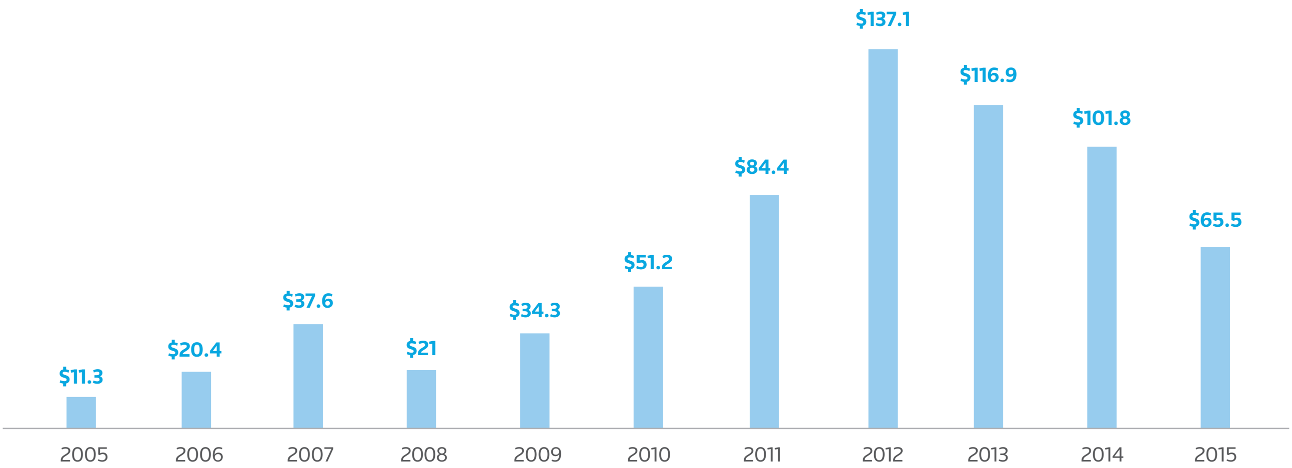
Indeed, sukuk could become a significant tool deployed by governments across the world for diversifying their funding pool in order to support economic and infrastructure development, particularly in Islamic countries where economic activity is sensitive to religious values.

Sukuk still depends heavily on government issuance to prop up markets. Corporations have recently tapped into the sukuk market to benefit from the high demand from Shariah-compliant investors and opportunistic buyers looking for diversification with good credit ratings and attractive yields. Also, in the wake of Basel III, some Islamic banks have issued sukuk as Tier 1 or Tier 2 capital instruments.

SUKUK MARKET OVERVIEW

Sukuk first appeared in Malaysia in 1990 in a corporate issuance by Shell MDS Bhd. Despite slow growth throughout the 1990s, sukuk started being issued at higher volumes in the early 2000s following sovereign issuances from Bahrain and Malaysia in the USD market, and since then, they have had a strong and steady growth rate. Sukuk, or as some would call them, Islamic bonds, in fact differ from bonds in number of ways. Sukuk are mainly structured to resemble fixed income instruments, and therefore have to be linked to a suitable income-producing asset or assets, whether the issuance is asset backed or asset based.

Figure 1: Global Sukuk Issuance 2005-2015 (US$ Bn)



Source: Thomson Reuters

As shown in Figure 1, sukuk issuances started growing in 2005 after the increase in oil prices in the GCC and Malaysia, accelerating from US$ 11.3 billion in 2005 to US$ 37.6 billion in 2007, before getting hit by the financial crisis in 2008. However, it did not take long for the market to recover. In 2010, sukuk issuance passed the US$ 50 billion mark. In 2012, with quantitative easing in full force, the sukuk market became a financing method for Islamic and conventional issuers from all over the world. 2012 marked the highest level of sukuk issuance thus far, at US$ 137.1 billion. In 2013, sukuk issuance slightly decreased to US$ 116.93 billion, followed by another decrease to US$ 113.7 billion in 2014. The decision to cease issuing short-term sukuk at Bank Negara Malaysia (BNM) also helped the market lose momentum, as total global issuance dropped to US$ 65.5 billion in 2015. Other markets have also struggled recently, such as Saudi Arabia, which had issued approximately US$ 7 billion in 2015, compared to US$ 12 billion in the year before.

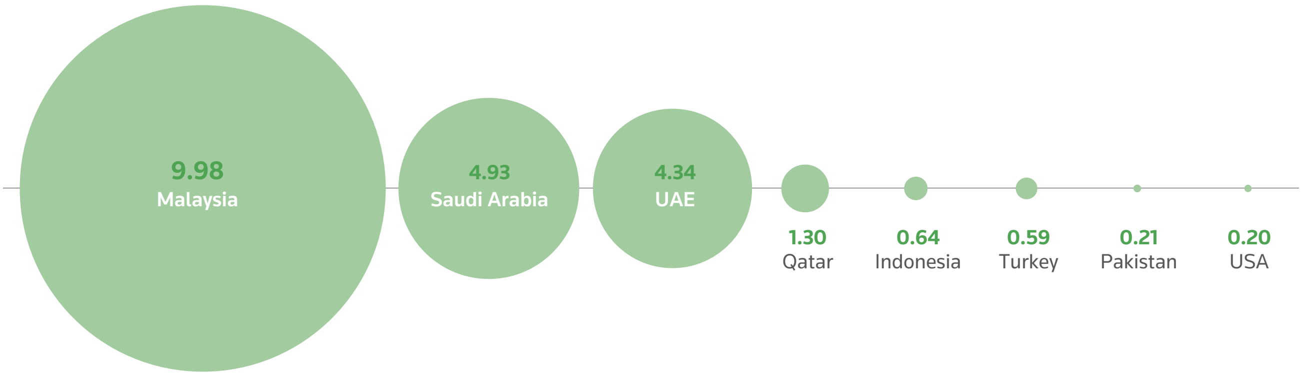
In 2014, 19 countries saw new issuances in the global sukuk market. This was the highest number the industry had ever seen, surpassing the previous high of 18 in 2012. There were notable debut issuers, including a group of sovereigns — the UK, Hong Kong, Luxembourg, South Africa, and Senegal — and corporate issuers — a real estate company in the Maldives, Goldman Sachs, and Bank of Tokyo-Mitsubishi. The strong momentum for sovereign and quasi-sovereign sukuk issuance has been met by fundamentally solid market demand and appetite for quality paper.

CORPORATE AND FINANCIAL INSTITUTION SUKUK

The biggest corporate sukuk market is Malaysia. This dominance is a result of decades of efforts exerted by the Malaysian government and regulators such as Bank Negara Malaysia (BNM) and Securities Commission Malaysia (SC) to facilitate matters for issuers with standardized laws and regulations. As of 2015, total sukuk issuances from Malaysia reached US$ 82.3 billion, followed by Saudi Arabia and UAE of US$ 41.9 billion and US$ 32.7 billion respectively.

Apart from financial institutions, the power and utility industry tops the list of the most prolific corporate sector issuers. Out of the 463 sukuk issued by power and utility companies, 431 were issued in Malaysia, representing a 93.1% market share. However, in terms of volume, Saudi Arabia is the largest, issuing around US$ 25.0 billion as of 2015 through 22 deals, surpassing the US$ 17.2 billion in Malaysian sukuk. The biggest corporate sukuk issuance in Saudi Arabia was made by Saad Trading and Contracting Company in 2007, which is owned and managed by Maan Al-Sanea, one of the leading businessmen in the kingdom. The Maan Al-Sanea sukuk, however,

Figure 2: Corporate Sukuk Issuance in 2015 (US$ Bn)



Source: Thomson Reuters

> *In October 2014, Malaysian Prime Minister Najib Razak announced adjustments in the tax structure to favor ijarah and wakalah sukuk until 2018.*

was one of the two major sukuk defaults in the Arabian Gulf besides Investment Dar. Interestingly, the sukuk defaulted two years after its launch, following a dispute between Maan Al-Sanea and the Al-Ghosaibi family. The financial crisis had negatively affected the financial position of the company, making it unable to meet its financial obligations to the Al-Ghosaibi family.

MURABAHAH STRUCTURE DOMINATES

In terms of structures, the *murabahah* structure dominates the sukuk market, holding a 32.8% market share, equivalent to 1,877 total issuances as of December 2015. It is a structure that is widely used in Malaysia, the biggest sukuk market globally. Malaysia's sukuk market leans heavily towards the *murabahah* structure. In 2015, *murabahah* sukuk totaled US$18.1 billion or 53.8% of total Malaysian sukuk issuance. Outside of Malaysia, for sukuk to be accepted as tradable per AAOIFI standards, the structure must have underlying assets comprising less than 50% of *murabahah* or other debt assets, but as the numbers obviously show, this is not an issue for the domestic local currency Malaysian market. Other debt-based structures such as *bai bithaman ajil*, and to a lesser extent *bay al-inah* and *bay al-dayn*, have also gained popularity within the local Malaysian market; these structures also are generally not accepted outside Malaysia as these structures are debt based, and are not tradable under AAOIFI standards

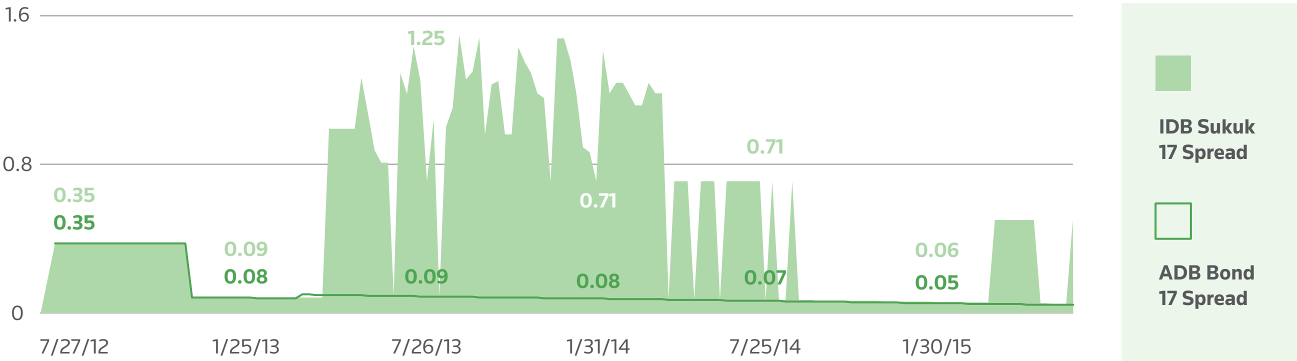
However, the types of sukuk structures used have shifted in the last five years towards the more globally-accepted *mudarabah*, *musharakah*, *wakalah* and *ijarah* structures, as Malaysia reorients itself to the international markets and the globalization of its Islamic finance industry. Previously, in October 2014, Prime Minister Najib Razak announced adjustments in the tax structure to favor *ijarah* and *wakalah* sukuk until 2018. No such favors were extended to *murabahah* sukuk. This is another telling sign that Malaysia is shifting its position to attract more foreign issuers and to narrow differences with the Gulf countries.

VOLATILE SECONDARY MARKET

When it comes to secondary market liquidity, high-quality credit is generally much more liquid, as there is a significantly greater demand to purchase such securities. However, the buy-and-hold mentality of the majority of sukuk investors leads to less secondary market liquidity in this sector, and sukuk sometimes struggle to achieve price parity with conventional bonds

The accompanying chart shows a comparison of the bid-ask spreads of two multinational corporations with similar credit ratings and the maturities, as a proxy for secondary market liquidity. The Islamic Development Bank (IDB) Sukuk and African Development Bank (ADB) bonds were both issued in 2012 and will mature

Figure 3: IDB vs ADB Price Spread



Source: Thomson Reuters Eikon

in 2017. We can see how tight the bonds market is compared to that for sukuk. Initially the two papers were moving in the same direction, before the IDB sukuk spreads started widening just after a year from issuance, while the ADB bond spreads became tighter as they got closer to maturity. The underlying reason for such low tradability in sukuk is because the majority of investors come from Islamic financial Institutions (IFIs). Because of the high demand and low supply of sukuk, nearly all IFIs tend to hold this paper to maturity, as it is hard for them to find alternative Shariah-compliant investments, and they seek to avoid reinvestment risk.

CONCLUSION AND OUTLOOK

The sukuk market will continue to be a prime market for Shariah-sensitive investors, given the limited options available to them. The outlook remains sound, especially with the drop in oil prices; many oil-exporting countries, such as Bahrain and Saudi Arabia, have already considered sukuk a source of funding to cover their budget deficits. Oil prices could witness further instability, as supplies could rise once sanctions are fully removed from Iran. The increase in global interest rates is another space both issuers and investors are carefully watching. Of course, there are implications for sukuk, just like any other financing instruments. However, the only factor distinguishing sukuk from other instruments is, without a doubt, on the demand side. This could be an advantage for issuers, who capitalize on the limited investment options available to Shariah-sensitive investors, allowing them to pull better pricing compared to other instruments. Even with a significant withdrawal of deposits from Islamic banks because of petrodollar liquidity diminishing, Islamic banks will continue to demand liquid assets—particularly those with higher investment grade ratings—which have been in acute shortage.

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EMERGING TRENDS IN THE SUKUK MARKETS

Blake Goud

OVERVIEW

Sukuk markets have undergone tremendous upheaval during the past two years, driven by the drop in oil prices and signified by typically large issuer Bank Negara Malaysia markedly reducing its issuance.[1] What has remained relatively consistent is the preference of industry stakeholders for shifting away from debt-based structures. These structures are viewed as compromising the authenticity of Islamic finance and, more importantly, bringing the same rigidity to Islamic finance that critics say makes debt instruments cause structural financial instability.

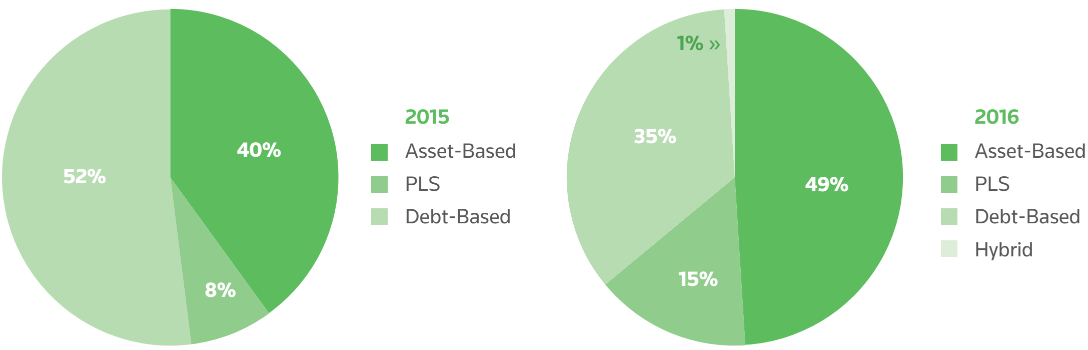
Primary markets for sukuk saw a sharp decline in the 12 months ending March 31, 2016 compared to a year earlier, falling 31%. Within this headline number, however, a summary overview of the sukuk market reveals an even larger 53% decline in issuance of debt-based structures like *murabahah*. These types of sukuk have in the past attracted criticism, such as the $500 million *murabahah* sukuk issued by Goldman Sachs in 2014). By contrast, there has been a corresponding rise in profit-and-loss sharing sukuk, which are widely viewed as best embodying the principles on which Islamic finance is built. Issuance of straight *musharakah* and *mudarabah* sukuk rose by $2 billion (32%).

THE MALAYSIAN EFFECT

This stark shift in structures used in new sukuk issuance should not be viewed in isolation from the wider factors affecting new issuance, particularly the reduction in issuance from the world's largest sukuk issuer, Malaysia, as foreign banks have extensively used Malaysian sukuk for their liquidity needs. Unlike most other countries regulating Islamic finance, Malaysia permits trading in debt-based sukuk. This is reflected in the breakdown of Malaysia's sukuk market, where nearly four-fifths of the sukuk issued in 2015 was debt-based. This ratio has fallen just over 50% in 2016 as Bank Negara's issuance has dropped, illustrated in Figure 2.

The Malaysian approach has facilitated a much deeper capital market, particularly when viewed

Figure 1: Global Sukuk Structuring



Source: Thomson Reuters[1]

in secondary market liquidity. Moreover, because of the big contribution of Bank Negara to the overall issuance volumes, the market has been much more domestically focused—nearly 90% of Malaysian sukuk in 2015 was Ringgit denominated. Nearly two-thirds of the non-Ringgit sukuk issued during 2015 was denominated in hard currencies (mostly the US dollar).

Most of the issuance outside of Malaysia conforms to the structure preferences of the Gulf Cooperation Council (GCC) investors, who shun trading in sukuk that represent financial receivables (rather than income streams connected to underlying activities or assets). This preference, as well as the continued expectation that returns and rights given to investors will mimic conventional fixed income, has led investment bankers to rely on two structures, *ijarah* and *wakalah*, that best meet these expectations. It has not led to much innovation on the profit-and-loss sharing front.

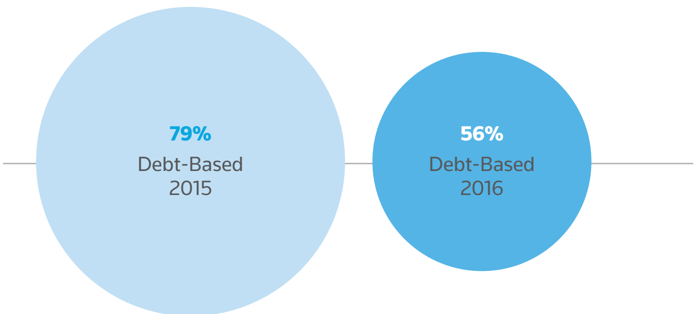
Before presenting and analyzing the sukuk market outside of Malaysia, it is key to note that the global rise in profit-and-loss sharing sukuk has entirely occurred in Malaysia's market. Even though issuance dropped from $60.2 billion in 2015 to $38.2 billion, the volume of *musharakah* and *mudarabah* sukuk rose from $3.6 billion to $6.4 billion. This rise could reflect the influence of greater market depth and a centralized Shariah board to provide the context within which new structures that push the envelope can develop.

Excluding the Malaysian market, to remove the influence of Bank Negara's issuance decisions on the aggregate breakdown of structures used in the sukuk market, there is much less of a shift in structures used between 2015 and 2016. By and large, most sukuk are still issued using asset-based structures. However, profit-and-loss sharing structures are not negligible in the overall issuance, and they represent a larger share of the market than in Malaysia.

In recent years, there has been a change in issuer preferences relating to asset-based structures. The *ijarah* structure has become less common in sukuk, while the *wakalah* structure has become more common. One reason may be that it allows issuers, particularly those who prefer holding few

> *"...the economy of scale of large issues makes it possible for more issuers to tap the sukuk market using a wakalah structure rather than an ijarah."*

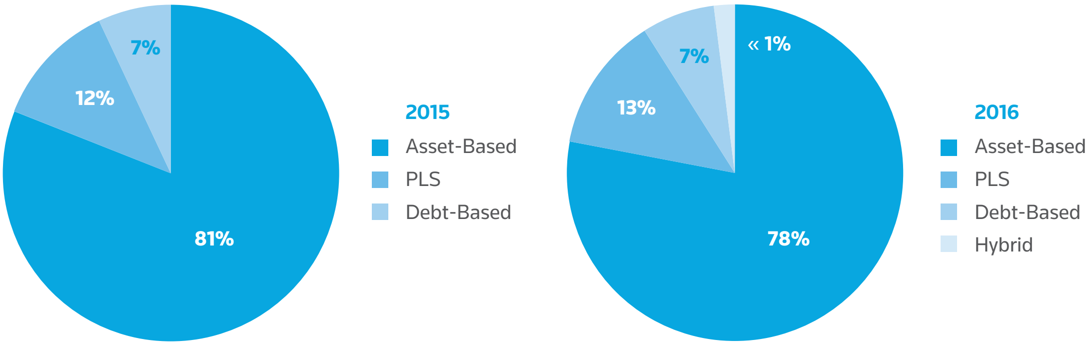
Figure 2: Debt-Based Sukuk Share in Malaysia



Source: Thomson Reuters
Note: Data for 2015 and 2016 are shown for the 12 months ending on March 31.

tangible assets, to use a smaller level of these assets, including financing assets such as *ijarah*, which are asset-based themselves. This allows them to create a larger sukuk by adding *murabahah* contracts into the mix, provided that they remain under 50% of the total size at issuance. Although it is included as an asset-based structure in the charts above, it functions in many cases as a hybrid structure.

Figure 3: Global Trends Outside of Malaysia



Source: Thomson Reuters

For example, a potential issuer with a building valued at $100 million would be limited to issuing an *ijarah* sukuk with this building to raise $100 million because the building would be sold (and later bought back) at the initial value, creating the transaction. With a *wakalah* structure, the issuer could increase the size of the transaction by combining the $100 million from the *ijarah* building with $100 million in *murabahah* financing to raise $200 million.

Given the structuring cost differential between a conventional bond and a sukuk (and assuming the cost of structuring is similar), the economy of scale of large issues makes it possible for more issuers to tap the sukuk market using a *wakalah* structure rather than an *ijarah*. This may explain some of the shift towards this structure currently observed. However, considering the lack of many repeat issuers in the market, there is also a possibility that the increase in the use of a *wakalah* structure is due to an increase in the share of sukuk issued by financial institutions, which tend to hold fewer physical assets.

In future years, changes in the composition of sukuk structures will need to allow for the widest share of sectors—both those with significant tangible assets and those lighter in tangible assets—be able to access sukuk markets. For the time being, as in conventional fixed income markets, most of the issuers are sovereigns and financial institutions. However, it is likely that the greatest degree of innovation in terms of structures will come from issuers in the non-financial corporate sector looking to sukuk markets to fund their business liquidity needs.

NOTES:

1 Data for 2015 and 2016 are shown for the 12 months ending on March 31. The categories used to group sukuk are classified by the primary Shariah structure included in the data from Thomson Reuters. Debt-based sukuk include *murabahah*, salam, BBA and bay al-inah. Profit & loss sharing (PLS) include mudaraba and musharaka. Hybrid include those which are classified as hybrid or where there are multiple Shariah structures mentioned. Asset-based sukuk cover the remaining structures, which are lease-based (ijara) or agency-based (wakala). A sukuk is included as asset-based only if it is not either debt-based or PLS-based regardless of whether recourse is to the originator. For example, an asset-based musharaka sukuk would be categorized as PLS to avoid double-counting.

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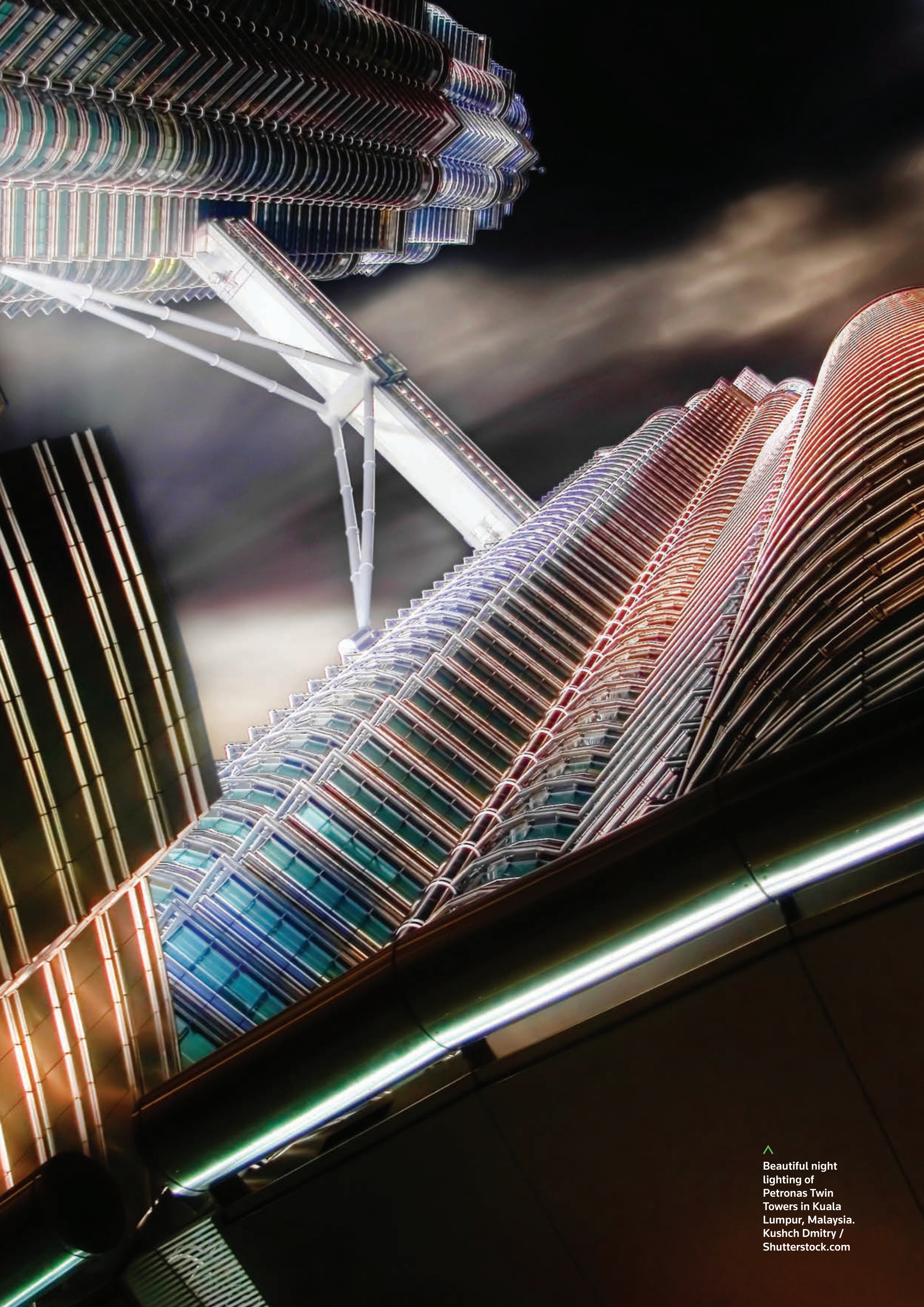


Beautiful night lighting of Petronas Twin Towers in Kuala Lumpur, Malaysia. Kushch Dmitry / Shutterstock.com

ADVANCING THE ISLAMIC CAPITAL MARKET THROUGH STOCKBROKING: THE CASE OF MALAYSIA

Jamaluddin Nor Mohamad

For years, attention has been skewed towards an emerging section of capital markets, namely debt securities, especially when discussing Islamic capital markets. The fixed-income asset class sukuk, which commonly refers to the Shariah-compliant alternative to bonds, has been without a doubt the most popular segment of the market in recent years.

With the benefit of hindsight, equities have deserved more attention in recent years. The tradability of shares and operationalization of sell-and-buy transactions are important subjects for industry participants to ponder.

The Malaysian equity market is one of the fastest growing in Asia. It also has the highest number of listed companies in ASEAN, with a total of 903 on 31 December 2015.

Participation in the Malaysian equity market is well balanced, with retail, domestic institutional, and foreign institutional investors accounting for approximately one-third of trade values respectively. In a volatile global environment, the Malaysian stock market has provided steady returns to investors, and, as shown in Figure 1, is the second highest in terms of market capitalization in ASEAN as at 31 December 2015.

One of the most attractive features of the Malaysian equity market is that it has provided sustainable returns, with an average dividend yield of 3.1%. In addition, the equity market in Malaysia has been resilient to the fluctuations of global prices and sentiments, and it is able to provide a consistent level of confidence to investors.

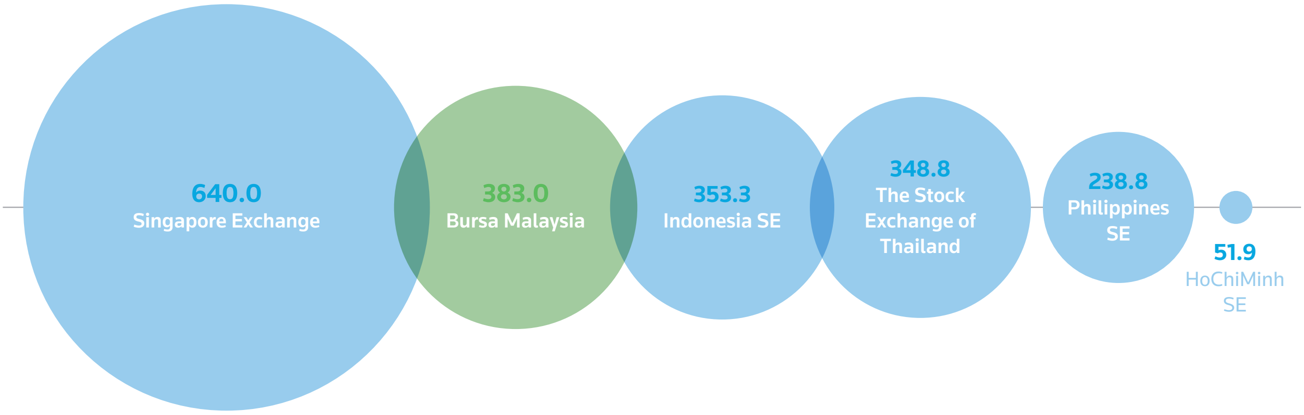
In Malaysia, the conversation about the Islamic equity market in general does not move beyond the list of Shariah-compliant securities. These are publicly listed companies categorized as Shariah-compliant or Shariah non-compliant based on the screening of their activity and financial information against the Shariah principles, according to methodology set by the Shariah Advisory Council (SAC) of the Securities Commission (SC).

In November 2013, the SAC announced a revised Shariah screening methodology, in which a two-tier approach to the quantitative assessment has been adopted. The quantitative assessment applies business activity benchmarks and newly introduced financial ratio benchmarks while at the same time maintaining a qualitative assessment.[3]

Following the revision, the threshold for Shariah compliance with regards to interest income from conventional accounts and tobacco-related business activities was reduced from 10% to 5%, while the threshold for income from hotel and resort operations, share trading and stockbroking business activities was reduced from 25% to 20%. In addition, companies with a high level of conventional debt and/or cash placement are now affected by financial ratio benchmarks of 33%.

This 'stricter' methodology has caused a significant drop in the total number of Shariah-compliant securities listed by the SAC of SC starting in November 2013. However, the market capitalization of Shariah-compliant securities has recorded only a slight decrease despite the significant decrease in their number.

Figure 1: Market Capitalization in ASEAN[1] (US$ Bn)

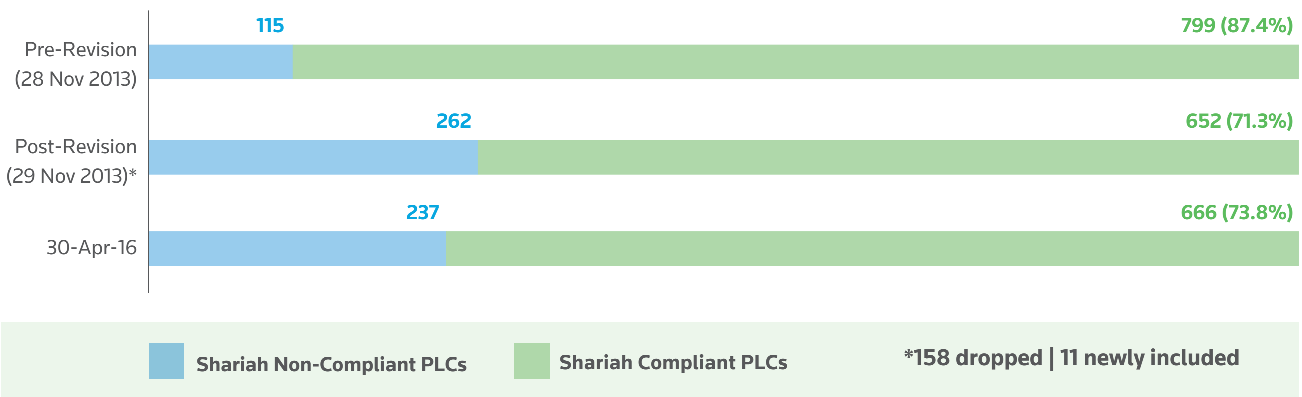


The last six years performance of the overall equity market of Malaysia vis-à-vis Shari'ah compliant securities is reflected in the following table

Figure 2: Key Stock Market Indicatorsket Indicators[2] (US$ Bn)

Key Market Indicators	2010	2011	2012	2013	2014	2015
Total Number of PLCs	964	944	927	915	906	903
Total Number of Shariah-compliant PLCs	849 (88.1%)	837 (88.7%)	819 (88.3%)	652 (71.3%)	673 (74.3%)	667 (73.9%)
Total Market Capitalization (RM Bn)	1,258	1,270	1,451	1,681	1,633	1,677
Total Market Capitalization — Shariah (RM Bn)	803 (63.8%)	810 (63.7%)	946 (65.2%)	1,044 (62.1%)	1,028 (63.0%)	1,104 (65.8%)
Total ADV OMT+DBT (RM Mn)	1,493	1,684	1,583	2,042	2,045	1,971
Total ADV OMT+DBT — Shariah (RM Mn)	994 (66.6%)	1,134 (67.3%)	1,106 (69.9%)	1,453 (71.2%)	1,396 (68.3%)	1,348 (68.4%)

Figure 3: The Impact of the New Shariah Screening Methodology



As at 31 December 2015, the total equity market capitalization for Malaysia stood at RM 1.677 trillion, of which Shariah-compliant market capitalization represents 65.8% (RM 1.104 trillion).[4]

THE ROLE OF THE STOCKBROKER

A key group of participants in the capital markets are professionals licensed to deal in securities and authorized to act as agents for investors who wish to execute an order—stockbrokers. Operating under the principle of *wakalah bi al-ujr* (paid agency), these professionals are responsible for acting on behalf of clients while following the highest ethical standards. For example, brokers cannot take a position in a stock that would result in a conflict of interest or improper recommendation.

As professional individuals who execute buy and sell orders for stocks and other securities, either through a stock market or over the counter, stockbrokers are usually associated with a brokerage firm and handle transactions for retail and institutional customers. Brokerage firms and broker-dealers are also often referred to as stockbrokers.

In Malaysia, a Participating Organization of Bursa Malaysia Securities that conducts its stockbroking business in accordance with Shariah principles, whether on a full-fledged basis or window basis, is known as an "Islamic Participating Organization."

With the objective of providing guidance and assistance to Islamic Participating Organizations in observing the desired practices when carrying out its stockbroking business, in 2007, Bursa Malaysia introduced its Best Practices in Islamic Stockbroking Services Undertaken by Participating Organizations. In 2016, the Best Practices have been revamped to stay relevant.

The revision has been made in line with a core strategy of the Capital Market Masterplan 2 (CMP2) to increase the efficiency and scope of intermediation by fostering a conducive environment for innovation, facilitating greater diversity and expanding growth prospects across the value chain. This includes providing a regulatory environment that supports the ability of capital

Figure 4: Companies Offering Islamic Stockbroking services on 31 December 2015

No.	Company	Type
1	BIMB Securities Sdn Bhd	Full Fledged
2	Affin Hwang Investment Bank Bhd	Window
3	AmInvestment Bank Bhd	Window
4	CIMB Investment Bank Bhd	Window
5	Jupiter Securities Sdn Bhd	Window
6	Kenanga Investment Bank Bhd	Window
7	Maybank Investment Bank Bhd	Window
8	RHB Investment Bank Bhd	Window

> *Participation in the Malaysian equity market is well balanced, with retail, domestic institutional, and foreign institutional investors accounting for approximately one-third of trade values respectively.*

market intermediaries to offer a wide range of services subject to their capabilities for managing the risks of their operations.

The best practices intend to be the fundamental reference of Islamic Participating Organizations for ensuring the compliance of its business activities to Shariah principles whether on a full-fledged basis or a window basis. They cover key goals and procedures that such an organization should embrace.

In the current business environment, Islamic Participating Organizations are expected to consider investing in human capital wisely. Such investment will equip these organizations with sufficient human resources with the necessary qualification, expertise and experience to manage and administer its Islamic stockbroking services. For instance, managers at Islamic Participating Organizations responsible for monitoring Shariah compliance, including heads of dealing, heads of operations and heads of compliance, should have sufficient exposure to Shariah knowledge.

Moreover, an Islamic Participating Organization is expected to provide assurance of its compliance to Shariah principles, concepts and rulings issued by the SAC, as may be amended from time to time. It should limit its dealings in securities traded on the Bursa Securities to Shariah-compliant securities, as determined and endorsed as such by the Shariah Advisory Council, or securities traded on other exchanges that are determined to be Shariah-compliant by the exchange or by a Shariah standard setting body or Shariah scholar, either in Malaysia or elsewhere.

Shariah provides *rukhsah* (an exception to a general law) for an Islamic Participating Organization to facilitate the disposal of Shariah non-compliant securities upon the advice of its client, either because of the reclassification of the securities as Shariah non-compliant following the review by the SAC, or if the investor is holding Shariah non-compliant securities that he or she wishes to dispose of for the purpose of cleansing.

In addition, an Islamic Participating Organization should appoint a professional or committee that is mandated to oversee the operations of the Islamic Participating Organization in terms of its adherence to Shariah rules and principles, i.e. the Shariah adviser.

Providing effective oversight of the compliance of a particular Islamic Participating Organization with Shariah rules and principles is the main responsibility of the Shariah adviser. This includes but is not limited to endorsing and approving the relevant policies, systems, operational procedures and internal controls in relation to the Islamic Participating Organization's day-to-day business operations in respect of its Islamic stockbroking services.

In ensuring compliance of its activities with the Shariah principles, an Islamic Participating Organization should free itself from any forbidden elements such as usury (*riba*) either in maintaining its own or its clients' accounts. Taking necessary measures to properly segregate funds for itself or its clients in respect of the Islamic stockbroking services from its conventional stockbroking services is an essential criterion for it to remain an Islamic Participating Organization. The proper observation of Shariah requirements for the imposition of compensation charges (*ta'widh*) and granting of rebate (*ibra'*) wherever relevant is part of the compliance of operations, systems and procedures.

To further emphasize that compliance with Shariah principles is significant, an Islamic Participating Organization should obtain Shariah confirmation annually from its Shariah adviser stating that it is providing an Islamic stockbroking services and that it complies with the Best Practices, and the Shariah principles, concepts and rulings issued by the SAC of SC or its Shariah adviser, as amended from time to time. In the absence of the annual Shariah confirmation, a Participating Organization should not describe itself as an Islamic Participating Organization or advertise Shariah-compliant stockbroking services.

From the eyes of an investor looking to make fully Shariah-compliant investments, the revised Best Practices is an important step into the future. In fact, undertaking "Shariah Investing" is not just about dealing in Shariah-compliant securities but to embark on the journey via recognized Islamic Participating Organizations.

SHARIAH INVESTING ON BURSA MALAYSIA

To further facilitate Shariah-compliant investing, in September 2016, Bursa Malaysia introduced a fully integrated Islamic securities exchange platform with a comprehensive range of exchange-related facilities including listing, trading, clearing, depository, and settlement services, known as "Bursa Malaysia-i".

In developing the platform, the existing securities investment infrastructure has undergone a review exercise that has resulted in the improvement of governance and operational structures and processes. The new landscape will better facilitate Shariah investors to undertake investment activities via a fully Shariah-compliant flow:

Aiming towards the protection of wealth, according with the objectives of Shariah (*Maqasid al-Shariah*), Shariah Investing on Bursa Malaysia via Bursa-Malaysia-i intends to achieve the following objectives:

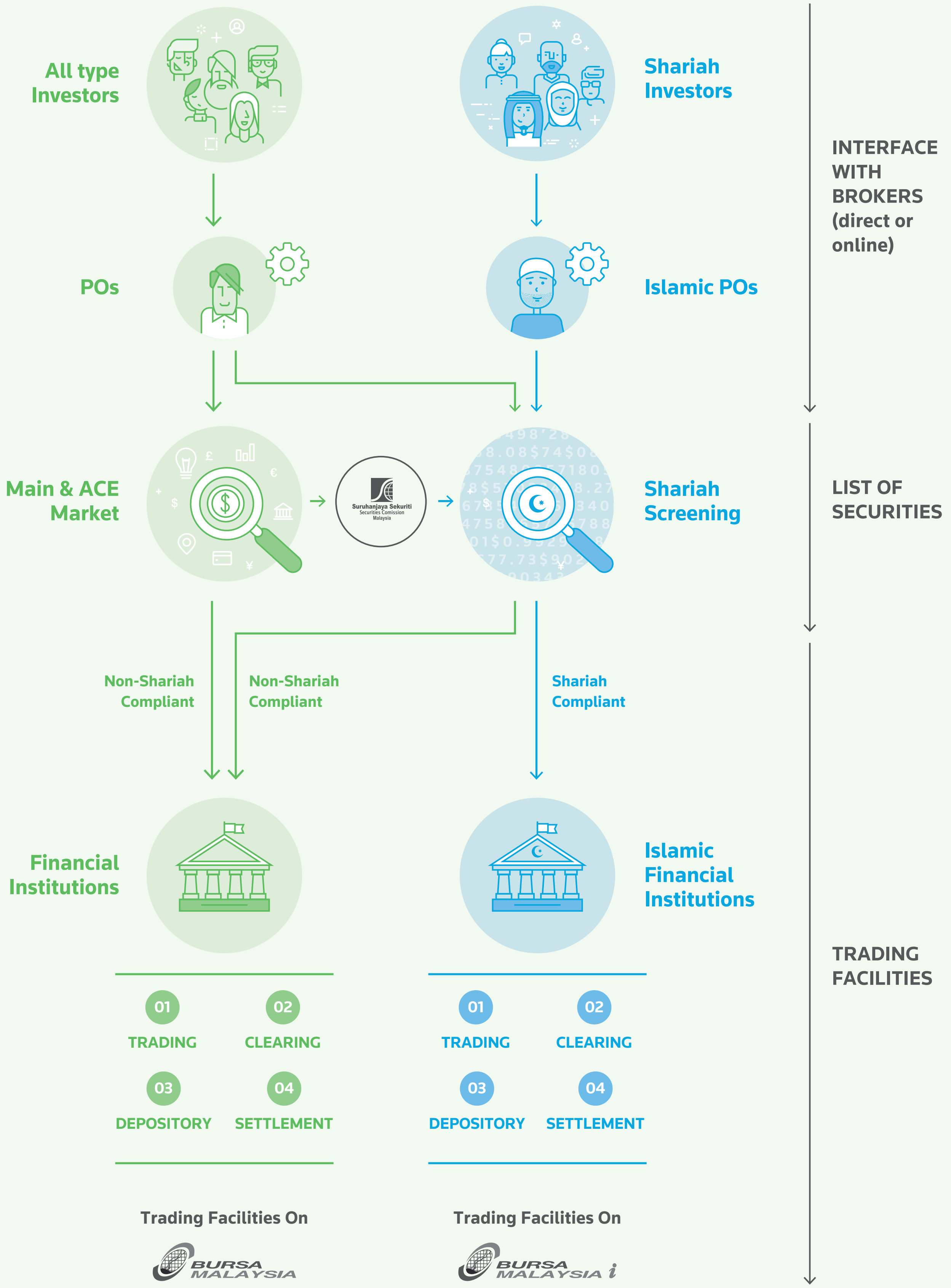
1. To establish a comprehensive range of Shariah-compliant exchange-related services including listing, trading, clearing, settlement and depository services; leveraging the existing infrastructure by incorporating Shariah-compliant features;

2. To strengthen Islamic products and services, and to make Shariah trading more visible, in order to further facilitate the future growth of the Malaysian Islamic capital market and provide a conducive marketplace for the Shariah investing community.

3. To help the development of Islamic Participating Organizations' market development and to enhance visibility of their services; and

4. To make Malaysia the preferred choice of destination for Islamic finance marketplace, and to boost cross-border activities.

Figure 5: The New Landscape of Shariah Investment Activities in Malaysia



Apart from issuing the revised Best Practices in Islamic Stockbroking Services Undertaken by Participating Organizations as discussed earlier, Bursa Malaysia-i had also introduced a new set of best practices for the purpose of guiding Shariah investors, namely "Best Practices for Shariah Investing." The Best Practices help the investors in order to ensure that their investment and trading activities are in accordance with the established and parameterized Shariah principles without any doubt.

CONCLUSION

It is hopeful that the issuance of the revised Best Practices will improve the visibility of Islamic Participating Organizations, and the number of Islamic Participating Organizations is expected to increase in time. As important intermediaries in the securities market, Islamic Participating Organizations are integral to a comprehensive Islamic capital market at Bursa Malaysia that ultimately fulfils one of the pertinent objectives of Shariah (*Maqasid al-Shariah*) of protecting wealth.

NOTES:

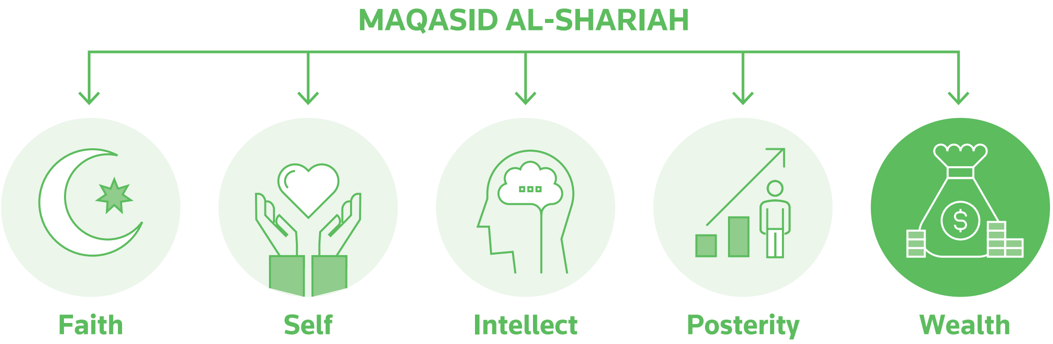
1 "Capital Markets Malaysia: Financing the Future," http://capitalmarketsmalaysia.com/wp-content/uploads/2015/06/factsheet-financing.pdf, Section 1, p.4.

2 Bursa Malaysia Berhad.

3 See Securities Commission website, http://www.sc.com.my/revised-screening-methodology/

4 Bursa ICM Factbook, May 2016.

Diagram 2: The Objectives of Shariah (*Maqasid al-Shariah*)



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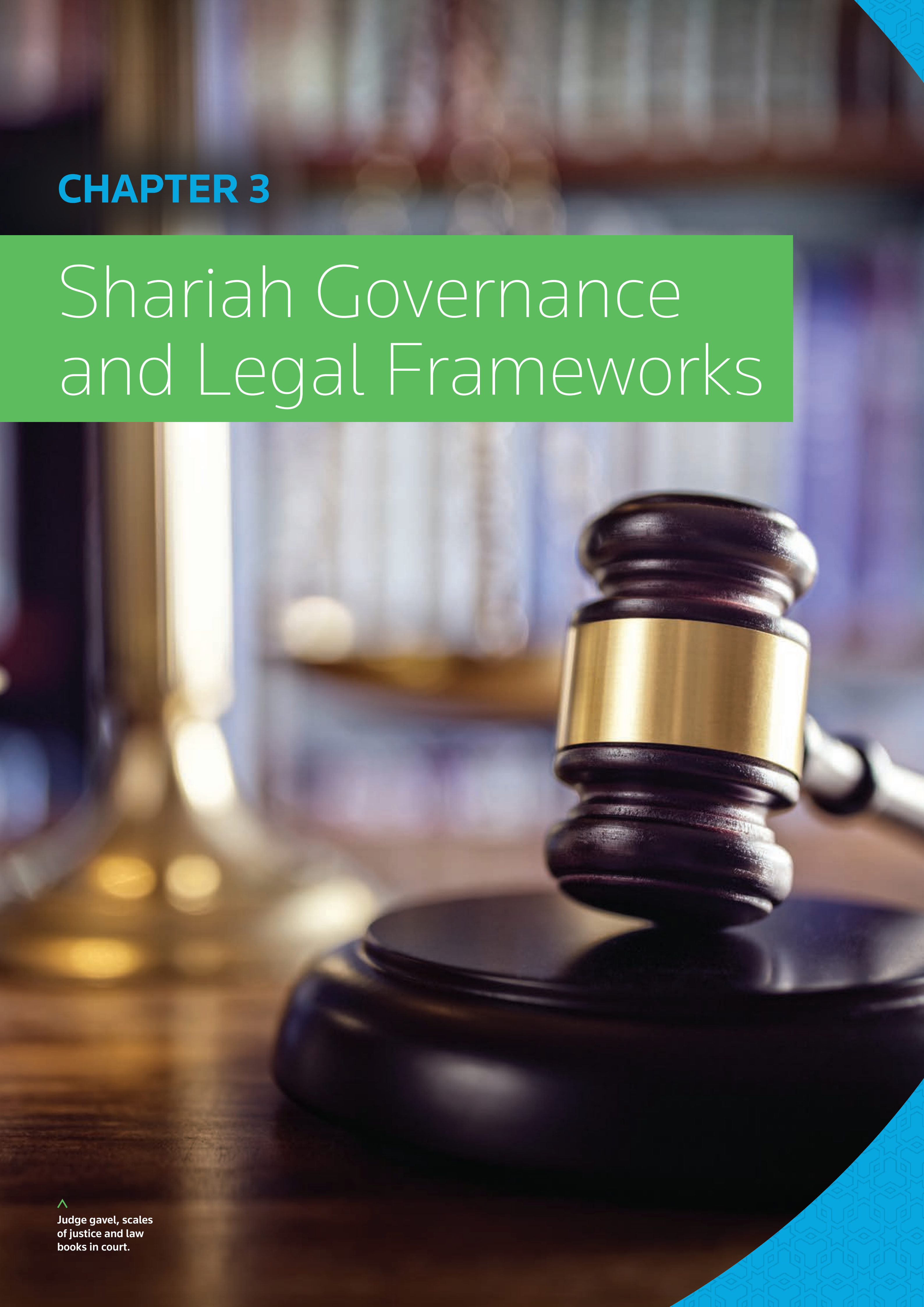
An investor monitors share market prices at a brokerage firm in Kuala Lumpur, Malaysia. REUTERS/ Olivia Harris

CHAPTER 3

Shariah Governance and Legal Frameworks



Judge gavel, scales of justice and law books in court.

Summary

The Shariah does not exist as a set code of positive law. Rather, it is the result of a living juristic tradition of the interpretation of law (*ijtihad*) as found in the Qur'an and the Sunnah. As a result, there have developed many different schools of Islamic law over time. Although the world's Muslim community is always striving towards unanimity (*ijma'*) in legal opinion, alternative opinions with expert support are considered legitimate. In seeking to spread the use of Shariah in contemporary business transactions, Islamic financial institutions and professionals therefore do not only confront the challenge of interfacing with the national secular legal codes of various countries around the world. It is just as important for them to create ways of standardizing Islamic financial legal practices to allow for international and regional cooperation, while accommodating the pluralism of Islamic legal tradition.

International industry bodies like the International Islamic Financial Market (IIFM) and the Islamic Financial Services Board (IFSB) have developed and promoted standard forms for Islamic capital markets instruments and Islamic financial institutions in general, respectively. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is perhaps the oldest such organization, and it has developed a series of standards for accounting, auditing and Shariah standards, which have been selectively adopted by the regulatory bodies of an increasing number of important Islamic finance jurisdictions.

There remains a need for broader framing goals for these harmonization efforts, similar to that provided for the conventional markets by the International Organization of Securities Commissions. Salman Syed Ali argues for the addition of broad mandates in Islamic finance to keeping finance tied to real economic activity and to keeping money in circulation between financial sectors and social classes.

The continued fragmentation in Islamic legal practices and expectations, and the adjudication of legal disputes in the many jurisdictions in which Islamic financial institutions and clients operate, highlights the need for standardisation. Sukuk holders have found difficulty enforcing their rights in the case of the default of the issuer when the sukuk contracts have been vague with regards to the Shariah principles being used, or have deviated from AAOIFI standards, particularly in courts outside the Muslim world. One remedy to the litigation trend has been to create mechanisms for alternative dispute resolution (ADR), such as arbitration, and build them into standardised forms and contracts for Islamic financial instruments.

THE ISLAMIC CAPITAL MARKET VIS-À-VIS THE INTERNATIONAL REGULATORY FRAMEWORK

Dr. Salman Syed Ali

IS THE CURRENT INTERNATIONAL REGULATORY FRAMEWORK SUFFICIENT FOR ISLAMIC FINANCIAL MARKETS?

Human initiatives tend to drive capital markets, and the desire for acquiring more keeps these markets active and vibrant. However, the smooth functioning of financial markets requires regulations to ensure fairness between transacting parties and to avoid adverse effects on others. Consequently, financial markets are regulated in all countries. The International Organization of Securities Commissions (IOSCO), the global organization setting standards for securities markets regulation, has formalized the objectives of financial markets regulations as follows:

1. Protecting investors;
2. Ensuring that markets are fair, efficient and transparent; and
3. Reducing systemic risk.

These objectives form the basis for the 38 principles of securities markets regulation issued by IOSCO (revised 2010). These principles establish a framework for the detailed rules and regulations drawn up by national regulatory authorities for their respective jurisdictions.

The questions we ask: Are the internationally stated objectives of financial markets regulation compatible with the objectives of Islamic financial markets regulation? Are these objectives sufficient to encompass the objectives of Islamic financial markets regulation so that the regulatory framework would be appropriate?

Examining the above three objectives of the IOSCO regulations, we do not find them in contradiction with the ethos and teachings of Islam. For example, investor protection aims to ensure that investors are not deceived and contracts are enforced as agreed. The second objective pertains to creating fairness in contracts and practices by mandating the timely availability of relevant and correct information to all market participants. The third objective of systemic stability intends to prevent financial market products and practices from concentrating risks, which lead to wild price swings that destabilize markets.

However, these objectives are not sufficient or comprehensive in themselves to encompass all the objectives of Islamic law and morals in the financial field. They therefore require specification of further objectives that are not part of the current regulatory framework.

TWO OBJECTIVES FOR ISLAMIC FINANCE BEYOND IOSCO

It is obvious that Islam does not treat money as a commodity of trade. Rather, it wants finance to remain tied to real economic activity—that is, money should be transformed into economic capital that should generate a return. Rules following from this principle include the prohibition of trade in debt including rollover of debt, the prohibition of selling what one does not own, and the prohibition of combining certain contracts.

Thus, a fourth objective of Islamic financial regulation should be "to keep finance tied to real economic activity at each point in time." This is a missing objective in the current regulatory regime. Some can say that the objective of "reducing systemic risk" covers it. However, if this were true, we would not have witnessed the recent global financial crisis, which resulted essentially from the delinking of the real and financial sectors. Financial assets, including various kinds of debts, grew too fast and out of proportion to the real economic activity, propelling the global economy toward a collapse.

The objective of reducing systemic risk, in conventional thinking, only calls for setting up circuit breakers or similar measures in financial markets to limit excessive speculative activity. However, this neither prohibits gambling instruments and derivative products nor insists on promoting the tight link to productive activity needed for finance to promote economic growth. The regulatory and supervisory system also does not stop various incentives for market players to continue such actions that create this divergence between the real and financial sectors.

A fifth objective of regulation of Islamic financial sector would be to keep money in circulation and ensure that it may not remain circulating only among the rich. The imposition of *zakah* on unused savings and the following Qur'anic ayah support this objective.

كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاءِ مِنْكُمْ

...in order that it may not become a fortune used by the rich among you. (Qur'an, 59:7)

This is an important objective in regulating Islamic financial markets. It calls for the diversification of products and participants, ensuring that trading does not remain concentrated among the few. It does not mean to make every financial product available to all types of investors irrespective of their capacity to analyze them and take the appropriate risks. However, it highlights the responsibility of the regulator to ensure the availability of a variety of products so that no potential investor is left without an option to use some products.

Moreover, it also shows the responsibility of the regulator to ensure that products and trading practices are not tilted towards the rich and resourceful—a requirement with a higher standard than the financial inclusion imperative.

Well-specified objectives of regulations will lead to better principles and better framework for securities market regulation. Consideration and inclusion of the fourth and fifth objectives stipulated above in the international regulatory framework has the potential to help capital markets function better to achieve their goals of financing with stability and promoting social justice in both Muslim countries and worldwide.

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SUKUK: DEFAULT OR NO DEFAULT?

Oliver Agha

Commentators have suggested that sukuk holders' rights and the resolution options available to them are no different from conventional bondholders'. This article offers a counter-argument to that perception.[1]

When defaults in market sukuk structures result from contractual covenants imported from conventional bonds, such defaults would not necessarily be enforceable in a Shariah adjudication, regardless of decisions made in foreign courts.

Islamic finance continues to develop as a viable form of investment, not only for Muslims but also as an alternative for non-Muslims. It would seem logical that as the products evolve — while holding true to their philosophical underpinning of risk-sharing and not risk transfer — both Muslim and non-Muslim investors will continue to invest in them. Blaming Islamic finance for sukuk defaults is both simplistic and misinformed. The 'defaults' occurring in instruments today would not necessarily qualify as genuine Islamic defaults because such provisions effect the kind of risk-transfer that is inimical to Islamic finance.

Condemning Islamic finance for provisions already identified as problematic by leading authorities, and which contravene the Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI)[2] Shariah guidelines, is actually an incrimination of disingenuous structures rather than Islamic finance itself. Islamic finance will continue to grow if it develops products that are genuine and offer the ethical foundation of risk-sharing rather than risk transfer.

This article addresses provisions imported from conventional bond structures and why their inclusion presents enforceability issues, and considers that sukuk holders may well be bound to their commitment to abide by Shariah, irrespective of the contractual terms agreed between the parties. Individual agreement does not transcend Shariah law.

SUKUK: BETWEEN EQUITY AND FIXED INCOME

Sukuk are certificates of equal value that represent an ownership interest in tangible and certain intangible assets. AAOIFI guidelines emphasize the difference between sukuk and conventional bonds. These guidelines note that sukuk do not represent a debt owed to the issuer by the certificate holder and that the owners share in the returns and bear the losses. Furthermore, the standards note the documentation must explicitly abide by Shariah and that a Shariah board must monitor its implementation.[3] Clearly, sukuk are meant to be equity-type instruments: any references to sukuk as being Islamic bonds are oxymoronic and misleading to investors who may believe they have certain bond-like remedies that, ultimately, may not be enforceable in some Islamic jurisdictions.

Scholars have raised issues with market sukuk structures that, inter alia: (i) guarantee the return of capital of the sukuk holders (either through manager or issuer covenants to redeem sukuk at face value, rather than market value); and (ii) provide for credit enhancement purchase guarantees by related companies.

In a release on sukuk structures in February 2008, the AAOIFI offered the following as additional guidance for sukuk issuers (as a supplement to the published AAOIFI standard on sukuk).

- Sukuk holders must own all the rights and obligations of the assets (tangible, usufructs or services), and the assets are to be transferred from the issuer to the sukuk holders' books;

- In order to be tradable, sukuk cannot represent receivables or debt except for trading/financial entity sales that unintentionally convey incidental debt;
- Sukuk managers may not cover loan shortfalls to sukuk holders, but reserve accounts established for such a purpose are permissible if disclosed in the prospectus;
- The purchase of assets at maturity is permissible at the market value rather than the nominal/face value; although sukuk issuers/managers can guarantee capital in the event of negligence;
- Lessees in sukuk *al-ijarah* may purchase the leased asset for its nominal value, provided the lessee is not a general partner, *mudarib* (working partner) or *wakil* (investment agent).[4] AAOIFI standards permit the redemption of sukuk for usufructs at fair market values or at a price agreed between the parties at the time of redemption;
- Shariah boards are to review all relevant contracts/documentation related to the transaction to ensure compliance with Shariah and oversee that implementation and operation complies with Shariah.

On balance, the sukuk standards and rulings, when synthesized, reflect an equity-type instrument that cannot represent a debt owed to the holder.

Conventional bond default provisions that are frequently incorporated into sukuk documentation appear to give to investors an Islamic instrument that looks, at least contractually, like a bond. While Shariah *fatwas* are procured to provide comfort that instruments are Shariah compliant, such endorsements are subject to different interpretations. When *fatwas* contravene AAOIFI standards, their reliability becomes tenuous. Even where there may be compliance with a standard, which has been passed with a narrow majority, a structure may be called into question by the individual judge, who may subscribe to the strong minority view.

Fundamentally, the issue is not with Islamic structures but with attempting to import provisions that are conventional risk transfers. Different jurists will have a different tolerance level for such 'innovation', with many rejecting the egregious provisions that substantially replicate a conventional instrument.

SHARIAH IN SUKUK CONTRACTS: JURISDICTIONAL PROBLEMS

Problems arise when sukuk investors are confronted with a situation where contractual agreements proffer bond remedies they find of questionable enforceability in a Shariah jurisdiction. In reality, sukuk holders do have substantial remedies under Shariah: they are the beneficial owners of the underlying assets that would need to be excluded from the insolvency proceedings of the issuer.

Even if overseas judgments are obtained in relation to imported bond provisions, these would likely be scrutinized in an Islamic locale to ascertain whether the judgment had been made in accordance with Shariah principles. Case law in some jurisdictions highlights this. For example, in England the case of Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd. (No.1) held that, irrespective of the election of the parties to subject English law to 'Shariah', English law applied because Shariah was not a governing body of law but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business. The court noted that the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, only contemplated and sanctioned the choice of the law of a country, not a religious principle.

It is possible to incorporate provisions of foreign (presumably Shariah) law into the terms of a contract. However, in this case the documentation did not identify any specific aspects of Shariah law the parties intended to be incorporated into the agreement. Furthermore, the court held that "the reference to Shariah law was repugnant to the choice of English law and could not sensibly be given effect to." Given the importance of this case, Islamic jurists will invariably revisit English judgments on a 'de novo' basis to determine whether there is genuine compliance with Shariah principles. When drafting clauses that subject the laws of a country to Shariah, the parties need to identify the specific governing principles of Shariah that will apply to the contract, such as the exclusion of *riba* (usury). This has not yet been tested but would seem a sensible solution to enhance the chances of such an appendix of relevant governing principles being incorporated in the country whose law is chosen.

Adoption of such an appendix of foreign law principles is subject to the judge's discretion and the case suggests that such adoption of foreign principles needs to be capable of being sensibly applied in the country. Some commentators have noted that if the foreign law is incorporated into the terms of the subject contract, it would mean no more than the court applying English law where certain black letter laws of a foreign jurisdiction were incorporated.[5] Such measures should be helpful in the incorporation of Islamic principles in the foreign adjudication. Furthermore, even though Islamic law would not prevail in the event of a conflict, such judgments would inevitably be accorded lesser scrutiny, depending on the circumstances, in Islamic *fora*.

However, for the purpose of enforcement or obtaining a judgment in a country that recognizes and accepts the underlying principles of Shariah law, as well as the selected country's law being applicable to transactions that are Islamic in nature, a court will naturally visit (or revisit) the specifics of the dispute and the underlying documentation to evaluate whether it resonates with Shariah principles. Expert witnesses will in all likelihood need to be called to assist in the interpretation of Shariah with the governing law. The influence of such witnesses should rest with the consensus (*ijma'*), as reflected in AAOIFI standards.

In short, purchasers of sukuk and other Islamic instruments need to be aware that these products may be subjected to scrutiny at enforcement and certain non-conforming provisions may be excised or disregarded. While sukuk holders share in the rewards, they would take the risk of a depreciation of their capital in adverse business circumstances provided there was no negligence on the issuer's or manager's part. Islamic finance is a permissive field and, apart from the fundamental prohibitions, a multitude of structures can be developed to serve varying commercial needs. However, referring to sukuk as Islamic bonds is like jamming a square peg into a round hole and then wondering why it doesn't fit.[6]

NOTES:

1 This article has been republished with permission but does not reflect a comprehensive review of current and updated legal research in relation to comprehensively updating the legal positions asserted therein.

2 The AAOIFI is the leading Islamic supranational standards body. Through its Shariah and related boards and committees, the AAOIFI issues Islamic finance standards that, generally, delineate the parameters for Islamic finance structures and products. The AAOIFI is also responsible for developing accounting, auditing, ethics and corporate governance guidelines.

3 AAOIFI Shariah Standard No. 17 (Investment Sukuk) as adopted on May 8, 2003.

4 This provision pre-supposes the price for assets is in general congruence with market value conditions. In the event of an egregious mismatch, such a sale may well be questioned along *Shariah* lines that generally require the sale of assets at fair market value or at prices to be agreed, on an arms-length basis, at the time of the sale.

5 New Law Journal, June 9, 2006, Juliette Levy.

6 Oliver Agha wrote this article when he was the managing partner of his firm and acknowledges the contributions of Claire Grainger on the English Law aspects.

OLIVER AGHA who currently works in Dubai in a senior position with a leading blue chip corporate is a New York lawyer who had written this article as the managing partner of a boutique law firm specializing in Islamic Law and was then also serving on the board of AAOIFI. He is regarded as a leading lawyer on matters relating to Islamic Law and has worked in the GCC for over a decade including on landmark deals. He is also published and has lectured on Islamic finance topics including at prominent Universities.

Interior of the Blue Mosque, Istanbul, Turkey.

STANDARDIZATION AND HARMONIZATION OF ICM PRACTICES

Ijlal Ahmed Alvi

The development of the international Islamic capital market (ICM) is considered an avenue for increased financial inclusion. However, such developments require further progress on the standardization and harmonization of international ICM practices. How much harmonization has the international ICM witnessed so far? And what is your general assessment of current trends toward standardization specifically in Islamic capital markets by various international institutions?

I totally agree that the Islamic capital market (ICM) is the backbone of a financial system and plays a major role in the development of the Islamic finance industry; sukuk is a good example of a growth driver. In terms of standardization in the ICM, there are four main areas that would help improve financial inclusion:

Standardization in Regulatory and Legal Aspects: IFSB is actively pursuing this goal and there is progress in this regard. It is likely to see more standards in the coming years. No doubt, the implementation of standards on a wider scale is the key to achieving the realization of the true benefits of standardization.

Standardization in Accounting and Auditing Standards: AAOIFI has issued a number of standards on accounting and auditing practices. Its ongoing revisions will bring further convergence with conventional accounting and auditing standards.

Shariah Standards: Over the last several years, AAOIFI has issued a number of Shariah standards concerning ICM, and these standards are a good source of reference. ICM is a relatively new segment in the Islamic banking and finance industry that started at the beginning of 2000 with the first issuance of sukuk. Therefore, there is an urgent need for new Shariah standards in order to keep pace with developments in this sector.

Standardization of Financial Contracts and Products: The International Islamic Financial Market (IIFM) has taken on the challenge and responsibility of addressing standardization in Islamic financial contracts and products. With regard to Islamic hedging products, the work is still in constant progress. During the relatively short time span of six years, IIFM will publish a complete set of standards for Islamic hedging. Moreover, IIFM has issued several standards to address Islamic liquidity requirements.

What have been IIFM's latest accomplishments in harmonizing Islamic capital markets practices? And what will be its focus regarding upcoming standards related to ICM?

IIFM's latest contribution is two standards recently published on Islamic foreign exchange forwards. The standards are designed to mitigate currency risk in ICM particularly with regard to sukuk.

In order to provide complete standardized solutions in Islamic hedging, IIFM has initiated the development of standards on credit support arrangements (CSA). Moreover, IIFM has also commenced work on the development of standards relating to Islamic trade finance and corporate finance.

The experience of the capital markets in terms of standardization emphasizes the benefits of international associations such as the International Primary Market Association (IPMA) and its successor body, the International Capital Market Association (ICMA). Would the ICM benefit from a similar initiative? If so, how might this be achieved, specifically in the sukuk market?

IIFM has a memorandum of understanding in place with ICMA. Once an area of common interest and expertise is identified, IIFM may jointly initiate a standardization project with ICMA similar to the projects being completed with the International Swaps and Derivatives Association (ISDA).

IIFM has carried out extensive analysis on the standardization needs for sukuk through consultative meetings. Currently, IIFM is fine-tuning terms and conditions to initiate the sukuk-related project.

The sukuk market overall has evolved in the past few years, and it has provided issuers with a wide range of structures to facilitate their needs. In order to provide clearer understanding and level playing field, IIFM will be embarking on a sukuk standardization initiative. However, in the short term, IIFM will look to bring out comprehensive guidance notes so that the market has a clear understanding of the product and its conditions.

In your opinion, what are the current issues impeding the implementation of standards in Islamic capital markets? Are there any solid initiatives toward eliminating such issues in the short term?

Undoubtedly, there are many challenges facing the Islamic finance industry and institutions around the globe that limit its rapid growth. It can struggle to compete with large and well-established conventional financial institutions, especially in financing large projects and in getting high ratings by the known international rating agencies. Among these challenges, lack of unified Shariah-compliant financial agreements is one of the most important.

IIFM's mandate is to develop master standard agreements in conformity with the provisions and principles of Shariah, as well as legal and other related issues. Its mandate in practice means bringing together the regulators, financial institutions and establishments, legal firms and other industry stakeholders to support a common platform of bringing uniformity and harmonization in practices through the standardization of Shariah-compliant financial contracts and product templates.

Therefore, IIFM certainly believes that it is of great importance to have such unified master agreements which serve as common transaction reference for the whole Islamic finance industry. However, these master agreements sometimes collide with the laws of sovereign and legislation of countries, making them difficult to be adopted in such countries. On the other hand, the differences of the schools of Islamic jurisprudence in the various countries where Islamic financial institutions are operating certainly reflect on the role we wish the unification of the agreements should play. To achieve this goal, we at IIFM are still working hard to unify all stakeholders' views on these issues, for the purpose of serving the future of the Islamic finance industry better.

IIFM remains deeply convinced that any success achieved by the industry in this regard will reflect positively on the economies of these countries. Uniformity and harmonization will also enable an attractive investment environment for investments that meet the needs of Islamic societies with the necessary funding at a reasonable cost, and provide an element of trust, transparency and security that any investor is looking for.

Going forward, what is your outlook on streamlining global standards for the ICM in the coming five years?

The IIFM-ISDA Tahawuut Master Agreement is a good example of streamlining, in which the main document is supplemented by short annexes as new products are developed and standardized. The same agreement will also incorporate the CSA.

We envisage a similar development on the sukuk front, using master sukuk standards with streamlined annexes for each of the structures, which will be further complemented by guidance notes.

IJLAL AHMED ALVI has extensive experience in the financial services industry spanning 25 years in areas such as treasury, capital markets, risk management, financial institution formation/restructuring, strategic planning and policy making with regional and international financial institutions. Over the last decade, he has been influential in introducing standardization in Islamic financial contracts and product templates as the Chief Executive of the International Islamic Financial Market (IIFM). He manages IIFM's market consultations, global working groups, Shari'ah guidance and legal reforms towards developing unified Islamic standard agreements and guidance notes for specific products covering Islamic hedging, liquidity management, capital market, trade finance and corporate finance. He also manages IIFM's market awareness programs by organizing various specialized seminars and technical workshops across the globe. Mr. Alvi has been part of several international working committees/task-forces on Islamic finance and currently is a member of the IMF External Advisory Group on Islamic finance, Working Group Member of AAOIFI FAS on Wa'ad & Khayar, OIC Member States Stock Exchanges Forum etc. Mr. Alvi holds a Masters in Finance from Golden Gate University, San Francisco, USA.

ALTERNATIVE DISPUTE RESOLUTION IN THE ISLAMIC CAPITAL MARKET

Dr. Umar A. Oseni

With the geometric surge in capital market transactions around the world and the continued complexity of Shariah-compliant transactions, there has been a palpable increase in the number of disputes in the Islamic capital market (ICM). Such disputes are not limited to certain sections of the ICM but rather permeate different transactions in the sukuk market, the Islamic money market, and the Islamic fund management and equity markets. In order to effectively protect investors, there is a need for a comprehensive dispute management framework in the ICM. While disputes are bound to arise in such an increasingly complex market, the Shariah-compliance requirement in transactions puts an additional burden on disputed transactions in ICM. This article makes a case for improvements in the regulation of the dispute management framework, which covers the whole spectrum of dispute resolution from the legal documentation stage to the termination of the underlying agreements.

Though there are no data to represent the tracking of the total number of ICM disputes across the world, some conservative estimates based on evidence from the sukuk market alone reveal the average value of disputes runs into millions of US dollars, including litigation and settlement costs. Therefore, rather than focusing on how to resolve disputes, managing such disputes properly at the very early stage through appropriate dispute avoidance mechanisms will ensure value creation in the ICM. It is needless to add that the cost of litigation and settlements are borne by fund managers and issuers, who realize the money from the investors' funds. The 2007-2009 global financial crisis was a major trigger for increased litigation costs. Although some have claimed the Islamic finance industry was able to weather the storm, it did not make it through unscathed.

In order to manage the legal risks associated with such global financial crisis, there is a need for effective dispute management framework that would provide carefully designed processes to manage securities-related disputes at different stages of transactions. While one cannot exclude litigation in an industry that deals with multi-billion dollar Shariah-compliant transactions, providing some early intervention mechanisms through alternative dispute resolution (ADR) will not only enhance the reputation of the industry but will also preserve the hard-earned moneys of investors.

LITIGATION TRENDS IN ICM

The recent trends in litigating ICM disputes in the English courts have not been very encouraging, considering the nature of the parties involved and the wider effect of such court processes on the stakeholders. Besides the legal risks associated with every Islamic finance matter heard and determined by the English courts, there is also the consequential reputational risk that skeptics will increasingly question the authenticity of Islamic financial transactions. Recently, apart from the earlier widely reported cases of *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 and *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and Ors* [2002] All ER (D) 171 (Feb), there have been a string of legal cases involving ICM transactions.

It is, however, interesting to note the recent reduction in corporate litigation more generally. In a recent survey of corporate legal departments conducted by BTI Consulting Group, it is expected that the international landscape will witness a downward trend in the amount of pending litigation. The reason for the lower number of cases is the increasing prominence of effective dispute management through early case settlement or proactive strategies put in place to either prevent disputes or to resolve emerging misunderstandings. Figure 1 shows the downward trend in corporate litigation, resulting from early case assessment and proactive settlement strategies.

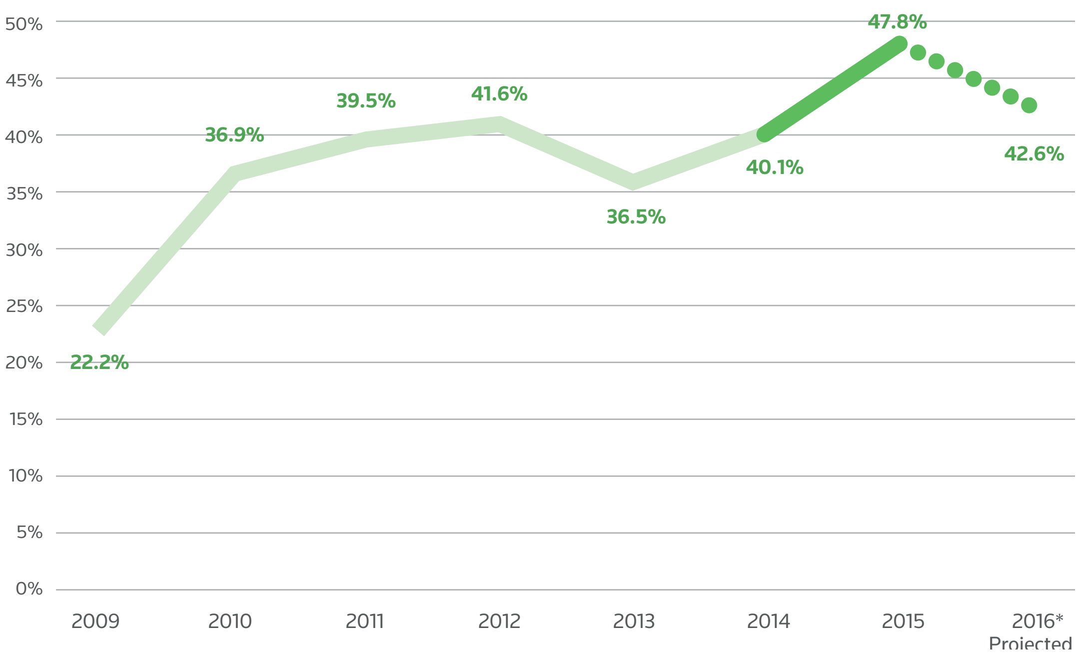
It is expected that the ICM will witness a downward trend in litigation as well, with the increasing importance of restructuring and arbitration in the leading Islamic finance jurisdictions. This paradigm shift is occurring because of the increasing use of arbitration clauses in corporate legal documentation for ICM transactions. Moreover, the global Islamic finance industry is gradually moving towards the standardization of legal documentation as most ICM transactions now adopt the International Islamic Financial Market (IIFM) Standard Documents and Product Templates. As discussed below, adopting standard documentation in ICM transactions helps with dispute avoidance in the overall framework of dispute management.

HOW CAN ADR PROMOTE BEST PRACTICES IN ICM?

Legal jurists generally agree that the future of ADR is only found in dispute avoidance strategies. Therefore, the only way to promote best practices for dispute management in the ICM is to put in place the relevant procedures, processes and structures to promote dispute avoidance in all transactions in the ICM. It is pertinent to note that in Islamic law, effective dispute management through non-hostile processes is the hallmark of dispute resolution epitomized by the concept of *sulh* (amicable settlement). The very nature of the ICM requires an effective dispute management framework that will take into consideration the interest of all stakeholders and market participants.

The above concerns and proposed strategies have been considered in some jurisdictions offering Islamic financial services and products. A brief examination of three unique jurisdictions often considered the most advanced financial hubs for Shariah-compliant securities will illustrate the ways such jurisdictions practically deploy ADR mechanisms in resolving related ICM disputes. Malaysia, Saudi Arabia and United Kingdom are

Figure 1: Trends in Corporate Case Resolution[1]



jurisdictions with unique mechanisms for dispute management that do not only include ADR processes but also some facilitative court processes that enhance cross-border commercial activities.

While there are instances where the exclusive jurisdiction of the English court is stipulated in the transaction documents, the general practice in sukuk transactions is to have non-exclusive jurisdictions owing to the multi-jurisdictional nature of the underlying asset, investors, trustee, issuer and arrangers. For instance, in the Trust Certificate Issuance Programme of EIB Sukuk Company Ltd. of US$ 2.5 billion issued in 2012, it was highlighted that prospective investors may enforce their obligations through arbitration under the London Court of International Arbitration (LCIA) Arbitration Rules, English courts and/or the Dubai International Financial Centre (DIFC). It is pertinent to note that the DIFC also has its standard legal infrastructure for arbitration through the DIFC-LCIA Arbitration Rules under the Arbitration Rules of the DIFC-LCIA Arbitration Centre. The Sharjah Sukuk (2) Ltd. Programme of 25 January 2016 chose arbitration under the DIFC-LCIA Arbitration Rules as the preferred mode of dispute resolution.

MALAYSIA

Capital market disputes are primarily resolved through the courts, but there are provisions for small claims involving securities transactions. While the KLRCA i-Arbitration Rules 2013 introduced by the Kuala Lumpur Regional Centre for Arbitration (KLRCA) is specifically meant for all types of Shariah-compliant disputes, including disputes emanating from ICM, there is another platform for resolving securities disputes. The Securities Industry Dispute Resolution Centre (SIDREC) was established as a corporate entity approved under the Capital Markets and Services (Dispute Resolution) Regulations 2010, pursuant to the Capital Markets and Services Act 2007. SIDREC provides an independent platform for investors to seek redress in disputes involving capital market players, including investors and licensed securities entities such as investment banks, fund managers, unit trust management companies, brokers and listed companies. This affordable, user-friendly and accessible platform is targeted at investors in the ICM with a monetary limit of RM 250,000 for both adjudication and an unlimited monetary limit for voluntary mediation mutually agreed by the parties. At KLRCA, on the other hand, the primary process for dispute resolution is arbitration, even though parties can agree to proceed for mediation under the Rules. The KLRCA i-Arbitration Rules option also provides a better platform for ICM disputes, particularly when such disputes involve cross-border transactions. Therefore, the two platforms provide different options for different types of capital market players and investors, which can be explored for amicable dispute settlement enforceable in the court of competent jurisdiction.

SAUDI ARABIA

The Capital Market Authority (CMA), which was established by Article 4 of the Capital Market Law (CML) 2003, regulates the ICM. The CML provides the regulatory framework for dispute resolution and conflict avoidance with the establishment of the Committee for the Resolution of Securities Disputes (CRSD). The dispute resolution process provided for under the CML is a two-tier process. In accordance with Article 25 of CML, two committees are established to settle securities disputes—CRSD and the Appeal Committee for the Resolution of Securities Disputes (ACRSD). The CRSD has "jurisdiction over disputes falling under the provisions of this Law, its Implementing Regulations, and the regulations, rules and instructions issued by the Authority and the Exchange, with respect to the public and private actions." As an appellate body, the ACRSD may render any of these three decisions: affirm the CRSD decision, refuse to review the CRSD decision, or even undertake a de novo review of the subject matter of the dispute and issue its decision. This provides a good framework for the settlement of domestic securities disputes. It is, however, not certain whether cross-border securities disputes can be referred to CRSD even though Saudi Arabia has substantially adopted the UNCITRAL Model Law of International Commercial Arbitration 1985 (as amended in 2006).

THE UNITED KINGDOM

Considering the unique nature of securities disputes, under which ICM disputes fall, the main process for dispute resolution in the UK is through the courts, even though arbitration under the London Court of International Arbitration (LCIA) is also an option depending on the contractual terms contained in the Master Sukuk Agreement. The English courts promote ADR in all disputes, and the legal infrastructure for ADR in the UK represents the best practices in the world. The link between the English courts and appropriate ADR processes, particularly in the commercial court, is quite unique. For instance, Rule 1.4 of the Civil Procedure Rules (CPR) of the English Court provides for active case management and requires the court to encourage the parties to explore an ADR procedure rather than proceeding for court proceedings, if it feels such disputes would be better resolved through an appropriate ADR process. Rule 26.4 of CPR also enables the judge, either on its own initiative or with the agreement of both parties, to stay proceedings where they consider the dispute to be better suited to be solved by ADR or other means. In *Dunnett v Railtrack Plc* (Costs) [2002] EWCA Civ 303, the English Court of Appeal reiterated the import of Part 1 of the CPR and the possibility of "uncomfortable costs consequence" if a party turned down the advice of the court to explore ADR. This provides a good platform to not only benefit from the certainty and predictability of the English law and its jurisdiction but to also have a forum and courts that could encourage amicable settlement of disputes involving ICM transactions.

CONCLUSION

Though litigation remains the main process for seeking redress in securities disputes generally, and in the ICM, due to the nature of the transactions and the certainty required by investors and other market players, there is a paradigm shift among market players to integrate ADR into the court process. This creates a good blend for effective dispute management in ICM.

In conclusion, it is quite clear that ADR not only protects the interest of all capital market players but also reduces the depletion of investors' funds on frivolous litigations. Needless to add that ADR also represents the generic process of dispute resolution in Islamic commercial law based on the Qur'anic principle *wa al-sulh khair* (amicable settlement is the best in all dealings). In line with this spirit, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued its Shariah Standard No. 32 on 12 September 2007 for both domestic and cross-border Islamic finance disputes, but it appears this standard is one of the least adopted of all AAOIFI standards. There is no doubt that ADR or amicable settlement of disputes is the way to go for expert dispute settlement. The challenge, however, remains for ICM regulators across different jurisdictions to proactively put in place effective dispute management frameworks that will address all budding disputes at an early stage.

NOTES:

1 Executive Summary, BTI Litigation Outlook: Changes, Trends and Opportunities, 2016, p. 6, http://static1.squarespace.com/static/51bb6aabe4b0820e6e778761/t/55f6ef0ee4b07d98b6d75aa0/1442246414038/BTI_Litigation_Outlook_2016_Executive_Summary.pdf

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PRACTICES OF SHARIAH GOVERNANCE IN THE ISLAMIC CAPITAL MARKET

Mushtak Parker

The Shariah governance function is an essential component of the Islamic system of financial intermediation. It is a red line that cannot be crossed or compromised because without it, the very raison d'etre of Islamic financial principles would be nullified.

From the point of view of financial stability, Shariah governance constitutes an extra tier of compliance, especially ethical compliance. However, it does introduce extra costs and a new risk characteristic termed Shariah governance and compliance risk.

The Capital Markets and Services (Amendment) Act 2015 of Malaysia, for instance, requires "giving full effect to the principles of Shariah in relation to a transaction in respect of Islamic capital market products."

The practice and culture of the Shariah governance function varies from market to market and in many respects reflects the degree of development of the capital market and the Islamic capital market (ICM) in that jurisdiction respectively.

Shariah governance depends on a number of factors:

- The sophistication and proactiveness of public policy on Islamic finance;
- The presence of enabling legal, regulatory and supervisory frameworks;
- The presence of a Shariah Governance Framework (SGF) enshrined in and enforceable by law;
- The particular *Madhhab* (school of Islamic law) followed in a jurisdiction, although the prevailing trend is currently the careful selection of elements from the four main Madhhabs through ijtihad for the sake of expediency and flexibility;
- The Shariah Advisory Council (SAC) model followed, whether an Apex entity at the central bank, at the securities regulator or at boards at individual institutions;
- Internal Shariah review and audit departments;
- The registration and regulation of Shariah advisories based on the requisite education and skills sets;
- The quality of Shariah education especially in Fiqh Al Muamalat (Islamic law relating to financial transactions);
- The quality of Shariah advisory training, teaching and institutions; the quality of research in Shariah relating to financial transactions;
- Recourse to law and court procedure including specialised Shariah Courts with an expertise in financial matters;
- Recourse to Shariah-compliant dispute resolution and arbitration;
- The quality of Shariah advisory training, teaching and institutions;
- The quality of Shariah scholarship relating to financial transactions;

- Recourse to law and court procedure including specialized Shariah Courts with an expertise in financial matters;
- And, recourse to Shariah-compliant dispute resolution and arbitration.

CENTRALIZED SHARIAH GOVERNANCE IN MALAYSIA

The world's most comprehensive Shariah governance framework is structured in Malaysia's Capital Markets and Services (Amendment) Act 2015, the Islamic Capital Market Master Plan II, the Islamic Financial Services Act 2013 (IFSA), and the Shariah Governance Framework 2010, currently under revision.

The prior IFSA had been in danger of over-regulation, especially by making board members responsible for the Shariah governance function in Islamic financial institutions in Malaysia.

Moreover, the Securities Commission Malaysia is the only jurisdiction that registers and regulates Shariah advisories. It alone has established practice notes and guidance principles relating to the required education for Shariah advisories from recognized institutions and even a fixed curriculum on Shariah knowledge in a financial market setting.

The Shariah Advisory Council (SAC) of the Securities Commission Malaysia was established in May 1996 to advise the Commission on Shariah matters pertaining to the ICM. Members of the SAC are qualified individuals who can present Shariah opinions and have vast experience in the application of Shariah, particularly in the areas of Islamic economics and finance.

At the end of August 2016, some 50 individuals of various nationalities were registered as Shariah advisories by the Securities Commission Malaysia. Some 15 Shariah advisory companies and 9 registered Shariah advisories in relation to foreign currency Sukuk in Malaysia are also registered, which is the single largest pool of registered Shariah advisories for the ICM by far in the world.

Malaysia is pioneering Shariah governance in two other important aspects. It is aiming to increase the number of female Shariah advisories in the ICM, and to set restrictions on Shariah advisories to only advise one institution in a particular market segment such as commercial banking, investment banking, Takaful, investment funds, etc. Its aim is to widen the pool of advisories and to develop its next generation.

The Malaysian model of putting an Apex SAC at the regulatory authority (the central bank or the securities regulator), which sets the Shariah rules for the entire industry and acts as the Shariah Authority of Last Resort, whose decisions are final, is becoming the industry standard around the world.

Pakistan, Oman and Indonesia follow the Malaysian model to a large degree. Bahrain and the UAE have in recent weeks followed suit by establishing an Apex Central Shariah Advisory Council (CSAC) at the Central Bank of Bahrain and the UAE Central Bank, although the Bahrain CSAC does not have authority over boards at individual institutions.

There is no doubt that the presence of an Apex SAC at the regulatory authority gives certainty and confidence both to customers and investors in a market. It is only a matter of time before this model is emulated in most of the markets where Islamic financial and capital market products are offered.

In Bahrain, to coincide with the establishment of its CSAC, the government is also working on drafting a Shariah governance framework for the country's Islamic financial services industry, which is aimed at strengthening Shariah governance in the sector.

DECENTRALIZED SHARIAH ADVISORY MODELS MOVING TO STRONGER OVERSIGHT

Rather than having have a Central Shariah Advisory Council at the central bank or securities commission level that sets the Shariah rules for the national Islamic financial services industry, many other countries still only require ad-hoc Shariah boards at the corporate level, in effect self-regulating. However, the Islamic Financial Services Board, which sets prudential and supervisory standards for the global industry, has issued a Shariah Governance Standard, which favors the establishment of a centralized Shariah board at the regulatory level.

This is in contrast to the actual practice in certain markets. Oman's new Sukuk Regulations, for instance, leaves Shariah governance and the choice of a Shariah Supervisory Board to the issuer, although the final approval for any issuance goes through the CSAC. Similarly, the recently launched 'Masterplan for Indonesian Islamic Financial Architecture' by the Indonesian Ministry of National Development Planning (BAPPENAS), made a specific recommendation to the government of President Joko Widodo to enhance the regulatory framework and the Shariah governance framework to cover existing gaps.

Shariah governance in finance, however, is also an interesting challenge in non-Muslim jurisdictions, especially where Islamic finance and capital market products are prevalent. Regulators in countries such as the UK, Luxembourg, Hong Kong and South Africa — all of which have issued sovereign Sukuk and have authorized Islamic equity and retirement funds — point out that they are secular jurisdictions and cannot as such rule or give certainty on the Shariah products in their markets. The advice to investors here is to rely on the Shariah Advisory Boards of the mandated lead arrangers and other financial institutions involved in the respective transactions for any matters relating to Shariah compliance.

The word 'Islamic' or 'Shariah' do not appear in the enabling legislation to facilitate Sukuk in the above jurisdictions. The UK legislation for instance mentions Alternative Financial Bonds or Alternative Investment Bonds (Sukuk).

The Bank of England (BoE), which only a few months ago became an associate member of the Islamic Financial Services Board (IFSB), has a long history since the 1970s of engaging with the Islamic finance sector, when it advised the IDB, for instance, on such mundane matters as liquidity management.

In today's much more complex environment, bankers believe that the BoE can make important contributions especially in the area of the global banking reform agenda and in particular how to regulate and supervise Islamic financial institutions in non-Muslim jurisdictions.

But even in non-Muslim jurisdictions there may be some groundbreaking policy changes. Luxembourg, which issued its debut sovereign sukuk in 2014 and is an established Islamic funds and sukuk listing domicile, is studying forming a centralized Islamic legal board, in effect, a Shariah advisory board.

THE BENEFITS OF STRONG GOVERNANCE

Shariah governance is crucial to most market players. In January 2017, the Employees Provident Fund (EPF), Malaysia's state-run social security fund, which is launching a dedicated Islamic pension fund, Simpanan Shariah, to complement its conventional pension fund, has its own such governance framework in place.

The underlying structure of investments of Simpanan Shariah, according to Shahril Ridza

Ridzuan, is *Akad Wakalah* (agency contract), which has been endorsed by EPF's Shariah Advisory Committee (SAC). The Shariah Advisory Committee (SAC) oversees all operational, investment and governance aspects of Simpanan Shariah and recognizes Shariah investment products as regulated or approved by Bank Negara Malaysia and the Securities Commission Malaysia.

Shariah governance and regulation is also an on-going process in most markets. In September 2016, for instance, the Securities Commission Malaysia (SC) and Bank Negara Malaysia (BNM) announced that commercial and Islamic banks offering capital market services and products will become members of the Securities Industry Dispute Resolution Center (SIDREC), as part of efforts to enhance the financial dispute resolution arrangements for consumers in Malaysia.

The SC has recently issued Shariah Parameters on Islamic Exchange-Traded Funds (i-ETF) based on gold and silver as a guidance and reference from a Shariah perspective to facilitate product development by industry participants. The SC last year also launched the first Sustainable and Responsible Investment (SRI) Sukuk Framework in the world in line with the SC's Capital Market Master Plan 2 to promote socially responsible financing and investment.

In the long run, more uniformity in regulation and practices between jurisdictions will provide further clarity to market practitioners and allow investor demands to be met effectively, allowing for better investor education on Islamic finance products, and encouraging cross-border activity market activity. Divergent Shariah interpretations currently have slowed the development of globally acceptable financial products and growth of the Islamic financial services industry. As such, convergence is perhaps a long-term developmental objective that would need to be spearheaded by Shariah scholars themselves. Such international professional bodies such as AAOIFI, IIFM and IFSB have taken strong steps towards this goal, but their work is just the beginning of establishing a set of globally accepted best practices.

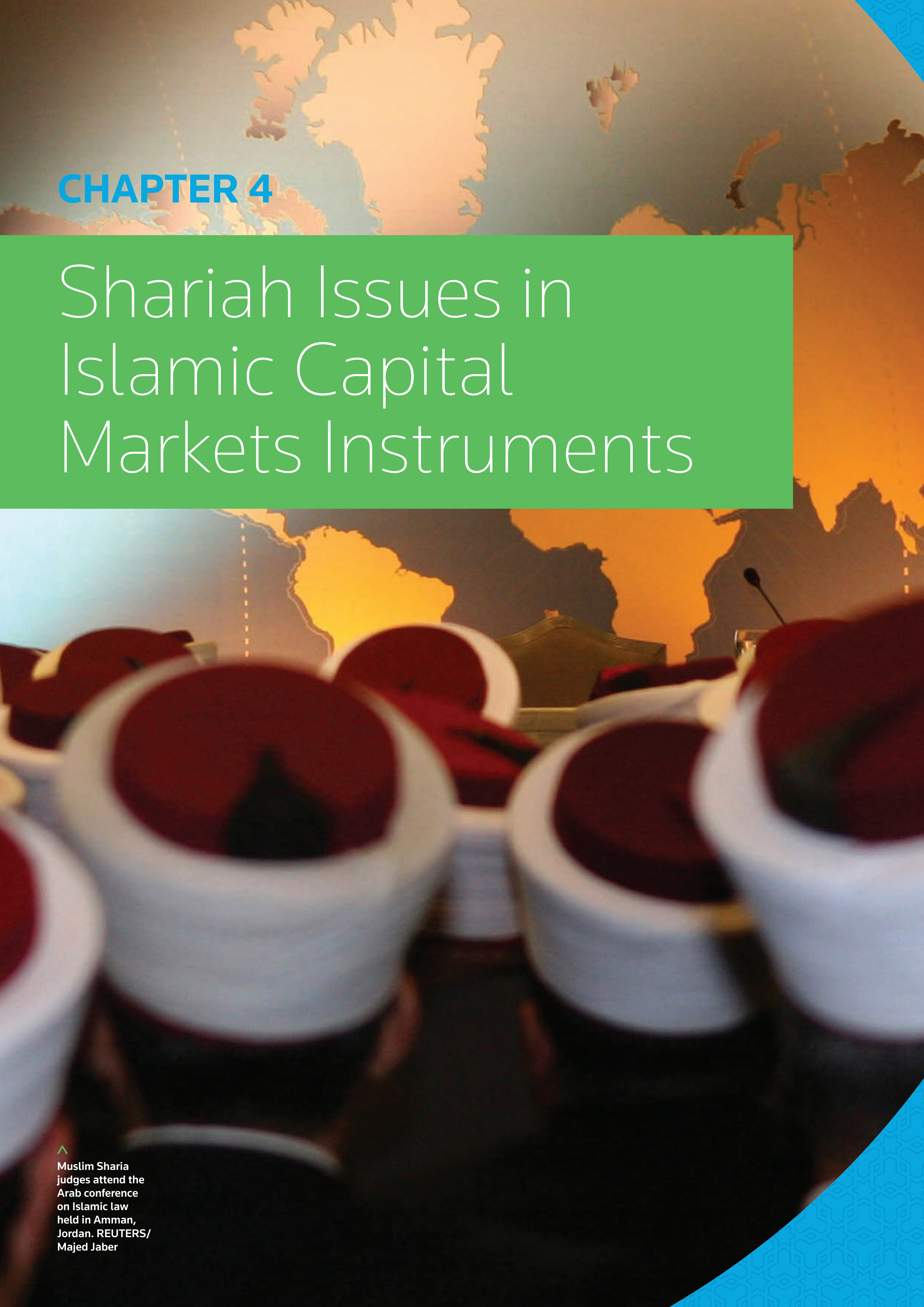
MUSHTAK PARKER is an economist, financial writer, analyst and research consultant with over 35 years of experience. He is Editor of Islamic Banker, the market reference for the global Islamic finance sector; a contributing senior correspondent to Cash & Trade Magazine, African Banker, African Business, New African, News Desk Publications and a contributor to a host of other publications and reports.

He has covered the Islamic finance and economy sector and the Middle East, South East Asia and Southern, East and West Africa for more than four decades and has published over 3,000 articles and reports on these areas. He has conducted interviews with most of the major figures in Islamic finance over the last four decades.

He has published two books — one on Human Rights in Yugoslavia and the other a Directory on Islamic Banking & Finance, and has written several bespoke confidential consultancy reports on Islamic finance and various economic and finance topics for major institutions including finance and economy ministries in a number of countries, central banks, investment banks, commercial banks, insurance firms, accountancy firms and professional bodies.

CHAPTER 4

Shariah Issues in Islamic Capital Markets Instruments



Muslim Sharia judges attend the Arab conference on Islamic law held in Amman, Jordan. REUTERS/ Majed Jaber

Summary

As the chief goal of Shariah is to increase the wellbeing of humanity, within the boundaries of revelation, it is commonly stated in juridical arguments that it is not intended for Islamic law to become a hardship on believers. When it comes to providing Shariah-compliant alternatives for all of the more exotic forms of capital markets instruments and strategies, debates between Shariah scholars occur between those taking more accomodationist and more strict interpretations. The former view, common in Malaysia, has had early success in promoting the use of Islamic finance products around the world by permitting a higher degree of similarity to conventional products. However, the success of Islamic finance itself has given greater impetus to the latter scholars, who wish to emphasize the unique profit-sharing structures in Islamic finance that have the potential to stimulate productive economic sectors. At this phase in the development of Islamic finance, it is safe to say there is creative tension between these two views, which is encouraging a host of proposals that can both engage the conventional capital markets and also encourage the spread of authentic and respected juridical opinions.

One of the key issues for maintaining the Shariah compliance of any portfolio, index or fund is regular screening of all portfolio components for their adherence to Shariah. To prevent hardship and to encourage Islamic finance's engagement with the majority of productive industries in the world that still use conventional debt, regulators and advisory boards in different countries have set various thresholds for leverage and income generated by Shariah non-compliant activities. The stock of companies that exceed these thresholds is officially deemed non-compliant, and investors in the field should divest from these equities as soon as possible. Even for those companies below the thresholds, scholars have provided methods for investors to "cleanse" any of their non-compliant income by donating all income in proportion to their income from non-compliant sources to charity. Careful screening perhaps even more crucial to building the field of Islamic private equity and venture capital, but investors and managers also have more influence in creating the Shariah-compliant, ethical businesses they desire to support.

More complex still is judging and managing the Shariah compliance of structured products and derivatives, often with an eye towards developing an Islamic hedge fund strategy. Shariah scholars have disputed the acceptability of instruments that are merely benchmarked to an underlying asset, rather than participating in its growth, particularly when the benchmark is related to an interest rate. Options similarly put a price on an immaterial good or concept, with high risk. Short selling is problematic because of prohibitions on selling items one does not own, while futures imply taking advantage of *gharar*. Some potential alternatives include using the rulings *khiyar al-shart* (stipulated option), to rescind a binding contract, or *bay' al-arbun* (down payment on an option). The practice of *bai' al-salam* (sale for delivery at a later date) could be used to legitimate a forward contract.

Finally, the chapter investigates debates over allowing third-party guarantee in equity-based sukuk, by either governments or private parties. The minority of scholars currently forbid this practice, they argue, as the guarantee opens the door to *riba*. However, the majority is willing to allow for guarantees on at least the principal, although the legal definition of a truly independent third party is still under question.

THIRD-PARTY GUARANTEE IN EQUITY-BASED SUKUK

Dr. Beebee Salma Sairally, Dr. Marjan Muhammad and Dr. Najeeb Zada

Protecting the capital of investors through the provision of a third-party guarantee has been practiced in sukuk structuring, including equity-based sukuk (EBS), i.e. *musharakah* and *mudarabah* sukuk. The guarantee has been used since the late 1970s, when the modern sukuk market first emerged with the issuance of *muqaradah* bonds by the Ministry of Awqaf, Islamic Affairs and Holy Places in Jordan. This issuance financed the renovation of *waqf* properties. Since these properties could not be subjected to sale, unlike other assets, the risk that investors could lose their capital was enhanced in the event of losses when payment was either stopped or deferred. In an attempt to increase the attractiveness of such instruments to investors, the government of Jordan provided a guarantee as a third-party for the principal invested in the sukuk. At the time of redemption, therefore, investors were guaranteed the return of their capital.

Other examples of EBS deals having this feature are Bin Ladin *mudarabah* sukuk 2008 (SR 1 billion sukuk issued by the Purple Island Corporation and guaranteed by Saudi Binladin Group Limited to fund a specific construction project in Makkah) and TSH *musharakah* sukuk 2011 (RM 100 million sukuk issued by TSH Musyarakah Sukuk Sdn. Bhd. and guaranteed by Danajamin to fund the business of TSH Resources Berhad). In the context of Malaysia, Danajamin Nasional Berhad (Financial Guarantee Insurer) acts as the national guarantor for bonds and sukuk issued by credit-worthy Malaysian companies to facilitate their access to private debt securities market.

Important questions ensue regarding third-party guarantee in EBS: Does the provision of such guarantee in *mudarabah* or *musharakah* sukuk connote a guarantee of capital that would breach the nature and implications of these contracts (*muqtada al-ʿaqd*)? Can third-party guarantee cover both capital and expected profits? Finally, can there be a "real" third-party that is totally unrelated to the transaction as well as to the transacting parties offering such a guarantee? This article briefly discusses these pertinent issues.

DEFINING THIRD-PARTY GUARANTEE

In the context of Islamic finance, third-party guarantee refers to a volunteer party having no contractual relationship with either of the two parties nor any interest or stake in the investment project that acts as a guarantor for any loss that may arise in relation to the principal amount of the investment. The guarantee, in this sense, stands for undertaking or readiness to bear losses on behalf of the investors. However, a third-party guarantee in trust-based contracts, particularly *musharakah*, should meet the following basic conditions:

1. The legal capacity and financial liability of the third-party as a guarantor should be independent from the contract.

2. The third-party guarantor should not own more than half of the capital in the entity to be guaranteed.

3. The guaranteed entity should not own more than half of the capital in the entity that undertakes to provide the guarantee.

4. The guarantee should not be provided for any consideration, according to the majority of scholars, or linked to the contract.

> *Benefits [from sukuk with third-party guarantees] will also result from the employment generated by the entrepreneurial companies, as well as the taxes that these companies, their shareholders and employees will pay to the government.*

Most EBS issuances are guaranteed either by governments or government-linked entities, and adhere to these conditions except for those issued in jurisdictions where Shariah scholars allow for guarantee with fee. Nonetheless, the total independence of government as a guarantor to EBS issued by local ministries is still questionable.

WHY IS THIRD-PARTY GUARANTEE NEEDED?

The accumulation of capital fuels the economic development of a nation. In the absence of enough capital to finance economic projects, it is difficult to conceive of a nation reaching a notable level of development. One of the inevitable means to attract risk-averse retail investors to certificates like *mudarabah* and *musharakah*, driving sufficient capital to such projects, is the provision of third-party guarantee. Çizakça argues that investment certificates that are backed by third-party guarantee should play an important role in introducing venture capital companies in the Islamic world.[1] He claims that, although different quarters including the public and academics question the provision of third-party guarantee on the grounds that it involves the spending of taxpayers' money to finance the losses of investors—particularly in the case of the government being the guarantor—the advanced technology developed by *mudarabah*- or *musharakah*-financed entrepreneurs will accrue enough benefits that should compensate for such losses. Benefits will also result from the employment generated by the entrepreneurial companies, as well as the taxes that these companies, their shareholders and employees will pay to the government.

ARGUMENTS FOR AND AGAINST THIRD-PARTY GUARANTEE

There are two opposing views amongst contemporary Shariah scholars on this issue. According to the minority view, guaranteeing the principal in *mudarabah* or *musharakah* sukuk would open the door to *riba*. Such a practice runs contrary to the *muqtada al-ʿaqd* of equity-based contracts. Guaranteeing capital is deemed impermissible, even in cases where such a guarantee is provided by government, because the state treasury is the property of the entire community and should not be exposed to the losses of certain individuals or entities. Moreover, it is inconceivable for an entity other than government to provide a benevolent guarantee without payment.[2]

Meanwhile, the majority of scholars including those of AAOIFI, Islamic Fiqh Academy of OIC, Shariah Advisory Council of Bank Negara Malaysia (SAC-BNM), Shariah Advisory Council of Securities Commission (SAC-SC) Malaysia and various Shariah supervisory boards of Islamic banks argue that as long as the guarantor is legally and financially independent from the contracting parties, such a practice is permissible. The justifications for this view are: (i) owners enjoy full freedom of disposition and action over their properties and such guarantee falls under the ambit of this principle; (ii) everything in transactions is permissible unless prohibited explicitly by text; and (iii) it is in the best interest of the people and the entire community to allow such practice.

The opinion of the majority is preferred because their arguments are more solid. However, we should also be cognizant of the fact that there are certain conditions, as indicated above, that should be adhered to.

CAN THIRD-PARTY GUARANTEE COVER EXPECTED PROFIT?

According to some scholars like Abu Ghuddah, and AAOIFI Shariah Standards No. 5 and 12, third-party guarantee should be limited to covering the loss of capital only to avoid from making this mechanism equal to guaranteeing capital and profit in an interest-based transaction.[3]

However, in a resolution of its 91st meeting on 1 October 2009, SAC-BNM allowed for third-party guarantee of both capital and expected profit in a *mudarabah* transaction, provided that the guarantor is an independent party and does not have any direct or indirect relationship with the *mudarib* (investment manager). The ruling is based on the principle of *maslahah* (public interest), which is to ensure that there is continuous investors' confidence in investing in a country's major projects.

In view of the current framework, in which sukuk falls under the debt capital market and is thus being perceived as a fixed-income instrument by investors regardless of the underlying Shariah contracts used for the structuring, the latter opinion is more favorable. Nonetheless, such practices should be allowed only when the guarantee is given by a real third-party guarantor that fulfils the above-mentioned criteria.

CAN THERE BE A REAL INDEPENDENT THIRD-PARTY GUARANTOR?

The proponents of third-party guarantee claim that guarantees offered by governments are ideal for third-party guarantees, as in the case of the Jordanian government offering such guarantee with respect to the *muqaradah* bonds issued by the Ministry of Awqaf. However, opponents argue that such instances are very rare, and it is very difficult to find an actual third party that has no incentive to offer such guarantees. Moreover, the aspect that the state is not really independent from its ministries or government-related companies that issue sukuk also renders third-party guarantee offered by the government questionable.

The issue of the real independence of the third-party also arises when such a guarantor is equally the obligor who sets up the special purpose vehicle (SPV) company for issuing the sukuk. Accordingly, some believe that even purchase undertaking at the nominal value by the obligor from the SPV is tantamount to a guarantee. In addition, the fact that third-party guarantor in some EBS structures is allowed to get recourse for the guaranteed amount from the issuer or obligor in the event of loss implies indirect relationship between both parties.

MAJOR CHALLENGES

Although the majority of scholars allow third-party guarantee in EBS, the issue of having a real and independent third-party guarantor remains unresolved and questionable. Moreover, third-party guarantee by government involves the spending of taxpayers' money to save or promote certain businesses. Such a practice has its own downsides, which have been criticized even in conventional finance literature. In addition, whether third-party guarantee in EBS is good for the progress of the Islamic capital market industry and is able to promote risk sharing remains debatable. Hence, various aspects, including *maslahah*, Shariah compliance and commercial considerations, have to be weighed before employing a third-party guarantee in the context of EBS issuances.

NOTES:

1 Çizakça, M. (2011). *Islamic Capitalism and Finance: Origins, Evolution and the Future*. UK & USA: Edward Elgar.

2 Al-Amine, M. A. M. (2008). Sukuk Market: Innovations and Challenges. *Journal of Islamic Economic Studies*, 15, p. 1-22.

3 Abu Ghuddah, A. S. (2010). *Al-Makhatir fi al-Sukuk wa Mawqif al-Shariah min Damaniha*. Nadwat al-Sukuk al-Islamiyyah: 'Ard wa Taqwim, Organized by Islamic Fiqh Academy of OIC on 25 May.

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INCOME PURIFICATION METHODOLOGY FOR SHARIAH-COMPLIANT STOCKS

Prof. Dr. Ashraf Bin Md Hashim and Dr. Farrukh Habib

INTRODUCTION

Among modern corporations, it is barely possible to find a company whose business activities or sources of income are purely Shariah-compliant. In view of this, the majority of Shariah scholars have allowed for investing in the stocks of companies which have mixed — permissible (*halal*) and impermissible (*haram*) — activities and income, provided that their primary business activities are permissible and the peripheral source of impermissible income activities such as interest-based transaction, sale of pork or alcohol, gambling, etc., does not exceed tolerable benchmarks.[1] Accordingly, if a company passes the selected Shariah screening criteria, the scholars consider the equity of such companies as Shariah-compliant for investment. Nevertheless, the income generated from the impermissible activities of these companies, even though they are on the Shariah-compliant list, requires special treatment, known as cleansing or purification. Purification refers to the process of identifying, separating and channeling the impermissible income of the stocks to charity. The process of purification is different, based on different scenarios of Shariah non-compliance of stocks. The objective of this article is to shed light on the income purification methodology of stocks based on those different scenarios. The main issues in this regard are to identify what needs to be purified and how it is purified. This article discusses such issues from a Shariah perspective.

PURIFICATION METHODOLOGY

There are several scenarios in the context of stock trading that require purification of income from stocks in order to achieve the objective of Shariah compliance. The first scenario is purifying any Shariah non-compliant portion of income from Shariah-compliant shares while an investor continues to hold the shares. The second scenario is purifying capital gains that are realized from selling Shariah-compliant shares. The third scenario is the purification treatment for any income generated during the process of disposing shares that have been excluded from Shariah-compliant lists. The fourth scenario is the purification of any Shariah non-compliant income from shares excluded from Shariah-compliant lists that an investor continues to hold. Each scenario has its specific Shariah rulings, which are discussed below:

1. Purifying Shariah Non-Compliant Income While Holding Shariah-Compliant Shares

According to most Shariah screening methodologies, i.e. AAOIFI, S&P, FTSE and MSCI, a company can be listed as Shariah compliant, if its income from Shariah non-compliant activities remains within 5% of its total revenue or income, given that it fulfils other criteria too. However, it is worth noting that an investor may receive gains from holding a share in different forms. He may earn cash income from the dividends distributed by the company, or non-cash income such as bonus shares, warrants and options to subscribe to preference shares. These warrants and options can be sold to other investors.

For dividend payments, purification is done in proportion to the percentage of the Shariah non-compliant income of the company. For example, according to the audited financial report, 3% of the total income of Company A is generated from Shariah non-compliant activities. Therefore, 3% of the dividend distributed

> *There is ample room for improvements in the contemporary methodologies of purification, because there are currently many limitations to the practice.*

by Company A shall go to charity for the sake of income purification. This ruling has been derived from an Islamic legal maxim which states:

ما حرم في نفسه حرم عوضه

"Whatever is impermissible itself, its compensation is also impermissible."[2]

As for non-cash benefits such as bonus shares, warrants and options, it is not a requirement to purify such benefits simply because there is no cash income that flows to the investor, so there is no direct gain from them. When such benefits are realized, although the documents show that the investor will have more shares, but the cash income from those additional shares will only occur in the next cycle of dividend distribution. The purification exercise for dividends will thus be performed at that time. Nevertheless, should the investor choose to sell his rights to any warrants or options, purification is required according to the same rule of purification of dividends, because in this case the cash income directly flows to the investor.

2. Capital Gains from Selling Shariah-Compliant Shares

The treatment of capital gains remains under debate. Some scholars, i.e. Sheikh Taqi Usmani, suggest that it is a safe approach to purify earnings made from selling shares. It is based on the understanding that the market price might reflect an element of interest or impermissible income. On the contrary, other scholars argue that it is not necessary to purify capital gains, because the change in the stock price does not directly reflect interest or other income generated from Shariah non-compliant activities of the company. It is the later opinion that can be preferred in this regard because, on the one hand, the changes in stock price in the market occur due to a complex phenomenon. They are attributed to multifarious factors, including demand and supply. Therefore, the capital gain is not a direct income from the Shariah non-compliant activities. On the other hand, the stock price in the market basically reflects the price that the buyer is willing to pay to acquire those shares. It would be far from reality to think that the investors consider interest or impermissible income during the trade of shares as the principal factor or objective of the transaction, especially when it is in a negligible amount (less than 5% of the total income).

This opinion is based on the Islamic legal maxim stating:

يغتفر في التابع ما لا يغتفر في المتبوع

"Something can be forgiven in the subsidiary which cannot be forgiven in the principal."[3]

The above maxim proposes that when a factor or element is subsidiary to a principal factor or element, it might be overlooked in issuing the Shariah ruling of the whole thing or case, while that subsidiary element cannot be overlooked otherwise. Putting it in the context of shares trading, the interest or impermissible income is definitely a subsidiary factor. Therefore, it seems more appropriate to exclude capital gains from income purification process.

3. Capital Gains during the Process of Disposing Shares Excluded From Shariah-Compliant List

Investors are not supposed to hold any shares that have been excluded from the Shariah-compliant list. They should dispose of such shares as soon as they have been informed of their exclusion. In disposing them, the main technical issue is the price of the shares that should be considered as the base line or principal that the investor is entitled to keep as his income. This is in-line with the principle mentioned in the verse of the Holy Quran:

وَإِن تُبْتُمْ فَلَكُمْ رُؤُوسُ أَمْوَالِكُمْ لاَ تَظْلِمُونَ وَلاَ تُظْلَمُونَ

"And if you repent, yours is your principal. Neither wrong nor be wronged."[4]

In this regard, the principal is the acquisition price or the price of shares on the date they are declared as Shariah non-compliant, whichever is higher. Any price increment above the base line or principal is channeled to charity, because such gain is obtained through the sale of Shariah non-compliant shares. The same Islamic legal maxim of compensation of impermissible item or activity, mentioned above, is applied here.

4. Income Generated While Holding Shares That Have Been Excluded From Shariah-Compliant List

The final issue is the ability of the investor to dispose the shares that have been delisted from the Shariah-compliant list in the fastest practical way, without any loss of principal. While disposing of shares, there is a possibility that a particular stock may be included again in the Shariah-compliant list in the next round of screening. This happens in particular to companies with a ratio on the margin of the threshold. Under such circumstances, the investors may hold those shares that have been delisted from Shariah-compliant list, but later included once again in the list.

If the investor decides to sell shares of a company that has been delisted from the Shariah-compliant list during the period of delisting, any capital gain above the acquisition price or the price on pronouncement date, whichever is higher, is channeled to charity. This means the same principle of disposing stocks that have been delisted from Shariah-compliant list is applied. If the investor receives any dividend payment during the period where the company has been delisted, the whole dividend payment needs to be channeled to charity because this income comes from Shariah non-compliant shares.

CONCLUSION

Purification of the income of stocks is indeed an important element of the overall framework for Shariah-compliant investment. Although there are some variances in purification methodologies between various institutions because of differences in their approaches, the objective of purification is generally the same. It is to purify the income generated from acquiring and trading of stocks according to the principles of Shariah.

There is ample room for improvements in the contemporary methodologies of purification, because there are currently many limitations to the practice. For instance, the main source of information in determining the Shariah non-compliant activities or sources of income of a company is its audited financial statements. Those statements are not current, but rather a reflection of the activities during the previous financial year. Moreover, the Shariah screening of companies has its own frequency and period. Another issue is that financial statements are prepared according to the regulations and requirements of particular standards, i.e. IFRS or standards specific to a certain jurisdiction. Those standards have not been designed to cater for the matters related to Shariah screening and purification methodologies. Therefore, they pose challenges in performing screening and purification process. In view of that, it is recommended that the review of Shariah compliance of companies should be based on the latest information and conducted on a more frequent basis. In addition, it is necessary to ensure that the relevant information is readily available to investors.

NOTES:

1 For instance, the Shariah stock screening criteria AAOIFI, S&P, FTSE, and MSCI do not allow the impermissible and interest income of a company listed among the Shariah-compliant companies to exceed 5% of the total revenue or income of the company. The Securities Commission Malaysia has a benchmark of 5% of the total income for the income generated from *riba*, gambling, *gharar*, and production or sale of impermissible products; while, 20% of the total income benchmark for the impermissible activities or sources which are other the activities that fall under the first category.

2 Al-Zuhayli, M. M. (2006). *Al-Qawa'id Al-Fiqhiyyah Wa Tatbieqaatuhaa Fi Al-Madhahib Al-Arba'a*. Damascus, Syria: Dar Al-Fikr. First Edition. Vol. 1., p. 632.

3 Ibid, p. 447.

4 Al-Qur'ān, Al-Baqarah, 2:279

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ISSUES IN ISLAMIC HEDGING STRATEGIES

Zairulnizad Shahrim

In financial terms, hedging means applying a specific strategy to minimize investment risk through the use of certain contracts and products in a much more calculated manner than standard asset management. It aims to protect an investor's investment position, but it can also manage investment risk to taking higher risks for a higher return. In today's world, Islamic finance and capital markets show tremendous growth year-on-year and Islamic investors' demand on products and services change as well. These investors are willing to accept much more risk than before in order to generate higher returns in their investment rather than investing mainly in plain vanilla fixed *murabahah* papers. These trends raise certain questions: Are Islamic hedge funds the answer? Moreover, are there any Shariah issues associated with Islamic hedge funds? This article seeks to find answers to these questions.

THE CONCEPT OF HEDGE FUNDS

It is very difficult to provide a general definition of a hedge fund, since it cannot be considered a homogeneous asset class. Some are highly leveraged, engage in hedging activities, bet on commodities, currencies, interest rates, while some do not. Most take advantage of the mispricing of certain securities in capital markets. The structure of hedge funds varies, offering such advantages like flexibility, tax efficiency and being tailor made according to investors' preferences. These legal structures allow the fund manager to take short and long positions on any asset and to use all kinds of derivatives and to leverage the fund without restrictions. There are hedge funds that use a feeder structure to solicit funds from investors in different jurisdictions. This feeder fund does not hold funds, but only acts as a conduit to channel money to a master fund, domiciled in different jurisdictions. Another important characteristic of a hedge fund is its fee structure. This consists typically of a base fee plus incentives. The Base fee will be a percentage of assets under management and be paid regardless of the performance of the fund and the incentive fee is a share to the realized profits depending on a pre-agreed hurdle rate, or the threshold before any performance fee is paid.

ISSUES RELATED TO HEDGE FUNDS

The issues related to Islamic hedge funds can be broken down into two categories. First, the way hedge funds are structured and, second, the use of derivative instruments in the operations of hedge funds.

It seems common to presume Islamic investors would not be able to invest in hedge funds because Shariah-compliant equivalents of options, short selling or balance sheet leverage are either very limited or unavailable, and Shariah advisors have different opinions on these issues. In short selling, Shariah does not allow selling something which one does not own, and the application of leverage will trigger the element of interest or *riba*. Conventional derivatives would be considered invalid contracts in most Islamic legal interpretations. Shariah rules ban *gharar* and *ba'i al-dayn bi al-dayn* making it difficult to find Shariah-compliant alternatives. An option is generally considered unacceptable because it is not an obligation and the payment is for some 'right' and not real property. The Shariah issue here is the trading of a right, and not the promise to buy or sell something, although some Shariah scholars have no issues with that. In addition, a right

> *Asset managers could use ba'i al-salam, or full payment for delivery, to replicate the forward contract. In the salam contract, goods are sold for delivery at a predetermined future date, but payment in full is made immediately.*

without an obligation makes it dependent upon future events, triggering an element of *gharar*, perhaps leading to *maysir*.

A forward contract may be acceptable in the event that if it's structured based on Islamic principles and used for hedging purposes only. However, non-payment creates the problem of selling promises to another party. The Shariah Advisory Council of SC, Malaysia (SAC) stated that futures trading of commodities is permissible, as long as the underlying asset is Shariah-compliant. The concept of a stock index futures contract is approved with a condition that the index only contains a Shariah-compliant equities. There is no formal opinion issued by the SAC on options, however the SAC has approved trading of warrants/Transferrable Subscription Rights (TSR) as long as the underlying stock is Shariah-compliant.

ISSUES RELATED TO ISLAMIC HEDGE FUNDS

What are the alternatives for Islamic hedge funds? There are some possible alternatives, but there is no standard Shariah ruling across the board. For instance, one technique to produce these effects is *khiyar al-shart* (stipulated option), which is the unconstrained right to rescind an otherwise binding contract for a fixed duration. An Islamic alternative to options may apply *ba'i al-arbun* (down payment) to legitimize the application of an options contract. In this structure, the buyer concludes a purchase and makes an advance of a sum less than the purchase price as a deposit, and he has the right but not the obligation to exercise the right. If he decides not to take the good, the seller will keep the advance. This is to compensate the seller for the opportunity loss while waiting for the buyer to make decision in the future. While this is the closest analogy to the options, the trading of such rights remains questionable to Shariah scholars.

Another contract that asset managers could use is *ba'i al-salam*, or full payment for delivery, to replicate the forward contract. In the *salam* contract, goods are sold for delivery at a pre-determined future date, but payment in full is made immediately. Even though the usage of Salam has usually been for agricultural goods, the principle could be applied to other assets classes as well, such as short selling in commodities. In *salam* sale, a seller sells a commodity to a buyer against immediate full payment for delivery at a future date. In this case, the existence of the goods at the contract time is not required. It is also possible to replicate the usage of *salam* sale in short selling. For instance, an investor can hedge part of his exposure to cover the downside risk when investing in stock by selling stock as *salam*.

Assume someone holding 1,000 shares of XYZ with a current market price of $10 per share expects a downward price movement in the future. He could enter into a contract to sell at $9.90 per share for delivery in six months. He would receive $9,900 today and after six months it will depend on the market price at that point of time. If the share price is $9.50 per share he would profit $400 ($9.90-$9.50) and if the share price is $10.30 per share he would lose $400 ($9.90-$10.30). The *salam* sale of shares might give the same economic result as a short sale, however, it differs in the nature of the contractual relationship. For instance, in short selling there is "borrowing" of stock at interest, but in *salam* there is only the sale and not the borrowing of stock. For short selling, the dividend even during the borrowing period belongs to the lender. However, in *salam*, it needs to be estimated and factored into the price.

In conclusion, Islamic hedge funds are not the total answer for Islamic investors who demand optimum returns on their investment, considering that the surrounding Shariah issues about the application of derivatives and the acceptability of this investment is still questionable by a majority of Shariah scholars. At the least, the Shariah Advisory Council of SC and BNM have taken a baby steps to explore the permissibility of derivatives but this remains a very limited, and there are still far more work to do until there are totally Shariah-compliant solutions on this matter.

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An investor holds the tasbeeh as he monitors electronic boards displaying stock information at the ADX Abu Dhabi Securities Exchange stock market. REUTERS/Ben Job

SHARIAH-COMPLIANT PRIVATE EQUITY AND VENTURE CAPITAL

Fara Mohammad

The economic expansion of Muslim countries worldwide and the growing network of business relationships between them encourage the growth of new investment opportunities in the Islamic finance industry. One such developing investment asset class is Private Equity (PE) and Venture Capital (VC). There is a gradually increasing awareness of interest in Shariah-compliant PE/VC across jurisdictions, both from Muslim and non-Muslim investors. In the past decade, global PE/VC activity has been limited. The majority of existing Shariah-compliant PE/VC assets are sourced and managed in Gulf Cooperation Council (GCC) countries and Malaysia. Many such structures are built on partnerships in non-listed companies, for example, start-up firms, small and medium sized enterprises and firms, innovative firms, and firms in financial or economic distress.

An essential condition for the establishment of an Islamic PE/VC instrument is that the core activities of the investee company must be fully Shariah-compliant. The underlying assets and investments of the fund must be permissible from a Shariah perspective, to the point of full divestment and termination of the PE/VC instrument. Accordingly, the creation of appropriate business or investment structures for the Islamic PE/VC instruments needs to be better understood and accepted by market players to enable the more rapid growth of the industry. New investment structures must be developed taking into account the changing investment climate and growth in wealth in many Muslim countries where they have sought to invest their wealth without compromising the requirements of the Shariah.

The appointment of a Shariah advisor is another fundamental requirement. The advisor's function is to provide continual guidance to ensure that the investment contract, the structure and other related documentation are in compliance with the Shariah at all times. The Shariah advisor is expected to disclose and declare to the company stakeholders that the company is managed according to Shariah principles. Shariah advisors report directly to the board of directors, and they will need to continuously carry out audits on investments, assets and business activities. The company's assets and investments will also be screened to ensure Shariah compliance. This screening methodology and processes should be transparent and auditable to be accepted by market players. All parties involved in the PE/VC instrument have a role to play. Although the parties do not themselves need to operate along the lines of an Islamic bank/entity, they must service the Shariah-compliant PE/VC fund without violating Shariah principles.

Common structures used for Shariah-compliant PE/VC are musharakah, mudharabah and *wakalah*, ideal models representing the unique modes of Islamic financing that can combine the profit and risk sharing concepts that are essential principles in Shariah. These structures facilitate concepts of mutual benefit, equity and fairness in financial dealings, and they provide the industry with access to portfolio diversification and diverse investment opportunities. The returns derived from Shariah-compliant PE and VC are earned through partners' active involvement and participation in the business risks of investment and not from the returns on lending or financing.

There are entities that offer Islamic PE/VC investment products such as Arcapita, Al Khabeer and Fajr Capital. Other entities offer both Islamic and conventional investment opportunities such as Maybank and CIMB. There are also cooperative relationships between conventional firms and entities offering Islamic investment products. In these collaborations, both institutions benefit from the experience and best practices of their counterparts, but in particular, the conventional firm gains insights and access to Islamic finance. These models of partnerships will enable the industry's long-term development and reach. Examples of this include the collaborations between Wafra Investment Advisory Group and Greenstone Equity Partners, and between Kingdom Holding Company and Pinebridge Investments Middle East. There is also increasing government awareness supporting the development of Islamic PE/VC across jurisdictions, with strong regulatory environment that creates a level playing field for the sector to grow. Malaysia, in particular, has taken the lead, and it provides some tax incentives for the establishment of PE/VC funds.

Moving forward, market players need to take the initiative and invest more effort in forming the structure of a deal, rather than adapting existing conventional financial structures into Shariah-compliant structures, which produces an economic outcome that is similar to conventional structures. There are a number of other underpinning issues in the PE/VC industry that can be resolved through time and persistence such as the costs of funds. Costs are increased in Shariah-compliant PE/VC structures because of the need to appoint and remunerate Shariah boards and to screen and audit assets. As the PE/VC sector matures, other issues such as attracting and retaining personnel with the appropriate knowledge and expertise will become vital.

Another challenge for the industry is satisfying the socially positive goals of Shariah-compliant investing. Market players have suggested that Shariah-compliant PE/VC firms should look for current global issues that can be solved through PE/VC investments. Such causes include those related to environmental, social and governance (ESG) investments and sustainable and responsible investments (SRI) to generate positive societal impact and long-term competitive financial returns. Market players should put more consideration into this, as effective PE/VC investing is not only about generating revenue and profit, but also about fostering enduring, beneficial business platforms.

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ISLAMIC STRUCTURED INVESTMENT PRODUCTS

Assoc. Prof. Dr. Aznan Hasan

In the past few decades, many financial institutions have developed innovative, Shariah-compliant products and structures in the Islamic capital market. Which of these products has stood out? Have any products benefited the markets in particular?

There are a variety of products offered in the Islamic capital market, both retail and commercial. Beside the common products, we also have new and innovative products such structured products, sukuk, Islamic derivatives and hedge funds. Which ones have stood out? This is a very difficult question to answer. It depends with whom we talk, and for what purpose they want to use these products. For example, if you ask the retail people, they will tell you that mass retail products are the most beneficial ones. If you have corporate people, they will claim the star product is sukuk. This is very true, because we have witnessed the issuance of many sukuk in the market that have been used by business and the corporate people, but which is alien to retail products by their nature. Lately, we have seen the development of what we call structured and complicated products.

Whether these are successful or not depends on lot of factors. It depends on the movement and growth of the market, and it depends also on the particular underlying asset that you want to benchmark. Equity-based structured products will only work if, for example, there is volatility and movement in the equity markets. On the other hand, commodity-structured products will depend on the movements of commodity products, but I believe there are parameters of good products that I think are very basic. For example, the product should be simple. The more complicated the product, the more difficult it will be to understand, and people will avoid investing in that particular product. It has to be able to create value, for example, weather you are corporate or retail, the products that you will offer must be able to create value.

Which of these Islamic capital market products are really linked to the real economy?

There are products, like sukuk, which are linked to the growth of the economy. But structured products, by their nature, are not meant to be linked to real development. As an example, if you have a bullish view on equity, you have two options—the first is that you really invest in the equity, you buy the stock or the share, you benefit from the movements of the share, and you will get the dividend payment from the company. This is what we call a direct investment in the equity.

This is not the case with structured products. Instead of investing directly in the equity, the performance of that structured product is linked to the performance of that equity. In a structured note that we call an equity-linked note, offered by an issuer or by a financial institution, the performance of the underlying will affect the performance of your note. In equity markets, when you buy directly, and there is any movement of the share, you can sell immediately. In structured equity-linked products, like the one I mentioned, you can't sell it, as you need to wait for the maturity.

The second difference between equity and structured products is the direct purchase of equity. With equity, you will benefit if there is any liquidation of the dividend, as you are the holder of the share. In structured products, when you buy an equity-linked note, you have no link to the share, hence you don't benefit from any dividend declaration by the company. Your performance will only dematerialize when the structured note matures. So you will look at the benchmark of that particular equity, if the performance is positive, you will get the benefit from the increase in the price, that's all. So, you don't really invest in the equity in the first case.

Therefore, when we talk about dealing with real economic development, structured products may not be able to do those particular things. However, they can help avoid unnecessary speculation and speculative products.

To what extent have Islamic derivatives protected Islamic assets?

Structured products are not meant to protect the underlying asset, they only protect your investment value. It depends also on what kind of structured products that you are investing in. For example, if you invest in a capital-protected structured product, it will protect your capital only and until maturity, you will be guaranteed the original capital back. There are structured products where the potential of returning the capital is not up to 100%. On the other hand, some structured products guarantee you some returns.

Which international markets have been the most innovative? What are the main issues some countries are facing in developing innovative products? In your opinion, what can other emerging markets learn from the leading markets to overcome some of the issues?

The GCC and Malaysia, I believe, always come up with innovative structured products. The UK does offer some from time to time. For example, they have one trade finance fund, which is a very good product.

The first challenge to innovation is really in understanding the needs of the respective segments of the market, and in devising products that suit them. Because the structured product is a very wide instrument, it can be used for a variety of purposes. So when you, for example, go to Tabung Hajji in Malaysia, they will have what they call "customized reasons." When you make a structured product for them, it needs to suit their demands. That is why structured products are customised products.

The second challenge is the regulatory framework and debt issues. The latest development in Malaysia was the introduction of IFSA (Islamic Financial Services Act) 2013, in which a structured product is categorized as investment. In 2014, BNM has issued what is known as guideline on the introduction of the new products, and structured NID (negotiable instruments of deposit) or INI (Islamic negotiable instruments) are considered investment products, while in some other countries they are still considered structured deposit products.

The third challenge is the infrastructure. In some countries, including Malaysia, the capability of producing structured products is not so high, as we are still relying on other experts. We are good at wrapping but not good at producing the materiality of the structured products.

The fourth challenge is the capital issue, because structured products are also subjected to Basel III. For example, in the case of structured products: although they are considered an investment, they still have capital charges. If you go for a normal *mudarabah* account, there is no capital charge, because this is an investment product.

> *"Equity-based structured products will only work if, for example, there is volatility and movement in the equity markets."*

> *In some scenarios, such as cross-border transactions, the standardization of opinions is very important. That's why we see now initiatives for standardization either locally or globally.*

What are the disputed Shariah risks or issues that are associated with Islamic structured investment products or their components? How are these risks or issues viewed by renowned Shariah boards or Shariah scholars?

In very general terms, structured products are investment vehicles whose value is derived from reference asset or investment strategy. That reference asset or benchmark asset may include equity, which can be securities, indices, commodities or even the interest rate of a currency. Therefore, structured products are hybrid products. Normally, structured products have two components, a note and derivatives. The derivative is normally an option, which in some situations may pay interest in the interval, or they may pay at the maturity without paying at interval. If you redeem the note before maturity, you may lose the capital.

So a structured product is usually created to fulfill specific needs that can't be satisfied through the standardized financial instruments available in the market. Basically, they can be used for three main things. The first one is to serve as an alternative to a direct investment; second, as part of overall asset allocation; or third, for risk reduction in a portfolio. From there, one can analyze that the main Shariah issue with the structured product is the nature of the product itself or the structure itself. For example, some products can be seen as too speculative. An example of that is using specifically bullish or bearish Islamic investing strategies, as some scholars see them as too speculative.

The second issue is benchmarking against the conventional benchmark. For example, you may benchmark yourself against the future currency market. This has positive and negative implications, despite the Shariah compliance of such operations according to many rulings. For example, if the structured product is linked to a conventional index or a particular equity as the underlying, any negative movement of the underlying will negatively affect its performance.

The third issue is the use of *wa'd*, which can be used to benchmark against a non-compliant index. Some Islamic products, for example, are deemed to be lacking a link to the real economy. This includes the Islamic callable structured product. Some scholars believe that this product lacks the link to the real economy. This is because the performance of this particular product is linked to the movement of interest rate.

Many Shariah scholars and institutions have been calling for greater standardization. Should standardization happen, what impact would it have on innovation? Would it make it easier or harder on institutions to develop structures/products? Would standardization narrow differences of Shariah opinions?

Standardization is good for the industry, especially in cross-border transactions. Lack of standardization may increase the risk of non-compliance with the Shariah, which creates a hazard or debate that leads the contract not to be recognized. This can open potential exploitation by the developer of the product. Having said this, I disagree with those who argue that the sustainable growth of the Islamic finance industry will be impaired by the lack of standardization of Shariah opinions. I believe that the most important thing that has impaired development is not only Shariah. It could be due to the lack of a transparent regulatory framework or transaction framework.

In some scenarios, such as cross-border transactions, the standardization of opinions is very important. That's why we see now initiatives for standardization either locally or globally. In some jurisdictions, they have formalized their central board of Shariah scholars, like in Malaysia, Nigeria, Oman and many other parts of the world. That's on the local jurisdictions. However, AAOIFI, IFSB, IIFM, are recognized in the international sphere for the purpose of the standardization of opinion. There are lots of benefits from standardization, such as time and cost saving, financial stability, data transparency, consistency in financial reporting, improvement of public confidence, increase in cross border transaction and so forth, but I think the most important thing is the kind of standardization framework you want.

If we look at Malaysia and AAOIFI standards, what we try to do in these two standards is not to have Shariah opinion on a product, but rather, what I call a broad Shariah standard. Instead of setting a standard for each particular product, we have standard on Shariah. In Malaysia, for example, in the *musharakah* standard, you have a framework that you have to follow, but that framework is flexible enough to allow you still innovate for you to create your own good product to the market.

I believe that in certain products, we may even want to regulate the product. For example, IIFM have produced certain standards and parameters that can be applied to the relevant products. For example, the swap product, the cross currency swap, the profit rate swap, the hedging product, all these products can be standardized. But to standardize the whole product, I don't believe in that because this could impair innovation. But we can have what I call a general standard framework on Shariah in which you need to follow the standard, yet it will still give you room for innovation.

Given the recent trend of Islamic finance industry, how do you foresee the growth of Islamic structured products in relation to the industry's growth and in relation to its conventional counterpart growth? Briefly what factors assist this growth or increase the demand for such products?

The performance of structured products is linked to their particular underlying. For them to grow, we have had to see the growth of that particular underlying. For example, if you offer a structured product based on commodity, you have to take the view that the underlying will continue to increase in price. The growth of the structured product merely depends on the growth of their underlying, except for interest-rate based structured products.

Some commodities can go further in terms of this product. For example, the CPO can grow, but we don't have such good CPO-based structured products until now. In addition, the interest rate structured product will continue especially, in the international market. I don't think oil-linked products will grow as structured products because the oil price is very volatile now. Equity-based products may come back, and bonds can be good underlying assets. The gold price is currently not so good, so I don't think anybody will take gold-based EPFs.

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CHAPTER 5

Innovation in Islamic Capital Market Product

Islamic monument in the city of Doha, Qatar.

Summary

Just as important to the expansion of Islamic capital markets worldwide as the growing awareness of the personal and social benefits of Shariah compliance and the adoption of Shariah standards between jurisdictions has been the proliferation of sophisticated structuring that adapts Shariah to the niche demands of the contemporary global economy. Beyond merely replicating the forms and intended results of conventional capital market instruments, Islamic finance provides corporations, entrepreneurs and investors the opportunity to collaboratively design replicable products and individual arrangements that are both efficient and also conform to Shariah rulings and practices.

Sukuk have shifted from purely asset-backed structures at their origin in the 1990s toward including increasing shares of intangible receivables, such as mobile talk time or public transportation receipts. Including socially responsible investing (SRI) principles in sukuk structures have become a significant way of expanding sukuk into new fields for fundraising both in social areas such as education as well as consumer goods.

While many SRI structures provide investors with profitable income streams, the chapter contains two examples of innovations in the purely charitable sphere, which underpin corporate social responsibility and tax management strategies. Awqaf New Zealand is preparing to issue a large sukuk that will provide funding for a variety of *waqf* charities around the world to supply livestock and process the non-meat portions of 'Eid sacrifices for industrial uses; investors receive their principal extended as *qard al-hasan* over time, but donate profits. Johor Corporation (JCorp) in Malaysia has created the first *waqf* backed solely by shares from a variety of JCorp businesses, from which revenues are dedicated to charitable causes from medical to educational and pilgrimage organizations.

In the field of profit-producing sukuk, new structures are finding ways of providing limited risk exposure that can provide positive alternatives to conventional debt and equity instruments. *Mudarabah-* or *musharakah*-structured sukuk have the benefit of providing equity-like upside, while limiting investors' risk exposure to only specific corners of a business enterprise. Multi-Level Protection Sukuk provides such a structure, which grants sukuk holders seniority by restricting their share of assets in part from the claims of creditors. Conversely, market professionals are considering ways of structuring contingent convertible Sukuk both to limit the potential downside for troubled enterprises such as banks, and provide higher-risk opportunities for investors, in a new global economy with systemic volatility.

A new method for raising funds for smaller projects is the new practice of Islamic crowdfunding. This allows retail investors interested typically in individual consumer goods projects to make micro-contributions to the enterprises making them, participating in the risk of these enterprises. Platform operators, typically based on the Internet, are negotiating with regulators over strong but flexible supervisory rules.

NEW APPROACHES AND INNOVATION IN THE ISLAMIC CAPITAL MARKET

Mohamed Rafe Mohamed Haneef

Innovation is crucial for the development of all markets. How would you describe the level of innovation in Islamic capital markets? What are the most innovative products and which countries are leading the innovation industry? What are the current trends in innovative Islamic capital market products?

Innovation happens in every market; no market can survive without continuous innovation. A good example is the Islamic capital market, which has been extremely innovative, and every year there are new products coming to the market. At the beginning in the 1990s, the market started with debt-based sukuk, based on the contract of *bay bi thaman ajil*, which basically revolves around buying and selling of financial instruments as underlying to create a debt instrument. Subsequently, we moved to instruments based on an *ijarah* contract that involves tangible or physical assets such as land and buildings, which are sold and leased back. Later on, *ijarah* sukuk evolved further from tangible assets to intangibles as underlying assets.

The 'buy and sell' structure where you exchange the debt as a tradable instrument is not allowed in many countries, because debt is not transferable except at par in most Shariah jurisprudence. However, it is still allowed in Malaysia, as authorities here take the view that debt can be sold at a premium or a discount, although I have not seen any scholarly article defending the position that *bay al-dayn* at premium or discount is allowed.

Moreover, we have moved in the way we look at underlying assets. At first, we had land and buildings as physical assets that we bought and leased. We created sukuk backed by the ownership of these assets, and the rental of this property gave us the returns. From physical assets we then moved to sukuk backed in part by physical assets, part by receivables. 51% was the requirement for physical assets while 49% was the limit for receivables that are debt. Thereafter, the practice has shifted from 51% to 33% physical assets while the remaining 67% represent receivables coming from commodity *murabahah* (*tawarruq*). Another innovation was made in the form of 100% intangible assets (such as airtime, or mobile talk time). So, from 100% tangible assets, some sukuk have now become backed by 100% intangible assets. You can use airtime or even seat capacity for LRT (light rail transit).

Based on data available on seats sold for the LRT, you can estimate future usage and revenues to be generated. For example, say 5 million passengers use LRT with average revenue coming to RM 10 million a month. This comes to RM 120 million a year, and you can issue sukuk based on seats sold for the next 10 years. So future usage is being sold. But then, I do not operate the trains. I appoint the operator as my agent, and their role is to sell the seat capacity at a higher price than what I have paid, and the profit is shared between us.

In other cases, there is a mix of different types of assets: 33% physical assets, 33% intangible assets, 33% debt receivables. Various combinations are being tried. So continuous innovation is taking place, and it is mostly about structural innovation.

There is also innovation in terms of the features of sukuk, where the structure combines 100% intangible assets like airtime with the principles of SRI (socially responsible investing). For example, money received through the sale of airtime could be used for building telephone towers that are constructed using recycled materials and built on land that has no environmental impact, which complies with SRI principles.

Also, there is innovation in terms of the structures as well as the features of sukuk. An example is sukuk issued by Khazanah that utilizes shares as the underlying tangible assets, combined with receivables. The money received will then be used to fund ten schools that have certain KPI (key performance indicators) to fulfill. For instance, the students must achieve a certain grade every year or they must pass the exams with a certain minimum number of distinctions. If they meet this target, then the returns payable on the sukuk will drop. Let's say the expected return is 4%. If the schools meet the target every year for five years, then investors' returns on the Sukuk will not be 4% but 3%, as a *hasanah* (good deed). But if they don't meet the KPI, then investors will get 4%. Thus, innovation today is not only happening on the structural level but also in the features of the offerings.

These examples are similar to conventional market offerings that sometimes take the form of bond and sometimes are offered as a hybrid product with some equity features.

How would you position Malaysia regionally and globally in terms of its Islamic capital market innovation? How much have Bank Negara Malaysia and the Securities Commission helped enhance the innovation in the Islamic capital markets?

In terms of Malaysia, regionally and globally, we are definitely the leader for sukuk. We were the first to come up with sukuk in 1990. That was the Malaysian ringgit sukuk. We were also the first to come up with the global USD Government of Malaysia sukuk in 2002. That represented another landmark sukuk issuance, and you will find today that we not only issue sukuk regularly, but we also have size. Last December, we issued one RM 8.9 billion sukuk with a 23-year tenure. We are seen as a global leader for sukuk, because we represent up to typically 60% to 70% of the total sukuk issuance in the world. We have the volume, and we do simple sukuk, project financing, and longer tenures of the likes of 23 years.

The Malaysian Securities Commission has played a critical role in developing several master plans to coherently develop the sukuk market in Malaysia. A lot of credit goes to the SC for their vision and leadership.

Facilitating innovative solutions in the ICM involves regulatory, legal, tax and Shariah aspects that require collective effort from key market players. The Securities Commission Malaysia has introduced Sustainable and Responsible Investment (SRI) sukuk in 2014, the first innovative social impact sukuk. To what extent such social products affect the industry? And how successful is SRI sukuk in your opinion, and what improvements are required?

The gradual shift to SRI is an important move, because today, SRI looks at the purpose of financing. Shariah looks at the nature of the financing. Shariah-compliant financing could be pure *mudarabah* (profit and loss sharing), but if the customer who took *mudarabah* financing is going to cut trees to build a factory that is going to pollute the whole environment, would it be wholly Shariah-compliant?

Shariah scholars today unfortunately do not look at the impact; they only look at the structure. They will say a product is Shariah-compliant, but it does not matter what the impact is. The scholar will say it is for the regulator or *muhtasib* to manage the impact of financing. SRI is trying to change this perception

"Shariah-compliant financing could be pure mudarabah (profit and loss sharing), but if the customer who took mudarabah financing is going to cut trees to build a factory that is going to pollute the whole environment, would it be wholly Shariah-compliant?"

by saying "when you give financing, you should see the impact as well." When the customer says I want to build manufacturing plants, then we must ask, "Do you have the EIA (environmental impact assessment) report?"

SRI is moving forward, but there is only one issuance so far. Khazanah has done it with its US$ 100 million SRI sukuk. It is quite well done and they are able to get a lower profit rate (if the KPI is met, as explained above). SRI is likely to gather momentum in the future. For example, plantation companies like Sime Darby, Felda and others can issue SRI sukuk. Money can be raised via sukuk and invested in palm oil plantation that is RSPO compliant. Though such companies can do it, the question is: what are the incentives to do it? They probably will do it if EPF, KWAP and other pension funds come out and say that they have a three year or five year plan to make sure that their investments are at least 50% SRI. The investors should drive it like in the West. Marks & Spencer has announced that they are socially responsible and consumers supported this initiative by buying from Marks & Spencer. They are starting to boycott products that are not socially responsible.

Most of the leading markets such as the GCC countries and some of the regional markets like Indonesia are moving at a fast pace to cope with Malaysia's capital market development. What are the lessons to be learned from Malaysia competitive position in terms of the ICM's innovative products? And what is the position of CIMB Islamic in empowering market innovation?

If we look at emerging market countries, they are all trying to develop infrastructure by issuing Sukuk. They are learning from Malaysia. They have set up securities commissions, central Shariah bodies, and they are coming up with various guidelines. But what they need to do is not only to develop the guidelines, but also to develop the buy side: who is going to buy the paper?

In Malaysia, we did both. That is the beauty about Malaysia. We not only developed the infrastructure to issue sukuk, we also created institutions to come up with new innovations and we have taken the same level of effort to develop the buy side. We looked at it this way: we are going to develop this paper (sukuk), so we need to develop the market for buying this paper. Who are the people who would buy sukuk? Insurance companies, takaful operators, mutual funds, asset managers, and reserve managers like pension funds.

So we came up with various incentives to grow this business. For example, if you are a taxpayer in Malaysia, if you buy takaful for education or health, you get a tax exemption. When people buy takaful, they contribute to takaful growth and takaful companies become bigger. They will want sukuk to match the long-term requirements. When you buy takaful, takaful operators will then buy sukuk to match.

The government, for instance, has come up with private retirement schemes (PRS). In PRS, you can add more from your salary to buy your additional retirement schemes. That PRS takaful company will then go out and buy sukuk. So through tax incentives, you can grow certain markets.

The market players that will go and buy sukuk are missing in many of the countries. [The regulators] just go and develop the sukuk markets, not realizing that they have to also develop the buy side. I think that is what they need to learn from Malaysia. When you grow your buy side, reserve managers, pension funds, takaful operators, mutual funds will have growing demand for sukuk and there will be demanding longer and longer tenures. When you buy life insurance, you are buying a 20-to-30-year protection. They therefore need to find corresponding instruments, so they would buy 20-year sukuk.

MOHAMED RAFE MOHAMED HANEEF became the Chief Executive Officer of CIMB Islamic Bank Berhad on 4th January 2016 and is in charge of the CIMB Group's Islamic banking and finance franchise. CIMB Islamic operates as a parallel franchise to the Group's conventional operations and covers Islamic wholesale banking, Islamic consumer banking, Islamic commercial banking and Islamic asset management and investment. Rafe has 20 years of experience covering a range of businesses and functional roles gained from three global banks, an international asset management company and a legal firm, at various financial centers including London, Dubai and Kuala Lumpur. He read Law at the International Islamic University Malaysia and also holds an LL.M degree from the Harvard Law School. He was admitted to the Malaysian Bar in 1995 and qualified for the New York State Bar in 1997. Rafe first joined HSBC Investment Bank plc, London in 1999 and thereafter HSBC Financial Services Middle East, Dubai where he set up the global sukuk business in 2001. Subsequently, he became the Global Head of Islamic Finance business at ABN AMRO Dubai in 2004 covering both consumer and corporate businesses. In 2006, he moved back to Malaysia with Citigroup Asia as the Regional Head for Islamic banking, Asia Pacific. He later joined HSBC Amanah in 2010 as the CEO, Malaysia and Managing Director of Global Markets, ASP.

Interior of the As-Syakirin mosque, Kuala Lumpur, Malaysia.

MULTI-LEVEL PROTECTION *MUSHARAKAH* SUKUK

Dr. Sami Al-Suwailem

INTRODUCTION

The 2008 global financial crisis proved the critical need for greater capital and risk-sharing instruments. Excessive debt makes the financial system fragile and prone to bank-runs that culminate into system-wide crises. This has been a major driver behind the revised Basel III capital requirements. The rules aim to improve the banking sector's ability to absorb shocks, thus reducing the risk of spillover from the financial sector to the real economy. Risk sharing is essential for a robust and resilient economic system. For this reason, many economists and experts call for increasing the role of equity capital and risk-absorbing instruments in funding financial institutions and economic activities.

While the sukuk market is growing in size, it is still very limited in product diversity. The variety in investors' preferences requires a corresponding variety in product offerings. While the existing sukuk satisfy preferences for debt-like instruments, there are very limited options for equity-like sukuk. While *musharakah* represents the "Cinderella" of Islamic financial instruments, it has very few applications in the sukuk market.

The Multi-Level Protection *Musharakah* Sukuk (MLP Sukuk for short) is an innovative structure that aims to design an instrument based on the principles of *musharakah* while at the same time providing a variety of risk-mitigation techniques to meet the diverse risk preferences of investors.

The MLP Sukuk project is a joint initiative of the Product Development Center at the Islamic Development Bank, SABIC Chair for Islamic Financial Markets at Imam Mohammad bin Saud University, the International Shariah Research Academy (ISRA) and the specialist Islamic finance law firm, Agha & Co. The project commenced in June 2013 and the result was published in 2016 in the report issued by the Islamic Development Bank: *Sukuk: Challenge and Prospects for Innovative Designs* (available at www.isdb.org). We present here an overview of the main aspects of the structure within the available space.

OVERVIEW

In brief, MLP Sukuk enjoys the following features:

- It provides a general-purpose, sustainable source of funding for corporations and Islamic financial institutions.
- It represents non-debt financing to corporations, with multiple levels of protection and risk mitigation to investors.
- It enjoys comparable levels of seniority as bonds, and can have a comparable level of authority as equity. Investors share the assets but not the liabilities of the institution or the company.
- It provides an additional layer of protection through "capital cushion," which represents an Islamic alternative to "over-collateralization" in conventional finance.
- The structure is consistent in principle with OIC Fiqh Academy resolutions and AAOIFI Shariah standards
- As a hybrid financial instrument, the structure in principle does not require legislating new laws or regulations.

> *In mudharabah arrangements, the capital provider (rabbul-mal) has the right to require the mudharib not to buy on credit, and that if the mudharib decides to do so, only the mudharib is responsible for such debt. This means that the mudharib becomes a partner in total assets and fully responsible for the liabilities, while rabbul-mal is sharing the assets only.*

Despite the large number of diverse hybrid financial instruments, we could not find structures that enjoy the set of features of the MLP Sukuk. Apparently, the MLP Sukuk might be a contribution to capital market instruments, both Islamic and conventional.

MLP SUKUK FEATURES

The most basic feature of the sukuk is its seniority among other liabilities. This means that investors' share in assets is not subject to the claims of creditors of the company or the institution issuing the sukuk. In other words, MLP Sukuk investors share the assets but not the liabilities of the institution. The Shariah aspects of this arrangement will be discussed after an elaboration of its structure.

Suppose that Company XYZ with the balance sheet shown below needs to expand its business activities by $100 million.

Assets (US$ Mn)		Liabilities (US$ Mn)	
A1	150	Debt	100
A2	100	Sukuk	100
		Equity	50
Total	**250**	**Total**	**250**

Investors now are partners in the company; they share 100/250 = 40% of the assets of the company as per their contribution. Seniority however, is achieved by having the sukuk held by investors protected from the creditors of the company in case the company defaults. So in principle, creditors of the company and investors are at the same level of seniority with respect to the assets.

Although investors have a senior claim against their share in the assets of the company, they are still taking the risk of the assets, since assets may for any reason fail to perform as expected.

To elaborate, suppose the assets of the company lose 20% of its value. Then total assets will be $200 million. Since sukuk holders own 40% of total assets, their share of the total assets is $80 million. The remaining $120 million is enough to pay the creditors their debt of $100 million. The remaining $20 million goes to shareholders.

Assets (US$ Mn)		Liabilities (US$ Mn)	
A1	120	Debt	100
A2	80	Sukuk	80
		Equity	20
Total	**200**	**Total**	**200**

It is important to emphasize that the MLP Sukuk do not affect creditors' rights. Without the MLP Sukuk, the 20% loss would have still allowed creditors to be repaid from the $120 million of total assets. Sukuk holders get their share of total assets, which is what they have contributed in the first place. They therefore have a senior claim on their share, but they are exposed to the risk of the associate assets.

SHARIAH RULINGS

The idea of sharing assets without sharing liabilities has been known in *fiqh* for quite some time. In discussing *mudharabah* arrangements, the capital provider (*rabbul-mal*) has the right to require the *mudharib* not to buy on credit, and that if the *mudharib* decides to do so, only the *mudharib* is responsible for such debt.[1] This means that the *mudharib* becomes a partner in total assets and fully responsible for the liabilities, while *rabbul-mal* is sharing the assets only.

The Shariah Committee of the Islamic Development Bank has approved the same concept whereby investors, as *rabbul-mal*, provide funds to the issuer or the Islamic bank, such that investors share the assets of the bank (*mudharib*) but not the liabilities (Ruling 26-2008).

The idea was discussed at the Islamic Financial Services Board (IFSB) while preparing the revised draft of its Capital Adequacy Standard (IFSB-15, Dec. 2013), whereby the Standard notes that *rabbul-mal* (investors) "would not be liable for the general liabilities of the IIFS (and notably for the amount owed to current account holders)" (p. 8, ftn 12). These findings consider this arrangement as part of *mudharabah*, not *musharakah* whereby investors share the assets and liabilities of the issuer. The latter however, might be better described as "equity" as they end up with the same rights and obligations of equity shareholders.

PROFIT DISTRIBUTION

The issuing company and investors share profits as agreed. Investors get their agreed share of profits periodically as dividends/coupons. It can be agreed that, if the share of investors in profits exceeds a certain level, excess returns are put into a reserve account to give investors protection for fluctuations in future returns. According to AAOIFI Standard no. 12 on *musharakah*, clause 3/1/5/9, if the profit realized is above a certain ceiling, it is permissible to agree that the profit in excess of such a ceiling belongs to a particular partner. The share of the company in aggregate profits shall be used to redeem the Sukuk held by investors, as below.

REDEMPTION

In principle, the Sukuk can be perpetual, as it is the case with some of the Sukuk issued recently by Islamic banks and other corporations. Or it can have an agreed maturity. For the MLP Sukuk, the company issues a promise to redeem the Sukuk held by investors if the company's accumulated share in aggregated profits is adequate to accomplish such redemption. If this is the case, the company shall redeem the Sukuk at nominal value. If, however, the accumulated share of the company in profits is not sufficient, the company is under no obligation to redeem. Hence, the promise to redeem is not a debt obligation on the company. It is conditional upon realization of sufficient profits. In this manner, the Sukuk are a genuine partnership in the underlying assets. There is no guarantee by the company that investors will get back their capital. This promise therefore does not violate the principles of Shariah.

Since the partners can agree to allocate profits beyond a certain level to one partner, as above, investors can agree to give up capital gain if total profits are such that the company's share equals or exceeds the nominal value of investors' Sukuk.

TRADABILITY

Since the MLP Sukuk represent a genuine partnership in the company, they are tradable irrespective of the composition of the assets (debts, cash, tangible assets, usufructs, etc.). This is in accordance with the principle of "subordination" (قاعدة التبعية) in Shariah, as adopted by the OIC Fiqh Academy Rulings no. 180 and 196. This principle implies that the company or the institution as an entity is responsible for creating the underlying assets. The entity, as a fully functioning corporation, is a set of tangible assets through which the entity is able to function, create assets and generate returns. The set includes the legal license, management, fixed assets and equipment, and similar productive assets. Since shares represent an undivided ownership in this set, shares are tangible by implication. The financial assets created by the company are subordinated to the set that creates such assets. Hence, as long as shares represent ownership in a genuine fully operational entity, the shares are tradable irrespective of the particular percentage of physical assets in the total assets of the institution.[2] Since MLP Sukuk represent a share of the ownership of the entity, Sukuk are tradable regardless of the nature of the underlying assets.

CONCLUSION

The MLP Sukuk is a hybrid instrument that combines the most important features of debt and equity, and offers various level of protections to investors. With the international trend towards reducing leverage and increasing equity and equity-based instruments, MLP Sukuk could be a viable choice for such instruments.

NOTES:

1 Mausu'ah Fiqhiyyah, Mudarabah.

2 In the absence of such subordination, the minimum of physical assets and usufructs, according to the OIC Fiqh Academy, is 51%.

DR. SAMI AL-SUWAILEM is currently Head of Financial Product Development Centre at the Islamic Development Bank (IDB), Jeddah, Saudi Arabia. He was previously Deputy Director of Islamic Research and Training Institute (IRTI) at the IDB Group. Before joining IRTI in 2004, Dr. Al-Suwailem managed the Research and Development Center of the Shari'ah Group at Al-Rajhi Bank, Riyadh, Saudi Arabia. He worked at Institute of Islamic and Arabic Sciences in America, Virginia, Southern Illinois University, Carbondale, Illinois, USA, and King Saud University, Riyadh. Dr. Al-Suwailem held membership in several professional committees, including the Technical Committee of the Islamic Financial Services Board; Economic Committee of Awqaf at the Ministry of Islamic Affairs in Riyadh; Academic Committee in Islamic Fiqh Academy of Muslim World League; Executive Committee of the Islamic International Foundation for Economics and Finance; Liquidity Risk Management Working Group for IFSB; and Task Force for Islamic Finance and Global Financial Stability, among others. He obtained his M.A. from Southern Illinois University in 1990, and his Ph.D. from Washington University, St. Louis, Missouri, in 1995. He authored many books and published several papers on Islamic economics and finance.

OVERCOMING THE DEBT DILEMMA WITH RISK-SHARING INSTRUMENTS

Prof. Dr. Obiyathulla Ismath Bacha

In a 2010 book, renowned economists Rogoff and Reinhart show that every single financial or banking crisis in the last several hundred years has had a single root cause, excessive system wide debt. Financial crises have not only become much more frequent, but deeper and a lot more painful. Governments, even of the mightiest economic super powers such as the United States, Britain and Japan, have been brought to their knees because of an excess buildup of debt within their economies. The huge social costs and negative externalities of debt-induced crises are now abundantly clear. Years of hard work and capital accumulation can be destroyed in a matter of weeks as debt-laden governments defend their currencies from speculative attacks. Despite the huge risks to debt-financed growth, the addiction to debt continues. The global debt to GDP ratio is currently higher than it was on the eve of the most recent global financial crisis of 2007. As of now, growth and development does not seem possible without leverage. Yet, given the debt overhang, leveraged growth is no longer tenable. Unfortunately, conventional economics has no solution to this dilemma of how to fund growth without debt. And this may be where Islamic finance can help, specifically with the risk-sharing contracts of *mudarabah* and *musharakah*.

Private institutions that want to raise funds have a choice between debt and equity. Governments do not have the choice of equity, only debt. But for both of these institutions, governments and private firms, the risk-sharing alternative of Islamic finance is available. In corporate finance, there is a trade-off between debt and equity financing. Debt is cheaper but riskier than equity. Equity, while being safer, is not only more expensive but can lead to unwanted ownership dilution. Given this trade-off, companies are often inclined to use debt financing. To be workable, a risk-sharing instrument must provide the advantages of debt without the associated leverage, be cost-effective, and be attractive to both potential borrowers and financiers. It must also be functional and fairly simple. Ordinary investors should be able to easily understand how the instrument works and its pricing. If the instrument can have features of existing market-traded instruments, it would make market acceptance much easier. Further, to be acceptable to Muslims, the instrument must comply with Shariah requirements.

FUNDING REVENUE-GENERATING PROJECTS WITH RISK SHARING (RS) INSTRUMENTS

To understand how a risk-sharing instrument could work, we will work through a simple example of funding a revenue-generating project. Such a project can be the initiative of either a corporation or government, the basic logic is the same in either case.

Here, risk sharing should be based on the revenue generated by the asset. In other words, the returns to the financier will be linked directly to the earnings of the project. In this sense, the RS instrument is a hybrid equity instrument. The financier or investor gets a return linked to the earnings of the funded project and thereby shares in its risk. The underlying contract can be a modified *mudarabah* or *musharakah* combined with a *wakalah*. The instrument will be terminal and have a fixed tenure. The tenure will depend on a number of factors, including (i) the economic life of the project or underlying asset (ii) the cash flows or earnings generated (iii) the profit-sharing ratio (PSR) and (iv) the required return given the riskiness of the project. The term should be set such that for a given PSR and required return, the financier can expect to get back his initial investment plus his required profit.

This RS funding instrument should be listed and traded on secondary markets. Secondary trading brings numerous benefits, including enhanced liquidity that should attract a wider range of investors. Issuers could encourage financial inclusion by providing at least a portion of the issuance in small denominations. This would attract small retail players, and their participation could be increased if the buying and selling of these instruments was handled through banks and institutions such as post offices. This would enable rural investors to participate with their small savings. Much like mutual funds, their daily prices can be determined from the previous day's closing prices or net asset values.

RS finance has key differences when compared with conventional debt or equity financing. First, unlike a new issue of common stock, which would have a claim on all existing assets of the issuing firm including the new project, this RS instrument would have a claim only on the earnings of the new project. Moreover, this claim would only last during the tenure of the instrument. Thus, any earnings dilution is specific to the funded asset and does not apply to all assets, and it is a terminal claim, not perpetual as with equity. Second, when compared to debt, aside from the leverage and increased risk, RS instruments avoid the fixed claim that debt holders have on all of the firm's assets. The linking of returns of the RS instrument to the earnings of the asset acts as an automatic stabilizer to the funded entity. Just as the issuance of new equity makes a firm safer, the use of these RS instruments would have the same impact. Growth without the leverage and riskiness of debt becomes possible. Such a possibility enables societies, even indebted ones, to undertake their needed growth. While debt limits act to cap the extent of borrowing, governments of poor economies are under constant pressure from growing populations to provide the services needed. The risk sharing instruments of Islamic finance offer a way out.

PROF. DR. OBIYATHULLA ISMATH BACHA is currently Professor of Finance INCEIF. Prior to this, he has held teaching positions at the International Islamic University Malaysia and Boston University, USA. He received his Doctorate in Finance, MBA and MA in Economics from Boston University. His undergraduate degree was from the Science University of Malaysia. Currently, President of the Malaysian Finance Association, he has published extensively in academic journals and has authored a textbook on Financial Derivatives. His most recent work is a co-authored textbook on Islamic Capital Markets.

AWQAF NEW ZEALAND (NZ): DEVELOPING THE WORLD'S FIRST SOCIALLY RESPONSIBLE *AWQAF* SUKUK

Shabana M. Hasan, Husain Benyounis and Mohamed Nalar

INTRODUCTION

Since its establishment in February 2011, Awqaf New Zealand (NZ) has made significant progress towards its goal of establishing *awqaf* farms on a large scale that will supply an additional 5 million livestock to the *adahi/qurbani* industry. As a result, it won first prize at the Global Islamic Economy Summit (GIEF) in the *awqaf* category, held in Dubai on November 25, 2013.

There are more than 50 million Muslims in the western world, with an estimated 5 million Eid sacrifices every year. Unfortunately, the wool, skin and bones of these animals are not usually claimed. The organization's new objective is therefore is to supply an additional 5 million livestock and to turn the unclaimed parts of these animals into *waqf* (endowment) revenues. Individuals and organizations that are involved in the charitable and relief industries will also be pleased to see the stability in livestock supply and that the formerly unclaimed parts of their animals will be fully utilized for the purpose of the sacrifice. At present, there is no infrastructure in place to handle this industry on a global scale. Therefore Awqaf NZ has been strongly motivated to fill in this gap. As part of its efforts to engineer and encourage the *awqaf* industry, it is currently in the process of structuring the world's first socially responsible *awqaf* sukuk, which will be used to fund *awqaf* farms in New Zealand initially and subsequently in other parts of the world.

CONTEMPORARY *AWQAF* SUKUK AND SUSTAINABLE AND RESPONSIBLE INVESTMENT (SRI) SUKUK

Although there have been previous successful *awqaf* sukuk issuances in recent years, such as the sukuk *intifa'* of Zam-Zam Tower in Mecca in 2003 and the *musharakah* sukuk issued by MUIS (Islamic Religious Council of Singapore) in Singapore in 2002, these types of sukuk are solely meant for investment purposes only, without a socially favorable outcome. Moreover, the sukuk proposed by Awqaf NZ will be different from Sustainable and Responsible Investment (SRI) sukuk, since only sovereign entities and governments typically underwrite SRI sukuk, usually with private placement. The *awqaf* sukuk proposed by Awqaf NZ will be issued through a public placement.

THE WORLD'S FIRST SOCIALLY RESPONSIBLE SUKUK, BY AWQAF NEW ZEALAND (NZ): A CASE STUDY

To date, there has been no sukuk issuance where the combination of *awqaf* and sukuk is meant for a social purpose alone. Awqaf NZ plans to issue its sukuk with these conditions, under the name Smart Waqf (S-Waqf). If successful, it will be the first of its type in the world. In this type of structure, sukuk owners are not motivated by financial returns. Instead, they are focused on the delivery of sustainable social outcomes and philanthropic objectives over the long run.

> *A successful issuance will set a standard for the development of new Islamic finance tools for the non-profit sector, the provision of secured infrastructure to globalize the awqaf industry and the development of a safe structure for private business to invest in the non-profit sector.*

Current New Zealand legislation permits the issuance of sukuk, which allows Awqaf NZ to promote new initiatives in the *awqaf* industry. Awqaf NZ, with the assistance of the International Shariah Research Academy for Islamic Finance (ISRA), will structure the S-Waqf issuance based on the Malaysian Securities Commission March 2015 "Sukuk for Awqaf Development" regulations. The table below provides the overall information summary of the proposed S-Waqf Sukuk.

Awqaf NZ has selected this specific project as it serves an existing need of the Muslim community. Currently the sector is not very well managed, and there are opportunities to increase value for donors and to generate greater benefits for the needy. New Zealand has a highly developed agriculture and livestock industry and has a suitable environment to successfully launch and manage this project.

Whilst the proposed sukuk issuance is focused on the *adahi* industry, the model can be applied for any other similar social project as long as it is linked to a productive industry sector or social service sector where it is economically and financially sustainable. Once the asset or the infrastructure is developed, it will run in perpetuity and the capital, as *qard al-hassan*, will be repaid back to the sukuk holder. Alternatively, it will be retained within the fund and will be used to finance another social project. These can be building hospitals, schools and other social infrastructure via social *awqaf* sukuk. Once the infrastructure is in place, the users or the government operational funding models and policies in place will operate these institutions.

The proposed S-Waqf sukuk will generate various benefits to society. It aims to help balance the Islamic economy, to enhance the efficiency of the non-profit sector and to help revive and apply the *Sunnah* of *qard al-hassan*. Moreover a successful issuance will set a standard for the development of new Islamic finance tools for the non-profit sector, the provision of secured infrastructure to globalize the *awqaf* industry and the development of a safe structure for private business to invest in the non-profit sector.

Table 1: Proposed World's First *Awqaf* Sukuk Structure – Smart Waqf (S-Waqf)

Awqaf Sukuk	Details
Name of Sukuk	*Adahi/Qurbani* ('Eid Sacrifice) Awqaf Farms Sukuk
Value of Sukuk	Multiple of US$ 100 or US$ 1,000 (subject to study)
Purpose	To purchase livestock farms initially in New Zealand (and other parts of the world later). The farms will be used to supply livestock to the *adahi (qurbani)* and relief industries
Reward/Return for the subscribers	Revival and development of the *Awqaf* sector around the world. The meat will be distributed to the poor and needy. There will be additional rewards gained by the donor from all other *Awqaf* projects established from utilizing the wool, skins, bones, and milk of the sacrificial animals. The infrastructure for processing of the by-products need to be setup and the capital raised from the issuance will go towards establishing the necessary infrastructure for a vertically integrated supply chain based on the highly developed NZ meat/livestock industry model. These include farms, abattoirs, milk, skin, wool processing factories etc. Some of the products that can be produced are blankets, clothing articles, carpets and winter products that demand a good price in the consumer markets in the western countries and also products for the relief industry. These are currently very profitable sectors within the industry. Further detail modeling will be done as part of the due diligence.
Proposed Issuance	100,000 *Awqaf* Sukuk — First Issuance (for a total potential value US$ 10 to US$ 100 million).

Source: Awqaf NZ

Figure 1: Benefits of S-Waqf Sukuk

Source: Awqaf NZ

CONCLUSION

For a successful issuance, Awqaf NZ relies on collaboration with leading development institutions. This will help to increase the global credibility of Awqaf NZ, to enhance its global awareness outreach, to encourage innovation in non-banking Islamic financial institutions, and to reveal the potential of minority Muslim communities in developing the Islamic economy. Nevertheless, since a structure like S-Waqf has never been accomplished before, more work is needed to define the proposed sukuk structure. ISRA will assess the sukuk structure with regards to the overall structuring of the *awqaf* sukuk and its Shariah compliance. The sukuk are expected to be issued in 2017.

SHABANA M. HASAN represents a new generation of Islamic economists in the making. She joined the International Shari'ah Research Academy for Islamic Finance (ISRA) as a researcher in December 2010. Prior to that, she had just completed an MSc in Islamic finance (with distinction) from the University of Durham, United Kingdom. She also holds a Diploma in Accounting and Finance from the Temasek Polytechnic, Singapore followed by a Bachelor of Economics (Hons) from the International Islamic University of Malaysia (IIUM). Presently, she is the Editor of ISRA Magazine named 'ISRA Islamic Finance Space' (IIFS) and a consultant with ISRA Consultancy Sdn. Bhd. She is also the youngest writer of the world's first comprehensive Islamic finance textbook, Islamic Financial System: Principles & Operations, and is also one of the writers of the world's first Islamic Capital Market — Sukuk textbook to be published by this year. In addition she is also one of the contributors in developing Shari'ah Guideline Frameworks for one of the regulators in Malaysia. In her young age, she has managed to contribute extensively in Islamic Finance through her regular writings featured in the Islamic Finance News (IFN), Business Islamica, New Horizon Magazine UK, The General Council for Islamic Banks and Financial Institutions (CIBAFI), Labuan IBFC and etc. She also has contributed regular writings on Islamic Finance to Berita Harian (BH) Singapura (Singapore Malay Papers). She was also an Islamic Finance news reader for Capital TV, Malaysia being the face for their Islamic Finance. Besides being an Islamic finance activist, she is also a Muslimah fashion figure in Malaysia and has featured in various Muslimah magazines for Muslimah fashion. She was also a TV personality in Malaysia

HUSAIN BENYOUNIS is one of the founders and the Secretary General of Awqaf New Zealand. His focus as Secretary General is to revive & increase the effectiveness of the role of the Islamic Waqf/Relief Industry in providing mechanisms and institutions for developing optimum use of the resources of charities for achieving self-sufficiency in accordance with Islamic Sharia. He is now working in Engineering the Awqaf Industry through the "Awqaf Sukuk". Model replication has been part of Awqaf engineering and therefore Husain has helped in setting up Awkaf Australia, Awqaf USA, Awqaf Fiji, Awqaf Canada & Awqaf UK. He represented Awqaf New Zealand to receive the first prize award in the Islamic Economy Award 2013 on the Awqaf category. He is now working towards establishing the Smart Waqf (S-WAQF) which he believes will be the communication platform between the Profit and Non-Profit sectors of the Islamic Economy.

MOHAMED NALAR is the Honorary CFO and Board member of Awqaf New Zealand. Nalar, is a Chartered Global Management Accountant (CGMA) and a Fellow of the Chartered Institute of Management Accountants (FCMA) UK. He has significant strategic financial management, business partnering and organisational performance management experience in both private and public sector environments in Sri Lanka, Saudi Arabia and New Zealand. Nalar is passionate about AWQAF and promoting the role of faith based communities towards the advancement of societies. He believes that it is time for Islam to take the lead in the global reform agenda during these regime shifting times that we are living in where the entire world is seeking answers to a number of critical challenges facing humanity. The key to success will be to work towards a unified and an integrated vision that needs to be underpinned by good and honest intentions, unity in our actions, combining our resources and an unconditional and relentless pursuit for excellence when it comes to commitment, performance and results.

THE KHAZANAH SUSTAINABLE AND RESPONSIBLE INVESTMENT (SRI) SUKUK

Dato' Mohd Izani Ghani

A Sustainable and Responsible Investment sukuk (SRI sukuk) is an innovative financial structure, recently regulated by the Malaysian Securities Commission, designed to drive private sector funding towards social service programmes while adhering to Islamic financial principles. Investors cover the up-front costs of such programmes, with the rate of return conditional upon its success. On 18 June 2015, Khazanah successfully issued the world's first Ringgit-denominated Sustainable and Responsible Investment sukuk ("SRI sukuk") of RM100 million. The proceeds from this seven-year sukuk issuance were used to fund the roll-out of 20 Trust Schools under Yayasan AMIR's ("YA") Trust Schools Programme for 2015. Yayasan Amir, a not-for-profit foundation incorporated by Khazanah, works to improve academic standards in Malaysian Government schools through a strategic partnership with the Ministry of Education. As of December 2015, there were 62 schools in the Trust School Programme.

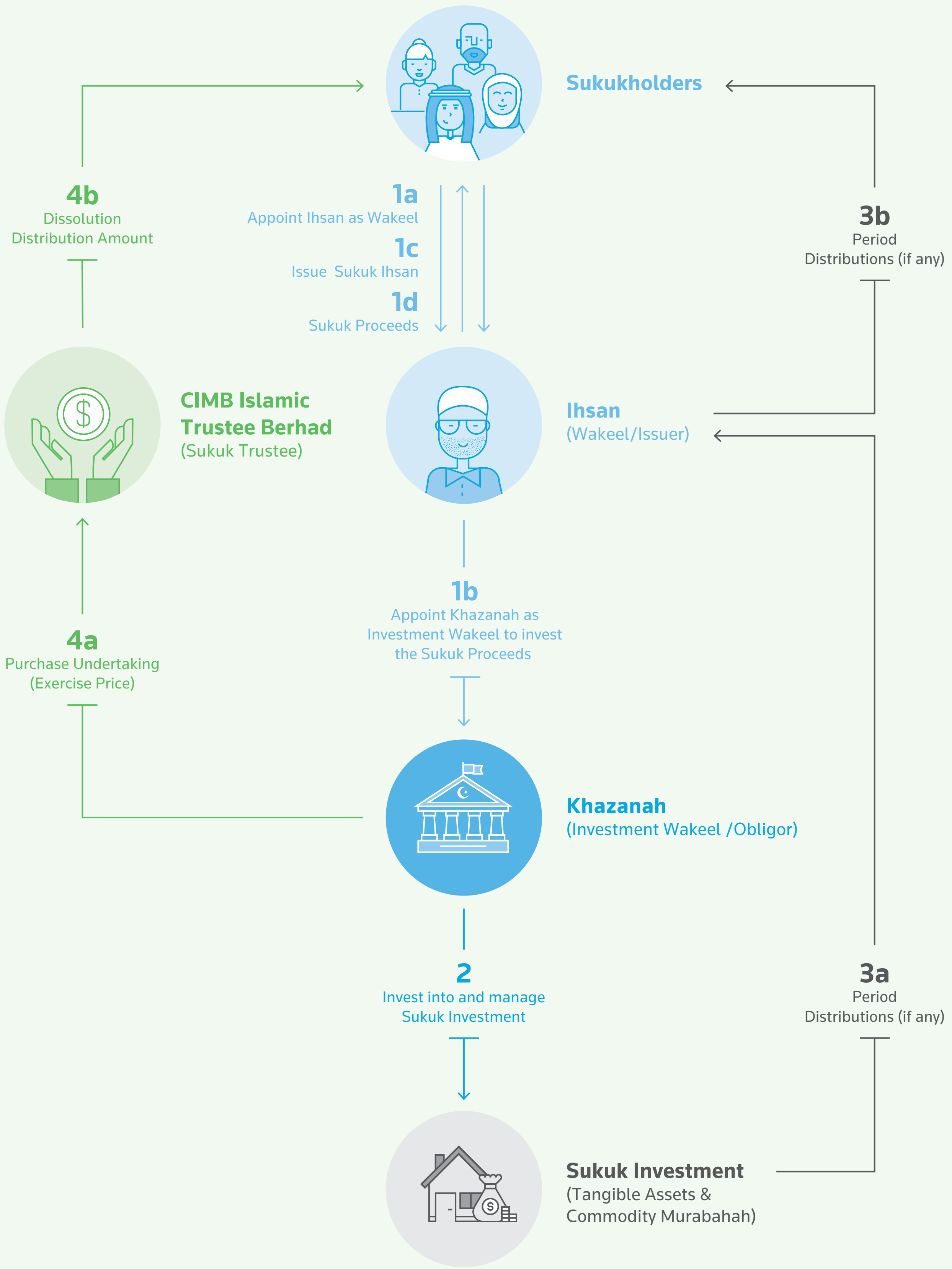
One of the unique features of the SRI sukuk is that its returns to investors are based on the success of the Trust Schools Programme in meeting a set of predetermined key performance indicators (KPIs). These KPIs cover four main areas: (i) minimum number of schools rolled out under the Trust Schools Programme, (ii) proficiency of the selected Trust Schools' teachers, (iii) proficiency of the selected Trust Schools' senior leadership team, and (iv) proficiency of the students, including set targets in relation to discipline, literacy and numeracy skills for the said students. The KPIs will be audited by an independent audit firm at the end of the fifth year and a report will be distributed to the Sukuk holders.

These KPIs are embedded into the financial mechanism of the sukuk. At issuance, Khazanah's sukuk was priced at the price guidance of 4.30% p.a. If the KPIs mentioned above are successfully met by the 2015 Trust School Programme at maturity, it will trigger a contribution in the form of a mandatory haircut of 6.22% on the principal repayment payable to the sukuk holders. However, if any of the KPIs are not met, sukuk holders will be entitled to the nominal value of the SRI sukuk in full. Sukuk holders also have an option to waive their rights, benefits, and entitlements under the SRI sukuk during the tenure of the sukuk. Pursuant to this, Yayasan AMIR, through Khazanah, will provide relevant tax vouchers to the relevant sukuk holders for an amount equal to the nominal amount of their sukuk holdings waived. The mandatory haircut and voluntary waiver are two channels for sukuk investors to recognize the positive social impact generated by Yayasan AMIR's Trust Schools Program for 2015.

A key catalyst for the establishment of the SRI sukuk programme was changes to the legal infrastructure in the Malaysian capital markets. In August 2014, the Securities Commission Malaysia ("SC") launched the Sustainable and Responsible Investment ("SRI") Sukuk framework to facilitate the financing of sustainable and responsible investment initiatives. The framework defines Shariah-compliant SRI projects as those that aim to:

- **a.** preserve and protect the environment and natural resources;
- **b.** conserve the use of energy;
- **c.** promote the use of renewable energy;
- **d.** reduce greenhouse gas emission; or
- **e.** improve the quality of life for the society.

Structure of Khazanah's SRI Sukuk



> *One of the unique features of the SRI sukuk is that its returns to investors are based on the success of the Trust Schools Programme in meeting a set of predetermined key performance indicators (KPIs).*

Khazanah's sukuk was the first SRI issuance to be approved under the SC's SRI sukuk framework. Using these guidelines, Khazanah was able to structure Malaysia's first social impact instrument based on the Islamic principle of *wakalah bi al-istithmar*. The structure, which allows for a combination of both tangible assets and commodities as the underlying security, is one of the Islamic structures approved by the SC's Shariah Advisory Council.

With social impact financing still being relatively new in the global capital markets, there is great potential for Malaysia to play a leading role in the SRI sukuk environment. Khazanah's inaugural SRI Sukuk issuance, which exemplifies the seamless integration of Shariah-compliant financing and socio-economic advancement, is a useful template. Similar to Khazanah's first exchangeable trust certificates in 2006, Khazanah supports the structure being replicated by other issuers for initiatives such as healthcare, affordable housing, and environmental conservation. Furthermore, this SRI sukuk will serve as a benchmark for other issuers tapping into both the Malaysian and international sukuk capital markets for socially responsible financing in the future.

Khazanah's first tranche offering of SRI sukuk in 2015 was a success, attracting a diverse investor base of asset management companies, banks, pension funds and foundations, among others. Building on this momentum, Khazanah is planning for future tranches to be available to retail investors, offering these investors the unique chance to earn healthy returns while contributing in a social cause. Although the issuance will present a new set of financial and legal challenges to be addressed, it will undoubtedly add a new facet to Malaysian capital markets and ethical financing. Bolstered by a strong local regulatory framework, supportive regulatory bodies such as the SC and Bank Negara Malaysia, and a market of increasingly conscientious investors, innovative issuers such as Khazanah are poised to further develop the unique value proposition of Islamic finance in SRI financing.

DATO' MOHD IZANI GHANI is the Chief Financial Officer/Executive Director of Khazanah Nasional Berhad (Khazanah). He was instrumental in establishing various Sukuk programs and landmark exchangeable Sukuk for Khazanah including the world's first exchangeable Sukuk in 2006. Dato' Mohd Izani Ghani graduated from London School of Economics (LSE), University of London in 1991. Thereafter he obtained his professional qualification from the Association of Chartered Certified Accountants (ACCA) and was conferred fellowship in 2000.

CROWDFUNDING FROM AN ISLAMIC FINANCE PERSPECTIVE

Hissam Kamal Hassan

INTRODUCTION

Business leaders[1] have heralded the current age as the beginning of a Fourth Industrial Revolution in which many services, including banking and finance, are being disrupted. This change is driven by recent advances in Big Data, artificial intelligence, and social networks. Most financial technology (FinTech), meanwhile, has been present for more than a decade. The ATM, credit card and internet banking transformed retail banking, while high-frequency trading, complex trading algorithms and dark pools are dominating present-day capital markets trading volumes.

Similarly, crowdfunding is not new. The direct solicitation of investment capital from the public enabled the First Industrial Revolution in the 18th to 19th centuries, as unregulated banking and capital markets grew exponentially in tandem with the growth in GDP of that era. The Great Depression of the 1930s introduced regulatory reforms that included outlawing unregulated crowdfunding. Investment and lending ceased to be peer-to-peer and regulated institutions were brought in to intermediate, ostensibly to address issues such as information asymmetry and financial illiteracy as well as fraud and herd-like irrational and destabilizing behavior. As regulation tends to be adapted to address prevailing circumstances, many of these 1930s regulatory reforms have since been dismantled, and the 2008 Global Financial Crisis sparked a new number of ongoing regulatory reforms. These recent reforms, coupled with advances in technology, are heralding a return to crowdfunding, among other disruptions in banking and finance.

Crowdfunding growth reported by platform operators[2] has been in the triple digits since 2009, with most activity occurring in the UK, China and USA in peer-to-peer (P2P) debt financing and re-financing (or marketplace lending) to both individuals and SMEs. The raising of equity through crowdfunding has been slower due to regulatory obstacles and the inherent riskiness of venture-type investing, although real estate-based crowdfunding has also witnessed rapid growth given the likely lower risk profile of this asset class.

CROWDFUNDING AND ISLAMIC PRINCIPLES

From a broad Islamic perspective, peer-to-peer (P2P) activity is undoubtedly encouraged. The groundbreaking Muslim initiative, A Common Word,[3] brought together diverse leading Muslim scholars to state, in simple terms, the fundamental role of the Golden Rule of " love thy neighbor" in the religion, alongside other tenets. Crowdfunding-enabled P2P finance activity has been observed to allow for greater communication, disclosure, transparency and hence trust between parties. This is in contrast to banking and intermediated capital markets, which functionally distance (and protect) depositors or investors from the user of funds. Thus, P2P crowdfunding potentially reintroduces *asabiyyah*[4] (social solidarity), which is necessary for a resilient economy.

CROWDFUNDING AND ISLAMIC CAPITAL MARKETS

It is well known that strengthening and deepening capital markets is a key economic strategy for developed and developing countries.[5] Research indicates that a diversification of funding sources adds to stability[6] but that an excessive finance sector dominated by a "rentier class"[7] becomes a drag on growth as well as a suboptimal allocation of resources.[8]

The traditional benefits of professional financial intermediation are that it leads to a greater concentration of financial literacy, resulting in a smaller number of intermediators to regulate. Despite this, professionally intermediated capital markets are not ideal, with numerous studies showing deficiencies in the key areas of efficiency, stability, transparency, equality and ethics.

Crowdfunding, with its use of technology and increased accessibility and disclosure, has the ability to potentially address these issues head-on. Through its reliance on P2P participation, it encourages the spread of financial literacy.

The dimension of crowdfunding that promotes greater social cohesion also contributes to a reduction in transaction costs, as crowdfunding encourages regular and direct communication through the platform and social media. For example, many crowdfunding portals provide basic education and some platforms (e.g. SyndicateRoom) highlight the activities of experienced senior investors so junior investors can potentially emulate best practices. In this way the 'wisdom of the crowds' [9] can be made to prevail over the potential 'madness of the crowds.'[10]

ISSUES TO BE ADDRESSED IN CROWDFUNDING FROM AN ISLAMIC PERSPECTIVE

Islamic crowdfunding platforms

The 2012 KL Declaration[11] stated "...risk sharing as a salient characteristic of Islamic financial transactions...". Many crowdfunding initiatives embrace this principle: equity crowdfunding and state-contingent debt finance[12] has been growing rapidly globally. Explicitly, Islamic crowdfunding is still extremely small, but is also gaining ground with the formation of an Islamic FinTech Alliance in 2016 and the Malaysian regulatory initiatives to promote equity and P2P crowdfunding, including the Islamic bank-led Investment Account Platform. However, debt-based crowdfunding for consumption purposes with risk-transfer[13] features remain a major part of nascent crowdfunding at present.

Increasing institutionalization of crowdfunding

Many platforms have grown in size by accepting institutional funds rather than receiving funds from the crowd. This has diluted the social feature of crowdfunding but has led to growth and greater acceptance by the wider public.

Very low levels of fraud to date

Although there have been some high-profile fraud cases in crowdfunding,[14] fraud levels have generally been very low. Many risk mitigation techniques have been successfully employed in crowdfunding, including inter alia, strict regulation of portals, requiring background checks, involvement of audit firms and other professional advisors, restricted marketing, investor limits, all-or-nothing campaigns, cooling-off and holding periods.

Islamic principles of regulating markets

The role of regulation and the structure of markets shape market behavior. The current regulatory regime of many capital markets is lacking with regard to some fundamental Islamic principles. For instance, one of the early acts of the first Islamic city-state in Madina in the 7^{th} century was to establish a new open market that neither levied taxes nor allowed permanent buildings.[15] Fair competition and low barriers to entry were key features and trade was to be conducted in the market (the meeting of suppliers at the outskirts of the market was prohibited). *Muhtasibs* (market inspectors) would consider the quality of goods, price discrimination (local/foreigner) and standard weight usage.[16] Newly introduced crowdfunding regulation tends to be overly complex and restrictive, such as rules barring larger companies from using crowdfunds, differentiating between accredited and retail investors and placing onerous obligations on operators. However, the regulatory sandbox approach (notably of the UK and Singapore) seems to lower barriers to entry and to promote innovation.

CONCLUSION AND FUTURE TRENDS IN CROWDFUNDING

The characteristics of crowdfunding are only starting to take shape. The near future will likely witness considerable development, especially given the advances in machine learning and artificial intelligence (e.g. in RoboAdvisors and RoboCompliance). This will likely lead to more diverse and innovative ways of raising capital based on revenue-sharing. A more Islamic approach to regulation is needed and Islamic finance jurisdictions must seize this opportunity to develop crowdfunding models relevant to their needs and compliant with their ideals. The progression from a less-developed or suboptimal capital market to one that is more advanced and facilitating need not be linear in nature — developmental leaps should be, and have been, made.

NOTES:

1 The influential World Economic Forum held in Davos-Klosters in January 2016 was on this theme.

2 Platform operators manage the interface between the individuals and organisations raising capital and those contributing funds (public and institutional). They typically showcase the capital raising opportunity through the Internet and also perform checks ranging from basic compliance services (e.g. KYC and AML), to more sophisticated credit-scoring/rating and due-diligence.

3 "A Common Word Between Us and You 5-Year Anniversary Edition" 2012. The Royal Aal Al-Bayt Institute for Islamic Thought. Amman, Jordan. The 2007 document has since been endorsed by many leaders of major world religions, traditions and ideologies.

4 As described by the great 14th century historian Ibn Khaldun in The Muqaddimah.

5 Stiglitz, J.E. (2004). Capital Market Liberalisation, Globalisation and IMF. Oxford Review of Economic Policy, 20 (1): 57–71.

6 Hawkins, J. (2002). Bond markets and banks in emerging economies. BIS papers, 11, 42-48.

7 Keynes, J. M. (1936). The General Theory of Employment, Interest and Money. London. Macmillan.

8 Stiglitz, J.E. (2000). Capital Market Liberalisation, Economic Growth, and Instability. World Development, 28 (6): 1075–86; Cecchetti, S. G., Kharroubi, E. (2014). Why does financial sector growth crowd out real economic growth? Bank for International Settlements Working Paper No 490 (February 2015)

9 Surowiecki, J. (2005). Wisdom of Crowds. New York, Knopf Doubleday Publishing Group

10 Shiller, R. J. (2005). Irrational exuberance. New York. Random House LLC.

11 The Kuala Lumpur Declaration was made by leading figures in the Islamic Finance Industry at Strategic Roundtable Discussions jointly organised by IRTI of the IDB Group, Durham University and ISRA held on 20 September 2012.

12 A number of marketplace lending portals have developed revenue-sharing financing, eg. List71.com, Startwise.com

13 The 2012 KL Declaration also states that "...Risk transfer and risk shifting in exchange contracts violate the Shari'ah principle that liability is inseparable from the right to profit..."

14 Notably, it was reported in February 2016 that Ezubao, a large Chinese P2P lending company, had committed fraud with most listings being fake, defrauding hundreds of thousands of investors of billions of Renminbi.

15 Kister, M. J., (1965). 'The Market of the Prophet' Journal of the Economic and Social History of the Orient 8 (1965): 272-76.

16 Kallek, C. (1996). Socio-Politico-Economic Sovereignty and The Market of Medina. International Journal of Economics, Management and Accounting, 4(1&2).

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Dome of the mosque, oriental ornaments from Isfahan, Iran.

ADDITIONAL TIER ONE SUKUK SHOW THE WAY TO THE FIRST CONTINGENT CONVERTIBLE (COCO) SUKUK ISSUANCE

Blake Goud and Redha Al Ansari

The market for contingent convertible (CoCo) bonds has grown since they were first introduced after the Global Financial Crisis in anticipation of Basel III rule changes that raise minimum capital requirements and limit the use of 'old' Tier 1 hybrid bonds.

The first CoCo bond was issued in 2009, and there has been more than $300 billion in issuance of CoCo bonds since then. A little more than half of these bonds allow regulators to write down the principal, and the remainder automatically convert into common equity upon 'trigger' events such as a low capital ratio.[1] Despite growth in the issuance of conventional CoCos, Islamic banks raising capital through sukuk have not yet used CoCo-type structures, although many Tier 1 sukuk use similar 'alternate' structures.

The CoCo bond is designed to address the situation facing many regulators during the financial crisis where the process of writing down debt would have taken longer than the time available to contain the immediate crisis. This presented regulators with the unappealing choice of pushing a bank into a disorderly bankruptcy or injecting public money to avoid contagion.

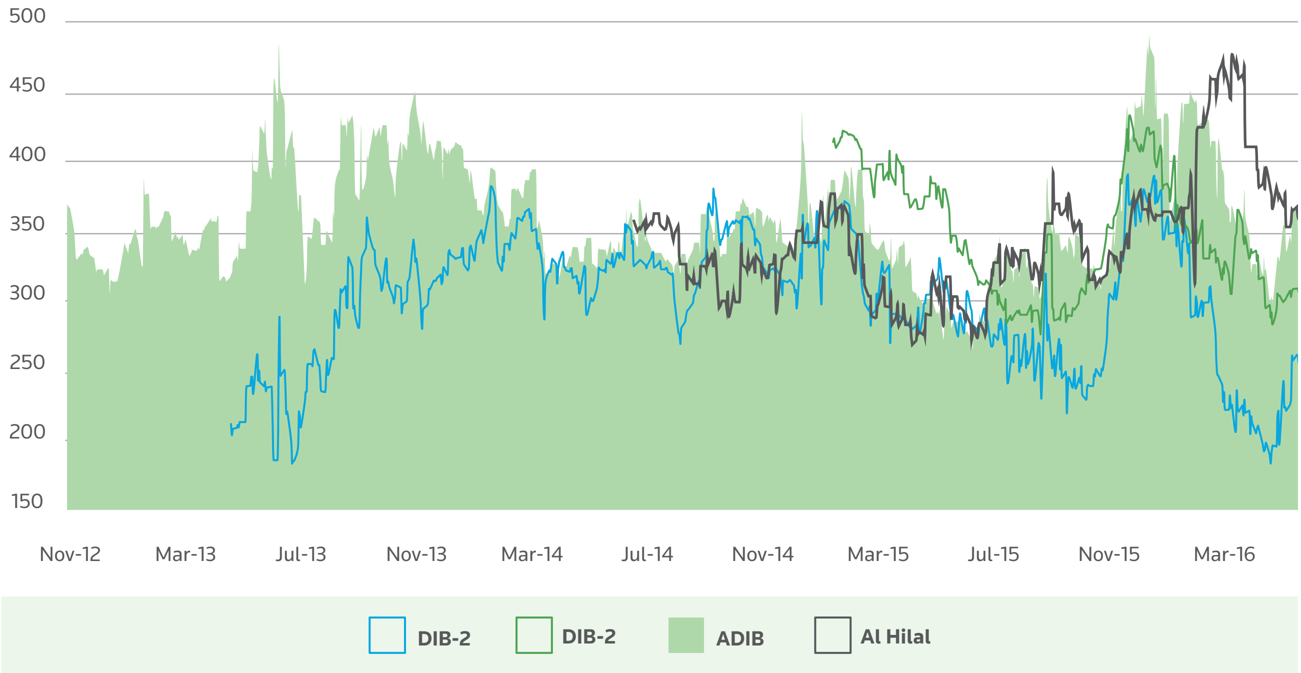
The distinguishing characteristic of a CoCo bond is that it may either be written down or converted into equity when the bank that issued it runs into financial difficulty, before any taxpayer financing is provided. The trigger for the write-down or conversion is either a determination by the bank's regulator or a quantitative trigger based either on book values (for example, the bank's Common Equity Tier 1 (CET1) capital ratio) or market values (the value of its common equity relative to its assets).[2]

The Basel III reforms provided a third option, whereby financing provided in the form of Additional Tier 1 (AT1) non-CoCo issuance could act as capital to be used as a cushion, adding to common equity or absorbing losses and reducing contagion during a crisis. On the basis of the 'risk-sharing' principles of Islamic finance and sukuk in particular, this structure should be theoretically appealing to Islamic financial institutions.

However, this largely has not come to pass. No sukuk currently issued can fully be considered CoCo sukuk. There has been some development of similar AT1 sukuk that are compliant with Basel III that were issued to raise capital levels to support anticipated future asset growth. The first two were issued by Abu Dhabi Islamic Bank and Dubai Islamic Bank, and most of the issuance to date has come from the UAE. Qatar Islamic Bank issued one in July 2015, Saudi Arabia saw a similar issuance from National Commercial Bank in December 2015 and Boubyan Bank is finalizing its issuance of an AT1 sukuk in May 2016. [3]

Below is a chart showing the relative spreads of the AT1 sukuk, which trade with a 300-300bps spread relative to the sovereign debt of Dubai or Abu Dhabi (for DIB and ADIB/Al Hilal, respectively). The spread is relatively wide due to the subordinated, equity-like features of the AT1 sukuk but has held at a relatively consistent level despite fears of a future rise in impaired financing driven by lower oil prices. Although the average spread has remained at a similar level, the volatility has increased as oil prices fell.

Figure 1 : Additional Tier 1 Sukuk Spread



Source: Thomson Reuters EIKON and authors' analysis
Note: In the chart above, the yield on the AT1 sukuk are taken and the yield on the comparable maturity government security (actual or extrapolated) for Abu Dhabi (Abu Dhabi Islamic Bank and Al Hilal Bank) or Dubai (Dubai Islamic Bank) is subtracted. The maturity date is assumed to be the year of the first call date. The securities used for comparison are Dubai Department of Finance (DOF) 2017 Sukuk, Dubai 2020 Bond, Abu Dhabi 2019 Bond, International Petroleum Investment Company (IPIC) 2017 Bond.

The general characteristics in the AT1 sukuk that align with the characteristics found with CoCo bonds are:

- they are perpetual issues (though most may be called after five years); and
- distributions are non-cumulative and may, at the discretion of the issuer, be skipped without triggering default.

The primary missing feature is the explicit conversion or write-down feature which, in some respects, is included as part of the point of non-viability (PONV) trigger common to all Tier 1 and Tier 2 bonds and sukuk.[4] Within the conventional CoCo issuance trends, there was a shift towards new bonds qualifying as AT1 capital beginning in 2012 as the Basel III implementation process was set to enter the beginning of the phase-in on January 1, 2013.[5]

For a financial institution to issue CoCo sukuk, it would likely start with the AT1 sukuk structure which is a *mudarabah* based on what is effectively a pro rata share of the bank's entire asset base.[6] On this structure, the bank would then have to add a conversion feature to allow the entire sukuk to have a mandatory conversion into equity.

There have been a number of convertible sukuk (where the sukuk is convertible into shares of the issuer) and exchangeable sukuk (where the sukuk can be exchanged for shares of a company owned by the issuer). However, in these cases, the conversion feature is generally designed to be economically beneficial, which helps the functioning of the conversion feature. The challenge with the conversion feature for CoCo sukuk, in contrast, is identifying a structure to:

1. Make it mandatory in a situation where the economic terms being offered are not economically preferable for the investors; and
2. Setting a fixed conversion price in advance to be tied to either the CET1 ratio or equity market capitalization to total assets.

These structural challenges, as well as challenges relating to pricing, have so far inhibited any CoCo sukuk issuances. However, with the volume of AT1 sukuk increasing, there may be an opportunity coming for an issuer to use a CoCo structure, particularly in jurisdictions where the Basel III implementation is moving forward like Saudi Arabia which is already compliant,[7] the UAE where the central bank has been working to implement Basel III during 2016,[8] and Kuwait which expects to be Basel III-compliant by the end of 2016.

NOTES:

1 Vallée, Boris. "Contingent Capital Trigger Effects: Evidence from Liability Management Exercises," Working Paper, http://www.hbs.edu/faculty/Publication%20Files/CallMeMaybe_Dec15_44855cde-b073-4003-b04e-d8f17fadf595.pdf

2 Avdjiev, Stefan, Anastasia Kartasheva and Bilyana Bogdanova. "CoCos: A primer," *BIS Quarterly Review*, September 2013, 43-56. http://www.bis.org/publ/qtrpdf/r_qt1309f.pdf

3 Narayanan, Archana. "Qatar Islamic Bank raises 2 billion riyals with Tier 1 sukuk," *Reuters*, July 1, 2015. http://www.reuters.com/article/qib-sukuk-idUSL8N0ZH0IJ20150701

4 Paul, Katie. "Saudi's National Commercial Bank (NCB) says settled issuance of 2.7 bln riyal sukuk," *Reuters*, December 23, 2015. http://www.reuters.com/article/nationl-comml-bk-sukuk-idUSL8N14C1Z920151223

5 Roy, Sudip. "Kuwait Boubyan Bank tightens guidance on $250 mln sukuk," *Reuters*, May 9, 2016. http://www.reuters.com/article/boubyan-bank-sukuk-idUSL5N18658J

6 Avdjiev et al. (2013).

7 Bank for International Settlements. (2013). "Basel III phase-in arrangements," http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf

8 For example, ADIB's 2012 AT1 sukuk offering document describes the mudaraba assets as (emphasis added): "ADIB shall be granted the express entitlement to commingle its own assets with the Mudaraba Assets and as a result, it may not be possible to identify the Mudaraba Assets separately from the assets of ADIB."

9 http://www.bis.org/press/p150930.htm

10 http://www.reuters.com/article/emirates-basel-idUSL8N13Y20L20151209

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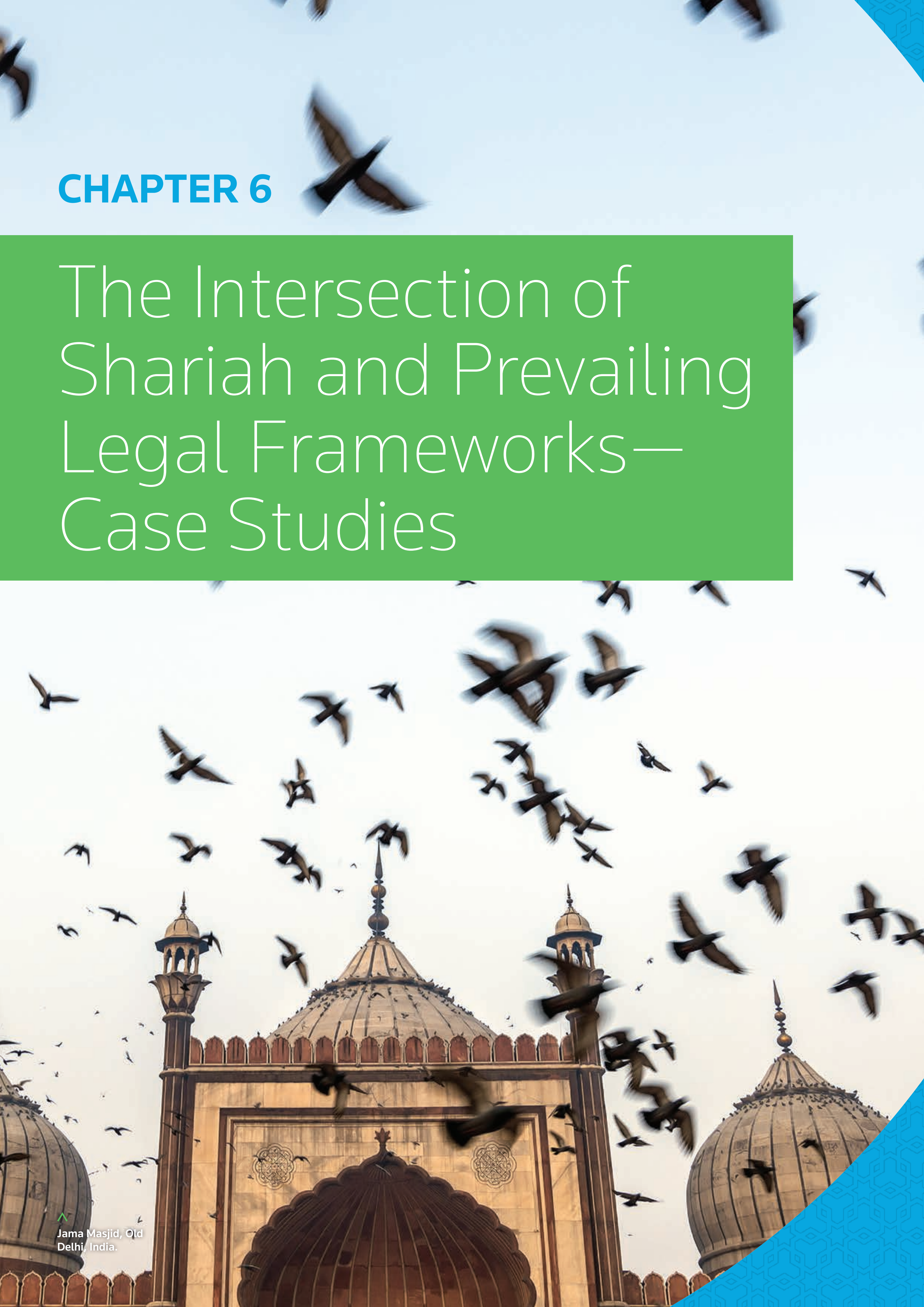
REDHA AL ANSARI is currently leading the Islamic Capital Markets team in Thomson Reuters covering Islamic economies, sukuk, liquidity management, Islamic funds, and equities. Redha has authored a number of books and wrote many papers on key trends in Islamic capital markets, in addition to advising governments, financial institutions and investors on potential markets for sukuk issuance and investments. Prior to joining Thomson Reuters, Redha worked at the Islamic International Rating Agency to look after financial institution and sovereign ratings. Before that, he worked at Arab bank in risk management. Redha holds a Master degree in Business Administration (MBA) from New York Institute of Technology and a bachelor degree in Finance from University of Louisiana at Lafayette, USA.

Sancaklar Camii, Istanbul, Turkey. Aivita Arika / Shutterstock.com

CHAPTER 6

The Intersection of Shariah and Prevailing Legal Frameworks— Case Studies



Jama Masjid, Old Delhi, India.

Summary

Although developing and standardising Shariah has dominated the global conversation in the Islamic capital markets, perhaps the greater part of day-to-day work for Islamic finance professionals in individual jurisdictions has been interfacing with conventional financial regulations and competing with conventional institutions. Islamic finance has made huge strides in this area in the past decade, despite the dominant position of conventional finance, persuading regulators to reshape the landscape with regards to disclosure, taxation, marketing and a host of other issues. Although much work remains to be done, different jurisdictions have learned by taking examples from each other, and experts are optimistic that new solutions are being crafted every year.

In Malaysia, the Securities Commission has launched an effort since the 2008 global financial crisis to enhance disclosure requirements while streamlining the bureaucracy behind the approval of new Islamic capital markets products. It has also committed more resources to investor education and alternate dispute resolution. Malaysia is also continuing to develop Islamic financial regulations at its Labuan International Business and Financial Centre, an offshore special economic zone that listed the world's first sovereign sukuk in 2002.

The GCC countries have seen an increasing volume of Islamic capital market activity, and have adjusted their regulations to encourage it further. After a surge of sukuk issuances in the UAE prior to the financial crisis, there has been a lull in part because of the 2009 Dubai World sukuk default. The regulator has responded by creating new regulations for bankruptcy protection and restructuring fixed income instruments. Earlier this year, the government approved a new Shariah authority to oversee the entire financial industry. In Oman, the Capital Market Authority has issued its first dedicated sukuk regulatory framework, which governs the use of an SPV, prospectus details, and a new bond and sukuk market at the Muscat Securities Market.

At the forefront of socially responsible investing (SRI), the International Finance Facility for Immunisation has expanded its program of sukuk that provide vaccinations to needy areas worldwide, at a competitive profit rate, backed by long-term pledges from nine nations. While in Malaysia, Khazanah has issued a sukuk under new SRI regulations which was fund a charitable educational initiative in interestingly the return to investors is dependent on key performance indicators; a lower return in the case these indicators are met. Such approach is intended as a motivational factor for the program.

Developing better comparative benchmarks as alternatives to conventional financial products is also on the agenda for Islamic finance professionals. Propose the benefits of using an Islamic Interbank Benchmark Rate rather than a conventional rate like LIBOR for pricing Islamic finance products, which provide a better reflection of Islamic banks cost of funding. Credit rating agencies still struggle to create comparable scores for conventional and Islamic fixed-income instruments, but it is hoped that the increase in volume and the standardization of sukuk contracts will aid the production of reliable ratings.

BUILDING A ROBUST INVESTOR PROTECTION REGULATORY FRAMEWORK: THE CASE OF MALAYSIA'S ISLAMIC CAPITAL MARKET

Dr. Noor Suhaida Kasri

Malaysia's Islamic capital market (ICM) has shown tremendous growth in recent years. By the end of 2015, its market value has reached RM1.70 trillion in size, which represents 60% of the entire Malaysian capital market. This expansion is driven mainly by the sukuk market and the Islamic fund management industry. Growth occurred despite the challenges faced by the market, namely the uncertainties emanating from the divergence of monetary policies in advanced economies, the impact of prolonged low commodity prices, and concerns over a structural slowdown in key emerging market economies.[1]

To foster a systemic, resilient, healthy and long-term growth of the market, the Malaysian capital market regulator, Securities Commission Malaysia (SC Malaysia), undertakes necessary regulatory measures. Among the most notable measures is ensuring that the public trust and investor confidence are safeguarded at all times. This objective is in line with the finding of a collaborative assessment exercise carried out by the Islamic Financial Services Board (IFSB), the International Organization of Securities Commissions (IOSCO) and the SC Malaysia in 2008. The assessment reveals the compatibility of IOSCO Core Principles with Islamic securities market though the application may warrant further consideration of specificities of Islamic securities products and practices. It also reveals the dire need for the regulators to develop disclosure regulatory standards and best practices for these products.

On that premise, this article attempts to analyze the key regulatory initiatives undertaken by the SC Malaysia. In implementing the investor protection regime, the approach taken by the SC Malaysia is to apply the same legal framework on Islamic and conventional ICM products unless it is specifically mentioned otherwise.

KEY REGULATORY INITIATIVES

The 2008 global financial crisis has reinforced the importance of robust disclosure rules and transparency to mitigate systemic risk to global regulators. Realizing that transparency and disclosure is the lynchpin of an effective capital market, the SC Malaysia took a more proactive approach to investor protection by introducing a number of important investor protection regulations and guidelines.[2]

To encourage and promote market and product innovation, market efficiency and to allow more informed investment decisions, the Capital Markets and Services (Amendment) Act 2012 (2012 Act) was passed. Under the 2012 Act, a new approval framework was introduced as part of the regulatory reform. It distinguishes between listed and unlisted capital market products based on their distinctive characteristics and risk profiles, and it applies the appropriate level of regulation for the risk element involved. This initiative allows investors to benefit from a wider array of investment options that matches their investment profiles and risk appetite. The *Guidelines on Sales Practices of Unlisted Capital Market Products* was also introduced to promote responsible conduct in the development and sale of unlisted capital market products. These guidelines provide investors with access to quality advice and require a

Product Highlight Sheet to be given to investors at the point of sale, through which investors are able to make product comparison and more informed investment decisions.[3]

Additional disclosure requirements have been introduced in the case of ICM products like sukuk. In 2015, the SC Malaysia issued two guidelines, *Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework* (LOLA Framework) and *Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors*. Both guidelines have specific provisions for Shariah disclosures, which require among others, the issuance of a detailed Shariah pronouncement on the sukuk structure. In particular, the pronouncement must include (a) the basis and rationale of the pronouncement, structure and mechanism of the sukuk, (b) the applicable Shariah rulings, principles and concepts used in the sukuk; and (c) the relevant Shariah matters relating to the documentation of the sukuk.

The LOLA Framework is a major reform introduced by the SC Malaysia affecting the products approval regime. It seeks to balance business efficiency and investor protection. The LOLA Framework applies to unlisted capital market products (which includes sukuk) that are offered to sophisticated investors only (such as accredited investors and high-net-worth entities and individuals). It permits wholesale products[4] to be launched once the required information is lodged with SC Malaysia. Product issuers do not have to seek SC Malaysia's prior approval before making available their products to investors—a process that took 14-21 days under the previous regime.[5] The new law ensures the protection of investors despite the fact that product approval is not required before the launching of capital market products. This is done through the ongoing post-lodgment monitoring by the SC Malaysia, based on the analysis of information submitted by product issuers. Thus the timeline stipulated in the LOLA framework for the submission of the required documents and information is strictly enforced by SC Malaysia. A daily penalty of RM1,000 is imposed for any delay. The onus is therefore on the party that lodges the relevant information and documents with the SC Malaysia to ensure that the disclosure document provided to the investor is reliable, complete and accurate. In this regard, issuers and advisers are expected to conduct the required due diligence to ensure accuracy and completeness of information lodged.[6]

Another regulatory initiative in 2015 was the Capital Markets and Services (Amendment) Act 2015 (CMSA Amendment) and Securities Commission (Amendment) Act 2015 modifying the Capital Market and Services Act 2007. The aim of these amendments was to facilitate innovative fund-raising structures, to enhance investor protection, to clarify responsibilities of issuers and advisors and to expand the scope of SC Malaysia's supervisory power. Importantly, the CMSA Amendment introduced a new recognized market framework to facilitate the establishment of alternative trading platforms including equity crowdfunding (ECF). As a result, by the end of 2015, SC Malaysia approved six crowdfunding operators, including one Shariah operator.[7] This makes Malaysia the first country in the Asia Pacific region to legislate ECF. These operators are subjected to the Guidelines on Regulation of Market under Section 34 of the Capital Market and Services Act 2007 (ECF Guidelines). The ECF Guidelines ensure that the operators have the ability to operate an orderly, fair and transparent market. The guidelines require the operator to have a strong governance structure, while imposing a requirement to ensure issuers compliance with platform's rules and processes. This ensures that investors' funds are safeguarded until the funding goal is met.[8]

EFFECTIVE INVESTOR EDUCATION AND DISPUTE RESOLUTION

Investor education is another important tool in empowering and enabling investors particularly retail investors, in making informed decision in a market place. In this respect, the SC Malaysia initiated InvestSmart, a three-year strategy for investor education and empowerment in 2014. InvestSmart addresses the issue of financial illiteracy and gaps in investors when faced with complex investment products. The positive effect of investor education is seen from the reduced number of complaints and enquiries received by the SC Malaysia. In 2015, the SC Malaysia received a total of 349 complaints, compared to 516 in 2014. 139 files were opened, and the majority of them related to allegations of improper practices in securities dealing and improper conduct by publicly listed companies and/or their directors. Meanwhile, 22% of the complaints related to poor or misleading disclosure of information by the company.[9]

As part of the investor protection ecosystem, the Securities Industry Dispute Resolution Centre (SIDREC) was established in 2010 under the Capital Market and Services (Dispute Resolution) Regulations 2010. SIDREC provides a free platform for the mediation and adjudication of disputes. As of September 2016, investors of capital market products or services offered by or through the Central Bank of Malaysia regulated commercial banks and Islamic banks can now access SIDREC for its dispute resolution services.[10] Another essential component is the Capital Market Compensation Fund established under the 2012 Act. It widened the scope of compensation to include private retirement schemes as well as claims arising from fraud, defalcation or mis-selling of products. This initiative improves administrative efficiency and makes recourse for compensation simpler for investors.[11]

THE WAY FORWARD

These regulatory initiatives demonstrate the commitment of Malaysia to ensure that regulatory developments in the ICM continue to be closely aligned with international best practices and standards. The strengthening of the regulatory framework together with the increase in investor confidence have indeed contributed to the consistent and steady growth of Malaysian Islamic capital market. This is apparent in the growth of its market value from RM 1.07 Trillion in 2010 to RM 1.70 Trillion in 2015, highlighting Malaysia as a global leader in the Islamic capital industry.

Notes:

1 Securities Commission. (2015a). Securities Commission Annual Report 2015, http://www.sc.com.my/wp-content/uploads/eng/html/resources/annual/ar2015_eng/scar2015_eng.pdf (accessed 7 July 2016).

2 Mahmood, Nik Ramlah. (2013). Developing a Platform for Consumer Protection in the Islamic Financial Services Industry. Kuala Lumpur: Islamic Financial Services Board.

3 Securities Commission Malaysia. (2013), http://www.sc.com.my/post_archive/capital-market-laws-amended-to-drive-innovation-and-promote-market-efficiency/ (accessed 7 July 2016).

4 'Wholesale products' under the LOLA Framework refers to unlisted capital market products comprising of wholesale funds, structured products, bonds, sukuk and asset-backed securities, which are offered to sophisticated investors only.

5 Securities Commission. (2015). The Reporter. January-August 2015, Volume 5 No. 1, http://www.sc.com.my/wp-content/uploads/eng/html/resources/reporter/reporter_2015_12.pdf (accessed 7 July 2016).

6 Ibid.

7 http://www.sc.com.my/wp-content/uploads/eng/html/icm/15_12_31_msianicm.pdf, p. 7.

8 Securities Commission. (2015). Securities Commission Annual Report 2015, http://www.sc.com.my/wp-content/uploads/eng/html/resources/annual/ar2015_eng/scar2015_eng.pdf (accessed 7 July 2016).

9 Ibid.

10 See SC Malaysia press release, 5 September 2016, https://www.sc.com.my/post_archive/commercial-and-islamic-banks-to-join-as-sidrec-members-under-enhanced-dispute-resolution-framework/

11 Securities Commission Malaysia. (2013), http://www.sc.com.my/post_archive/capital-market-laws-amended-to-drive-innovation-and-promote-market-efficiency/ (accessed 7 July 2016) and Securities Commission. (2015a). Securities Commission Annual Report 2015, http://www.sc.com.my/wp-content/uploads/eng/html/resources/annual/ar2015_eng/scar2015_eng.pdf (accessed 7 July 2016).

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An investor monitors share market prices in Kuala Lumpur, Malaysia. REUTERS/ Olivia Harris.

UAE: YOUNG, YET GROWING ISLAMIC CAPITAL MARKETS

Abdulaziz Goni

Although relatively young compared to their counterparts in Asia, the capital markets of the United Arab Emirates (UAE) have witnessed phenomenal growth in the years since their inception. The Dubai Financial Market (DFM) and Abu Dhabi Securities Exchange (ADX) were both launched in 2000 as the nation's first trading platforms. A decade later, Dubai International Financial Exchange (DIFX) was established to provide the UAE a forum to make listings in the international markets; it was later renamed as Nasdaq Dubai.

REGULATORY AUTHORITY FOR ISLAMIC CAPITAL MARKET IN THE UAE

The regulator for sukuk in the UAE is the Securities and Commodities Authority (SCA). The SCA first approved and issued sukuk regulations in 2005. Among the salient features of these regulations is the classification of sukuk as an ownership tool, not as debt financing. Prior to listing, a sukuk issuance must be approved by the Shariah committee of the issuer; the minimum value of a listed sukuk had been AED 50 million. A revision of the SCA law in 2014 saw this minimum amount reduced to AED 10 million to encourage corporate issuances in the Emirates. Prior to 2014, the vast majority of sukuk issued within the UAE were either sovereign or quasi-sovereign. Unlike other jurisdictions, sukuk issued by UAE companies must be listed on an exchange in the UAE. As of 2015, the principal market for debt issuances in the UAE, Nasdaq Dubai, had a total value of $36.7 billion in listed sukuk both matured and outstanding, while Malaysia was in second place with a value of $26.6 billion.1

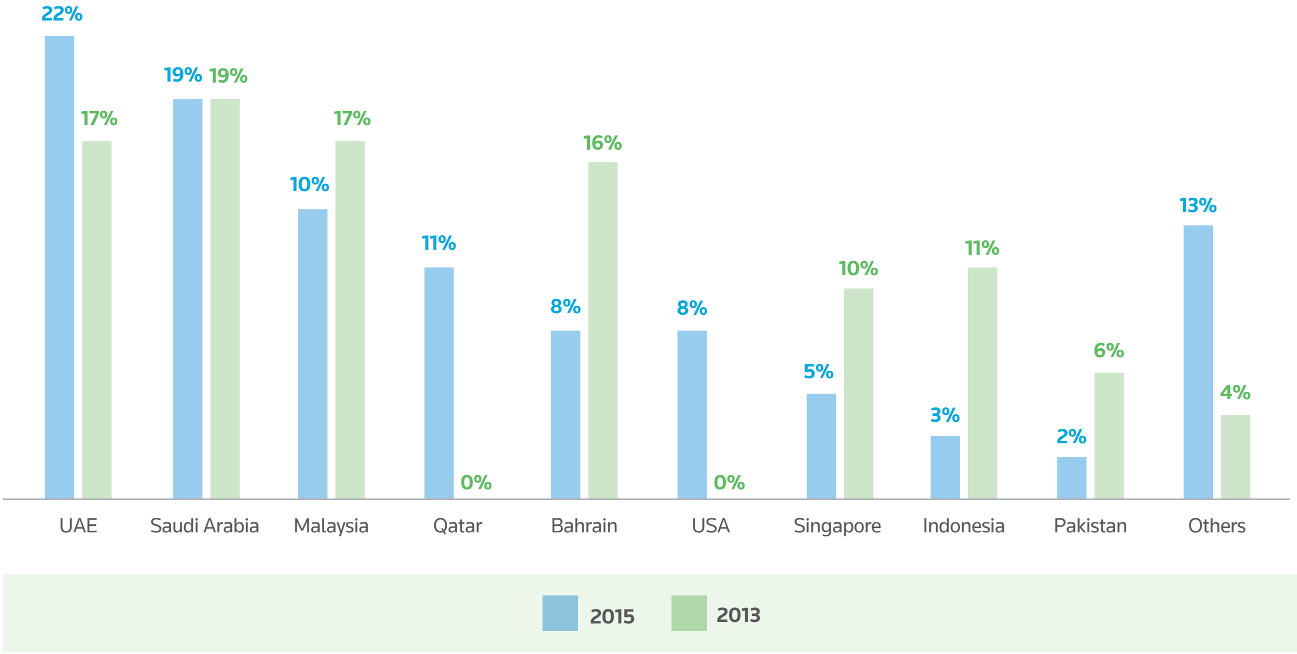
Other significant regulatory requirements on sukuk include:

1. Listed sukuk can be traded and cleared either inside or outside the market but must follow strict market procedures.
2. Any trading of listed sukuk conducted outside the market must be recorded and the specific purpose and tenure for the sukuk issuance must be clearly identified.
3. Any sukuk trading conducted outside the market shall be null and void if market procedures are not adhered to.
4. Entities that wish to issue retail sukuk in the UAE must be established within the UAE and outside of a financial free zone.

INSTRUMENTS IN THE UAE ISLAMIC CAPITAL MARKETS

According to the Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016 report, investors and issuers have a strong preference for the UAE as a location for sukuk issuance and investment, because of its flexible regulations for sukuk issuance. In the Q3 of 2015, the UAE has issued $4.7 Billion worth of sukuk. According to Nasdaq Dubai, 56% of Dubai's listed sukuk are from UAE issuers while 22% are from Saudi Arabia. A significant number of large sukuk have been issued out of the UAE. Among the most recent issuers is DP World, which listed a $1.2 billion sukuk with a seven-year tenure in 2016. This recent issuance follows DP World's most successful refinancing of $1.1 billion of an existing $1.7 billion sukuk that will mature in 2017. The first DP World

Figure 1: Survey Findings: Country Preference 2013 vs 2015



Source: Thomson Reuters Barwa Sukuk Perceptions and Forecast 2016

sukuk had the longest tenure in the region[2] of 10 years, which will mature in 2017.

After the revision of the minimum issuance amount, there has been an increase in the number of issuances from Islamic financial institutions in the UAE. Islamic banks, in an aim to increase their liquidity, frequently issue sukuk in the Emirates. Notable recent issuances are the Dubai Islamic Bank issuance of $750 million, which is the fourth issuance the bank has made between 2013 and 2016, as well as Noor Bank, which made a debut issuance of $500 million, the first sukuk to be issued in the UAE in 2016.

One of the first sukuk issued in the UAE was in 2007 by Jebel Ali Free Zone FZE (JAFZ), worth $2.04 billion, which was rated A1 by Moody's with a tenure of five years.[3] Another notable issue was the quasi-sovereign sukuk with a three-year tenure issued by Nakheel group in 2006, valued at $3.52 billion. Although a quasi-sovereign sukuk, the Nakheel sukuk was explicitly guaranteed by Dubai World, the holding company of Nakheel, and not by the Dubai government. This was the shortest tenure for a sukuk issuance in the GCC with such a high value, and it was noted as being the largest sukuk issuance in the history of Islamic banking prior to 2006. The sukuk had an *ijarah* structure, with the proceeds to be used in real estate development projects in Dubai.

In 2008, Nakheel issued a second three-year tenure sukuk worth $750 million using the same *ijarah* structure. In 2009 Dubai World announced that it would not be able to meet its repayment obligations. This was partly due to the financial downturn in 2008 that was affecting global markets. This adversely affected financial markets in the UAE and was a huge blow to the UAE Islamic capital market. The key issue with the Nakheel default was the lack of a well-established special purpose vehicle to guarantee investors in the event of a default and the clear disconnect between Dubai World holdings and the Dubai government in terms of guaranteeing the reimbursement of investment funds to certificate holders. Since the default, the UAE Central Bank and the SCA have been working on new methods of reviving investor confidence in the UAE Islamic capital market by setting out new regulations to allow for bankruptcy protection and guidelines on restructuring for bond and sukuk issuers.

RECENT DEVELOPMENTS ON THE REGULATORY STRUCTURE OF ISLAMIC CAPITAL MARKETS IN THE UAE

In May 2016, the UAE Cabinet and the Central Bank of the UAE approved the introduction of a centralized Shariah authority to oversee the overall Islamic banking industry in the UAE. Prior to this, the UAE had a decentralized structure of Shariah compliance, with most Shariah approvals being conducted by the Shariah boards of individual institutions. This gave rise to inconsistencies and conflicts of interest, and uncertainty among investors. The centralized Shariah authority was established after requests by Islamic financial institutions to UAE regulators for a Shariah authority at a federal level to work with corporate Shariah boards to ensure a transparent Shariah compliance process in the Emirates.

> *The centralized Shariah authority was established after requests by Islamic financial institutions to UAE regulators for a Shariah authority at a federal level.*

The launch of the centralized Shariah authority follows Malaysia's centralized Shariah Advisory Council of Bank Negara Malaysia. This new Shariah authority will review and approve products that are to be introduced into the UAE Islamic financial markets and will aid in maintaining uniformity in Shariah compliance standards across the UAE. This new Shariah authority is viewed as a step towards reviving investor confidence in the UAE Islamic capital market, as well as being a central body that aims to resolve disputes and to increase sukuk demand and issuances in the nation. The establishment of the central Shariah authority is a significant step forward in Sheikh Mohammed Bin Rashid Al Makhtoum's vision into making Dubai the capital of the Islamic economy.

NOTES:

1 http://www.nasdaqdubai.com/products/dubai-tops-sukuk-listing

2 http://web.dpworld.com/wp-content/uploads/2016/05/2016_05_29_Sukuk-Announcement_Eng.pdf

3 http://www.nasdaqdubai.com/press/jebel-ali-free-zone-fze-lists-its-first-sukuk-of-7-5-billion-dirhams-on-difx

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The Gate of Dubai International Financial Centre, Dubai, UAE. Philip Lange / Shutterstock.com

THE USE OF CONVENTIONAL RATING METHODOLOGIES FOR SUKUK

Khalid Ferdous Howladar

Islamic finance passed a landmark in 2014, when it transitioned from a niche market, with sukuk issuances solely from Islamic financial institutions and Muslim nations, into a broader financial market with an increasing number of non-Islamic participants. Over the past two years, we have seen prominent sukuk activity from entities outside of the Islamic world: from sovereigns such as the U.K., South Africa, Hong Kong and Luxembourg, and from leading international financial institutions, such as Goldman Sachs, Société Générale and Bank of Tokyo Mitsubishi. Lower oil prices are likely to drive increased volumes out of the Gulf countries as they attempt to plug their deficits and banks and corporations have to raise new funding. However, the jumbo recent bond issuances from the region, US$5 billion from Abu Dhabi and US$9 billion from Qatar, have had no sukuk portion, reflecting the desire to tap liquidity from outside the region.

Credit rating agencies are playing an important role in the market's rapid expansion, firstly by increasing awareness and education in a sector that—for many international investors—is still an unfamiliar market. Secondly, agencies provide international credit benchmarks by which investors can compare the creditworthiness of a sukuk instrument and Islamic financial institutions against their 'conventional' counterparts, for instance, Canadian sovereign debt or Toyota corporate bonds.

It is worth emphasizing that credit risk, and hence rating methodologies to analyze credit risk, are broadly independent of Shariah compliance considerations. Indeed, like conventional finance, cashflows, the contracts governing those cashflows, and the risk of non-payment of those cashflows are always key. Shariah may drive some structuring decisions but it does not change the basic financial and legal analysis needed.

ISLAMIC FINANCE IS PART OF GLOBAL CAPITAL MARKETS

Islamic finance is still specialized and idiosyncratic, but it now exists as part of the wider, global financial markets. Credit ratings agencies provide the financial markets with independent and valued views on credit risk. They provide ratings and credit opinions on numerous entities, including banks, corporations and sovereigns and their bonds or other credit instruments. Islamic banks, along with Islamic insurers (takaful companies) and sukuk, fall within this rating universe.

Credit ratings create benchmarks for the credit risk of investments and issuers across and between these different markets, countries and locations. This global comparability is a key aspect of a credit rating. For each agency, their own rating methodologies provide global standards that help an investor compare, for example, the credit risk of US Treasuries versus Malaysian sovereign Sukuk, or the credit risk of property company Emaar's sukuk versus the sukuk issued from Qatar International Islamic bank.

A YOUNG, COMPLEX AND EVOLVING MARKET

Islamic finance is a young industry and its financing structures, which seek to satisfy Shariah-based investment and financial principles, are still evolving. When new parties seek to participate in the market, they can become dis-

> *"Credit rating agencies are playing an important role in the market's rapid expansion... by increasing awareness and education in a sector that — for many international investors — is still an unfamiliar market."*

concerted by the complexity of the instruments and of the institutions. Islamic instruments often incorporate Arabic terminology and structures that help give the sector its own identity, but which create challenges to understanding for those participants in countries beyond the core Islamic markets of the Gulf and parts of Asia. When analyzing sukuk structures or Islamic banks' financial statements credit rating agencies often need to look through this first layer of complexity before they can apply their existing rating methodologies.

As an example, established asset management firms are often seeking information on the nature and risks of Islamic financial products. They have 'Shariah-sensitive' clients who want to move into sukuk investments but their own risk management and compliance teams may be unfamiliar with the industry. By assigning a credit rating and providing a credit opinion, the agencies provide an independent opinion on the credit risk elements of these instruments, which can facilitate a greater flow of international funds into these relatively new and complex markets.

The same rigorous analysis and methodology applies to both Islamic issuers and issuances and to all global market issuers and instruments. Ratings tend to follow the same global methodologies and standards. For an Islamic bank, being benchmarked to other conventional banks enables its shareholders, investors and even its own management to get an objective, third party opinion on the relative credit-related strengths and weaknesses of the institution.

SUKUK ARE (STILL) HIGHLY COMPLEX INSTRUMENTS

Islamic banking is a complex business. The fact that it is still in development creates many issues in terms of new business practices, documentation, operations and regulations that need to be addressed by any institution trying to operate according to Shariah based principles. Sukuk instruments in particular are characterized by a lack of standardization within the structures that are still essentially 'simple' fixed-income instruments.

Assigning a credit rating for unsecured sukuk instruments can be a lengthy exercise, particularly when comparing to more standardized conventional bonds. When a multinational conglomerate such as General Electric or a global bank like Barclays issues conventional, plain vanilla Eurobonds, their bonds are likely to have (for example) the same basic legal structures, the same default events, the same payment obligations, and the same investor priority in case of default. By contrast, sukuk are structured esoterically to comply with key Shariah investment principles that favor tangible, asset-backed financing (like securitization) and equity-like profit sharing, both of which are typically inconsistent with fixed income instruments rated by the agencies. The interpretation of these principles and ultimately their application in financial transactions is subjective, and it can lead to wide and crucial variations in the legal structure and in the documentation of sukuk. A credit analyst has to dig deeply into this extensive documentation to accurately assess the creditworthiness of the instrument, and whether there are any additional credit risks not typically seen in rated fixed income instruments.

BRIDGING TWO MARKETS

While the sukuk market remains relatively small compared to conventional markets, it is broadening its base beyond the Islamic world. As noted above, key non-Muslim countries issued sovereign sukuk in 2014. Although 2015 was a more difficult year for emerging markets and the Gulf countries in general, key issuers of sukuk, we will see more issuance in the future, which will bring more conventional investors into Islamic finance markets.

This market phenomenon, with conventional entities now operating more frequently within the Islamic capital markets, is creating a bridge between the two worlds and attracting a new segment of investors who are largely unfamiliar with the principles of Islamic finance. This addition of non-Islamic issuers could multiply the size of the market many times over since, even in the Gulf, conventional banks generally outnumber Islamic banks by more than five to one. This development could mark a step change in the size of the market and the possible number of institutions that will participate. For non-Islamic, global investment banks like Société Générale and Goldman Sachs, issuing sukuk may be a way to raise funds, but it is also a means to engage participants in these newer segments and to promote the bank's own capabilities in the sector.

As the market becomes more globalised, there will be a growing demand for Islamic finance-related credit ratings and insightful research. Rating agencies will continue to support an improved understanding of the credit risks and market trends in this rapidly expanding sector.

KHALID HOWLADAR is the Global Head of Moody's Islamic Finance Group and also leads the GCC Banking team in Dubai. He is a leading figure in the fields of sukuk finance and Islamic banking as well as in conventional GCC credit and securitization markets. Currently based in the Dubai International Financial Centre, he joined Moody's in London in 2001 and was initially an analyst responsible for rating cash, synthetic, high yield, structured and project finance CDOs. Subsequently he took lead roles in the MENA Business Development team with responsibility for new markets and client outreach before taking leadership of the Dubai-based banking team in 2010. Khalid provides extensive commentary on both Islamic and regional credit markets and is a well-respected speaker at conferences. In addition to providing various educational workshops for market participants, he has also enjoyed lecturing at the Paris-Sorbonne University (Abu Dhabi) as well as at Universities in Dubai and Beirut. In addition to Moody's own research, he has also authored many articles for numerous finance journals and books across the globe which focus on GCC and Islamic banks, sukuk, securitization, and credit ratings in general. Previously Khalid spent four years at Credit Suisse where he was working in the emerging market fixed income group in the Risk Management team. Khalid holds an MSc in Finance from London Business School, an MSc in Information Technology and a BEng in Software Engineering both from the Imperial College of Science and Technology and Medicine.

An officer of Malaysia's Islamic authority uses a telescope to perform "rukyah", the sighting of the new moon of Ramadan, in Putrajaya outside Kuala Lumpur. REUTERS/ Samsul Said

OMAN HERALDS A NEW FRAMEWORK FOR SUKUK ISSUANCES AND NEW LISTING CATEGORIES

Sadaf Buchanan

Oman is a relatively new entrant among the global Islamic financing players, having formally introduced Islamic financing in only 2012. The spring of 2016 has seen frenetic activity in key legislative developments in Islamic finance in Oman. Hot on the heels of the publication of Oman's new sukuk regulations on 5 April 2016 came the introduction of new listing categories on the Muscat Securities Market (MSM).

WHY ARE THE SUKUK REGULATIONS SIGNIFICANT?

The Capital Market Authority (CMA) Decision 3/2016 issued on 5 April 2016 introduced the CMA's long-awaited sukuk regulations. The regulations mark the culmination of more than three years of drafting, re-drafting and consultation with industry players both locally and internationally. The CMA has worked hard behind the scenes to include the comments of key stakeholders to achieve a framework that will promote capital market issuances in Oman.

As an interim measure pending release of the regulations, an amendment to the Capital Markets Law was promulgated in November 2014 (Sultani Decree 59/2014) that added licensing and regulation responsibility of SPVs to the CMA. It also specified the identification of the terms and conditions of financial trusts and issuance, the listing and trading of sukuk instruments and their Shariah supervision.

The absence of a dedicated sukuk regulatory framework, along the lines of the new regulations, did not hamper the ability of the Government of Oman to launch its debut sukuk in 2015, nor the ambitions of a number of key corporations in planning their issuances. However, those of us who are working on structuring sukuk transactions for a range of Omani issuers drawn from a broad spectrum of industries and sectors welcome a more formal legislative basis, which brings more certainty for both issuers and investors.

It is also interesting to note that the Government of Oman sold a $500 million six-year sukuk in a private placement at the end of June 2016, further supporting its plans to issue regularly in the capital markets. This is also a welcome development for other issuers who look to the government for benchmarking, as seen in other regions.

WHAT ARE SOME OF THE KEY FEATURES OF THE SUKUK REGULATIONS?

The SPV

The new regulations offer the ability to issue sukuk through an Omani limited liability company SPV with significantly lower minimum capital requirements, rather than through a joint stock company that requires minimum paid-up capital of OMR 500,000 (approximately US$ 1.3 million).

The SPV must not only be a company registered at the Ministry of Commerce and Industry, but the CMA must also grant a separate license to the SPV (terms and conditions have yet to be disclosed), which will mean a fee of OMR 1,000 with further fees on renewal of the license every five years.

> *…The Government of Oman sold a $500 million six-year sukuk in a private placement at the end of June 2016, further supporting its plans to issue regularly in the capital markets.*

The Prospectus

The regulations refer to issuances taking place with a "draft prospectus as per the form prepared by the CMA." Currently, no such form exists for sukuk issuances and the current practice to date has been to adapt the model form of prospectus for equity issuances. This is not ideal, and there are a number of areas of uncertainty in trying to fit bond and sukuk issuances within that framework. It remains to be seen whether a new dedicated model form will be released for sukuk issuances, but this would certainly assist issuers. The regulations mention no requirement that the prospectus must be issued in Arabic form, thus providing a greater degree of flexibility to potential issuers in terms of both the cost and timing of a launch. In practice, however, the CMA is still insisting that the Arabic prospectus is filed and signed by the various advisers and the issuer.

Credit Rating

The CMA may request a credit rating of the obligor but this is not a strict requirement.

Sukuk Programs

The regulations anticipate both standalone sukuk issuances as well as programs. This marks a positive development and one designed to encourage issuers to have the program establishment completed with the flexibility to take advantage of favorable market conditions and issue quickly and regularly. This was not formally set out in Oman law or regulation prior to the regulations being introduced.

Shariah Supervisory Board

There appears to be no requirement for the beneficiary or obligor to have its own Shariah Supervisory Board, hence issuers may be able to engage the services of an independent Shariah consultancy firm. Further clarification will be required from the CMA as to how this is reconciled with annual reporting obligations confirming that the sukuk is Shariah-compliant. The requirement of an annual certification by a Shariah Supervisory Board introduces further obligations on the issuer that were not included in previous drafts of the regulations.

Financial Trust

There has been formal introduction into Oman law of the detailed requirements for constituting financial trusts in the context of sukuk transactions.

Subscription by Omanis Only

The CMA may restrict subscription and trading to Omani nationals in certain circumstances and further clarity will be required on these provisions.

NEW LISTING CATEGORIES ON THE MUSCAT SECURITIES MARKET

The other key development this year is a further amendment of the Executive Regulations of the Capital Market Law of 1998. Decision No. 5/2016 came into force on 6 June 2016.

One of the notable features of this amendment is the introduction of a new "Bond and Sukuk Market" on the Muscat Securities Market (MSM). The CMA intends to have existing and future bonds and sukuk listed on the MSM to be placed into this new category over time, and is therefore expected that the CMA will disclose the associated transitional arrangements.

The Bond and Sukuk Market does not yet have US dollar capability, but it is understood that this facility is being developed quickly. It remains to be seen what additional administrative requirements will be implemented by the MSM and whether privately placed bonds and sukuk will be subject to public disclosure requirements, or whether there will be an equivalent of a Third Market framework where bonds are traded OTC.

Together with the Bond and Sukuk Market, there are a number of other new categories also being introduced, such as an "Under Monitoring Market" and a "Rights Issue Market". The categories are largely designed to create ease for investors as the market grows and to ensure that groupings more accurately reflect the type of instrument or issuer details that would be relevant. The new and updated categories are also intended to serve as an upgrade and to facilitate the review of market information in line with the CMA's mandate to promote capital markets in Oman.

WHAT IS NEXT IN RELATION TO SUKUK ISSUANCES?

The new regulations refer to further forms and directives to be issued by the Executive President of the CMA to specify their implementation, and the market will continue to consult with the CMA as to the implications for potential issuers, arrangers and investors.

Whilst not all industry recommendations have made their way into the regulations—for example, the prohibition on issuing bonds in excess of issued share capital (in the context of sukuk issuances) or related party approval exemptions (as the SPV will likely be a subsidiary of the obligor) has been maintained—the regulations do provide a number of key concessions not previously available under Oman law.

The Regulations therefore mark a significant and positive step forward in the promotion of sukuk issuances in a market that has grown by more than 50% in the past year alone. There is certainly more to come, and these legislative developments signal the much-needed steps being taken to facilitate issuances in and from the Sultanate of Oman.

SADAF BUCHANAN heads up the tier 1 ranking Banking and Finance team in Muscat and has more than 15 years' experience in restructuring and finance work. She previously spent some time in-house on secondment to Royal Bank of Scotland in Edinburgh. Sadaf works alongside both lenders and borrowers in advising on security issues and options, enforcement (both solvent and insolvent routes) and commercial lending and borrowing and has also advised on a number of the landmark debt capital markets' transactions from the Sultanate. Sadaf has broad experience in acting on both local and international deals and advising banks, businesses, shareholders and other stakeholders in relation to business restructurings and financing issues involving a variety of sectors from hotel and leisure to oil and gas as well as many international companies and financial institutions considering doing business in Oman. Sadaf also heads up the Islamic Finance initiative for the Oman office and has been awarded 'leading individual' status by the Legal 500 directory for her work in Oman.

Archway inside of
Grand Mosque,
Sultanate of Oman.

THE LABUAN INTERNATIONAL BUSINESS AND FINANCE CENTER (IBFC) ISLAMIC FINANCIAL ECOSYSTEM

Danial Mah Abdullah

Malaysia has been one of the pioneers of Islamic finance. Malaysia's Islamic finance infrastructure, coupled with the regulatory strength and the favorable environment for Shariah-compliant business at Labuan International Business and Financial Centre (IBFC) has paved the way for Labuan IBFC to expand its Islamic finance market in recent years.

The legislation governing Labuan IBFC, a special economic zone on an island off the coast of Borneo near Brunei, provides a comprehensive and flexible framework for industry players to innovate and to create new products for their clients. Labuan IBFC's leadership constantly seeks to enhance the regulatory and business frameworks in order to meet market demands, whilst ensuring its market practices are at par with international standards.

Labuan IBFC offers the following attractive conditions to Islamic financial entities established in the centre:

- Competitive overhead and operational cost (as compared to other international financial centers in Europe, GCC, South East and Far East Asia)
- A competitive tax rate (non-trading companies are tax exempt, while trading companies can opt to pay tax each year at the rate of 3% of the net audited profits or a flat rate of RM20,000)
- Access to Malaysia's wide range of double tax agreements
- A comprehensive legal framework with better clarity for Islamic finance with international recognition
- Continual innovation in Islamic capital market products, supported by Bank Negara Malaysia (the Central Bank of Malaysia)
- Amendments to the Malaysian taxation framework to create a level playing field and an unbiased market for Islamic finance transactions

In recent years, Labuan IBFC has fostered the development of Shariah-compliant financial services in the areas of international Sukuk, Islamic banking, Islamic investment banking, Islamic funds, retakaful, Islamic trusts and foundations. Shariah-compliant businesses have gradually increased their market share among Labuan financial businesses whilst providing viable alternatives to the conventional financial system. Stiff competition in the global financial environment has driven leading international financial centers to provide niche services, with Islamic finance gaining popularity in particular.

New omnibus acts, including the Labuan Financial Services and Securities Act and the Labuan Islamic Financial Services and Securities Act, were introduced in 2010 to govern both conventional and Shariah-compliant business offerings in Labuan. The enactment of these provisions will ensure that Labuan laws remain competitive and relevant for businesses to grow. There already has been a success after the introduction of the new act, evidenced by the establishment of entities undertaking new Shariah-compliant businesses introduced under the Act.

THE LABUAN ISLAMIC CAPITAL MARKETS

Labuan's Islamic capital market made its debut on the global market with the issuance of the world's first sovereign Sukuk in 2002. The five-year Sukuk was the world's first Shariah-compliant international bond and was listed on the Labuan International Financial Exchange (LFX) and the Luxembourg Stock Exchange. The issuance attracted participation from investors in Asia, the Middle East, the United States and Europe. It was listed on the Labuan International Financial Exchange, which provides facilities for the listing and trading of a wide range of financial instruments based on both conventional and Islamic principles.

The response to these Sukuk was a clear indication of a demand for such quality instruments with competitive pricing. This benchmark issuance has spurred the development of similar instruments worldwide with more innovative issuances being issued out of Labuan. Public acceptance of the Shariah compliance of these instruments amongst the international financial community has been key to their success. This development has stimulated an increase in the depth of global Islamic liquidity, in which Labuan FSA participates actively through its membership in the International Islamic Financial Market (IIFM).

The Islamic capital market in Labuan has been making inroads into new markets, including countries that are not predominantly Muslim, but which are interested in using capital market instruments based on Shariah principles to tap into a wider liquidity base outside Asia. Labuan's Islamic finance firms target this growth area with Shariah-compliant product offerings that are also universally acceptable in the international community.

Socially Responsible Investment (SRI) has recently become a focus of global capital markets. This can be seen from mature markets to emerging economies such as South Korea, South Africa, Brazil and Taiwan. In advanced economies like Europe, the SRI market has risen by 36% on average during the period of 2003-2006. Such investments with screening methodologies similar to Shariah screening could easily be structured into popular international instruments, creating a wider client base for Islamic fund management.

LABUAN'S LEGAL AND TAX FRAMEWORK

Labuan, with its strong legal framework, efficient tax structure and international linkages, is well prepared to take up this business opportunity. Labuan's strong regulatory framework ensures that Islamic financial transactions can be completed effectively. The Labuan taxation framework creates a level playing field for both conventional and Islamic financial transactions. Financial centers (Labuan included) with fiscal systems developed within a framework of conventional financing have found it necessary to introduce specific measures to enable the matching of profits in Islamic finance instruments and transactions to those of conventional instruments and transactions.

Issues arise because interest is prohibited under Shariah law. In general, this results in Islamic financial products being based on equity shares as opposed to the debt-based approach of conventional financing.

Tax laws always treat equity and debt differently. Therefore, Islamic finance transactions face disadvantages such as:

- Exposure to multiple transfer taxes on the transfer of property and the creation of leases
- Profits might be subject to an upfront taxable capital gain
- The "finance cost" of the issuer might be regarded as a distribution of profit and non-tax deductible
- The "finance return" to the investor might be made from after-tax income thus reducing the return on investment.

In an international context, there may be additional issues. Since the "finance return" is not considered interest, it may not enjoy the reduced rate of withholding tax for interest under tax treaties. With some Islamic finance transactions taking the form of a partnership, a cross-border transaction may create a taxable presence in a foreign location.

Hence, the straightforward Labuan tax system has the following features that overcome all of the prior issues:

- No tax on profits from passive investment
- No capital gains tax
- No withholding taxes
- No transfer taxes

Furthermore, Labuan has no exchange control restrictions. A Labuan entity that is tax resident in Malaysia may access the majority of Malaysia's extensive tax treaty network. This is beneficial because the tax treaty may prevent a taxable presence being created in the foreign treaty party's location and Malaysia's more recent treaties replace the "interest" article with a "finance cost" article to ensure Islamic finance transactions benefit.

It follows that Islamic finance transactions enjoy tax neutrality in Labuan. When factored into the pricing of the products, this allows for competitive pricing with conventional products. Moreover, due to the inherent safeguards that Islamic financial instruments and solutions offer, the Asia Pacific region has seen a rapid growth of Islamic finance, post global financial crisis. This development is expected to continue for the next 20 years.

The jurisdiction is currently working on the guidelines on Shariah governance for Labuan Islamic financial institutions. It is a governance framework that will be implemented by Labuan Islamic financial institutions to ensure Shariah compliance in all aspects of Islamic financial business operations in Labuan IBFC.

DANIAL MAH ABDULLAH is currently Chief Executive Officer of Labuan IBFC Incorporated Sdn Bhd (Labuan IBFC Inc), the official promotion and marketing agency for Labuan International Business and Financial Centre (Labuan IBFC). His experience spanning numerous years as a central banker has him put in good stead promoting Labuan IBFC as the ideal midshore jurisdiction in Asia Pacific. Mr Danial is a member of the Executive Committee of the International Islamic Financial Market (IIFM) and the Financial Stability Committee; alternate Board member of the IIFM; and a Board member of Labuan IBFC Inc, LabuanFSA Incorporated Sdn Bhd and Pristine Era Sdn Bhd. Mr Danial has a Bachelor of Accounting (Hons) from the University of Malaya, Malaysia; and a Masters in Business Administration from the Manchester Business School, UK. He is a Chartered Accountant registered with the Malaysian Institute of Accountants.

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A view of An Nur Jamek Labuan mosque during Maghrib sunset at Labuan island Malaysia. hkhtt hj / Shutterstock.com

IS IT TIME FOR ISLAMIC INTERBANK BENCHMARK RATE (IIBR) TO BE TESTED?

Blake Goud and Redha Al Ansari

The Islamic banking industry spent decades as a niche field in the financial sector, but today, it has reached maturity. Although there are many areas in which this maturity has been clearly demonstrated, one key area in which Islamic banking still needs development is in the way it prices its products. Most Islamic financial products are priced using conventional interest-based benchmarks like LIBOR, a practice that is widely accepted as being Shariah compliant. Nonetheless, the use of an interest-rate benchmark is a concern frequently raised by consumers, who believe it limits the authenticity of the product.

It would be easy for Islamic financial institutions to push back against consumers' preferences for non-interest-based pricing benchmarks, and it was a common refrain for years that there is no alternative. However, since 2011, Thomson Reuters has calculated and distributed an Islamic Interbank Benchmark Rate (IIBR) that could provide an alternative to LIBOR for pricing Islamic finance products. Like LIBOR, it collects the indicative funding costs for a collection of Islamic banks, and uses a transparent calculation method to determine the fixing.

BENEFITS OF IIBR

Beyond the issue of consumer perception, an IIBR may also provide a better reflection of the true funding costs of Islamic banks, which have been diverging in many markets. The IIBR rates are calculated based only on Islamic banks and fully segregated Islamic windows, which reflect any imbalances in the money market. These imbalances, which can be significant in size, are created by restrictions on the ability of Islamic banks to place funds with conventional banks. In these markets, Islamic and conventional banks are competing against one another, and often, price is the area where they compete the hardest. The prices that an Islamic bank is able to offer depends on its own cost of funding on its balance sheet which, at the margin, will be dependent on the interbank market, where prices reflect the available supply and demand of liquidity. For Islamic banks, the source of liquidity can come from any institution; any institution can place funds with an Islamic bank.

However, the reverse is not always true, because Islamic banks cannot place funds through interest-based transactions. This creates a barrier to liquidity flows between conventional and Islamic interbank markets, which affects the funding costs of the institutions in each segment of the market. If the cost of funding in each market differs, it is sub-optimal to use a benchmark from another market, when there exists a benchmark that more closely tracks the actual funding cost for Islamic banks.

Islamic banks can better manage their liquidity positions if they match their funding costs with their financing earnings, something that is important for all banks, but particularly for Islamic banks because they act more directly as pure intermediaries. The funds they receive from investment account holders are invested in the banks' assets and the returns are shared with depositors, so matching the benchmark on which each side is calculated makes sense in terms of the P&L for Islamic banks. It also may help with Islamic banks' long-term stability.

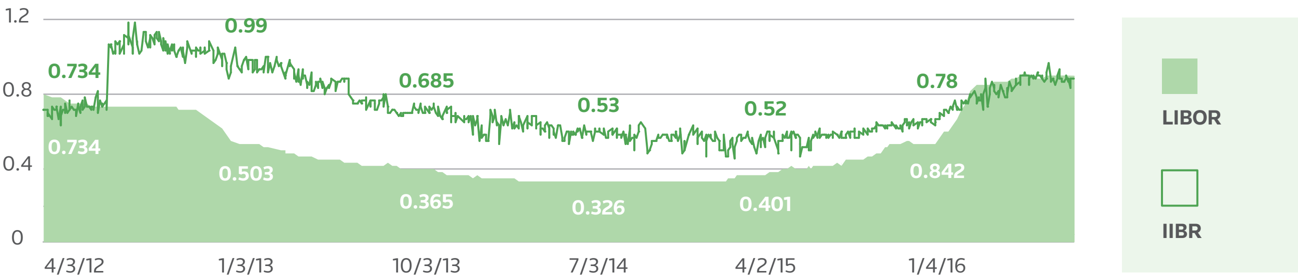
Promoting the change from an interest rate benchmark towards one based on Islamic banks' funding costs in their day-to-day business should make Islamic banking easier to explain to skeptical customers who do not see how it differs from conventional banking. It also should make Islamic banks' net financing income more stable, which would help bankers and reassure regulators. All these results are conducive towards the growth of Islamic finance, and these examples should be used to support the wider use of non-interest-rate benchmarks for pricing Islamic banking products.

COMPARING IIBR VS. LIBOR

The performance of IIBR, compared to LIBOR, has been somewhat divergent in 2012 and 2013, as the contributors to the two benchmarks come from different geographical regions and markets. Market conditions ultimately drive the rates. During 2013, LIBOR was affected by the European debt crisis, which led to retrenchment by many global banks based in Europe. This effect has faded gradually and the divergence has become narrower. LIBOR has significantly risen in 2015 and early 2016, following the decision by the Federal Reserve to increase global interest rates, which has caused the two benchmarks to converge.

To conclude, for IIBR to gain market players' confidence, the benchmark should be tested, particularly as the rate has been more stable over the past year. The rate should further stabilize as the contributor base widens, capturing the risk appetite of different institutions, countries and regions. Historically, the volatility of the benchmark resulted in a higher standard deviation in cases where IIBR was meant to be used for evaluation or discounting securities. It thus derived a lower value for Islamic assets in comparison to the use of other benchmarks. Using a volatile benchmark is difficult for other non-treasury transactions, as it offers less certainty about the pattern of future cash flows and makes it difficult to secure client approval.

Figure 1: IIBR vs. LIBOR (US$ 6 month)



Source: Thomson Reuters

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REDHA AL ANSARI is currently leading the Islamic Capital Markets team in Thomson Reuters covering Islamic economies, sukuk, liquidity management, Islamic funds, and equities. Redha has authored a number of books and wrote many papers on key trends in Islamic capital markets, in addition to advising governments, financial institutions and investors on potential markets for sukuk issuance and investments. Prior to joining Thomson Reuters, Redha worked at the Islamic International Rating Agency to look after financial institution and sovereign ratings. Before that, he worked at Arab bank in risk management. Redha holds a Master degree in Business Administration (MBA) from New York Institute of Technology and a bachelor degree in Finance from University of Louisiana at Lafayette, USA.

SHARIAH-COMPLIANT SCREENING METHODOLOGIES

Mohammed Donia

Shariah-compliant equities screening is a surprisingly complex task. Screening methodologies have evolved over the past few decades, typically filtering by the industries in which the equity does business. If these match a short list of industries, such as distilling, the equity was considered inappropriate for Shariah investing; otherwise, it was deemed appropriate. Unfortunately, this simplistic methodology can frequently mislabel equities as appropriate or vice-versa. This results when material income from minor business activities derives from non-permissible sources such as alcohol, or a business such as a bank lends and borrows permissively. For example, Louis Vuitton (LVMH) is categorized as "clothing and accessories." Based on that alone, Louis Vuitton would be considered Shariah-compliant. However, a remarkable proportion of its income comes from sales of wines and spirits, and LVMH should therefore be classified as being non-compliant. Most screening methodologies now track income from non-permissible activities rather than simply looking at sectors.

In addition, if a business receives only a small fraction of its income from non-permissible sources, many Shariah investors will invest provided they can know the relative percentage of such income, so they can "purify" that proportion of their gains by donating it to charity. These more careful screening methods yield a far more accurate — and larger — list of appropriate equities.

Due to the magnitude of the global equity universe, with more than 40,000 listed companies, this screening process is very complex and require major investments in research, tools, and information to provide accurate results.

UNDERSTANDING SHARIAH-COMPLIANT SCREENING

Thorough screening puts each equity through two proportional filters:

1. Income from "*haram*" (i.e., inappropriate) sources such as pork and alcohol
2. Financial measures such as interest-bearing debt or investments

If an equity passes both, then the percentage of income from *haram* sources is estimated, so that the investor's proportionate gains can be purified.

Changes over time can affect both appropriateness and the relative "purification" percentage. These changes could reflect changes in financials as well as income. And, corporate actions such as mergers and acquisitions must be quickly and carefully re-evaluated.

There are around seventy or more screening methodologies globally. They differ in their definitions of non-permissible income and in their financial ratios. For example, their treatment of music, weapons, stem cell research or income, *halal* food ingredients, investment income, use of assets, market cap, or enterprise value in calculating filter ratios. The investing institution's Shariah board typically determines these.

> *If a business receives only a small fraction of its income from non-permissible sources, many Shariah investors will invest provided they can know the relative percentage of such income, so they can "purify" that proportion of their gains by donating it to charity.*

EFFECTIVE SCREENING METHODOLOGIES

Depending on the screening methodology used, the universe of passing equities is 20% to 40% of the 40,000-equity universe worldwide. Both automated and manual screening (involving primarily review of publicly available documents such as securities filings, news items, press releases, web-sites, analyst reports, etc.) must evaluate each equity for non-permissible income sources and financial aspects such as interest-bearing debt. If screening finds the equity clearly inappropriate (e.g. alcohol sales exceeding 5% of income), the equity is labeled inappropriate.

Additional research is done on remaining equities to estimate exact percentages of potentially non-permissible income or inappropriate levels of non-permissible financial status. These more-exact screening results are useful to let investors with different Shariah-based threshold models decide for themselves whether a given equity is appropriate.

All but the most obviously inappropriate equities should be re-screened periodically, and immediately re-screened upon corporate actions such as mergers.

CASE STUDIES

IdealRatings review two large-cap technology equities: Apple, Inc. and Amazon. Both equities are evaluated against the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) threshold model for income sources and financial characteristics, as of April 4, 2016.

Apple, Inc. — Shariah Compliant (i.e., appropriate)

Due to its primary industry (technology), this equity passes initial industry screening. As of its last 10K filing, its income streams from non-permissible sources are:

Source	Out of income
Music	1.42%
Cinema	0.86%
Interest Income	1.22%
Total Non-permissible Income	**3.50%**

Since the AAOIFI threshold for non-permissible income is 5%, non-permissible income is counted a PASS, with the need to purify 3.50% of all gains from equity gains or dividends.

Financial screening results for this equity are:

Source	AAOIFI Threshold	Company	Compliance
Interest-bearing Investments	30%	5.84%	PASS
Interest-bearing Debts	30%	9.66%	PASS
Liquidity	67%	14.08%	PASS
Preference Share*	False	False	PASS

* Islamic investing does not consider certain preferred shares as Shariah compliant

Since each financial screening measure passes and the non-permissible income is within the AAOIFI guidelines, this equity is considered Shariah compliant.

Amazon – Shariah Non-Compliant (i.e., inappropriate)

Due to its primary industry (technology), this equity passes initial industry screening. As of its last 10K filing, its income streams from non-permissible sources are:

Source	Out of income
Pork	0.21%
Alcohol	0.39%
Tobacco	0.10%
Music	3.50%
Cinema	3.50%
Adult Entertainment	0.01%
Conventional Interest Bearing	0.47%
Interest Income	0.046%
Total Non-permissible Income	**8.24%**

Since the AAOIFI threshold for non-permissible income is 5%, non-permissible income is counted a FAIL.

Financial screening results for this equity are:

Source	AAOIFI Threshold	Company	Compliance
Interest-bearing Investments	30%	7.68%	PASS
Interest-bearing Debts	30%	5.71%	PASS
Liquidity	67%	34.09%	PASS
Preference Share	False	False	PASS

Since each financial screening measure passes but the non-permissible income is not within the AAOIFI guidelines, this equity is considered Shariah non-compliant.

Ethical and Social Responsible Investment (SRI) can be considered the natural evolution of Islamic finance and Shariah-compliant investment. SRI comes in various forms such as negative screening, positive screening, impact investing and integration of ESG (Environment, Social, and Governance) factors. Both have the negative screening as a base common factor. Similar to

Shariah-compliant investment, SRI also excludes companies involved in sectors that negatively affect human beings, society and environment. Moreover, SRI has added more items that should be taken care of such as investments in fossil fuel, for example due to its adverse effect on human health and environment, genetically modified organisms (GMOs), depleted uranium, etc.

The social aspect is included in both Shariah-compliant investment and SRI. In the former, *zakat* takes an important aspect of the Muslims' obligations whereas in the latter it is implemented through social screening via ESG and through impact investments. As a start, ESG can take into consideration Shariah-compliant financial factors. A recent case occurred when Volkswagen was accused of corruption case regarding an environmental incident, though it was the top of various SRI related indexes. Having taken into consideration the fact that its debt rate was an enormous 145% at that time, investment in such equity could have been avoided with Shariah-compliant screening.

> *Ethical and Social Responsible Investment (SRI) can be considered the natural evolution of Islamic finance and Shariah-compliant investment.*

CONCLUSION

Shariah-compliant screening is a complex task, but over the last decade, Shariah scholars have helped define comprehensive screening rules. With the development of research tools and applications in today's markets, investors are able to easily identify Shariah-compliant companies, invest, and purify their investments easily.

MOHAMMED DONIA is an entrepreneur, and financial services executive, who Co-Founded IdealRatings in San Francisco in 2006 to become the leading provider serving the Islamic finance industry. Today, IdealRatings is known as one of the top global providers serving clients around the world. Prior to IdealRatings Mr. Donia was Co-Founder of Cogency Inc, a silicon valley start-up, where he helped define Cogency solutions for the hedge funds and fund of funds firms to become a leading solution provider with some of the world's largest hedge funds and fund of funds as clients. Prior to Cogency, Mr. Donia was Vice President of Applications at TenFold corporation, a silicon valley start-up, which IPO'ed on NASDAQ in 1999, where he was responsible for leading customer engagements for Fortune 500 customers in the financial services, banking, insurance, and energy verticals. Mr. Donia held several management positions at PepsiCo, and started his career at Proctor and Gamble. Mr. Donia holds a B.SC in Computer Engineering from Ain Shams University in Cairo, Egypt.

SOCIALLY RESPONSIBLE INVESTMENT SUKUK: THE CASE OF THE INTERNATIONAL FINANCE FACILITY FOR IMMUNIZATION (IFFIM)

Ahsan Ali

The International Finance Facility for Immunization (IFFIm) is a multilateral development institution set up in 2006 as a charity to provide funding to the GAVI Alliance (a Swiss based non-profit foundation) for immunization and vaccine procurement programs in some of the poorest countries in the world. Since 2000, GAVI Alliance's mission has been to save children's lives and protect people's health by increasing the widespread use of vaccines in poor countries with 'front loading' funds using vaccine bonds, providing flexible access to capital markets and predictable funding for health and immunization programs. It aims to improve access to underused vaccines such as pentavalent[1] and new vaccines such as pneumococcal[2] and rotavirus[3] vaccines. Vaccine bonds provide an ideal Socially Responsible Investment (SRI) portfolio diversification opportunity with attractive risk-adjusted returns and socially responsible goals.

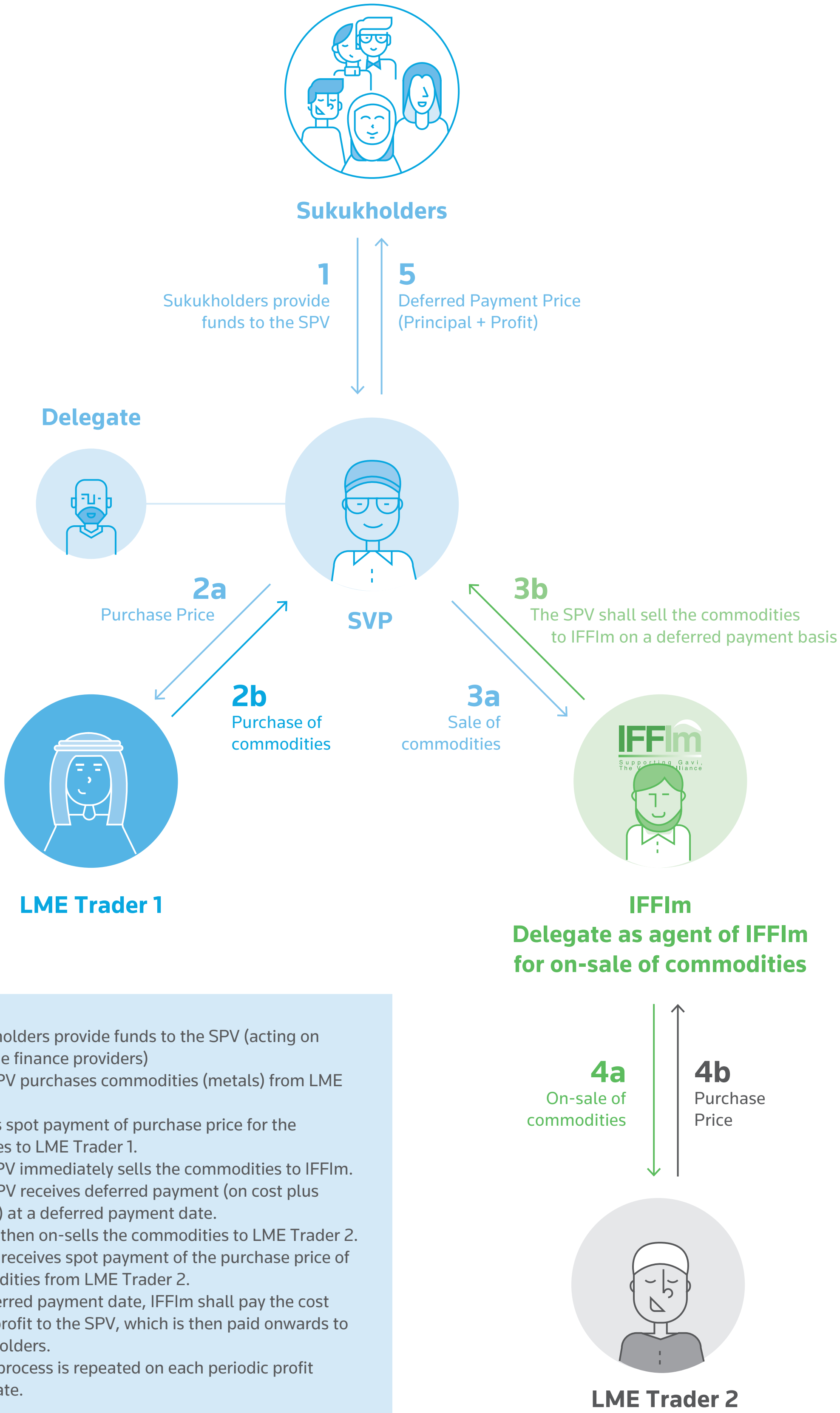
The governments of nine nations (Australia, France, Italy, Netherlands, Norway, South Africa, Spain, Sweden and the United Kingdom) have made legally binding pledges to pay US$ 6.3 billion over 20 years, in addition to the GAVI Matching Fund which matches contributions from private sector partners either by the Bill & Melinda Gates Foundation or the government of the United Kingdom. IFFIm has been assigned the right to receive these donor pledges and to use the funds to provide grants to GAVI for programs of immunization and/or vaccine procurement. The World Bank was appointed to act as a treasury manager of IFFIm, and since its inception in 2006, a total of US$ 5.2 billion has already been raised with conventional bonds and sukuk backed by these pledges for GAVI to purchase vaccines. The capital markets have therefore enabled the rapid scaling of immunization programs in recipient countries.

IFFIM'S SUKUK ISSUANCES

IFFIm has expanded the boundaries of Islamic finance with its debut 2014 sukuk transaction, launching the largest sukuk *al-murabahah* issuance in the international capital markets and also the largest inaugural sukuk from a supranational organization to date. This marked the first time an issuer accessed the international sukuk markets to raise funds for a socially responsible purpose with funds to be utilized for vaccinations, and it has paved the way for other supranationals to tap the Islamic capital markets.

IFFIm's issued the sukuk to meet the objectives of diversifying its investor base, establishing a benchmark for IFFIm in the international sukuk market, and raising Islamic liquidity for a socially responsible purpose. The most suitable Shariah structure was commodity *murabahah*, which suited IFFIm's objectives and gave Islamic investors an opportunity to invest in a high-quality socially responsible investment. The structure flow of the sukuk was a commodity *murabahah* as depicted in Figure 1.

Figure 1: Structure Flow of the IFFIm's SRI Sukuk



1. The Sukukholders provide funds to the SPV (acting on behalf of the finance providers)
2. (2.a) The SPV purchases commodities (metals) from LME Trader 1.
   (2.b) Makes spot payment of purchase price for the commodities to LME Trader 1.
3. (3.a) The SPV immediately sells the commodities to IFFIm.
   (3.b) The SPV receives deferred payment (on cost plus profit basis) at a deferred payment date.
4. (4.a) IFFIm then on-sells the commodities to LME Trader 2.
   (4.b) IFFIm receives spot payment of the purchase price of the commodities from LME Trader 2.
5. On the deferred payment date, IFFIm shall pay the cost price plus profit to the SPV, which is then paid onwards to the Sukukholders.
6. The above process is repeated on each periodic profit payment date.

Term Sheet: Details of Both IFFIm's Sukuk Issuances are Listed Below

Date	**27th November 2014**	**17th September 2015**
Issuer	IFFIm Sukuk Company I Limited	IFFIm Sukuk Company II Limited
Obligor	International Finance Facility for Immunization Company	International Finance Facility for Immunization Company
Obligor Rating	Aa1/AA/AA+(Moody's, S&P, Fitch)	Aa1/AA/AA+(Moody's, S&P, Fitch)
Issue Size	US$ 500 million	US$ 200 million
Profit Rate	US$ 3 month LIBOR + 15bps	US$ 3 month LIBOR + 14 bps
Type	Floating Rate, Senior Unsecured Trust Certificates	Floating Rate, Senior Unsecured Trust Certificates
Maturity	3 years — due 2017	3 years — due 2018
Sukuk Structure	*Murabahah*	*Murabahah*
Format	Regulation S, standalone documentation	Regulation S, standalone documentation
Governing Law	English Law	English Law
Global Coordinator	Standard Chartered Bank	Standard Chartered Bank
Joint Lead Managers	Barwa Bank, CIMB, NBAD, NCB Capital and Standard Chartered Bank	ENBD Capital, Maybank, NBAD & NCB Capital and Standard Chartered Bank
Co-Lead Managers	n/a	Crédit Agricole CIB and Morgan Stanley

OUTCOME

In 2014, Standard Chartered acted as a global coordinator and a joint lead arranger for the sukuk and worked closely with the issuer in each step of the transaction process, including: sukuk structuring, pre-marketing to identify exclusive demand of US$ 300 million, and finally, running a seamless execution process as the global coordinator. On the back of a successful pre-marketing exercise and a focused deal roadshow, IFFIm was not only able to increase the deal size from its original target to a final print of US$ 500 million but also to price it tighter than its earlier conventional public issuance in 2013 for a US $700 million vaccine bond.

Subsequently in 2015, the joint lead managers again pre-identified exclusive demand of US$ 200 million providing IFFIm the necessary comfort to access the sukuk market in less than a year and set a tight pricing target of US$ 3 month Libor +14 bps after its inaugural offering of US$ 500 million priced at US$ 3 month Libor +15 bps in November 2014. IFFIm's unique life-saving purpose attracted interest from both traditional sukuk investors and conventional investors with a strong Environmental, Social and Governance (ESG) focus, some of which purchased sukuk for the first time. IFFIm Chair René Karsenti hoped IFFIm's sukuk issuance would pave the way for more socially responsible investing in the Islamic market in the future.

Furthermore, Doris Herrera-Pol, Director of IFFIm and former global head of capital markets at the World Bank was delighted to bring together two rapidly growing fields: Islamic Finance and Socially Responsible Investing and grateful for the strong support from investors who valued the diversification benefit of IFFIm as a highly rated name in the Islamic capital markets with a SRI purpose.

Each of the sukuk issuances attracted strong interest from the Middle Eastern and Asian investor base, enabling IFFIm to achieve strong diversification within its investor base with the majority of the orderbooks coming from primarily Islamic institutional investors who were new to IFFIm credit.

In line with its mandate, IFFIm utilized the proceeds from the issuances to fund GAVI Alliance's immunization programs and health systems, strengthening initiatives for children in the world's poorest countries.

> *“Vaccine bonds provide an ideal Socially Responsible Investment (SRI) portfolio diversification opportunity with attractive risk-adjusted returns and socially responsible goals.”*

NOTES:

1 Pentavalent protects against diphtheria, tetanus, pertussis (whooping cough), hepatitis B and hib.

2 Pneumococcal protects against pneumonia, meningitis and sepsis.

3 Rotavirus protects against a highly infectious stomach bug.

AHSAN ALI is Managing Director and Global Head of Islamic Origination at Standard Chartered Bank. Ahsan is responsible for the global Islamic Origination business at Standard Chartered Saadiq, the Bank's Islamic banking arm. His portfolio comprises all Islamic structured transactions including Sukuks, Syndications, Project & Export Finance, Shipping & Aviation, Structured Trade Finance, Corporate Advisory and Financial Markets. Since joining Standard Chartered Bank in March 2004, Ahsan has played a key role in building out the Bank's Islamic business and has led several award-winning and industry-defining deals. He has over 20 years experience in the financial services industry of which the last 12 years have been in Islamic banking. Ahsan holds a Masters in Business Administration from the Indian Institute of Management, Calcutta and a Degree in Mechanical Engineering from the Indian Institute of Technology, Delhi. He is also a Chartered Financial Analyst (CFA).

CHAPTER 7

The Way Forward

Light came through a mosque window, Iran.

SUMMARY

Our report has highlighted several fundamental themes in the development of an authentically Islamic capital market. Among the most important are the development of sophisticated Shariah governance at the institutional level, the improvement of disclosure and supervisory rules at the national level, and the standardization and harmonization of Shariah rulings on the global level. Such efforts will make it easier for new Shariah-compliant products to spread, including tax-efficient cross border investments and socially responsible sukuk, as well as asset management and crowdfunding. As the volume of Islamic capital markets transactions continues to increase, demand grows for a range of profit-and-loss sharing products including sukuk and structured instruments, which will allow a broader range of investment strategies and risk profiles to investors.

The articles in our concluding chapter extend these themes to projections or recommendations for future development in the field. An examination of the role of the fatwa in Islamic finance recommends the development of a robust Shariah scholarship oriented to the particular problems of the capital markets: how to distribute risk across markets and portfolios, and how to structure fixed income securities in a way that is true to the Shariah.

There remains a wide range in the Islamic financial regulatory conditions in and coordination between Organization of Islamic Conference member countries. Although there have been preliminary cross-border Islamic financial investments connecting members, the harmonization of legal frameworks will facilitate expansion. The most important areas are in insolvency, tax, corporate and securities laws. The unification of taxation rules for cross-border equity financing is particularly crucial.

A final recommendation to expand the global profile of Islamic capital markets is to better identify and align their goals and offerings with the worldwide movement towards Environmental, Social and Governance (ESG) based investment strategies. In general, implementing ESG standards lowers companies' costs and improves performance and share prices. Moreover, this strategy will lead to a virtuous reinforcing cycle, in which Shariah scholars refocus their attention, whenever appropriate, on judgments that increase social benefits (*maslaha*). In turn, Islamic capital market products will become further identified with ethical investing strategies among investors worldwide, whether Muslim or non-Muslim.

THE ROLE OF FATWA IN THE ISLAMIC CAPITAL MARKET

Dr. Mohamed A. Elgari

After many years, Islamic capital markets across the globe seem to be thriving thanks to the introduction of new products and new regulations and the increase of the volume of financial assets traded by investors. How do you assess the current method of fatwa issuance and the role of *fatwas* in the expansion of Islamic capital market?

Despite the fact that Islamic capital markets are thriving, Islamic capital markets have a long way to go to really become a full substitute to the conventional capital markets. Not all the blame can be directed at the "fatwa," but Shariah scholars do carry part of the responsibility for the slow movement towards a full Islamic capital market. Two important building blocks of capital markets are given very little research priority by Shariah scholars and *fiqh* academies: these are the practice of exchanging risks through the market and the entire class of fixed income securities.

Capital markets are important for the growth of any country and the welfare of its people. To function properly, they must have a full menu of securities and instruments that facilitate this most important function. Absent of such effective means, a big chunk of Muslim investors will remain outside the market, and it will fail to mobilize all possible resources towards economic growth. Or, worse yet, they will remain in the conventional markets. The current method of issuing *fatwas* follows the traditional approach in a modern setting, where a fatwa is reflects the majority rule. So far, this has worked. What is missing and may cause difficulties in the future is the lack of serious research by Shariah board members on the issues that have no precedent in the classical *fiqh*. This, as well as critical *ijtihad* is much needed if Shariah solutions are to be reached.

Trading Islamic debt-based securities in Malaysia, which permits the sale of debt (*bay al dayn*), is seen by some financial experts as an advantage over regulations in other jurisdictions. This concept has played an instrumental role in developing the Islamic capital market in Southeast Asian countries. Could Shariah ensure a fair and a competitive environment for all Islamic capital markets through the application of this concept?

The contemporary *fiqh* discourse has followed the positive law in according to juristic persons, such as corporations, the same Shariah rules of the natural person. Hence, when a company borrows by issuing bonds, we apply the same Shariah rules of natural persons. These rules were intended to be applied on obedient believers, or what is called in the books of *fiqh*, the *mukallaf*.

Manmade laws such as common law have gone too far in this equalization of natural and juristic persons to the extent that in the US, corporations enjoy all the rights afforded in the constitution to natural persons including freedom of speech. However, Muslims must not lose sight of the fact that everything we do in the realm of obedience to Allah (SWT), we do because we believe there is a day of judgment where our deeds will be adjudged and will be sentenced. A legal person is a fictional entity. Actions taken by such an entity must have their own jurisprudence.

The world we live in today, unlike in the past, is replete with debt. Every legal entity, and every individual, is indebted. We must deal with this fact and recognize that debt must be, at times, transformed through sale. Such sales are not allowed. However, unless we understand why Shariah prohibited the sale of monetary debt for money, we have no hope of discovering the right solution. We must remember that when it comes to *muamalat* (business dealings), the objective of Shariah is the "(business deal (*maslaha*) of the society. Hence, we should articulate this "general good" and know how to innovate within its parameter.

International Shariah standards like AAOIFI and the Shariah resolutions of Majma' Fiqhi are supposed to narrow the gap between ICM practices across the globe, such as trading debt based securities in Malaysia versus its prohibition in the GCC countries. However, we still

see a stark difference of opinions of Shariah advisory boards or authorities. Why does the wide gap still exist, despite the efforts of AAOIFI and Majma' Fiqhi?

There is no denying that a difference of opinion does exist, but I wouldn't describe such difference as stark. Majma' Fiqhi got interested in the early 1990s in setting Shariah rules for capital markets transactions. Several important conferences were held and resulted in historic rulings about capital market transactions.[1] Nevertheless, a substantial effort is necessary by Shariah scholars to meet the expectations of Muslim investors. Scholars need to come to grips with the fact that no modern society can live and thrive without an efficient and effective capital markets. And a capital market without ways and means to transfer risks is of little economic consequence.

Our time-tested method of combing and sweeping classical *fiqhi* books looking for answers may not work. What we are facing is new and unprecedented. It would be more useful if we could follow classical scholars' methodology rather than their conclusions.

Is there any way to regulate *fiqh al-hajah* (the jurisprudence of urgent need) and *darurah* (necessity) in the Islamic capital market? If so, how? What is your view on the *hajah*-based practices in Islamic capital market?

Sometimes we are impatient when the going is "long." We look for a shortcut. *Fiqh Al-Hajah* and *Hukom Al-Darurah* should only be a last resort and temporary in nature. And they are helpful only for those who meet their requirements. They can't be general and global solutions. We must put in the hard work. We are in no way near the limits of tolerance of Shariah rules. I sincerely believe we are doing very little to really comprehend and decipher Shariah in such a way that emancipates ourselves from our lack of will to really do *ijtihad*.

Is the Islamic capital market Shariah-driven or market-driven? How can we ensure that profit-and-loss sharing is soundly implemented in the Islamic capital market?

The Islamic capital market is, without a question, market driven. Our job is to make sure that where Shariah requirements are not met, we come up with solutions, with alternatives and substitutes that can deliver the same economic outcome within the confines of Shariah. Nothing will happen without serious efforts by all, but especially by Shariah scholars. The capital market is very conducive to structures that can deliver profit-and-loss-sharing schemes. However, it will not happen by itself. If we continue just emulating the conventional products, then we will not go anywhere. We have to innovate. No matter how little and modest our innovation is, it will always be a step in the right direction.

Notes:

1 AAOIFI didn't seem to have a similar interest.

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STRENGTHENING GLOBAL CONNECTIVITY AND CROSS-BORDER INVESTMENTS IN ISLAMIC CAPITAL MARKETS

Prof. Dr. Mohd Azmi Omar and Dr. Dawood Ashraf

Despite the idealistic vision of Islamic finance, in which equity participation and risk sharing are the norm, Islamic capital markets[1] are still relatively underdeveloped. This is particularly the case in the Organization of Islamic Cooperation (OIC), the members of which are a diverse set of countries with different cultures, ethnicities and income groups for which Islam is the only common factor. The diversity of OIC member countries is, however, a blessing in disguise. Islamic capital markets can help to mobilize funds and channel them to all those countries and companies in them, including SMEs, that need funds to grow and to create jobs. In particular, the public sector can benefit hugely from Islamic capital markets by tapping into funds for infrastructure projects necessary for long-term and sustainable development.

Stronger capital markets enhance investor confidence and open avenues for cross-border investment. Cross-border investments on a risk-sharing basis not only reduce the dependence of governments on public funds, but they also deepen financial inclusion and enhance financial stability. A globally well-connected Islamic capital market potentially creates a linkage between owners of funds (investors and savers) and users of funds, both sovereign and corporate. Shariah principles ensure a more equitable distribution of returns, based on risk-sharing modes of investments.

There are instances of cross-border investments using Islamic capital instruments such as the issuance of sukuk by both sovereigns and quasi-sovereigns from Pakistan, Kazakhstan, and Turkey to mobilize funds from the international capital market.[2] However, to reap the full benefits of the Islamic capital markets, there is a need to strengthen ties between the OIC member countries and to create an enabling environment for cross-border investments using Islamic capital markets instruments. It is essential for regulators and policymakers to work together to remove impediments and to develop a unified approach for connecting the national capital markets of member countries.

The levels of capital market development and the existence of necessary regulations among the OIC member countries are at best uneven. Markets in Southeast Asia and the Middle East are reasonably developed, while markets are yet to be developed in Sub-Saharan Africa. Efforts should be made to promote the development of capital markets in all member countries. A South-South cooperation strategy could be helpful, wherein member countries would support each other to strengthen the administrative capacity of countries where capital markets are evolving.

One of the biggest challenges to cross-border investment is the diversity of legal frameworks among member countries, including insolvency, tax, corporate and securities laws. It is necessary to harmonize the legal and supervisory infrastructure that delineates uniform listing and disclosure requirements for cross-border issuances and regulates trading of securities to enable companies to raise funds publicly at a low cost. There is also a need to introduce appropriate regulations to facilitate cross-border, long-term and sustainable investments in infrastructure projects in member countries.

Any transaction using Islamic finance requires the transfer of assets, which triggers tax liabilities in the form of capital gains and transfer fees. This additional tax burden reduces the attractiveness of executing the transaction in a Shariah-compliant manner. Furthermore, in cross-border transactions, some jurisdictions require higher taxes for the transfer of dividends. A simple unified tax treatment could be arranged among member countries for facilitating cross-border equity financing. Tax incentives could also be used to encourage venture capital and business angels to raise investment in SMEs and start-ups across member countries.

Most of the OIC member countries do not have sufficient investment choices for savings besides bank deposits. Special attention is essential for putting into place an infrastructure that would support across jurisdictions for pooling investors' funds. Appropriate instruments include mutual funds, venture capital, private equity, or more innovative forms of investments like crowd funding, and Islamic microfinance/savings that allow the cross-border free flow of funds whilst protecting investors' rights. Mutual funds especially provide the benefits of low-cost and professionally managed investment opportunities for small investors. Further opportunities could also be explored by developing a fund responsible for investment in micro, small and medium enterprises across jurisdictions. A committee under the auspices of the OIC could further explore the option to develop an OIC-wide personal private pension fund backed by sovereign guarantees that would offer affordable investments for retirement. A *waqf*-based approach is particularly appropriate for pooling such funds.

Islamic banks play a vital role in the development of capital markets, particularly by reducing information asymmetry because of their strong local knowledge and relationships. Islamic banks can be instrumental in issuing asset-based Sukuk (i.e. securitization). However, there is the need to develop simple, transparent and standardized procedures to help improve the balance sheets of Islamic banks, and provide long-term investment opportunities in the capital markets.

Investment in Islamic capital markets requires compliance with Shariah principles. However, there are multiple standards available for the screening of Shariah-compliant equities. It would be best to harmonize Shariah standards for all jurisdictions, which would make the flow of funds easier. Furthermore, providing free access to cross-border investment data on Islamic capital markets will provide a boost to investments.

Notes:

1 Investment in Islamic capital market is possible through individual securities such as Shariah compliant equities and Sukuk (debt), or through pooled funds such as mutual funds, venture capital, and hedge funds for both long and short horizons.

2 The Development Bank of Kazakhstan and Turkiye Finans raises MYR 240 million and US$252 million from Sukuk issuance in Malaysia.

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ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INVESTING STRATEGIES IN ISLAMIC FUNDS

Rehan Pathan

Environmental, Social and Governance (ESG) and Shariah-compliant investing share many similarities. In your opinion, what needs to be done to bring the two closer? How do you find the progress so far of the development of Shariah-compliant ESG investing?

At heart, ESG and Shariah-compliant investing are both based around a set of similar values. Whereas conventional finance has traditionally been built on the basis of maximizing risk-adjusted returns, Islamic and socially-responsible investors are driven by the requirement of seeking a financial return that is sustainable. The increase in global assets under management (AUM) that we are witnessing in both types of investing is a reflection of a wider shift in how investors are seeking returns and in particular with ESG strategies, increasing demand for products that are sustainable.

However, a key difference between the Shariah investment model and ESG investing is how information is screened and analyzed. The former largely relies on historical data, whilst the latter is based on more forward-looking information, assessing how portfolio companies perform on various ESG issues. Shariah screening only takes into account business screens and doesn't factor in corporate governance and management, as ESG screening does. Furthermore, Shariah investment models rely on screening out companies, whilst ESG based strategies are able to include companies based on such forward-looking data.

The process of screening out non-Shariah compliant entities and then assessing ESG considerations ultimately identifies companies that are both Shariah-compliant and sustainable in terms of their business models and are run by responsible management teams with sound leadership and governance. Both investment styles are complimentary and can deliver superior returns.

Research by Arabesque and the University of Oxford demonstrates that between 80% and 90% of studies show that implementing sustainability standards lowers companies' costs, improves performance and boosts share prices. As awareness grows that strong sustainability performance pays, I believe companies and investors will gravitate towards ESG-based strategies.

Progress, however, is slow, and the uptake is only just beginning. Few asset managers have so far been successful in converging the two sectors or in attracting a new set of investors outside mainstream Islamic markets.

Globally, a lack of standardization in Islamic investment principles and limited understanding and awareness amongst investors and distributors have also hindered growth in the broader Shariah product space. Limited development and research by Islamic asset managers into the Shariah screening process has meant that the Shariah investment model has not significantly changed until now.

Whilst we have seen a gradual increase in mandates issued by institutional Shariah-sensitive investors to managers that can integrate ESG factors into the screening process, there is still a long way to go. A few pioneering firms are moving into the ESG and Shariah product space, but the majority of both retail and institutional wealth has yet to embrace these strategies.

What are the opportunities for Islamic investors to embrace ESG principles within their Shariah-compliant mandate? What are the main challenges that Islamic asset managers are facing today when incorporating ESG to meet such a demand?

The opportunities up until this point have been few and far between for Islamic investors. As a retail investor in Europe, you may be hard pressed to find more than a handful of funds, across all asset classes, that fulfill both Shariah values and ESG considerations. The landscape is changing though, and there are clear benefits for investors looking for this product mix. By investing in this way, not only can investors ensure that the returns they make are *halal*, but they will also be taking into consideration environmental, social and governance elements that Shariah screening alone does not always take into account.

Evidence is growing that companies which have less exposure to poor ESG practices have a better chance of generating higher returns for their investors. By embracing ESG, Islamic investors can therefore utilize an investment solution that is both Shariah-compliant and can deliver better financial returns.

Despite growing demand for sustainable products from all investor segments, to date there has been limited growth and innovation in ESG funds that have crossed over to the Islamic investor, and vice versa. ESG-based investment is a process in which a great deal of analysis needs to be undertaken before assessing the ESG credentials of a company. The factors that need to be assessed and their actual contribution to the positive performance of the underlying investment are both relatively new and sophisticated in nature, and only a handful of investment firms have been able to generate meaningful results. Another challenge is that the label 'Islamic' has somehow translated itself into an exclusionary platform that only caters to the Muslim world. For the majority of institutional investors, Shariah screens may not be understood and might sometimes be viewed negatively, despite the many positive aspects of Shariah screening that would satisfy investors' concerns about ESG and sustainability.

How much are Shariah screening methodologies impeding the development of ESG investing? What can be done to tackle the unattractiveness of leverage restrictions by Islamic screenings that could diminish returns?

I believe that both Shariah and ESG investment styles are complimentary and can work in combination with each other. What is required, however, are new and modern visions to take Shariah investment strategies to the next level. At Arabesque, we believe that we have developed such a vision — the creation of investment products that are simultaneously suitable for all investors, built on a fusion of global values, ESG data and cutting-edge quant technology, offered at a price that charges no premium over conventional investments, and with the aim of gen-

“*Evidence is growing that companies which have less exposure to poor ESG practices have a better chance of generating higher returns for their investors.*”

erating performance comparable to the best conventional investments. Arabesque screens thousands of stocks to identify around 1,000 companies that comply with its corporate responsibility guidelines and demonstrate strong environmental, social and governance performance. It then applies a range of other non-ESG filters to these companies to identify which companies score highly on other criteria such as financial stability, earnings momentum and market sentiment. The firm's two funds — Prime and Systematic — have both consistently outperformed their benchmark (the MSCI All Country World Index) since inception in August 2014, and rank in the top 20% (Prime) and 5% (Systematic) of their respective peer groups according to latest Morningstar peer analysis.

With regard to leverage restrictions, they are attractive to certain groups of investors, and those focused on Shariah-compliant investments should take these leverage restrictions into account within their investment model. By incorporating ESG data and quant technology, we aim to generate performance which 'balances out' potentially diminished returns. We believe this method of fusing Islamic and ESG values is a modern example of responsible investment.

In which regions do markets appeal the most to potential 'prudent ESG' (Islamic compliance and ESG screening) fund managers? What drives the demand for such funds by Islamic investors and by ESG-focused investors?

AUM for Shariah-compliant, socially responsible funds stands at around US$3.6 billion, a figure that is still dwarfed by the respective overall size of both the Islamic asset management and broader ESG investing sectors. We are starting to see change in markets such as Malaysia, where the government has been actively supporting development of the Islamic funds market for at least a decade, and in Indonesia. Indeed, policy is one of the most important drivers of sustainable investing in Asia, with several countries in the region rapidly developing national policy and regulatory frameworks to increase ESG disclosure and reporting requirements. The shift, however, is going to take time.

Demand for a more sustainable financial system should, I believe, be driven by investors all over the world, regardless of their faith and values. Today, almost US$60 trillion of global AUM is held in responsible investment strategies, which is initiating change everywhere. If this energy keeps on building, it will drive change everywhere, and demand will catch on.

Demand is also based on availability. The more we can make 'prudent ESG' products available and understood, the more they will be taken up, as knowledge around the available financial returns increases. I am hopeful that the shift in thinking between generations will only increase this demand. Today, millennials — and the generations that will follow them — think differently than those born earlier in the 20th century. Investors everywhere are starting to take greater interest in where their money goes and how returns are made. The potential for greater convergence between Shariah and ESG investing is huge, and we have only just begun.

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A boy cools himself in a canal on a hot day in Hyderabad from Karachi, Pakistan. REUTERS/ Akram Shahid

CONVERSION OF CAPITAL MARKETS INTO ISLAMIC CAPITAL MARKETS — THE GLOBAL EXPERIENCE

Mushtak Parker

The concept of an Islamic capital market (ICM) is often used loosely, and in some respects, erroneously. Furthermore, the total conversion of any capital market into an ICM is neither realistic nor pragmatic, just as the Islamization of the entire banking system has proved elusive because of inherent anomalies, despite attempts to do so in the past by some countries such as Sudan and Iran.

In 2004, a task force set up by the International Organization for Securities Commissions (IOSCO) concluded in a report on developing an ICM 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." IOSCO agreed that the ICM constitutes a niche segment of the wider global securities market, the regulation of which should comply with IOSCO's Objectives and Principles.

Twelve years on, that conclusion is as relevant today as it was then. There has indeed been proliferation of the Sukuk market beyond traditional markets into non-Muslim jurisdictions such as the UK, Luxembourg, Hong Kong and South Africa. Sukuk structures have also seen innovations ranging from project, infrastructure, and capital-enhancing sukuk to social, SRI and waqf sukuk, new types of asset pools, and the diversification of the investor base from institutional to ultra retail. However, these developments have at best been piecemeal.

Current practices have not supported a systemic approach to the development of an ICM as alluded to by IOSCO. This approach implies a comprehensive public policy from the government to support an ICM, including the adoption of enabling legislation and regulatory framework, ICM products and services guidelines, Shariah parameters and governance framework, the registration of Shariah advisories involved in ICM, human capital development, investor education and protection enforcement, and other types of oversight

THE ICM IN MALAYSIA OPERATES IN PARALLEL WITH THE CONVENTIONAL CAPITAL MARKET

Unfortunately, only Malaysia has a developed systemic ICM regulatory framework that meets the IOSCO criteria. Akin to its banking model, in which the conventional system operates side-by-side with an Islamic one, cooperating but not interacting, the Malaysian ICM is a component of the overall capital market, playing its role in generating economic growth for the country.

The ICM is underpinned by core legislation and plans including the Capital Markets and Services (Amendment) Act 2015; the provisions of the Islamic Financial Services Act 2013 (IFSA); and the various components of the Islamic Capital Market Master Plan II.

Despite low world commodity prices and a sluggish global recovery, the Malaysian capital market continued its steady growth across all segments in 2015, with its size expanding by 2.1% to RM 2.82 trillion, equivalent to 2.5 times the size of the domestic economy. Of this, according to the Securities Commission Malaysia, the ICM grew by 6.7% to RM 1.70 trillion in 2015, compared to RM 1.59 trillion in 2014.

Malaysia continues to be the global leader in the sukuk market, accounting for 54.3% of the global sukuk outstanding as at the end of 2015. Sukuk issued in 2015 totaled RM 117.7 billion, or 43.6% of RM 270.15 billion in total bonds issued. By contrast, in 2014, Malaysia saw RM262.76 billion in sukuk issued, representing 53.4% of RM492.23 billion total bonds issued.

For the Securities Commission Malaysia, the priorities for 2016 and beyond include the launch of a new Corporate Governance (CG) Code; the introduction of the Peer-to-Peer (P2P) Lending Framework; centralizing information for corporate bonds and sukuk issuance to enhance transparency, to widen information access to investors and to promote secondary market liquidity; measures to expand the offering of bonds and sukuk to the retail market; and the introduction of an Islamic Fund and Wealth Management (IFWM) Blueprint.

In most member countries of the Islamic Development Bank (IDB) Group, a comprehensive capital market legal regulatory framework, let alone one for the ICM, is missing or at a very preliminary stage. In other markets such as Dubai and the UAE and Turkey, it is more advanced, but not structured in a systemic and holistic way as in Malaysia.

Take for instance Indonesia, the world's most populous Muslim country. In August 2016, the Indonesian Ministry of National Development Planning (BAPPENAS) launched the Masterplan

> *"The development of Islamic finance sector enhances Kenya's capital market and create wider rangeof innovative products that can be offered to both domestic and foreign investors."*

for Indonesian Islamic Financial Architecture, which highlights several obstacles to the growth of the industry, including disjointed government policy, lack of market awareness and education, shortage of quality trained professionals, the under-capitalization of Islamic financial institutions, an under-developed Islamic capital market, and a lack of transparency and disclosure by participating institutions.

The Masterplan also makes several recommendations, including forming of a National Islamic Finance Committee to champion Islamic finance public policy; creating a level playing field for Islamic finance in legal and tax frameworks with conventional finance; upgrading the Islamic capital market infrastructure; and launching a government sukuk policy to increase the issuance of government sukuk, especially related to infrastructure development, agriculture and educational projects.

GCC NATIONS ARE CATCHING UP WITH BROADER REGULATORY FRAMEWORKS

Dubai, by contrast, has the ambition of becoming the "Capital of the Islamic Economy," particularly as an origination center for sukuk, which it has been promoting with much fanfare since 2013.

On his personal website, Sheikh Mohammed assured the public at the time that the Islamic finance sector in the UAE is based on a sound legal framework, which has served to attract several financial institutions to operate in the Dubai International Financial Centre (DIFC). In this context, the Dubai Financial Market (DFM) introduced in 2014 the 'DFM Standard for Issuing, Acquiring and Trading Sukuk,' which is a comprehensive set of guidelines for sukuk origination out of Dubai. Despite this fanfare, the UAE cabinet only passed a bankruptcy law in September 2016.

Kuwait's Capital Market Authority (CMA) also introduced new regulations for the issuance of Sukuk and other capital market products only in early 2016, which could pave the way for the country's maiden benchmark sovereign sukuk issuance in early 2017.The CMA itself was only established in November 2015, when the Kuwaiti Cabinet passed Law No. 7 of 2010 (as amended by Law No. 22 of 2015), establishing the Authority as the primary regulatory body supervising and regulating corporations and their financial investment activities by way of mandatory filings, disclosures and approvals. This law provides the CMA with the exclusive authority to regulate Islamic capital activities including sukuk in a fair, transparent and efficient manner.

NON-CORE NATIONS IN ISLAMIC FINANCE SEEK INNOVATIVE SOLUTIONS

Similarly, Pakistan's Federal Board of Revenue adopted tax neutrality for sukuk transactions similar to the tax treatment for conventional bonds as late as September 2016. The UK, Hong Kong, Luxembourg and South Africa, all non-Muslim jurisdictions, have had such measures in place for the last few years.

One non-traditional country taking a systemic approach to developing an ICM is Kenya. The Capital Markets Authority of Kenya launched its Capital Market Master Plan (CMMP) 2014-2023 in April 2014. The CMMP has detailed short- and medium-term proposals for the development of an ICM as "a Center of Excellence."

According to the Master Plan, the development of Islamic finance sector enhances Kenya's capital market and create wider range of innovative products that can be offered to both domestic and foreign investors. The medium-term proposals envisage the development of a separate policy, legislative and regulatory framework for ICM products and services. This will further include the establishment of a standard setting body for Islamic financial products, the establishment of a regulated industry body, and an association of Islamic financial institutions.

The above developments point to a piecemeal as opposed to a systemic ICM development culture worldwide, which poses a challenge for the Islamic Financial Services Board (IFSB), whose mandate is to set prudential and regulatory standards for the global Islamic finance industry. The IFSB has adopted the Standard on Core Principles for Islamic Finance Regulation (Banking Segment), the IFSB-17, which was developed with input from the International Monetary Fund (IMF) and the World Bank. This comes under the latter's Financial Sector Action Plan (FSAP) for the effective assessment of the progress of the banking, insurance and capital market sectors in a particular jurisdiction. It will help measure how far a particular jurisdiction and market complies with sets of core principles of the regulation of these three sectors.

The IFSB is also in the process of finalizing similar Core Principles for the Regulation of Islamic insurance (Takaful) and Islamic capital market sectors, with a view to adopt these in 2017. However, by the time the IFSB adopts these two new standards, many of its member countries will still not have an ICM in place worth assessing. At best, the IFSB can play an educational and technical facilitating role. But then, it would need far more resources to effect such a strategy.

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He has published two books — one on Human Rights in Yugoslavia and the other a Directory on Islamic Banking & Finance, and has written several bespoke confidential consultancy reports on Islamic finance and various economic and finance topics for major institutions including finance and economy ministries in a number of countries, central banks, investment banks, commercial banks, insurance firms, accountancy firms and professional bodies.

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