

# Regulatory challenges posed by Islamic capital market products and services

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This paper explores some of the issues that arise in the regulation of Islamic capital market products and services. As many of the products are distributed to retail clients by Islamic banks and through the Islamic windows of conventional banks, it is also pertinent to deal with the regulation of these institutions, not least because of the distinctive liability and asset structures of Islamic banks. Liquidity and capital adequacy are considered, as well as questions of product information disclosure and transparency. Islamic banks and the Islamic windows of conventional banks offer brokerage facilities for securities trading. How should such facilities be regulated, and are there any unique issues that arise because of the need for *shariah* compliance? Islamic banks also use Islamic *sukuk* securities for liquidity management. How does the status of such assets compare with their conventional equivalents? This is likely to become a major issue confronting regulators in the years ahead given the rapid growth of these securities.

Financial services regulators and central banks cannot take on the responsibilities for *shariah* compliance, but they should ensure proper procedures for ensuring compliance are in place. They should be aware of what *shariah* law implies, and follow the moves to arrive at international *shariah* classification standards. Regulators should concern themselves with corporate governance issues that involve examining the remit of the *shariah* advisors or

committee, and their responsibility to end users and management.

Islamic securities regulation also involves monitoring the disclosure requirements for Islamic managed funds and Islamic *sukuk* notes and bonds. The regulators have a responsibility to ensure the proper functioning of Islamic securities markets.

### **Prerequisites for the regulation of Islamic financial institutions**

The regulation of Islamic financial institutions is most effective where there is already a sound regulatory framework in place that provides for adequate reporting, monitoring of capital adequacy, risk management controls and customer disclosure. The latter refers to procedures to ensure that institutions know their customers to prevent money laundering. Sound regulation can help ensure problems of asymmetric information are overcome, as if customers lack confidence in a financial institution then this may result in a financial panic, in the case of a bank a run on deposits threatening the collapse of the institution.

In the case of Islamic institutions the same concerns apply, and the issue of financial soundness has to be addressed by the regulatory authorities. If part of customer assurance results from governments having a majority or minority stake in conventional financial institutions rather than through confidence in regulation, then it is probably advisable for the government to have a similar stake in any Islamic financial institution given an operating licence.

Over restrictive regulation can be counter productive, as it restricts the menu of financial products on offer and potentially raises transactions costs and reduces financial efficiency. In the case of Islamic financial institutions this would be particularly unfortunate, as it would stifle product innovation.

Invariably new Islamic banks will be established in an environment where conventional banks already operate, and therefore regulators will not be starting

with a blank sheet. The crucial challenge is to adapt existing regulations so that Islamic bank clients enjoy similar, although not necessarily the same, protection as clients of conventional banks. At the same time regulators should aim to ensure there is a level playing field, so that neither Islamic banks nor conventional banks are disadvantaged. For Islamic banks there is the issue of sequencing, as they are inevitably the latecomers, but there can be advantages as well as disadvantages from being in this position.

Edward Kane's concept of a "regulatory dialectic" may be especially useful in the context of Islamic banking regulation. This refers to the dynamic interaction between the regulated and the regulator, where there is continuous action and reaction by all parties in a kind of strategic game. Islamic financiers will find out by trial and error over time what is acceptable to regulators and what is unacceptable. The aim could be to encourage Islamic financial engineers to adapt their behaviour to ensure that the likely demands of regulators are anticipated and brought into new financial product design. Less regulated players can of course move faster and more freely, and once a relationship of trust is established, this may strengthen the case for a lighter regulatory touch.

As with their conventional counterparts, many Islamic financial institutions operate in offshore jurisdictions such as Bahrain or Labuan, where there are less stringent regulations. There is the possibility of structural arbitrage, where in the absence of barriers between countries, no transactions costs and no sovereign risks, all financial institutions migrate to the location with the least regulation and the lowest taxation. It would be possible to envisage a situation where regulators compete with each other to minimise the regulatory burden on Islamic financial institutions, but such a situation would be potentially damaging to the Islamic finance industry in the longer term if there were bankruptcies, and would put its Muslim clients in jeopardy. Ultimately there has to be a balance between ensuring that Islamic financial institutions have sufficient freedom to innovate,

while maintaining the basic soundness and credibility of the Islamic finance industry.

### **The protection of Islamic bank depositors**

The role that regulators play in relation to Islamic banks has been much discussed at the theoretical level, but there has been much less discussion of practical policy issues and documentation of actual experiences. Within regulatory bodies and governments much of the discussion has taken place behind closed doors, as many of the issues are seen as sensitive, and central banks and finance ministries do not wish to be portrayed as acting against Islamic interests and in conflict with the *shariah* law in countries with majority Muslim populations. Even in countries with Muslim minority populations such as the United Kingdom, the regulation of Islamic banks and investment companies is regarded as an issue where caution and diplomacy are needed.

Assets and liabilities of Islamic banks are different to those of conventional banks, which have implications for their regulation. The prime responsibility of the regulator in their supervisory capacity is the protection of depositors, but they may require less protection in the case of an Islamic bank. As most of the liabilities consist of investment deposits placed on a profit sharing basis, this arguably reduces the bank's risk in comparison to deposits where interest has to be paid regardless of the profitability or losses of the bank. Furthermore in Islamic banks the value of deposits is not even guaranteed, and their value may be reduced in the case of severe losses. Depositors may regard this as preferable to the bank going into liquidation, which could result in the complete loss of all their funds with the bank.

In these circumstances where the bank does not guarantee the value of deposits, and this is clearly understood by the customers, there would seem little need for the regulatory authority to indemnify depositors against losses. In practice there

has never been a case where the value of deposits has been written down, and hence the absence of a guarantee has not affected depositor interests.

### **Monitoring Islamic bank assets**

The composition of Islamic bank assets may also pose problems for regulators who are accustomed to dealing with conventional banks. Islamic banks cannot hold treasury bills or bonds or other interest yielding securities. Hence conventional measures of liquidity cannot be applied to Islamic banks, yet this is one measure that is important for regulators in their role as protectors of depositors. Islamic banks tend to hold greater cash reserves than conventional banks, and short-term trade finance assets can be regarded as being fairly liquid, but these are not tradable instruments, and therefore cannot be transformed into cash until the importer being financed repays.

The basic problem is the absence of a secondary market for Islamic financing instruments that impedes not only liquidity management, but also liquidity evaluation. The creation of the Islamic liquidity management center in Bahrain should potentially solve this problem for Islamic banks in the Gulf, and in the case of Malaysia the *mudarabah* inter-bank investment market (MII) has helped liquidity management since its opening in 1994.

### **Dedicated Islamic banks and Islamic windows in conventional banks**

Where conventional banks have Islamic banking units or separate counters for Islamic banking services, this also poses potential regulatory problems. The Islamic deposits have to be matched by assets that are acceptable under *shariah* law, which may have implications for the asset structure of the bank. It would be discriminatory if each group of depositors were not given equal protection, but their position is inevitably asymmetric as different types of assets back the deposits. Yet if the Islamic assets failed to perform, or had to be written down or written off, it would be unacceptable if the value of the Islamic deposits was

written down, or the Islamic arm of the institution was declared bankrupt, while the conventional part continued in business.

It would of course be possible for a hybrid bank offering both conventional and Islamic banking services to simply leave the *shariah* compliant managed assets and liabilities off its balance sheet. In an environment where most banks are conventional, and the regulators look to conventional liquidity measures, such a solution may be tempting. This, however, would be to undervalue the bank's business, and not account for the Islamic transactions. It would result in a loss of transparency, and arguably be to the detriment of Islamic depositors. If such a distinction is to be made it might be better to have the Islamic part of the business as a separate entity to the bank, perhaps regulated as an investment company, as then at least those with Islamic investment deposits would know where they stood.

Under the first Basel Committee conventions there is the principle that all banks should be subject to the same capital requirements. Given the nature of Islamic bank liabilities, it has been suggested that this provision is unnecessarily restrictive. On the other hand some authorities have suggested that Islamic banks need more regulation than conventional banks, including a former Governor of the United Arab Emirates Central Bank, Abdul Malik-al-Hamar. The nature of Islamic bank assets and the lack of tradable Islamic financial instruments could be taken as justification for such a position.

### **Bank inspection**

There is little reason why most bank inspection issues have to be treated differently for Islamic banks and conventional banks apart from the issue of assets described above. Issues such as the creditworthiness of the institution are just as important for Islamic as conventional banks if depositors are to be protected, and there would seem no case for treating questions such as lending

to managers or major shareholders, or indeed the duties and responsibilities of directors any differently.

Islamic banks by definition should be ethical in their behavior, and any disguised lending to a small group of managers or shareholders would be a particular cause for concern. Bank regulators can rightly insist on a diversified and balanced asset portfolio, with no concentration of funding on particular individuals or groups. When institutions are small, and part of larger business entities, this can potentially cause problems, especially where ownership is in the hands of individuals or families, a factor which concerned the Bank of England in its dealings with Islamic banks in the early 1990s before the Financial Services Authority assumed responsibility.

### **The cases of Egypt and Kuwait**

Two contrasting illustrations of central bank dealings with Islamic financing institutions are provided by Egypt and Kuwait. In both cases Islamic institutions got into difficulties, but in the case of Egypt no attempt was made to protect investors, and the institutions were allowed to fail, whereas in the case of Kuwait depositors were protected and the institution survived and subsequently prospered.

In Egypt the institutions were Islamic investment companies rather than Islamic banks, Al Rayan being the largest. The government and the Central Bank argued that they had no responsibility to protect investors in a private Islamic company, even though many of the investors regarded the company as a bank. Over one million small investors lost their savings from 1988 onwards when Al Rayan and the other Islamic investment companies collapsed. The institutions themselves were not regulated, and had been rewarding existing depositors from the funds subscribed by new depositors rather than from profits generated. Once the flow of new deposits slowed these returns could not be sustained, and when depositors attempted to withdraw their funds the pyramid collapsed. Clearly the

companies were fraudulent, but the authorities should arguably have assumed some responsibility for their regulatory failure.

In the case of Kuwait the Central Bank supported all the commercial banks and the major Islamic bank, the Kuwait Finance House, after the crash of the unofficial stock market, the *Souk Al Manakh* in 1982. When the market collapsed, many bank clients lost considerable sums of money, and could not service their debts or make loan repayments. In the case of the Kuwait Finance House, clients could not honor their *murabaha* obligations to repurchase goods acquired on their behalf by the House and meet the mark-up. Obligations arising from leasing contracts also presented problems. As the Ministry of Finance and the Central Bank provided compensation to the investors in the devalued stock market, this enabled them to meet their obligations over time. Similar help was offered after the liberation of Kuwait following the Iraqi occupation. Many businesses had ceased to function, and needed time to recover. By the Central Bank providing liquidity to the commercial banks, including the Kuwait Finance House, this enabled clients to have time to sort out their business affairs, and meet their commitments. Two years after the liberation, business was virtually back to normal without any financial institution being allowed to fail.

### **Contrasting legal frameworks**

Farah Fadil, who is cited in the bibliography, questioned whether Islamic banks should be subject to the same regulations as conventional banks. In many Muslim countries Islamic banks exist in financial environments where conventional banks dominate, but in some cases, as in Turkey, Egypt and Jordan, they are governed by special regulations that allow for their operational conformity with the *Shariah* law. In other countries they are regulated in the same way as conventional banks, even though these regulations were usually drafted with western financial practice in mind.

Circumstances are clearly different in Iran and Pakistan where there has been more inclusive regulation either to Islamise the entire domestic financial system as in Iran, or to Islamise a range of financial instruments as in Pakistan. These experiments presumably approximate more closely to the type of comprehensive interest free banking system envisaged by those drafting Iran's Islamic banking law in 1983. There have been a number of articles and monographs on Islamic banking in Iran by Zubair Iqbal, Abbas Mirakhor and others, including one of which is listed in the references, but the lessons from the Iran's central bank practices are not dealt with by these authors. The approach of most authors is basically deductive from the *Shariah* law and conventional monetary principles rather than being inductive from the actual experiences of Muslim countries.

Pakistan provides an example of the practical problems that arise when an attempt is made to convert financing operations to comply with Islamic law. There the Central Bank is very much an agent of government, and it has been obliged to follow changes in monetary policy decided within the Ministry of Finance. There is a real issue of how much autonomy central banks should enjoy, and its relation with governments in Muslim countries. In an Islamic context there is also the issue of the relationship between central banks and religious bodies, in the case of Pakistan the Council of Islamic Ideology. It drew up a blueprint for interest free banking, but this was never properly implemented due to changes in government. Nevertheless the religious authorities have a duty to ensure that the *Shariah* law is upheld in the sphere of monetary policy, and in 1991 the Federal *Shariah* Court of Pakistan ruled that interest transactions were illegal, although the government successfully appealed to the Supreme Court against this ruling. All this illustrates the dilemmas a central bank can face when there is uncertainty and a lack of clarity over the direction of policy.

### **The execution of regulatory responsibilities in an Islamic context**

Traditional discussion of the responsibilities of central banks has often centered on their role as lender of the last resort. In many western countries, however, this

role is less significant as banks in countries such as the United States are obliged to take out deposit protection insurance. Often when banks get into difficulties it is not so much a matter of the central bank simply providing funding to bale them out, but rather of arranging a take-over or merger with a sounder institution that is interested in increasing its market share. This also seems the preferred policy of central banks in a number of Muslim countries including Saudi Arabia, not simply reflecting the lack of central bank resources, but rather a desire to avoid getting too involved with particular commercial banks when a better long term solution is to place the bank on a firmer financial footing by encouraging institutional enlargement. In Islamic banking, as with conventional banking, it is the smaller institutions that are more vulnerable to runs on deposits as a result of a loss of customer confidence.

In the United Kingdom the Bank of England in its role as the central bank has taken an interest in Islamic banking development. Both the Governor, Eddie George, and Michael Ainley, the senior manager involved in surveillance and supervision, have attended and spoken at Islamic banking conferences. More recently with the Financial Services Authority taking over the banking supervisory role Toby Fiennes, the manager of the Middle East and Levant Group, has assumed much of the responsibility, and has spoken often at Islamic finance conferences. This interest reflects the fact that both British banks, and those based in the Muslim world but with offices in London, are engaged in Islamic financing to varying degrees, a trend that is becoming more marked. The London market, according to Michael Ainley, has always welcomed innovation, and Islamic banking is seen in these terms. For the Bank of England, and other central banks, prevention is seen as preferable to a cure for commercial bank malpractice that can undermine client confidence. Often insufficient attention is paid to regulatory responsibilities when discussing central bank functions, yet is more important to have regulatory safeguards to protect depositors than simply stating that the central bank will act as lender of the last resort.

For banks operating in more than one country the key central bank will be that of the home country where the bank is based, as the central banks of host countries will rely on it to exercise adequate supervision. If however the home country has Islamised its banking but the host country has not, this can result in complications over compatibility of rules and regulations. Consolidating what occurs in different jurisdictions always presents problems. The Iranian banks function according to the *Shariah* law within Iran for example, but in London they operate like conventional banks so that they are able to offer as full a range of services as their rivals.

### **Regulators or facilitators?**

In the discussion of the role of regulators there is now much less emphasis on direction and more on how they can act to facilitate the efficient operation of banking systems in deregulated markets where private modes of financing are assumed to be the norm. Such liberalized markets can serve Islamic economies well, but it is nevertheless important that in their behavior market participants, including the bankers as intermediaries, respect Islamic business ethics in general and the *Shariah* law in particular.

Muslims may legitimately disagree over the degree of independence the regulatory authorities should have from government, as well as over what the role of government should be in monetary policy. The relation of regulators vis-à-vis the religious authorities needs to be clarified however, as does the question of whether regulatory bodies should have *shariah* advisors or religious supervisory boards. There is also the issue of whether the Islamic banks can be subject to the same statutes as conventional banks under the jurisdiction of the regulatory authorities, or whether separate provision needs to be made to respect their modes of operation, as is the case in many Muslim states.

Corporate governance issues highlight some of the distinctions between conventional and Islamic banks. Both share common stakeholders, namely

depositors and those being financed, management and employees and shareholders. With Islamic financial institutions regulators however need to be conversant with the authority and remit of the *shariah* board versus management and shareholders. The role for non-executive directors representing shareholder interests is also likely to be important in a business where management may encourage higher profit shares going to depositors to build up banking business rather than paying dividends to shareholders.

### **Regulating banks or regulating products?**

In most countries with Muslim minority populations and an absence of dedicated Islamic banks, regulators have nevertheless been expected to approve and monitor Islamic financial products, including those offered by Islamic managed funds. These may be offered to local Muslims, or in the case of the United Kingdom, to Muslim investors who are non-resident. Islamic banks have been re-depositing funds in the United Kingdom since the early 1980s, and increasingly the banks and their clients are being offered structured products designed to comply with their *shariah* requirements.

Customer entitlements should include clear information on the nature of the Islamic products. They should also have the assurance that such products have regulatory approval, although as already indicated this relates to their financial acceptability, not their *shariah* compliance, that is a matter for the *shariah* advisor or committee. The Islamic products offered are likely to involve some degree of risk taking for the purchasers, although the latter should have a higher position in the pecking order than the shareholders in the institution offering the products in the event of institutional insolvency. As the return on Islamic investment accounts relate to institutional profitability and not general monetary developments, customers should be informed how their returns are calculated. Although at present there are no Islamic certificates of deposit issued or traded, such product innovation is likely given the increasing interest in *sukuk* securities. Again any

purchaser of Islamic certificates of deposits should be provided with clear written information on how the returns are calculated.

Purchasers of Islamic securities should be provided with the same information as shareholders to help them judge the credibility of the institution they are dealing with. The corporate reporting should include the audited accounts showing income and expenditures as well as assets and liabilities. Information should also be disclosed on the number of securities issued and a statement given of their valuation, probably not less than every six months. Timely information is important, and the regulator should be informed if any delay is likely in the issuing of annual reports, including the reasons for any delay.

### **Information provided on *shariah* compliance and procedures for compliance**

Any institution offering Islamic financial products or services should have a *shariah* advisor or committee of high repute, a committee of at least three advisors being preferable. Whether a single *shariah* advisor or a committee is used will of course depend on the volume and value of business conducted in accordance with the *shariah*, but it would be inappropriate not to have adequate reviewing capacity, or to place an excessive burden on a single *shariah* scholar in order to save on costs. Ultimately the reputation of the institution for *shariah* compliance will depend on the reputation and integrity of the *shariah* scholars involved. Unfortunately in the absence of any formalised system of accreditation of *shariah* scholars or even a professional association of *shariah* scholars, regulators have to take the assurance of the Islamic financial service provider that its *shariah* scholars are competent to fulfil their duties.

Malaysia has taken action in this respect by establishing a national *shariah* advisory council to ensure a degree of uniformity of *shariah* opinions. Other bodies such as the United Kingdom Financial Services Authority have been

reluctant to get involved in such matters in view of their sensitivity, as centralised direction implies less decision making authority for individual *shariah* scholars.

The Bahrain based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has taken a great interest in *shariah* standards, and has been concerned with the “representational faithfulness of transactions undertaken by Islamic banks”. It has for example been concerned with the comparability of the *ijara*, *murabahah* and other financing methods reported on the financial statements of different Islamic financial institutions. Islamic bank financial reporting has generally improved over the years, but there is scope for more work on reporting to clients by Islamic managed funds.

The Islamic Financial Services Board based in Kuala Lumpur has as part of its remit the promotion of international standards of *shariah* compliance. It has an interest in all financial services and not only banks, although it will be involved indirectly through national regulatory authorities rather than with commercial institutions.

Islamic financial service providers should make clear to both regulators and their own clients the remit of the *shariah* committee versus the management, shareholders and customers. To ensure sound corporate governance and fewer conflicts of interest it may be preferable for non-executive directors representing shareholder interests to be appointed to the board of directors as already indicated. *Shariah* advisors and committee members are in a comparable position to auditors, and are therefore not usually represented on the Board of Directors, but the Directors can seek advice from the *shariah* committee as required, usually with the agreement of the Board rather than through individual initiatives. The Board will of course be responsible for the business strategy of the institution and ultimately its profitability, whereas the *shariah* committee’s remit is legal rather than commercial.

Within the securities industry the *shariah* committee will want to ensure that securities being traded are asset backed, as this is an important distinguishing feature of Islamic instruments. As Islamic securities will normally be constructed on the back of an income yielding asset, and the *shariah* committee has to be assured that the underlying income is legitimate, that the assets are acceptable under Islamic law and that the securities are properly designated with respect to the underlying finance being provided. It may be appropriate to designate a security based on a leasing transaction for example an *ijara sukuk*.

Usually *shariah* committees, like company auditors, report through a securities company to its shareholders and clients rather than directly. It would be unrealistic for market traders purchasing and selling securities to have continuous access to *shariah* advice, either from their own point of view, as it would slow trading, or from the perspective of the *shariah* committee members who may be busy with other tasks.

It is important that the procedures for decision-making by *shariah* committees should be clear and transparent. Rulings are usually unanimous rather than by majority vote, but this means more conservative members of the committee may exercise a power of veto. Investigations of issues referred will generally involve the study of *fiqh* and the examination of *fatwa* by other *shariah* committees, many of which have helpfully being classified and published as compendiums by the Institute of Islamic Banking and Insurance based in London. As many *shariah* committee members serve several financial service providers, their experience elsewhere may be of great value.

Issues that may arise in securities dealing include concerns over brokerage practice. There is for example the issue of whether prices are fixed at the time of retail purchases or sale, or if the bundling of purchases is permissible to save on transactions costs, as then the price cannot then be guaranteed. Costs of dealing should be clearly set out. The rules governing traditional transactions through

*hisba* are of potential relevance. *Shariah* committee members will not approve of speculative practices with only short term securities holding, and day trading may be regarded as gambling. *Gharar*, which implies uncertainty or ambiguity in a contract, will make the dealing void. Churning securities portfolios to increase transactions fees is unacceptable, as is cornering the market to increase price volatility to create speculative opportunities. Insider dealing is of course unlawful.

### **Disclosure requirements for Islamic equity funds**

There are over one hundred Islamic equity funds, some dating from the 1980s, with a concentration in Saudi Arabia and Malaysia. In many respects the regulatory issues are similar to those with ethical funds in the West, where regulators do not and cannot endorse the criteria, but do aim to ensure that clients are content that the fund is respecting their wishes. Minimally each fund should provide investors with information on what type of fund it is and whether its prime objective is capital growth or provision of a regular income. There should be regular statements provided of assets held in the portfolio and some indication of historical performance data.

Specifically Islamic investor assurance should include details of the procedures to ensure *shariah* compliance and an indication of whether *shariah* advisors are reactive or proactive. The frequency of monitoring by *shariah* committee should be spelt out and a statement of *shariah* compliance in reports to investors is desirable.

Islamic screening is of course important for such funds with sectors excluded from any portfolio including brewers and distillers, manufacturers or distributors of pork producers, gaming clubs and casinos and conventional banks. Islamic financial compliance is assured where companies with over 1/3 outstanding debt to assets/market value are excluded, as are those where cash and interest bearing securities exceed 1/3 of assets. In addition receivables and cash should account for less than 50 percent of assets, and purification is required for any

interest income.

### **Development of Islamic securities markets**

An Islamic securities market makes liquid asset holding more profitable for Islamic banks and reduces reliance on inter bank deposits. As Islamic banks cannot hold short-term interest yielding assets such as treasury bills because of the prohibition of interest under the *shariah* Islamic law, they have always had a problem in profitably managing their liquidity.

### **The Malaysian experience of Islamic securities**

The first attempt to overcome this problem was taken by Bank Negara Malaysia in July 1983 after the first Islamic bank in Malaysia began operations, as it was realized that Bank Islam Malaysia could not hold government securities or treasury bills which paid interest. Therefore non-interest bearing paper was issued, Government Investment Certificates and Government Investment Issues. Bank Islam Malaysia could acquire these certificates, which represented a beneficial loan (*Qard Hassan*) to the government. There was no pre-determined rate of interest on these securities, rather instead the rate of return would be declared by the government at its “absolute discretion”. A dividend committee was established to regularly declare the rates, the committee comprising representatives of the Ministry of Finance, Bank Negara, the Economic Planning Unit and the Religious Affairs Section of the Prime Minister’s Office. There was no fixed formula for determining the rate of return, the stress being on qualitative rather than purely quantitative considerations. Those setting the return considered a range of indicators including macroeconomic conditions, the inflation rate and the yield for similar instruments.

Following the decision in Malaysia to allow conventional banks to accept Islamic deposits and offer Islamic financing facilities, Bank Negara recognized that these developments would be helped if an inter-bank money market could be established. On the 18<sup>th</sup> December 1993 guidelines were therefore issued on

how a new Islamic inter-bank money market would operate. The market was opened on 3<sup>rd</sup> January 1994 in Kuala Lumpur, its main functions being to facilitate inter-bank trading of Islamic financial instruments, notably *mudharabah* interbank investments (MII). The MII scheme provides a mechanism whereby a deficit Islamic banking institution (the investee bank) can obtain funds from a surplus Islamic financial institution (the investor bank) by issuing a *mudharabah* certificate for a fixed period of investment ranging from overnight to 12 months.

The investor bank in the MII scheme does not know in advance what the actual profit will be, as it depends on the gross profit of the investee bank. The profit sharing ratio is however agreed in advance, and the principal is repaid at the end of the loan period. To increase certainty further Bank Negara introduced a minimum benchmark rate on February 2<sup>nd</sup> 1996, which is the prevailing rate on Malaysian government investment issues plus a spread of 0.5 percent. Investee banks are not obliged to declare profit shares based on this benchmark, rather it is a guide to investor banks to the sort of return they can reasonably expect, and therefore can be taken into account in the negotiations on the profit sharing ratio.

### **The Bahrain experience of Islamic securities**

On June 13<sup>th</sup> 2001 the Bahrain Monetary Agency offered for the first time in the Gulf government bills that were structured to comply with the *shariah* Islamic law. The bills were worth \$25 million, and were in the form of three-month paper, referred to as *Sukuk Salam* securities. Although the Malaysian government has offered Islamic bonds since the 1980s as already indicated, governments in the Gulf have been forced to borrow in international markets rather than locally because of Islamic objections to trading in debt and interest based securities. Governments have issued paper that the local commercial banks have held to maturity, but not traded. This however restricts the liquidity of bank assets, and makes it more difficult for the government to raise finance directly from the public.

With its new *Sukuk Salam* Securities Bahrain has overcome this problem, by providing a fixed return, initially equivalent to 3.95 percent at an annualized rate, for the first Islamic bill issue, which is not based on interest. The return has been calculated in relation to the real benefit the government expects to obtain on the funds, rather than with reference to market interest rates. The first securities matured on September 12<sup>th</sup> 2002, and a new issue was launched, a process that will be repeated every three months.

The establishment of the Islamic money market in Bahrain will, it is hoped, result in the emergence of markets in longer term Islamic securities, notably bonds, with Bahrain playing a similar role in the Gulf and West Asia to that of Kuala Lumpur in South East Asia. So far prospects look encouraging, as the initial offer of bills in June 2001 worth \$25 billion was oversubscribed, with almost \$60 million being offered. The minimum subscription was fixed at \$10,000, which meant that relatively small financing houses could participate, as well as private investors seeking a non-banking home for their dollar denominated liquidity. The same minimum subscription limit was set for the longer-term *ijara* leasing securities worth \$100 million that were offered in August 2001. These were issued on 4<sup>th</sup> September 2001 and will mature in five years time. They offer a rental return of 5.25 percent per annum, guaranteed by the government of Bahrain.

Bahrain hosts the *General Council for Islamic Banking* that promotes co-operation between Islamic banks internationally and informs the public of the concepts and rules governing Islamic banking and finance practices. The Islamic Development Bank spearheaded the establishment of the Council, and its membership of Islamic banks is growing rapidly. The Islamic Development Bank has also chosen to locate its Infrastructure Fund in Bahrain because of the island's position as an Islamic financial centre. The Infrastructure Fund is a private equity fund that is being managed by the Emerging Markets Partnership of Bahrain. The Islamic Development Bank has also agreed to set up an International Islamic Rating Agency that will be located on the island. This

agency will rate Islamic securities that should help ensure their international acceptability. Islamic and conventional banks that purchase and hold such securities will have a clear indication of the risks involved. This should enable them to compare risks versus returns for different categories of Islamic securities, increasing transparency and the potential efficiency of the market.

### **Future security issues**

Islamic corporate bonds are likely to be an important alternative to sovereign issues in the future. Regulators should be concerned that information on risks are provided to investors. There is the issue of whether rating should be obligatory, as rating agency classification is useful for investors. An Islamic rating agency has been established in Bahrain through an Islamic Development Bank initiative.

Further issues arise with respect to the capital protected funds such as those launched by HSBC Amanah Finance from Dubai. Are such guarantees acceptable from an Islamic perspective? Investors may have limited knowledge of the financial mechanisms to hedge against capital loss or how the guarantees are provided. There clearly needs to be protection of retail investors who may not be aware of the sacrifice of potential returns to guarantee capital. The transparency of such investment products is important, as is assurance on the adequacy of risk management systems.

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